

1 FRC periodic review (Lecture A811/ A812/ A813 – 16.19/ 19.38/ 14.30 minutes)

On 15 December 2022, the Financial Reporting Council (FRC) issued FRED 82 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review*. This 346-page document contains some significant proposals for change following the Requests for Views phase which ended on 31 October 2021.

Comments on FRED 82 are open until 30 April 2023. All interested parties are encouraged to submit their comments on the proposals by email to ukfrsperiodicreview@frc.org.uk. For some, it will be pleasing to see the FRC confirm that no amendments to FRS 102 are proposed to reflect the expected credit loss model from IFRS® 9 *Financial Instruments* in this periodic review. Although, it has stated that it will reconsider this issue in due course.

A couple of the principal amendments are summarised as follows (note references to ‘draft para X’ refer to the proposed paragraph in FRED 82):

1.1 On-balance sheet lease accounting

As expected, the FRC propose to change the lease accounting requirements in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. There are no equivalent changes proposed in this area for FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. The proposed changes are intended to align FRS 102 to IFRS 16 *Leases* (albeit with a number of simplifications).

Interestingly, the International Accounting Standards Board® (IASB®) has decided not to change the equivalent Section 20 *Leases* in the *IFRS for SMEs Accounting Standard* in its current comprehensive review of that Accounting Standard. However, the IASB may well decide to align *IFRS for SMEs* with IFRS 16 during a future review. This accentuates the point that the FRC does not necessarily follow in the footsteps of the IASB when developing accounting standards.

Essentially, the vast majority of leases for a lessee (with some limited exceptions related to ‘short-term leases’ and low-value leases) will be reported on-balance sheet. A short-term lease is a lease which, at the commencement date, has a lease term of 12 months or less. Draft para 20.9 confirms that the value of an underlying asset is based on the value of the asset at the start of the lease. Draft para 20.11 cites the following examples of underlying assets that would typically be considered to be of low value:

- tablet computers;
- personal computers;
- home printers and photocopiers;
- mobile phones;
- desk phones;
- televisions;
- small items of furniture; and
- portable power tools.

The FRC has cited ‘efficiency within groups’ as one of the reasons for aligning lease accounting within FRS 102 to that of IFRS 16. Some entities applying FRS 102 could well be members of a group which prepares consolidated financial statements in accordance with IFRS Accounting Standards. Hence, the proposed change to lease accounting in FRS 102 would minimise accounting differences, thus enabling comparability. To that end, the proposed simplifications in FRS 102 are optional rather than mandatory.

The simplifications within FRS 102, Section 20 are as follows:

	IFRS 16	FRS 102 simplification
Discount rate	IFRS 16 requires a lessee to use the interest rate implicit in a lease. If that is not readily determinable, the lessee’s incremental borrowing rate is used to discount lease payments to present value.	The lessee’s <i>obtainable borrowing rate</i> can be used as an alternative to the incremental borrowing rate. This is expected to be easier to determine so is deemed to represent a proportionate simplification. If, in exceptional cases, the lessee’s incremental (or obtainable) borrowing rate cannot be readily determined, the lessee can apply a publicly available rate (referred to as the ‘gilt rate’).
Determining a revised discount rate	A lessee must revise the discount rate when there is a modification that is not accounted for as a separate lease.	FRED 82 proposes to reduce the number of situations in which a lease modification requires a revised discount rate.
Practical expedients for lease agreements containing multiple components	Lease agreements may contain multiple components and both lessors and lessees must identify and separate lease and non-lease components in applying IFRS 16. For a lessee this will determine what proportion of the contract will be recognised on-balance sheet.	There are additional practical expedients proposed for contracts containing multiple components (for example, draft para 20.33).
Sale and leaseback transactions	The approach taken by IFRS 16 where a sale and leaseback transaction is concerned is complex and there will often be a need to consider whether, in fact, the transfer qualifies as a sale in accordance with IFRS 15 <i>Revenue from Contracts with Customers</i> .	There is a simpler approach proposed for dealing with sale and leaseback transactions in FRED 82, which is broadly consistent with the approach currently in FRS 102 (January 2022). There is a requirement to consider if the transfer of an asset by the seller-lessee satisfies the requirements of FRS 102, draft Section 23 <i>Revenue from Contracts with Customers</i> (draft paras 20.128 to 20.130) or not (draft para 20.131) as this will affect the accounting treatment
Variable lease payments	Changes in lease payments arising from a change in an index or rate would trigger recalculation of the lease liability.	Draft para 20.74 provides an option for the lessee to choose <i>not</i> to remeasure the lease liability where there has been such a change. Where this is the case, the difference between the lease payments included in the lease liability at the commencement date and the revised lease payments is recognised in profit or loss in the period to which each payment relates (see also draft para

So, how could leasing work under the proposals? The example below illustrates some of the principles contained in IFRS 16 which may apply in FRS 102 if the periodic review amendments are finalised as drafted:

Example – On-balance sheet lease accounting

On 1 January 2025, Sunnie Ltd enters into a contract to lease a specialist machine for three years. The lessor agrees to maintain the machine during the term of the lease. The total contract cost is £210,000 and Sunnie must pay £5,833 per month (or £70,000 per annum). Sunnie Ltd accounts for non-lease components separately from leases.

If contracted separately, it has been determined that the standalone price for the lease of the specialist machine is £190,000 and the standalone price for the maintenance services is £48,000.

If Sunnie Ltd were to go to its bank for an equivalent borrowing, the bank would charge a rate of 4%.

Step 1: Allocation of payments

The annual payments of £70,000 are allocated between the lease and non-lease components of the contract based on their standalone selling prices as follows:

Lease of machine: $(£190k / £190k + £48k) \times £70k = £56,000$

Maintenance: $(£48k / £190k + £48k) \times £70k = £14,000$

If Sunnie Ltd did not have a policy of separating lease and non-lease components, the entire £70,000 would be recorded as lease payments.

Step 2: Accounting treatment

The lease liability is calculated as the present value of the minimum lease payments:

Date	Cash flow	Discount rate	Present value
	£		£
31.12.2025	56,000	1 / 1.04	53,846
31.12.2026	56,000	1 / 1.04 ²	51,775
31.12.2027	56,000	1 / 1.04 ³	49,784
			155,405

There are no directly attributable costs associated with the right-of-use asset (otherwise these would be included in the cost of the right-of-use asset itself). The entries are:

	£
Dr Right-of-use asset (balance sheet)	155,405
Cr Lease liability	155,405

Being initial recognition of right-of-use asset

The lease liability is then accounted for using the amortised cost method per FRS 102, Section 11 *Basic Financial Instruments* as follows:

Year	Opening balance	Cash flow	Interest (4%)	Closing balance
	£	£	£	£
2025	155,405	(56,000)	6,216	105,621
2026	105,621	(56,000)	4,225	53,846
2027	53,846	(56,000)	2,154	-

In year 1:

	£
Dr Lease liability	56,000
Cr Cash at bank	56,000

Being payment to lessor

Dr Finance costs (profit or loss)	6,216
Cr Lease liability	6,216

Being interest paid at 4%

At the end of 2025 the lease liability of £105,621 will be split between its current portion of £51,775 (£105,621 - £53,846) and its non-current liability of £53,846 to comply with the statutory formats of the balance sheet.

Step 3: Depreciate the right-of-use asset

The right-of-use asset is depreciated over the three-year lease term. This gives a depreciation charge of £51,802 (£155,405 / 3 years).

Dr Depreciation expense	51,802
Cr Accumulated depreciation	51,802

Depreciation of right-of-use asset over 3 years

In the above example, you can contrast between the current accounting treatment under FRS 102 and the proposed new treatment. As the lessor agrees to maintain the machine at its cost over the term of the lease, it could be argued that under the current edition of FRS 102 this lease is an operating lease. Hence lease rentals would simply be charged to profit or loss on a straight-line basis over the three-year term. Under the proposals, the lease rentals would not be charged to profit or loss, so the impact can be seen as follows:

Impact on profit or loss at 31 December 2025

FRS 102 (January 2022)

- Lease rental expense is £70,000

FRS 102 proposals

- Interest charge of £6,216
- Depreciation of £51,802
- Total expense £58,018

Impact on the balance sheet as at 31 December 2025

FRS 102 (January 2022)

- No impact as the lease would be an operating lease

FRS 102 proposals

- Asset reported of £103,603
- Liability reported of £105,621

1.2 Revenue

The title of FRS 102, Section 23 is proposed for change from *Revenue* to *Revenue from Contracts with Customers*.

Section 23 has been completely re-written in FRED 82 and reflects a simplified version of IFRS 15 *Revenue from Contracts with Customers*. Notably, the ‘five-step model’ approach to recognising revenue as follows.

- **Step 1** – Identify the contract(s) with a customer (draft paras 23.6 to 23.15)
- **Step 2** – Identify the promises in the contract (draft paras 23.16 to 23.40)
- **Step 3** – Determine the transaction price (draft paras 23.41 to 23.60C)
- **Step 4** – Allocate the transaction price to the promises in the contract (draft paras 23.61 to 23.74)
- **Step 5** – Recognise revenue when (or as) the entity satisfies a promise (draft paras 23.75 to 23.101)

The term ‘promise (in a contract with a customer)’ is defined as an obligation to transfer a good or service (or bundle of goods or services) that is distinct.

While many of the requirements in proposed Section 23 are consistent with the IASB’s Exposure Draft of the third edition of *IFRS for SMEs*, there are some FRED 82-specific amendments to permit entities to use an accounting policy for revenue which meets the requirements of both FRS 102 and IFRS 15 as follows:

- The proposals require an entity to account for a warranty as a separate promise when the warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. This applies even if the warranty is insignificant to the contract.
- FRED 82 proposes to allow an entity to account for an option to provide a customer with a material right as a separate promise when the effect of doing so is insignificant to the accounting of the individual contract.
- There is a proposal to require refund liabilities to be measured based on amounts of consideration received which are not included in the transaction price, where such amounts are determined by considering the requirement to constrain estimates of variable consideration.

1.3 For smaller entities applying FRS 102, Section 1A

Following the UK’s departure from the EU, the FRC is now able to require more disclosure from small companies in the UK. Previously, the FRC was constrained by the requirements of the EU Accounting Directive, but this is no longer the case. However, this does remain the case for entities in the Republic of Ireland so FRS 102, Section 1A, Appendix D *Disclosure requirements for small entities in the Republic of Ireland* remains unchanged.

Some of the notable changes proposed in FRED 82 to FRS 102, Section 1A, Appendix C *Disclosure requirements for small entities in the UK* include:

- A requirement to make an explicit and unreserved statement of compliance with FRS 102, including Section 1A. Currently this is an encouraged disclosure per FRS 102, para 1AE.1(a).
- Mandatory going concern disclosures to comply with draft para 3.8A, which states:

When an entity prepares financial statements on a going concern basis, it shall disclose that fact, together with confirmation that it has considered information about the future as set out in paragraph 3.8. It shall also disclose, in accordance with paragraph 8.6, any significant judgements made in assessing the entity’s ability to continue as a going concern.

In addition, the small entity will be required to provide disclosures relating to material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern as set out in para 3.9. Currently, this requirement is an encouraged disclosure per FRS 102, para 1AE.1(c).

- There are additional disclosures proposed in respect of leasing arrangements (draft para 1AC.31A) including short-term leases, leases of low-value assets and variable lease payments (draft para 1AC.32A); provisions and contingencies (draft para 1AC.31B); share-based payment transactions (draft para 1AC.31C); and promises in contracts with customers (draft para 1AC.32B).
- Disclosures in respect of deferred tax (draft para 1AC.36A).
- Dividends declared and paid or payable during the period (draft para 1AC.40). Currently this is an encouraged disclosure per FRS 102, para 1AE.1(d).
- Transition information on first-time adoption of FRS 102 (draft para 1AC.41). Currently this is an encouraged disclosure per FRS 102, para 1AE.1(e).

1.4 Other notable changes

The main focus of FRED 82 is, of course, on leasing and revenue recognition and these are the areas likely to attract a lot of attention during the comment period on the Exposure Draft.

Some other notable changes proposed in FRED 82 are as follows:

1.4.1 Section 2 Concepts and Pervasive Principles

The entire *Concepts and Pervasive Principles* in FRS 102, Section 2 has been revised and updated to reflect the IASB's *Conceptual Framework for Financial Reporting* which was issued in 2018.

This redrafted section is structured as follows:

- The objective of financial statements
- Qualitative characteristics of information in financial statements
- Financial statements and the reporting entity
- The elements of financial statements
- Recognition and derecognition
- Measurement
- Presentation and disclosure

There is also an additional Section 2A *Fair Value Measurement* which replaces the Appendix to FRS 102, Section 2 in the January 2022 edition.

1.4.2 Going concern

There is a new paragraph 3.8A proposed which states that when an entity prepares its financial statements on a going concern basis, it must disclose that fact. In addition, the entity must also disclose confirmation that it has also considered information about the future to comply with paragraph 3.8. Keep in mind that the entity is required to consider all available information about the future, which is at least, but not limited to, 12 months from the date when the financial statements are authorised for issue.

In addition, paragraph 3.8A will also require an entity to disclose any significant judgements made in assessing the entity's ability to continue as a going concern.

1.4.3 Accounting policies

Currently, FRS 102 requires an entity to disclose a summary of its **significant** accounting policies (FRS 102, para 8.5). The term 'significant' is not defined in FRS 102 and the FRC propose changing this paragraph to require an entity to disclose its **material** accounting policies. The paragraph goes on to clarify that accounting policy information is material if, when considered together with other information included in the financial statements, it can reasonably be expected to influence decisions that the users of the financial statements make on the basis of those financial statements. The disclosure must also include the measurement basis (bases) used when preparing the financial statements.

A new paragraph 8.5B is also proposed which provides further clarification on when accounting policy information is material. It states that an entity is likely to consider accounting policy information material if it relates to material transactions, other events or conditions and:

- a) the entity has changed an accounting policy during the period which has resulted in a material change to the information in the financial statements;
- b) the entity chose the accounting policy from one or more options permitted by FRS 102;
- c) the accounting policy was developed in line with FRS 102, Section 10 *Accounting Policies, Estimates and Errors* in the absence of a specific section of FRS 102 which would otherwise apply;
- d) the accounting policy relates to an area that requires significant judgement or assumptions in applying an accounting policy (and the entity discloses those judgements or assumptions in accordance with FRS 102, paras 8.6 and 8.7); or
- e) there is complex accounting required and the users would otherwise not understand those material transactions, other events or conditions (for example if an entity applies more than one section of FRS 102 to a class of material transactions).

1.4.4 Accounting estimates

The FRC have proposed to include an additional paragraph 10.14A which provides a non-exhaustive list of examples of accounting estimates as follows:

- Estimated selling price less costs to complete of inventory
- Recoverable amount of a fixed asset
- Depreciation expense for a fixed asset
- Fair value of asset or liability, applying FRS 102, Section 2A *Fair Value Measurement*
- A provision for warranty obligations

Proposed paragraph 10.14D clarifies that an entity will need to change an accounting estimate if changes arise in the circumstances on which the accounting estimate was based, or as a result of new information, new developments or more experience.

1.4.5 Financial instruments

There is a new paragraph 11.14A proposed which clarifies when a dividend receivable is recognised in profit or loss which is when:

- The entity's right to receive payment is established
- It is probable (i.e. more likely than not) that the economic benefits associated with the dividend will flow to the entity
- The amount of the dividend can be reliably measured

An equivalent new paragraph has been included in Section 12 *Other Financial Instruments Issues* at paragraph 12.9A.

There are additional paragraphs 11.48ZA and 11.48ZB proposed which relate to financial institutions and retirement benefit plans. These new paragraphs require quantitative and qualitative information to be disclosed concerning amounts that have arisen due to expected credit losses. This would apply where the financial institution or retirement benefit plan has used the accounting policy option to apply IFRS® 9 *Financial Instruments*.

1.4.6 Investments in associates

A new paragraph 14.3A provides examples of situations when significant influence can usually be evidenced as follows:

- a) Representation on the board of directors or equivalent governing body
- b) Participation in the policy-making processes (including participation in decisions concerning dividends or other distributions)
- c) Material transactions between the investor and its associate
- d) Interchange of managerial personnel
- e) Provision of essential technical information

1.4.7 Investment property

A new paragraph 16.2A is proposed which clarifies that an entity must use its professional judgement in determining whether the acquisition of investment property is the acquisition of an asset or a group of assets or a business combination which would fall in scope of Section 19 *Business Combinations*. Hence reference to both FRS 102, Section 16 and Section 19 will need to be made in this respect.

There are also consequential amendments proposed to Section 16 as a result of the proposed on-balance sheet lease accounting for lessees. For example, the amendments proposed to paragraph 16.7 clarify that when the lessee uses the fair value model to measurement investment property that is held as a right-of-use asset, it must measure the right-of-use asset and not the underlying property at fair value.

1.4.8 Intangible assets other than goodwill

A new paragraph 18.3B is proposed which clarifies the accounting treatment for an intangible asset that may be contained in, or on, a physical asset. The paragraph cites an example of software for a machine that cannot be operated without that specific software and confirms that this is an integral part of the related hardware and hence is treated as property, plant and equipment (FRS 102, Section 17). The same treatment would apply to the operating system of a computer or mobile device.

If the software is not an integral part of the related hardware, the software is treated as an intangible asset.

1.4.9 Business combinations

There is a new paragraph 19.11B proposed that confirms that a transaction that remunerates employees or former owners of the acquiree for services in the future is not part of the cost of a business combination.

There are more paragraphs proposed which clarify the accounting treatments for provisions and contingent liabilities. Proposed paragraph 19.15F states that contrary to paragraphs 21.4(b) and 21.12, the acquirer must recognise a contingent liability assumed in a business combination at the date of acquisition, even if it is not probable that the acquirer will be required to transfer economic benefits in settlement. To qualify for recognition, the contingent liability must be a present obligation that arises from past events **and** its fair value can be measured reliably.

There are also consequential amendments to Section 19 in respect of the proposed on-balance sheet lease accounting treatment as well as additional disclosure requirements for business combinations.

There is a new appendix proposed to Section 19 which is an integral part of Section 19 and provides guidance on identifying an acquirer. This appendix replaces the guidance provided in paragraph 19.10.

1.4.10 Share-based payment

There is a new paragraph 26.1B proposed which confirms that equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of Section 26. However, equity instruments granted to employees of the acquiree in their capacity as employees are within the scope of the section.

There is also clarification in proposed paragraph 26.1C which confirms that the term 'fair value' is used in a different context in Section 26. For the purposes of Section 26, fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Proposed paragraph 26.13A clarifies that the settlement of an equity-settled share-based payment transaction may involve an entity transferring cash or other assets as an alternative (or partial alternative) to the transfer of equity instruments. In such cases, the payment made is treated as a deduction from equity. The exception to this would be where the payment exceeds the fair value of the equity instruments. In such cases, the excess is recognised as an expense.

Paragraph 26.15B is proposed to be changed to clarify that where a counterparty has a choice of settlement of a share-based payment in cash or equity, the transaction is treated as wholly cash-settled unless:

- the choice of settlement in cash or other assets bears no commercial substance; or
- the choice of settlement relates only to a net settlement feature.

In these cases, the entity accounts for the transaction as a wholly equity-settled transaction.

1.4.11 Taxation

There is additional clarification in proposed paragraphs 29.17A to 29.17C which clarifies the treatment of uncertain tax treatments.

1.4.12 Related parties

Paragraph 33.9 is proposed to be changed to require the amount of outstanding balances **and commitments** to be disclosed in addition to the terms and conditions and details of any guarantees given or received. Currently, the paragraph just requires the amount of outstanding balances, terms and conditions and guarantees given or received.

1.4.13 Specialised activities

There is a new paragraph 34.9A proposed which clarifies the elements of cost of a biological asset.

There is clearer guidance on when an asset is a heritage asset. In addition, separate disclosure is required of heritage assets held by a lessee as a right-of-use asset.

For public benefit entities, there is clearer guidance in proposed paragraph PBE34.70A in respect of donations and legacies.

Appendix B to Section 34 *Guidance on incoming resources from non-exchange transactions* is deleted as much of this has been moved into the main body of the section.

1.4.14 Transition to FRS 102

Paragraph 35.10(a)(ii) is proposed to be amended to confirm that where goodwill was previously assessed as having an indefinite useful life under the entity's previous financial reporting framework, it must be re-assessed to determine its remaining useful life and then subsequently measured in accordance with FRS 102, para 19.23. This is because goodwill must always be amortised on a systematic basis over its useful life under FRS 102.

There is an additional transitional exemption proposed in paragraph 35.10(IA) in respect of decommissioning liabilities included in the cost of right-of-use assets.

In addition, there are additional optional exemptions in respect of development costs, leases, revenue from contracts with customers and cost determined under a previous financial reporting framework as deemed cost.

There are also additional disclosure requirements for an entity transitioning to FRS 102 for the first time.

1.5 Effective date

The FRC have stated that the planned effective dates of the amendments arising from the periodic review are expected to be for accounting periods commencing on or after 1 January 2025. Early adoption will be permissible, provided all the amendments are adopted at the same time.

As always, at this stage, it is important to keep in mind that these dates are tentative and may be subject to change by the FRC once the comment period has closed. Further updates will be covered as developments in this area progress.