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New UK GAAP
The impact on professional services firms and your questions answered

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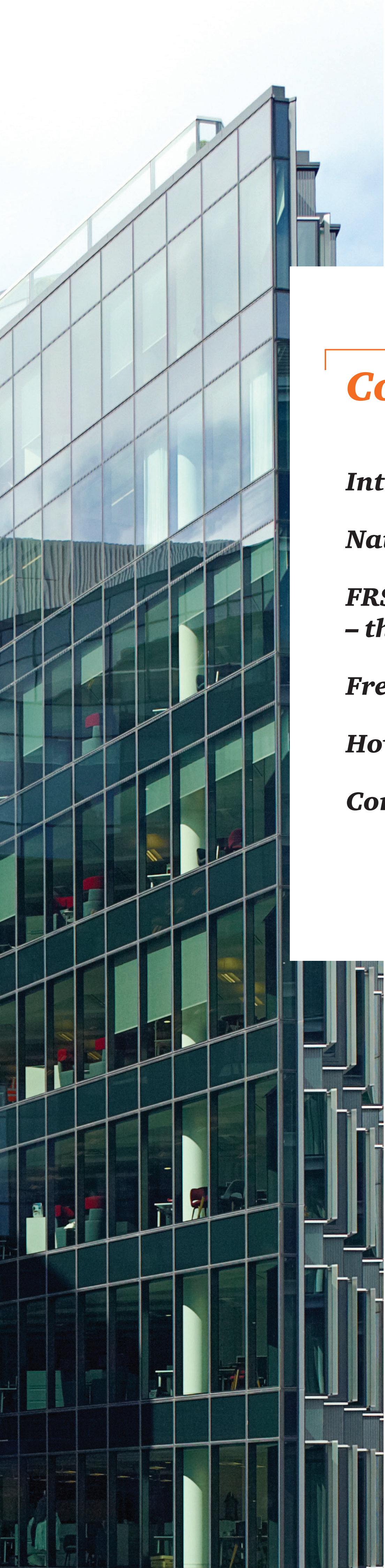

Contents

Introduction	2
Nature and scope of the changes	3
FRS for UK and Republic of Ireland (FRS 102) – the standard and its adoption	4
Frequently asked questions	7
How we can help you	9
Contacts	9

Introduction

The Financial Reporting Council (FRC) has issued three new accounting standards that will impact all entities currently reporting under UK GAAP in the UK, including professional services firms reporting as either limited companies or limited liability partnerships. The FRC has stated that its overriding objective in setting accounting standards is to enable users of financial statements to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and the users' information needs. To this end, the Accounting Council (AC) (and its predecessor, the Accounting Standards Board (ASB)) have developed a new financial reporting framework for use in the UK. This is based on an International Financial Reporting Standards (IFRS) framework for all but the very smallest companies in the UK and the Republic of Ireland (RoI). The focus has been to reduce complexity and cost for companies, while introducing a coherent and succinct set of standards.

The FRC issued FRS 100, 'Application of financial reporting requirements' and FRS 101, 'Reduced disclosure framework', in November 2012. FRS 102, 'The financial reporting standard applicable in the UK and Republic of Ireland' was issued in March 2013. This replaces existing UK standards (FRSs and SSAPs) and UITF abstracts ('old UK GAAP'). The LLP SORP is also in the process of being updated to reflect the requirements of FRS 102.

The effective date for FRS 100, FRS 101 and FRS 102, is for accounting periods beginning on or after 1 January 2015, subject to the early adoption provisions in FRS 101 and FRS 102. FRS 101 can be adopted early without restriction (apart from the need to notify shareholders/members). Early adoption of FRS 102 is generally available for accounting periods ending on or after 31 December 2012.

This document answers a number of common questions about the implications of the FRC's new standards and, in particular, considers the impact on professional services firms that currently apply UK GAAP.

We set out on pages 4 to 6 a summary of the key changes arising from the adoption of FRS 102, with the key areas of potential difference for professional services firms being:

- Business combinations and intangible assets
- Revenue recognition
- Disclosures in connection with related parties

If you have additional questions you would like to discuss with us, please contact your local PwC contact or one of the contacts on the back page.

David Snell

Law Firm Advisory Group

Nature and scope of the changes

What has changed?

The FRC has updated old UK GAAP by:

- Replacing the existing mix of guidance (FRSs, SSAPs, UITFs) with a single Financial Reporting Standard (FRS 102)
- Introducing a reduced disclosure framework for parent entities and subsidiaries of groups that prepare publicly-available consolidated financial statements under EU adopted IFRS (FRS 101)

In summary, entities will be able to apply one of:

- EU-adopted IFRS (IFRS)
- IFRS recognition and measurement with reduced disclosures (FRS 101, the 'reduced disclosure framework' or RDF)
- FRS 102, the FRS for UK GAAP reporters ('new UK GAAP'), which is based on the IFRS for SMEs
- FRS 102 (new UK GAAP) with reduced disclosures available in that standard
- The Financial Reporting Standard for Smaller Entities (FRSSE). This will still be an option for eligible entities

All except IFRS are within the Companies Act accounts framework. Thus, a group may use a mixture of the last four options above and still meet the company law requirement to use a consistent accounting framework.

Under FRS 100, the requirement to use IFRS only applies to the consolidated financial statements of entities listed on a regulated market in the EU, or if required by other legislation. This is consistent with the previous requirements.

Why change UK GAAP?

The UK GAAP rule book was previously made up of 2,500 pages, largely as a result of changes and additional guidance added over several decades. While many of the changes made in recent years have brought UK GAAP closer to IFRS, the standards lacked consistent principles.

In addition, 'old UK GAAP' guidance needed to be updated for accounting for financial instruments, given that certain common transactions remained unrecognised on the balance sheet.

The FRC addressed these concerns to provide pragmatic solutions based on entity size, complexity, public interest, and users' information needs.

There is also an emphasis on the cost-effectiveness of changes.

When will the new framework be introduced in the UK?

The effective date for FRS 100, FRS 101 and FRS 102, is for accounting periods beginning on or after 1 January 2015. That is, an entity with a 30 April year end would have to prepare its first set of financial statements under the new regulations for the year ending 30 April 2016, with an opening balance sheet at 1 May 2014 (i.e. the first day of the comparative period).

FRS 100 can be adopted early, subject to the early adoption provisions in FRS 101 and FRS 102.

FRS 101 can be adopted early without restriction provided shareholders/members do not object.

FRS for UK and Republic of Ireland (FRS 102) – the standard and its adoption

Are there any differences between old UK GAAP and FRS 102 (new UK GAAP)?

There are a number of differences between old UK GAAP and FRS 102. These are summarised below together with an indication of the likelihood of potential impact for professional services firms*.

Key

- Differences are not likely to have a significant impact on the majority of professional services firms
- Differences are likely to have some impact on professional services firms
- Differences are likely to have significant impact on professional services firms

* Note: the above categorisation is a high level assessment based on the typical activities and financial statement components of an average professional services firm with an LLP structure (i.e. owned by its members). The actual impact will depend on the circumstances of individual firms.

Area	*Difference*	*Potential impact on professional services firms*
Business combinations	All business combinations are accounted for using the purchase method, except for group reconstructions, which may be accounted for using merger accounting, and public benefit entity combinations that are in substance a gift or merger. Merger accounting for all other combinations is no longer permitted. This represents a change from current practice in the sector where some business combinations are accounted for using merger accounting. A partnership converting to an LLP can continue to use merger accounting, providing relevant criteria for a group reconstruction are met. The purchase method requires an acquirer to be identified, the acquirer being the combining entity that obtains control of the other combining entities or businesses. The cost of the business combination is measured and allocated to the identifiable assets acquired and liabilities assumed at the acquisition date and any excess is recognised as goodwill.	
Cash flow statements	The cash flow statement is similar to that under IFRS, showing movements on cash and cash equivalents, and with fewer standard headings than under FRS 1. Qualifying entities# are exempt.	
Consolidations	Groups are exempt from consolidating subsidiaries held as part of an investment portfolio (because these are considered to be held for resale). All portfolio investments are measured at fair value through profit or loss. These subsidiaries would be consolidated under old UK GAAP.	

A qualifying entity is a member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view and that member is included in the consolidation

Area	*Difference*	*Potential impact on professional services firms*
Deferred tax	Deferred tax is recognised on a 'timing difference plus approach' – similar to FRS 19. The 'plus' requires recognising deferred tax on asset revaluations and on assets (except goodwill) and liabilities arising on a business combination. Deferred tax cannot not be discounted.	
Defined benefit pension schemes	The method for calculating the finance cost has changed. Interest and return on assets is calculated as a net amount by applying the discount rate to the net pension deficit/surplus. 'Expected return on assets' will no longer apply.	
Derivatives	For firms that use hedging instruments, these will need to be fair valued and recognised on the balance sheet – a change for those that did not apply FRS 26. For example, sales and purchases in a foreign currency transaction can no longer be measured at the forward contract rate. The hedging requirements are to be based on IFRS 9. This is more likely to have an impact on larger multinational firms.	
Equity investments	Many equity investments will need to be fair valued with the gain or loss recognised through profit or loss.	
Goodwill	The rebuttable presumption of useful economic life for goodwill has been reduced to five years in line with EU legislation.	
Holiday pay	An accrual for short term employee benefits such as holiday pay needs to be made. Previously, whilst good practice suggested making such a provision, there was no specific requirement under UK GAAP.	
Intangible assets	The definition of intangible assets has changed so there may be more intangible assets recognised as part of a business combination. These could include brand/name and client relationships. All intangible assets are assumed to have a finite life so they have to be amortised (intangibles with indefinite lives were possible under UK GAAP).	

Area	*Difference*	*Potential impact on professional services firms*
Investment properties	The change in fair value of investment properties will need to be recognised in profit or loss rather than reserves.	
Lease incentives	Lease incentives are recognised over the lease term. Under old UK GAAP, lease incentives are spread over the shorter of the lease term and the period to the first market rent review.	
Related party transactions	Key management personnel compensation must be disclosed. Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the firm, directly or indirectly. This could include a combination of members and non-members. Compensation is disclosed in total.	
Revenue recognition	The requirements of FRS102 are for the most part very similar to those in UK GAAP, other than the accounting for contingent revenue (specific guidance for which was contained in UITF40). Under FRS102, revenue from the rendering of services is recognised when the amount can be reliably measured and it is probable that the economic benefits associated with the transaction will flow to the entity (and both the stage of completion and costs to complete can be measured reliably). As such, revenue that is contingent on events outside the control of the entity may be able to be recognised earlier under FRS102 when there is a probable inflow that can be reliably measured. Under UITF 40 revenue recognition was delayed until the contingent event occurred.	

Frequently asked questions

What will happen with the LLP SORP?

SORPs contribute to the improvement in financial reporting and help promote consistency. An exposure draft on a new SORP for accounting for LLPs has been issued and proposes updates to the previous SORP (2010) to reflect the requirements of FRS102, including in particular:

- Updating the guidance on business combinations and group accounts to reflect the fact that FRS102 only allows merger accounting to be used for group reconstructions
- Updating the guidance on contractual or constructive obligations and annuities to reflect FRS102's requirements relating to financial liabilities. Liabilities in respect post retirement payments to members will be required to be analysed to determine whether they are basic financial instruments, other financial instruments, insurance contracts or non-financial liabilities (provisions and contingencies). This will depend upon the nature of the obligation and the level of uncertainty regarding the timing or the amount of payment, and will determine the appropriate accounting to be adopted.

What will the financial statements look like?

The format of the primary financial statements will continue to follow the formats set out in company law/LLP Regulations. This means that entities previously reporting under IFRS and now using FRS 101 may have to change the presentation of their primary statements.

What will it mean if my professional services firm merges with another?

Merger accounting will no longer be allowed. The 'acquirer' will have to be identified, and the cost of the business combination will be measured as the fair value of any assets given, liabilities incurred or assumed by the acquirer in exchange for control of the entity being acquired (also referred to as the fair value of the consideration). The draft updated LLP SORP also states that any profit share promised to new members in the enlarged LLP should be assessed to determine whether any portion of that remuneration represents consideration for the business acquired, rather than future remuneration. The acquirer will then allocate the cost of the business combination by recognising the acquiree's identifiable assets and liabilities at their fair values at the acquisition date, and any difference between the cost of the business combination and the net amount of assets and liabilities acquired will be recognised as goodwill. It is likely that more intangible assets will be recognised under FRS102/101, including brand/name and client relationships, which will be recorded at fair value and amortised over their useful economic life.

What happens when an entity converts to the new standards?

An entity's first financial statements prepared using this new UK GAAP/IFRS will include reconciliations of equity determined in accordance with old UK GAAP to equity determined under new UK GAAP/IFRS as at the date of transition and as at the comparative period end, and a reconciliation of the comparative profit or loss under old UK GAAP to new UK GAAP/IFRS, together with an explanation of each change. The adjustments arising from applying new UK GAAP/IFRS in its opening statement of financial position are recognised directly in retained earnings at the date of transition. In an LLP this is likely to be reflected in members' other interests.

Transitional relief/exemptions are available in a number of areas, for example:

- There should be no changes to previous accounting estimates
- Business combinations effected before the date of transition do not need to be restated (but the first-time adopter can elect to do so)
- A first time adopter can elect to perform a one-off revaluation of any property, plant and equipment, intangible asset or investment property at the date of transition and use that fair value as its deemed cost at that date
- Lease incentives do not need to be restated provided the term of the lease commenced before the date of transition

Is there any disclosure relief available to subsidiaries?

There are disclosure exemptions for entities applying FRS 102 (new UK GAAP). For example, the previous consolidation and cash flow exemptions continue to apply for applicable subsidiary entities.

Subsidiaries that are included in a group that prepares publicly-available financial statements that give a true and fair view may also be able to take advantage of a reduced disclosure framework. FRS 101 allows subsidiaries and parent entities to prepare their individual financial statements using the recognition and measurement requirements of IFRS, but with reduced disclosures.

We have dormant companies in our group – will they be affected?

FRS 102 provides transitional relief for dormant companies applying the new UK GAAP. On transition to the new UK GAAP, a dormant company can elect to retain its accounting policies for reported assets, liabilities and equity until there is any change to those balances, or the company undertakes any new transactions.

Will a firm that currently uses IFRS be able to change to new UK GAAP?

The Companies and Limited Liability Partnerships (Accounts and Audit Exemptions and Change of Accounting Framework) Regulations 2012 (SI 2012/2301) changed the law to allow an entity that prepares individual IFRS financial statements to switch to Companies Act financial statements, (either FRS 102 or the RDF in FRS 101 for qualifying entities) provided they have not previously switched in the prior five years. These regulations came into force on 1 October 2012 and apply to financial years ending on or after that date.

Will the new UK GAAP be a stable platform prior to adoption in 2015?

The new UK GAAP is expected to be the platform of standards for adoption in 2015, with the exception of accounting for financial instruments. The FRC has published exposure drafts on hedging and basic financial instruments (FRED 51 and FRED 54) and also intends to publish an exposure draft on impairment once this remaining phase of IFRS 9, 'Financial instruments' is completed.

Choosing between the reporting options available

What are the advantages of using FRS 102?

The advantages include:

- Its relative similarity to old UK GAAP
- At around 10% of the volume of old UK GAAP, the guidance is more compact and concise
- The option to look to other GAAPs for answers where the FRS is silent. There is no mandatory fallback to IFRS

What are the disadvantages of using FRS 102?

FRS 102 is not just a simplified version of IFRS. FRS102 introduces certain measurement principles that differ from IFRS, meaning it will not be appropriate for all organisations, and there is a risk that its simplicity may reduce the benefits in a global organisation. Large multinational firms may wish to adopt IFRS in order to be comparable with global/listed corporate entities reporting under IFRS. FRS 102 will also not be accepted for use in a listing document and subsequent filings, therefore entities preparing for an IPO will have to adopt IFRS.

Entities that intend to adopt IFRS should consider planning the transition process earlier rather than later to ensure a successful approach to the conversion.

What else should management be thinking about now?

Management should consider the impact of a GAAP change on projects and transactions it is currently undertaking, for example business combinations, property transactions. It is important to plan ahead to identify potential issues affected by conversion to new FRS102, IFRS or FRS 101, such as the impact on:

- Medium-term profit distributions
- Bank or loan covenants
- Contractual arrangements (where they are GAAP dependent in any way)
- Bonus schemes
- Commercial implications of increased disclosures where they may be commercially sensitive

How we can help you

FRS 102 and FRS 101 reporting impact assessments

Our FRS 102 and FRS 101 reporting impact assessments are a practical service that illustrates how your most recent financial statements would have been affected by a move from old UK GAAP to new UK GAAP (FRS 102) or FRS 101. It can then be used to focus your adoption efforts and help you plan your transition away from UK GAAP. Further information about this service is available on our web page: www.pwc.co.uk/frs102

Support through your conversion

Your management team will want to anticipate the complexities involved in a GAAP conversion. We can help you with the planning to make sure your conversion will be efficient and effective. We can also support you throughout or at selected stages of your conversion, with the level of support that you would like. For instance, with additional resource or as a review of the completeness and robustness of each part of the process.

Technical advice on IFRS and new UK GAAP

Whatever your need, whether it be advice on complex accounting issues or news on the latest developments or best practice, we have specialists in all areas of accounting, including industry specialists. We can draw on our extensive experience to develop the best solution for you.

Contacts

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