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Periodic review of FRS 102

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This *Need to know* outlines the proposals set out by the FRC's exposure draft, **FRED 82 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review*** (FRED 82) which proposes to make significant amendments to FRS 102 and the other UK accounting standards as part of its periodic review of the UK financial reporting framework.

- The most significant changes set out in FRED 82 are to lease accounting and revenue, with the following proposed principal amendments:
  - The lease accounting requirements for lessees will be based on the on-balance sheet model from IFRS 16 *Leases*, with appropriate simplifications. This is expected to result in an impact on the financial statements of most entities that are lessees under one or more operating leases.
  - The accounting requirements for revenue will be based on the five-step model for revenue recognition from IFRS 15 *Revenue from Contracts with Customers*, with appropriate simplifications. The extent to which this will change an entity's revenue recognition in practice will depend on the form of its contracts with customers.
- Several other changes are proposed which affect numerous areas of FRS 102. These include a revised section on concepts and pervasive principles, changes to fair value measurement and additional disclosure requirements for UK small entities.
- For FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, FRED 82 proposes the same principal amendments for revenue as for FRS 102, with further simplifications, and various incremental improvements and clarifications. However, no principal amendments are proposed to the FRS 105 lease accounting requirements.
- The proposed effective date is for accounting periods beginning on or after 1 January 2025. Early adoption will be permitted provided that all amendments are adopted at the same time.

Background

When it first issued FRSs 100-105, the FRC committed to a periodic review of the UK financial reporting framework to ensure it continues to function as intended and to meet its overriding objective of high-quality, understandable financial reporting that is proportionate to the size and complexity of the entity and users' information needs through the application of an IFRS-based solution unless there is a clearly better alternative.

In line with this objective, in December 2022 the FRC issued FRED 82, an exposure draft proposing changes to FRS 102 with related amendments to the other FRSs. In developing FRED 82, the FRC considered a wide range of potential sources of improvements and clarifications including feedback from stakeholders on implementation issues, areas identified by the FRC for review, developments in financial reporting and changes to IFRS Accounting Standards and Interpretations issued by the IFRS Interpretations Committee. The FRC sought feedback from stakeholders through its consultation document issued in March 2021 requesting views to inform the periodic review. The FRC also considered proposals in the exposure draft **IASB/ED/2022/1** issued by the IASB in September 2022 ("the IFRS for SMEs ED"), which proposes amendments to the IFRS for SMEs, upon which FRS 102 was originally based.

The main proposals of FRED 82 are discussed below. FRED 82 proposes much more substantial changes than the 2017 review of FRS 102, predominantly to keep pace with significant new IFRS Accounting Standards that have since come into effect – notably IFRS 15 *Revenue from Contracts with Customers*, which took effect for IFRS preparers in 2018, and IFRS 16 *Leases*, which took effect for IFRS preparers in 2019.

Responses to FRED 82 are requested by 30 April 2023 and the proposed effective date of the amendments is for periods commencing on or after 1 January 2025, with early adoption permitted provided all amendments are adopted at the same time. A number of transitional reliefs are proposed to assist companies with adoption.

New or significantly revised requirements

Leases

The extant Section 20 *Leases* of FRS 102 is aligned with the requirements of IAS 17 *Leases* which was superseded by IFRS 16 *Leases* from 2019. The proposed new requirements are designed to align Section 20 with IFRS 16 with the consequence that, for lessees, the distinction between an operating lease and a finance lease is removed and all leases are instead recognised 'on balance sheet' with a right of use asset and corresponding lease liability. There are limited exceptions for short-term leases, being those with a term of 12 months or less, and for leases of low value items. Rather than providing a numerical threshold, the proposals give examples of assets that would typically be considered low value, including tablet computers, personal computers, mobile phones and portable power tools. Examples of items that would not be considered low value include cars, vans, trucks and lorries and land and buildings. Lessor accounting would remain relatively unaffected.

The FRC proposes to simplify the IFRS 16 requirements regarding discounting for FRS 102 reporters where the implicit rate of the lease cannot be readily determined (as it requires insight into the asset's fair value and residual value). In such cases, the FRC proposes that the lessee's 'obtainable borrowing rate' can be used as an alternative to the lessee's 'incremental borrowing rate'. In exceptional cases, where none of these rates can be readily determined, it is proposed that a suitable gilt rate be sourced from the Bank of England website.

Other proposed simplifications include mandating fewer circumstances when discount rates must be updated, allowing entities to 'inherit' existing lease liability carrying values where leases are transferred within a group and a simpler calculation when accounting for sale and leasebacks, albeit with 100% of any gains or losses being deferred. To promote efficiency within groups, which may be producing consolidated accounts under IFRS, the FRC proposes to make the use of simplifications optional, where possible.

Practical expedients are proposed for first-time adoption of the new requirements. Unlike the transition to IFRS 16 for IFRS reporters, the FRC proposes to prohibit fully retrospective restatement on first-time application; instead, companies would be required to recognise the cumulative effect of initial application as an adjustment to opening equity. As a further practical expedient for group entities, it also proposes to allow the use of the carrying amounts of right-of-use assets and lease liabilities previously calculated under IFRS 16 on the date of initial application (when applying new requirements under Section 1) or at the date of transition (if adopting FRS 102 for the first time under Section 35).

Revenue

The extant Section 23 of FRS 102 is based on IAS 18 *Revenue*. The IASB replaced IAS 18 with IFRS 15, a much more detailed and prescriptive standard, effective for periods commencing on or after 1 January 2018. FRED 82 proposes to revise the revenue recognition requirements based on IFRS 15 and to provide more detailed requirements for reporters to enhance consistency and comparability of reporting. The proposals in FRED 82 are based on those in the IFRS for SMEs ED.

The proposals are based on IFRS 15's five-step model for revenue recognition which provides a more detailed framework for revenue recognition. This would result in more prescriptive and more detailed requirements in FRS 102, including for the following:

- Identification of the contract with a customer;
- Identification of distinct "promises" within a contract and the allocation of the transaction price between those promises;
- Determination of whether an entity is acting as a principal or an agent in a contract;
- Accounting for variable consideration and significant financing components;
- Recognition of revenue arising from licences; and
- Additional presentation and disclosure requirements, with some exemptions for qualifying entities.

Based on feedback from stakeholders the FRC proposes some simplifications, largely consistent with the IASB's proposals for SMEs. In addition, some changes in terminology have been proposed, which are designed to make the standard more accessible to reporters. For instance, the standard uses the word "promise" in place of "performance obligation". Other simplifications include the introduction of an accounting policy choice on accounting for costs of obtaining a contract, and no requirement to adjust revenue recognition for the time value of money when consideration is received in advance. However, whereas IFRS 15 allows the time value of money to be ignored when consideration is received no more than 12 months in arrears, the FRC proposes to restrict this period to six months or less. The proposed simplifications will generally be optional to reduce the number of differences arising for FRS 102 reporters that also produce IFRS figures for group reporting purposes.

Transitional arrangements are proposed to allow entities to apply the changes either fully retrospectively or retrospectively but with the cumulative effect of initial application presented as an adjustment to equity at the date of initial application (consistent with the 'cumulative catch-up' transition option in IFRS 15).

Observation

Unlike the proposed transitional arrangements for lease accounting (see above), the current proposals for transition regarding revenue accounting do not appear to allow use of amounts derived under IFRS 15 where these already exist for the purpose of group reporting. Companies whose contracts with customers have a longer duration may therefore find that the numbers calculated under the proposed revised Section 23 differ from those calculated under IFRS 15 for consolidation purposes.

These revised revenue recognition requirements are also proposed for FRS 105 for micro-entities, with several further simplifications and no requirement to account retrospectively at all; all changes would apply prospectively from the effective date.

Concepts and pervasive principles

FRED 82 proposes a revised Section 2 of FRS 102 to reflect the IASB's *Conceptual Framework for Financial Reporting*, which was introduced in 2018.

The proposed definitions of assets and liabilities shift focus onto rights or obligations rather than the flow of expected economic benefit. The proposed definition of an asset also introduces a greater focus on control and includes guidance on how to determine whether control exists. The FRC proposes to retain the existing definitions of assets and liabilities in some sections of FRS 102, pending further review.

Other proposed changes to FRS 102

Fair value measurement

The FRC proposes to move the requirements for fair value accounting from the appendix to Section 2 into a new Section 2A, giving them greater emphasis and presence within the standard. Additional requirements based on IFRS 13 *Fair Value Measurement* are proposed to improve reporting consistency and quality in respect of the measurement of fair value. One of the most significant proposals are the change to the definition of fair value to align to that in IFRS 13. Under the proposed definition, liabilities would be measured on the basis of the value at which they could be transferred rather than settled, and adjustments for own credit risk would likely become more common and more significant.

Observation

The requirement to use transfer value rather than settlement value when measuring the fair value of liabilities may prove challenging for preparers. There are also currently no transitional provisions proposed, meaning that as FRED 82 stands, application of Section 2A would be fully retrospective. This contrasts with IFRS 13 which was required to be applied prospectively from the beginning of the period of initial application.

Financial instruments

The FRC decided not to introduce the expected credit loss model of financial asset impairment measurement from IFRS 9 *Financial instruments* as part of the current periodic review, based on feedback from stakeholders. However, it will reconsider this position following finalisation of the IASB's third edition of IFRS for SMEs, in which the IASB currently proposes to include an expected credit loss approach.

Small entities

In response to changes to the UK legal environment following the UK's withdrawal from the European Union (EU), the FRC is now able to specify further disclosures which it believes should be required by small companies in the UK for their accounts to provide a true and fair view. FRED 82 proposes to mandate some FRS 102 disclosures that are currently only encouraged for small UK companies. However, it does not change the position for Irish entities applying FRS 102 as these continue to be within the EU.

Business combinations and goodwill

In response to feedback the FRC proposes to bring limited parts of IFRS 3 *Business Combinations* into FRS 102. Additional guidance is proposed on identifying the acquirer in a business combination. Furthermore, in situations where former owners become employees, guidance is proposed for identifying which amounts should be accounted for as consideration and which amounts constitute remuneration for continued services. Guidance is also proposed on the treatment of liabilities and contingent liabilities that would be within the scope of Section 21 *Provisions and Contingencies*.

The FRC has decided to await the outcome of the IASB's ongoing project on *Business Combinations Under Common Control* before proposing further amendments in this area.

Share-based payments

FRED 82's proposals are similar to those made in the IASB's IFRS for SMEs ED. These changes clarify that instruments issued in a business combination in exchange for control are not within the scope of Section 26. Requirements for measuring the fair value of liabilities arising from a cash-settled share-based payment transaction will be added as well as requirements for equity-settled share-based payment transactions which have cash alternatives. The definition of fair value for the purpose of Section 26 would not be amended by the proposed definition of fair value in Section 2A.

Income tax

An amendment is proposed to insert requirements which specify how to reflect effects of uncertainty in accounting for income taxes. These are based on the conclusions of IFRIC 23 *Uncertainty over income Tax Treatments* and are consistent with the IASB's IFRS for SMEs ED.

Specialised activities

The FRC proposes various updates to Section 34 *Specialised Activities*, including a clearer description of when resources from non-exchange transactions should be recognised and how they should be measured, more guidance on how to determine whether an asset meets the definition of a heritage asset, and for agricultural activities, additional guidance on what amounts should be included in the cost of a biological asset.

Transition to FRS 102

Section 35 of FRS 102 is proposed to be updated to remove transitional provisions that have become redundant and add new provisions for the proposed changes to revenue and lease accounting for first-time adopters of FRS 102.

Proposed changes to other UK Financial Reporting Frameworks

FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* – The major proposed change is to incorporate the proposed revised FRS 102 Section 23 into FRS 105, with further simplifications. No changes to lease accounting are proposed for FRS 105 reporters.

FRS 103 *Insurance Contracts* – Minimal changes are proposed to the body of FRS 103. However, the FRC proposes to update the definition of a contract in the Glossary to FRS 103 to "an agreement between two or more parties that creates enforceable rights and obligations", consistent with the proposed amendments to the Glossary to FRS 102. The proposed updated definition could have significant implications for reporters applying FRS 103. Before wider changes are made, the FRC expects to wait for several years of application of IFRS 17 *Insurance Contracts* before considering alignment with that standard.

FRS 101 *Reduced Disclosure Framework* – the main proposal is to clarify that FRS 101 reporters must apply the statutory requirements applicable to large and medium-sized entities even if they would otherwise qualify for small company reporting. This does not represent a change but adds needed clarity.

Invitation to comment and next steps

Comments on the Consultation document have been requested by 30 April 2023.

The **press release** and **consultation document** are available on the FRC website.

Once the proposed changes to FRS 102 are finalised, SORP-making bodies will need to consider how the changes will impact the extant SORPs and issue separate consultations on any revisions to be made.

Further information

All our past newsletters can be found **here**.