

- 12 Interest payable and similar charges
- 13 Tax on profit or loss on ordinary activities
- 14 Profit or loss on ordinary activities after taxation
- 15 Extraordinary income
- 16 Extraordinary charges
- 17 Extraordinary profit or loss
- 18 Tax on extraordinary profit or loss
- 19 Other taxes not shown under the above items
- 20 Profit or loss for the financial year

Turnover, cost of sales, distribution costs and administrative expenses

5.12 As discussed in paragraph 5.6, the standard requires that, as a minimum, turnover is presented on the face of the income statement (or statement of comprehensive income). [FRS 102 para 5.7C]. Turnover (or revenue) is discussed in chapter 23.

5.13 Cost of sales will normally include:

- Opening (less closing) inventory.
- Direct materials.
- Other external charges (such as the hire of plant and machinery or the cost of casual labour used in the productive process).
- Direct labour.
- All direct production overheads, including depreciation, and indirect overheads that can reasonably be allocated to the production function.
- Product development expenditure.
- Cash discounts received on 'cost of sales' expenditure (this is not an offsetting, but an effective reduction in the purchase price of an item).
- Inventory write-downs.

5.14 Distribution costs are generally interpreted more widely than the name suggests and often include selling and marketing costs. Items normally included in this caption comprise:

- Payroll costs of the sales, marketing and distribution functions.
- Advertising.
- Salesperson's travel and entertaining.
- Warehouse costs for finished goods.

- Transport costs concerning the distribution of finished goods.
 - All costs of maintaining sales outlets.
 - Agents' commission payable.
- 5.15** Administrative expenses will normally include:
- The costs of general management.
 - All costs of maintaining the administration buildings.
 - Professional costs.
 - Research and development expenditure that is not allocated to cost of sales (sometimes this is shown as a separate item).

5.16 In some specific instances, the allocation of costs between the headings proposed above might not be appropriate. For example, in the context of a mail-order company, agents' commission payable might be regarded as a cost of sale rather than as a distribution cost.

5.17 The way in which a company analyses its costs will depend very much on the nature of its business. Where a company incurs significant operating expenses that it considers do not fall under any one of the headings 'cost of sales', 'distribution costs' and 'administrative expenses', there is nothing to prevent the company from including an additional item for these expenses in format 1 or 3. The overriding consideration is that a company should analyse its operating expenses consistently from year to year.

Depreciation (including other amounts written off assets)

5.18 If format 1 or 3 is adopted, charges for depreciation (or the diminution in value of assets) have to be analysed under the headings set out in paragraph 5.11. [SI 2008/410 1 Sch Profit and loss account formats note 14]. The type of analysis will depend on the function of the related assets. Where an entity prepares its profit and loss account in accordance with either format 1 or 3, expenses are classified by function. So, any provisions for depreciation or the diminution in value of tangible and intangible fixed assets will not be disclosed in the profit and loss account format. Accordingly, this information must be disclosed separately in the notes to the financial statements. [SI 2008/410 1 Sch Profit and loss account formats note 17].

5.19 Company law also requires separate disclosure of the aggregate amount of:

- Any provision against a fixed asset investment for diminution in value.
- Any provision against a fixed asset for permanent diminution in value.
- Any write back of such provisions which are no longer necessary.

[SI 2008/410 1 Sch 19, 20].

5.20 Accounting for depreciation and diminutions in value of tangible and intangible fixed assets is considered in chapters 17 and 18.

Classification of expenses by type

5.21 In formats 2 and 4, expenses are classified by type (such as raw materials and consumables, staff costs, and depreciation). Format 2, which is the vertical presentation, is set out below. Format 4 is not set out, because it is rarely used and replicates the information in format 2.

Profit and loss account — Format 2

- 1 Turnover
- 2 Change in stocks of finished goods and in work in progress
- 3 Own work capitalised
- 4 Other operating income
 - 5 (a) Raw materials and consumables
 - (b) Other external charges
- 6 Staff costs:
 - (a) Wages and salaries
 - (b) Social security costs
 - (c) Other pension costs
- 7 (a) Depreciation and other amounts written off tangible and intangible fixed assets
 - (b) Exceptional amounts written off current assets
- 8 Other operating charges
- 9 Income from shares in group undertakings
- 10 Income from participating interests
- 11 Income from other fixed asset investments
- 12 Other interest receivable and similar income
- 13 Amounts written off investments
- 14 Interest payable and similar charges
- 15 Tax on profit or loss on ordinary activities
- 16 Profit or loss on ordinary activities after taxation
- 17 Extraordinary income
- 18 Extraordinary charges

- 19 Extraordinary profit or loss
- 20 Tax on extraordinary profit or loss
- 21 Other taxes not shown under the above items
- 22 Profit or loss for the financial year

Own work capitalised

5.22 Where an entity has constructed some of its own property, plant and equipment or intangible assets, and it adopts either format 2 or 4 (which classify expenses by nature) for its profit and loss account, it should include the costs of direct materials, direct labour and overheads that it has capitalised as a credit under the heading 'own work capitalised'. The costs of direct materials, direct labour and overheads are charged in the profit and loss account (income statement) by including these amounts under the relevant expenditure headings. The amount capitalised is then credited in the profit and loss account as own work capitalised, and it is debited to property, plant and equipment or intangible assets, as appropriate (see chapters 17 and 18). So, items such as raw material costs in the profit and loss account will include the costs connected with such work.

Depreciation (including other amounts written off assets)

5.23 Paragraph 5.18 sets out disclosure requirements that apply regardless of the profit and loss account format adopted. Accounting for depreciation and diminutions in value of tangible and intangible fixed assets is considered in chapters 17 and 18.

Other operating charges (including other external charges)

5.24 The relevant formats (formats 2 and 4) place 'other external charges' next to 'raw materials and consumables' under a single item number. Therefore, such charges are likely to include any production costs from external sources that are not included under other headings (for example, equipment rentals and the costs of subcontractors).

5.25 'Other operating charges' is a separate line item which tends to be a residual class of all charges relating to a business's trading activities that do not fall into any other category. In practice, the distinction between 'other external charges' and 'other operating charges' is blurred. Some companies do not attempt to make a distinction, and include only one heading to cover all residual operating costs.

Operating profit

5.26 FRS 102 does not require entities to disclose results from operating activities. But entities will often present 'operating profit', an undefined term; the standard emphasises that, where an entity does so, it should ensure the amount disclosed "... is representative of activities that would normally be regarded as

“An interest:

- (a) for which a purchaser has been identified or is being sought, and which is reasonably expected to be disposed of within approximately one year of its date of acquisition; or
- (b) that was acquired as a result of the enforcement of a security, unless the interest has become part of the continuing activities of the group or the holder acts as if it intends the interest to become so; or
- (c) which is held as part of an investment portfolio.”

[FRS 102 Glossary of terms].

9.112 In this situation, the ‘interests’ of the parent entity are the interests attributed to it under the definition of ‘parent undertaking’. Again, this exemption is repeated in section 9 of the standard, but with the important difference that the Act *permits* exclusion on these grounds, whereas section 9 *requires* exclusion. [FRS 102 para 9.9(b)]. The circumstances in which a subsidiary held for resale is permitted (and required) to be excluded is also restricted to those where “the undertaking has not previously been consolidated in group accounts prepared by the parent undertaking”. [FRS 102 para 9.9].

9.113 A subsidiary held exclusively with a view to resale and not previously consolidated, although controlled by its parent, does not form part of the group’s continuing activities. The parent’s control is temporary and is not used to deploy the underlying assets and liabilities of that subsidiary as part of the group’s continuing activities and for the parent’s benefit. So, the subsidiary should be excluded from consolidation on these grounds and be treated as a current asset.

9.114 Measurement of the current asset depends on whether or not the investment is held as part of an investment portfolio. If the investment is held as part of an investment portfolio, it is measured at fair value, with changes in fair value recognised in profit or loss. [FRS 102 para 9.9B]. The measurement at fair value through profit or loss prescribed by section 9 of the standard is a departure from the requirements of the Act for the purpose of the consolidated financial statements providing a true and fair view. [SI 2008/410 4 Sch 1(36); FRS 102 para A4.17]. The Act does not permit investments in subsidiaries, associates and joint ventures to be measured at fair value. In this circumstance, the notes to the financial statements must provide the “*particulars of the departure, the reasons for it and its effect*”. [SI 2008/410 4 Sch 1(10(2))].

9.115 An investment that is not held as part of an investment portfolio is measured using the accounting policy selected to account for investments in subsidiaries, associates and jointly controlled entities in the parent’s separate financial statements. [FRS 102 para 9.9B]. See paragraph 9.175 below for further guidance.

Consolidation procedures

9.116 In preparing its consolidated financial statements, a group should combine the financial statements of the parent and its subsidiaries and present that information as if the group were a single economic entity. [FRS 102 para 9.13]. Consolidated financial statements should generally incorporate all of the information contained in the individual financial statements of the entities included in the consolidation.

9.117 The accounting principles that are used in the consolidation process should be disclosed in the accounting policies note. The accounting principles that need to be considered when performing a consolidation, many of which should be covered in the accounting policy note, are as follows:

- The effective dates and methods of accounting used to consolidate new subsidiaries; that is acquisition accounting (see further chapter 19) and how to account for disposals (see para 9.155 below).
- The treatment of any goodwill arising on consolidation (see further chapter 19) and the treatment of other differences arising on consolidation.
- The translation of foreign subsidiaries’ financial statements (see chapter 30).
- How to account for non-controlling interests (see para 9.138 below).
- How associates and joint ventures are dealt with (see chapters 14 and 15).
- How the non-coterminous year ends of the parent and subsidiaries are dealt with (see para 9.130 below).
- The treatment of intra-group transactions (see para 9.132 below).

Procedure for consolidation

9.118 The income and expenses of a subsidiary are included in the consolidated financial statements from the acquisition date, except where a business combination is accounted for by using the merger accounting method under section 19 of FRS 102 (see chapter 19) or for some public benefit entity combinations falling under section 34 of the standard (see chapter 34). The income and expenses are no longer included from the date on which the parent ceases to control the subsidiary (see para 9.155 below). [FRS 102 para 9.18].

9.119 The consolidated statement of financial position and the consolidated statement of comprehensive income should incorporate the information contained in the individual financial statements of the entities included in the consolidation, subject to some consolidation adjustments. But section 9 of FRS 102 does not specify in detail how the aggregation of this information should be undertaken.

9.120 Section 9 of the standard makes little comment on the process of consolidation, apart from mentioning that, in preparing consolidated financial

of any significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements. [SI 2008/410 6 Sch 2(2)(a); FRS 102 para 9.16(a)]. Alternatively, the subsidiary must prepare interim financial statements to coincide with the end of the parent entity's financial year. [SI 2008/410 6 Sch 2(2)(b); FRS 102 para 9.16(b)].

Elimination of intra-group balances and transactions

9.132 Intra-group balances, transactions, income and expenses must be eliminated in full. [FRS 102 para 9.15].

9.133 The rules are as follows:

- Intra-group balances and transactions, including income and expenses and dividends, should be eliminated in full.
- Profits and losses resulting from intra-group transactions that are recognised in assets, such as inventory and fixed assets, should be eliminated in full.
- Intra-group losses might indicate an impairment that might need to be recognised in the consolidated financial statements.
- Section 29 of the standard should be applied to any temporary differences that arise from the elimination of profits and losses resulting from intra-group transactions. See chapter 29 for further guidance on deferred tax recognised on these eliminations.

[FRS 102 para 9.15].

9.134 The rationale for full elimination of unrealised profits or losses, even where the related transactions are between subsidiary entities with non-controlling interests, might not initially be obvious. However, transactions between subsidiaries included in the consolidation are wholly within the control of the parent entity, whether or not the subsidiaries are wholly owned. All the assets and liabilities of a subsidiary, and transactions between subsidiaries, are brought into the consolidation in full, again whether or not they are wholly owned. So, because the group includes 100% of all the subsidiaries' assets and liabilities, intra-group transactions that give rise to profits or losses that are unrealised at the balance sheet date are wholly unrealised to the group and do not represent any increase or decrease in the group's net assets. As a result, they should be eliminated in full, even where the transactions involve subsidiaries with non-controlling interests.

9.135 The following example deals with the elimination of intra-group profit on the sale of assets by a subsidiary to its parent and the elimination of intra-group profit on sale of assets by a parent to its subsidiary. For the purposes of the examples tax is ignored.

Example 1 – Elimination of intra-group profit on sale of assets by a subsidiary to its parent

A parent owns 60% of a subsidiary. The subsidiary sells some inventory to the parent for C70,000 and makes a profit of C30,000 on the sale. The inventory is in the parent's balance sheet at the year end.

The parent must eliminate 100% of the unrealised profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at C40,000 (C70,000 – C30,000). The consolidated income statement will show a corresponding reduction in profit of C30,000.

The double entry on consolidation is as follows:

		C'000	C'000
		Dr	Cr
Dr	Revenue	70	
	Cr Cost of sales		40
	Cr Inventory		30

The reduction of group profit of C30,000 is allocated between the parent company and non-controlling interest in the ratio of their interests – 60% and 40%.

Example 2 – Elimination of intra-group profit on sale of assets by a parent to its subsidiary

The situation is as above except that, on this occasion, it is the parent that makes the sale. The parent owns 60% of a subsidiary. The parent sells some inventory to the subsidiary for C70,000 and makes a profit of C30,000 on the sale. The inventory is in the subsidiary's balance sheet at the year end.

The parent must eliminate 100% of the unrealised profit on consolidation. The inventory will, therefore, be carried in the group's balance sheet at C40,000 (C70,000 – C30,000). The consolidated income statement will show a corresponding reduction in profit of C30,000.

		C'000	C'000
		Dr	Cr
Dr	Revenue	70	
	Cr Cost of sales		40
	Cr Inventory		30

9.136 Where an entity makes a loss selling assets (at fair value) to another group entity, careful consideration needs to be given to whether a consolidation adjustment is made. This is because the result of the transaction might indicate that there has been an impairment in the asset, and so it would be wrong to reinstate the asset at a value above its recoverable amount.

14.5 Whilst there is similarity between the definitions, there are two key differences. The Act requires the relationship to be based on a 'participating interest' which is not mentioned by FRS 102. The other difference concerns how significant influence is exercised.

14.6 Participating interest is defined in paragraph 11 of Schedule 10 to SI 2008/410, 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008', to mean "... an interest held by an undertaking in the shares of another undertaking which it holds on a long-term basis for the purpose of securing a contribution to its activities by the exercise of control or influence arising from or related to that interest".

14.7 The meaning of 'shares' in the definition is explained in section 1161(2) of the Act. For this purpose, references to shares also include rights to share in the capital of an undertaking that has no share capital, rights to share in the profits or liability to contribute to the losses of an undertaking without capital or interest giving rise to an obligation to contribute to the debts or expenses of an undertaking without capital in the event of a winding up.

14.8 It is also quite clear under the Act that a participating interest includes an option to acquire shares or any interest that is convertible into shares. [SI 2008/410 10 Sch 11(3)]. For this purpose, it does not matter whether the options can be exercised now or in the future, their mere existence is taken into account whether or not they are currently exercisable. An interest or option in shares falls within this definition even if the share to which it relates, until conversion or the exercise of the option, is unissued. [SI 2008/410 10 Sch 11(3)]. In addition, interests held on behalf of an undertaking should be treated as held by it. [SI 2008/410 10 Sch 11(4)].

Voting power

14.9 Significant influence is presumed to exist when an investor holds directly or indirectly 20% or more of the voting power of the investee. Conversely, it is presumed that significant influence does not exist if the investor holds directly or indirectly less than 20% of the voting power of the investee. Indirect holdings that are taken into account in assessing significant influence are those held through subsidiaries but not through associates or joint ventures. [FRS 102 para 14.3(a)(b)].

14.10 The presumptions mentioned in the previous paragraphs can be overturned where the ability or lack of ability, to have significant influence can be clearly demonstrated. [FRS 102 para 14.3(a)(b)].

14.11 More than one entity can have significant influence over another entity at the same time and a substantial or majority ownership by another investor does not preclude an investor from having significant influence. [FRS 102 para 14.3]. For example, entity A might hold 25% of the voting power in entity B, which is presumed to be its associate, even though another entity C might control entity B

through its holding of the remaining 75% of the voting power. In practice, however, the substance of the investor's 25% interest should be examined carefully to determine whether it gives that investor significant influence.

14.12 The standard gives no further definition or guidance as to the meaning of 'voting power'. We consider voting power to mean the rights that shareholders have to vote at general meetings of the entity on all, or substantially all, matters.

14.13 UK entities should follow the definitions given in UK law. For the purposes of the definition of an associated undertaking, 'voting rights in the undertaking' means the rights conferred on the shareholders in respect of their shares to vote at general meetings of the undertaking on all, or substantially all, matters. Where the undertaking has no share capital, it can also mean any other rights conferred on members to vote at the undertaking's general meetings on all, or substantially all, matters. [SI 2008/410 6 Sch 19(3)].

14.14 Voting rights should not be treated as held by a person (which includes an undertaking) if they are held in a fiduciary capacity. Similarly, voting rights held by a person as nominee should not be treated as held by him. Such voting rights will be considered held 'as nominee' if they can only be exercised on the instructions or with the consent of another person. It is not possible to treat voting rights held by a parent undertaking as held by a subsidiary by using nominee holdings. [SI 2008/410 6 Sch 19(4); CA06 7 Sch 6, 7 Sch 7(2), 7 Sch 9(2)].

14.15 Voting rights that are attached to shares held as security should be treated as held by the person providing the security where those voting rights (excluding any right to exercise them to preserve the value of the security, or to realise it) are only exercisable in accordance with his instructions. This rule applies where the shares are held in connection with granting loans in the normal course of business and the rights are exercised only in the interest of the person providing the security. This provision cannot be used to require voting rights held by a parent to be treated as held by any of its subsidiaries. Furthermore, voting rights should be treated as being exercisable in accordance with the instructions of, or in the interests of, an undertaking if they are exercisable in accordance with the instructions of, or in the interests of, any group undertaking. [SI 2008/410 6 Sch 19(4); CA06 7 Sch 8, 7 Sch 9(2), 7 Sch 9(3)].

14.16 The voting rights in an undertaking should also be reduced by any voting rights held by the undertaking itself. [SI 2008/410 6 Sch 19(4); CA06 7 Sch 10].

Potential voting rights

14.17 Potential voting rights held by an investor are considered when assessing whether an entity has significant influence. [FRS 102 para 14.8(b)]. Potential voting rights exist where an entity owns share warrants, share call options, debt or equity instruments that are convertible into ordinary shares or other similar instruments that have the potential if exercised, or converted, to give the entity

- The investor's share of the other comprehensive income of the associate, (for example, foreign exchange translation differences, actuarial gains and losses and changes in fair values of hedging instruments). These are recognised directly in other comprehensive income of the investor.
- The investor's share of equity.

[FRS 102 para 14.8].

Share accounted for

14.29 Before it is possible to equity account for associates, it is necessary to establish what share the group owns. The meaning of a group's share or holding is not defined in the standard. In a simple situation, where the investor only has an interest in the associate's equity share capital, it is easy to ascertain the share to be equity accounted: it will normally be the number of shares held as a percentage of the total number of equity shares in issue. There are a number of matters that need to be considered in determining what is the appropriate share because, in many situations, the percentage will not be apparent.

14.30 Where investments in associates are held by group members, all of the interests held by group members are aggregated to determine the share of the associate that falls to be equity accounted. However, indirect interests held through associates or joint ventures are excluded in computing the group's share, because these entities are not controlled by the group.

14.31 In many situations, the share to be taken into account will be derived from the percentage holding in shares; in some situations the economic interest might differ from the shareholding, but it will be the appropriate interest to take into account. For example, although the shareholding in an associate might be 40:60, the investors might share profits in the ratio 30:70. So it would be appropriate to equity account for the economic share rather than the equity participation. As a result, considerable care needs to be taken in establishing the appropriate share to be equity accounted.

14.32 Associates might have outstanding cumulative preference shares in issue that are not owned by the investor. In that situation, the investor's share of the associate's profits should be calculated after deducting the dividends on such shares, whether paid or not.

Distributions and other adjustments to carrying amount

14.33 Any distribution from the associate should be treated as a reduction in the carrying amount of the investment. The investor might also need to adjust the carrying amount as a result of changes in the associate's equity arising from items of other comprehensive income. [FRS 102 para 14.8(a)].

Potential voting rights

14.34 Although potential voting rights are taken into account in determining whether the investor has significant influence, such interests are not taken into account in determining the share to be equity accounted. Only the investor's present ownership interest is used to measure its share of profits or losses and other comprehensive income and its share of changes in the associate's equity under the equity method. Those measurements do not reflect the possible exercise or conversion of potential voting rights. [FRS 102 para 14.8(b)].

14.35 Having an option interest or a convertible interest is very different from holding the shares to which such an option relates.

Example – Significant influence with presently exercisable options

An investor has significant influence over its associate by virtue of its present ownership interest of 15% and presently exercisable options to acquire a further 10% for a fixed price. The investor equity accounts for its investment in the associate using its present ownership interest of 15%. The option to acquire a further 10% share is ignored for this purpose. However, the option is a derivative that is accounted for as at fair value through profit or loss in accordance with FRS 102 section 12, 'Other financial instruments issues'.

Implicit goodwill and fair value adjustments

14.36 On the associate's acquisition, management should measure any implicit goodwill as the difference between the cost of the acquisition and the share of fair values of the net identifiable asset acquired. [FRS 102 para 14.8(c)]. Although measurement of implicit goodwill is as described in section 19 of FRS 102 the implicit goodwill is not treated as a separate asset in the same way as goodwill arising on the acquisition of a subsidiary, but is included as part of the carrying amount of the investment in the associate. [FRS 102 para 14.8(c)].

14.37 Where the goodwill is negative, the entity needs to reassess the identifiable fair value of the net assets acquired to ensure that fair values of the identifiable assets and liabilities have been appropriately determined. Any excess of the revised net fair value over cost is recognised in profit or loss over the time frame in which the non-monetary assets are recovered. [FRS 102 para 19.24(a)(b)].

14.38 Subsequent to acquisition, the goodwill should be amortised over its useful life on a systematic basis as set out in section 19 of FRS 102. The amortisation should be charged against the investor's share of the associate's profits or losses after acquisition. [FRS 102 paras 14.8(c), 19.23(a)].

14.39 In addition, the investor should also adjust its share of the associate's profits or losses to account for any additional depreciation or amortisation of the associate's depreciable or amortisable assets on the basis of the excess of their fair values over their carrying amounts at the time of acquisition. [FRS 102 para 14.8(c)]. The additional depreciation or amortisation is calculated over the

The investor eliminates its share of the profit against the carrying amount of the associate. The investor's interest in its associate is not increased by the profits that it generates from selling upstream until the transaction has been crystallised by an onward sale to a third party. The accounting entries are to debit the share of profit of associates £40 and to credit the investment in associate £40.

Assuming the investor sells the inventory to a third party in the following year for £500, it is necessary to reverse the profit elimination entry made on consolidation in the prior year; this is because the unrealised profit has now been crystallised by an onward sale. Overall, there is a profit on the transaction of £200, and the group's share of this profit is taken up in the share of its associate's result. Any additional profit made by the investor by selling the inventory would be recorded as part of operating profit in the normal way.

Example 2 – Downstream: elimination is made against the carrying amount of the associate

An investor has a 20% interest in an associate. The investor sells inventory to the associate of £500. The original cost of the inventory was £300. The inventory has not been sold to a third party at the balance sheet date.

The investor records a profit of £200. However, as the sale was to an associate an element of this profit is unrealised and should be eliminated. The unrealised profit is £40 ($20\% \times £200$).

The adjustments required to be made in the investor's books are to debit revenue £100 ($£500 \times 20\%$), credit cost of sales £60 ($£300 \times 20\%$) (alternatively, the investor could debit the share of profit of associates by £40) and credit the investment in associate £40.

The adjustments will be reversed by the investor when the associate sells the inventory onto a third party.

14.46 It is not uncommon for an investor to contribute its own business in exchange for an investment in an associate. The accounting for such contributions can be complex and is explained in chapter 9.

14.47 Unrealised losses on both upstream and downstream transactions could provide evidence of an impairment of the asset transferred (see para 14.41 onwards above). [FRS 102 para 14.8(e)].

Date of associate's financial statements

14.48 Where the investor incorporates its investment into its consolidated financial statements by using the equity method of accounting, it should use the associate's financial information for the same date as its own financial information. This means that, where the financial year ends are different, the investor would require the associate to prepare financial statements for its (that is, the investor's) year end. [FRS 102 para 14.8(f)].

14.49 The standard acknowledges that preparation of an 'extra' set of financial statements by the associate is sometimes impracticable. If it is impracticable, the investor should use the most recent available financial statements of the associate. However it should make adjustments for any significant transactions and events that occur between the associate's and the investor's year end. [FRS 102 para 14.8(f)]. There is no requirement, unlike in IAS 28, 'Investments in associates', that the difference between the associate's and the investor's reporting date should not be more than three months.

Associate's accounting policies

14.50 In arriving at the amounts to be included by the equity method of accounting, the associate needs to use the same accounting policies as those of the investor. Where the accounting policies used by the associate and the investor for similar transactions and events are different, the investor should adjust the associate's financial statements to harmonise accounting policies, unless it is impracticable to do so (for example, where the information necessary to make the adjustments is not available). [FRS 102 para 14.8(g)].

Losses in excess of investment

14.51 A problem might arise where an associate starts to make losses, particularly where those losses are such that the associate has net liabilities. Where an investor's share of losses of an associate equals or exceeds its interest in the associate, the investing group should discontinue recognising its share of further losses. [FRS 102 para 14.8(h)].

14.52 After the carrying amount of the investor's interest is reduced to nil, no further losses should be recorded, unless the investor has incurred legal or constructive obligations or made payments on behalf of the associate (that is, amounts that the investor has guaranteed or otherwise committed, whether funded or not). [FRS 102 para 14.8(h)]. The standard does not deal with the situation where an investor has lent funds to, or invested in preference shares of, the associate. As this is not specifically mentioned in FRS 102, it will be necessary to consider whether such interests are recoverable and provide against them where necessary in accordance with the requirements in section 27, 'Impairment of Assets' of the standard (see above and chapter 27).

14.53 In practice, an investor might have a constructive obligation to its associate if, for example, it is unwilling to abandon its investment, and it would continue to record its share of the associate's losses. If the investor does have a constructive obligation to its associate and continues to account for its share of losses, such losses should be recognised as a provision in accordance with section 21, 'Provisions and contingencies' of the standard. [FRS 102 para 14.8(h)].

14.54 If the associate subsequently reports profits, the investor resumes including its share of those profits only after its share of the profits equals the

any such factors are present, they are likely to be contingent rentals over and above a minimum level of rentals. Such contingent rentals are included in profit or loss in the period in which they occur. But, if the entire stream of rentals is contingent, the lessor might not recover its investment, in which case the rentals are other than payment for use of the asset. Such agreements would be accounted for as financial instruments in accordance with section 12 of FRS 102.

20.6 In addition, the measurement rules of the standard do not apply to:

- Measurement of property held by lessees that is accounted for as investment property, and measurement of investment property provided by lessors under operating leases (see section 16 of the standard).
- Measurement of biological assets held by lessees under finance leases and biological assets provided by lessors under operating leases (see section 34 of the standard).

[FRS 102 para 20.1(c)(d)].

20.7 An entity might have an interest in a property that is leased to another party under an operating lease. If this property meets the definition of an investment property in section 16 of the standard, it should be measured in accordance with the rules of section 16 rather than section 20. The property interest held by the entity could be a freehold interest or a leasehold interest. If the interest is freehold or the lease is a finance lease, the entity is required to measure the investment property at fair value. But, if fair value cannot be measured reliably without undue cost or effort, the property interest is measured at cost. The same rule applies to a property interest held under an operating lease, but only if the entity wishes to treat the interest held as an investment property (see further chapter 16).

20.8 A property that is leased to a third party under a finance lease cannot be treated as an investment property; this is because leasing an asset under a finance lease is, in substance, no different from selling the property to the lessee. So the measurement rules of section 20 of the standard will apply.

20.9 Section 20 applies to agreements that transfer the right to use assets, even though substantial services by the lessor might be called for in connection with the operation or maintenance of such assets. [FRS 102 para 20.2]. For instance, entities often rent properties and equipment (such as motor vehicles, computers and photocopiers) from third parties. Such rental contracts often include an operation or a service contract, under which the third party is also required to maintain, repair, service and generally keep the rented asset in good working order. Such contracts fall within the scope of section 20 of the standard, because they convey the right to use assets from one contracting party to the other. The inclusion of other services in the contract does not change the characterisation of the contract as a lease. In these circumstances, the contract should be broken down into its lease and service components, and each component should be accounted for separately.

20.10 Conversely, section 20 of the standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other. [FRS 102 para 20.2]. This means that separable service components in contracts that include both assets and services (for example, the maintenance and repair of motor vehicles, computers or photocopiers) are not leases.

Determining whether an arrangement contains a lease

20.11 Some arrangements do not take the legal form of a lease but convey rights to use assets in return for payments. Examples of arrangements in which one entity (the supplier) might convey a right to use an asset to another entity (the purchaser), often together with related services, include outsourcing arrangements, telecommunication contracts that provide rights to capacity, and take-or-pay contracts. [FRS 102 para 20.3].

20.12 The standard provides as follows:

“Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

- (a) *fulfilment of the arrangement is dependent on the use of a specific asset or assets. Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset. An asset is implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets; and*
- (b) *the arrangement conveys a right to use the asset. This will be the case where the arrangement conveys to the purchaser the right to control the use of the underlying asset.”*

[FRS 102 para 20.3A].

Classification of leases

20.13 All leases should be classified as either finance leases or operating leases. The classification of leases under section 20 of FRS 102 is based on the extent to which risks and rewards incidental to ownership of the leased asset lie with the lessor or the lessee. The risks associated with assets include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards could include the expectation of profitable operation over the asset's life, the gain from increase in the capital value of the asset, or the right to sell the asset and realise the residual value.

20.14 A lease is classified as a finance lease if it transfers substantially all of the risks and rewards incidental to ownership. [FRS 102 para 20.4]. It follows that a

finance lease is an arrangement that has the substance of a financing transaction for the lessee to acquire effective economic ownership of an asset. So, a finance lease usually involves payment by a lessee to a lessor of substantially all of the cost of the asset, together with a return on the finance provided by the lessor. Title to the asset might or might not transfer under such a lease.

20.15 A lease is classified as an operating lease if it does not transfer substantially all of the risks and rewards incidental to ownership. [FRS 102 para 20.4]. In practice, this means that a significant element of risk and rewards must remain with the lessor or some party other than the lessee. As a result, an operating lease is usually for a period that is substantially shorter than the asset's useful economic life, and the lessor will be relying on recovering a significant proportion of his investment from either the proceeds from the asset's sale or the asset's further hire after the end of the lease term.

Primary lease classification indicators

20.16 The standard provides as follows:

“Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- (a) *the lease transfers ownership of the asset to the lessee by the end of the lease term;*
- (b) *the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;*
- (c) *the lease term is for the major part of the economic life of the asset even if title is not transferred;*
- (d) *at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and*
- (e) *the leased assets are of such a specialised nature that only the lessee can use them without major modifications.”*

[FRS 102 para 20.5].

20.17 When classifying a lease, it is important to recognise the substance of the agreement rather than its legal form. In analysing substance, more weight should be given to those terms of the agreement that are likely to have commercial effect in practice. Terms that are not likely to have commercial effect should be ignored. Paragraph 20.16 above sets out situations that ‘would normally lead’ to a lease being classified as a finance lease.

Lease term

20.18 The lease term is key to classifying a lease and is defined as “*the non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option*”. [FRS 102 Glossary of terms]. So, it is important to consider carefully those parts of the lease that deal with: the lease's non-cancellable period (sometimes referred to as the ‘primary period’); cancellation (or ‘break’) clauses; exchange and upgrade conditions; and options to extend the lease. Further guidance on the lease term can be found in chapter 19 of the IFRS Manual of Accounting.

Transfer of ownership

20.19 A contractual clause that automatically transfers ownership of the leased asset at the end of the lease term is normally a strong indication of a finance lease. This is particularly the case if transfer of title is for no consideration or for a fixed consideration.

20.20 Transfer of ownership can also occur where the lessor has a put option to sell the asset at an amount that is more than the expected fair value at that date. In this situation, the option is priced in such a way that it is very likely to be exercised by the lessor, with the result that the lessee has no choice but to take ownership of the asset. But, where the put option is at market price, as determined at the end of the lease term, the residual value risk remains with the lessor, and such an option would not, in isolation, indicate finance lease treatment. In addition, it is important to consider whether there is any other commercial or economic compulsion for the lessee to exercise such options, even when the option appears to be priced at or above fair value.

20.21 The criterion in the second point in paragraph 20.16 above is an extension of the transfer of ownership situation. An option held by the lessee to purchase the leased asset below its fair value at the date of exercise is a bargain that is very likely to be exercised by the lessee. Such bargain purchase options are quite common in lease agreements, and they are designed to ensure that the lessor earns its expected return on its investment in the leased asset, but no more, over the term of the lease. So, a lease with such an option is classified as a finance lease. On the other hand, if ownership of the asset is transferred to the lessee at the end of the lease for a variable payment equal to the asset's then fair value, or if there are contingent rents, the lessee does not have substantially all of the risks and rewards incidental to ownership.

Economic life of asset

20.22 The criterion in the third point in paragraph 20.16 above refers to the asset's economic life. The standard does not define ‘economic life’ of an asset, but the term is understood to have the same meaning as defined in full IFRS. It is the

interest method. The borrowings themselves are likely to be basic financial instruments that will be accounted for at amortised cost in accordance with section 11 of FRS 102, and the finance costs will be calculated using the effective interest method. The effective interest method is explained further in chapter 11. But, where the borrowings are not basic financial instruments, they would be accounted for at fair value through profit or loss (as discussed in chapter 12). In that situation, any transaction costs incurred in connection with such borrowings would be recognised immediately in profit or loss.

Exchange differences as borrowing costs

25.6 Entities may sometimes raise funds in a foreign currency, because the interest cost in the foreign currency over the term of the borrowing is less than an equivalent loan in the entity's functional currency over the same term. Where this is so, the last bullet point in paragraph 25.2 above makes it clear that exchange differences arising on the borrowing should be regarded as a borrowing cost 'to the extent that they are regarded as an adjustment to interest cost'. The standard is silent on how to estimate the extent to which foreign exchange differences should be included in borrowing costs.

25.7 We believe that, as a minimum, the interest cost in foreign currency translated at the actual exchange rate on the date on which the interest expense is incurred, should be included in borrowing costs. What is not so clear is how much of the exchange difference arising on the retranslation of the principal should be treated as borrowing costs. We believe that, in most circumstances, it is appropriate to include all of the exchange differences on the borrowing as interest cost, on the grounds that the exchange rate movements are largely a function of the differential interest rate between the two currencies.

Recognition

25.8 An entity can either:

- capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset, or
- recognise all borrowing costs as an expense in profit or loss in the period in which they are incurred.

[FRS 102 para 25.2].

For entities that adopt the policy of capitalising borrowing costs, this should be applied consistently to a class of qualifying assets.

Capitalisation of borrowing costs

25.9 A qualifying asset is defined as:

"An asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following may be qualifying assets:

- a) inventories;
- b) manufacturing plants;
- c) power generation facilities;
- d) intangible assets; and
- e) investment properties.

Financial assets, and inventories that are produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets."

[FRS 102 Glossary of terms].

25.10 Qualifying assets require a 'substantial period of time' to bring them to a saleable condition. Section 25 of FRS 102 does not define 'substantial period of time'. Management exercises judgement when determining which assets are qualifying assets, taking into account the nature of the asset. An asset that normally takes more than a year to be ready for use will usually be a qualifying asset. Once management chooses the criteria and types of asset, it applies this consistently to those types of asset. The notes to the financial statements should disclose, where relevant, how the assessment was performed, which criteria were considered, and the types of asset that are subject to capitalisation of borrowing costs. Property, plant and equipment that fall within the definition might include a manufacturing plant, power generation facilities and the construction of investment properties. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

25.11 Management should assess whether an asset, at the date of acquisition, is 'ready for its intended use or sale'. The asset may be a qualifying asset, depending on how management intends to use it. For example, where an acquired asset can only be used in combination with a larger group of fixed assets (or was acquired specifically for the construction of one specific qualifying asset), the assessment of whether the acquired asset is a qualifying asset is made on a combined basis.

management have commissioned an independent valuation for a special purpose (such as for resolving a dispute, repurchase of shares, entering into a joint venture agreement or for assessing the value of an offer for the entity made by a third-party bidder). A valuation of the entity might also be available if management generally uses value-based methods to review and target the performance of the entity's business operations. Such valuations could be used for estimating the fair value of the shares granted in a share-based payment transaction, but the valuation should be adjusted for any changes in conditions between the transaction/valuation date and the grant date for the equity shares. In limited circumstances, counterparties might have the right to shares which are not readily marketable. Only in this situation is it appropriate to apply a discount to the fair value for lack of marketability.

26.56 As a last resort, management should estimate the fair value of the shares indirectly by using a valuation method. The objective of using a valuation method is to establish what the price of the equity instruments would be on the grant date in an arm's length transaction between knowledgeable willing parties. So, to arrive at a reasonable estimate of fair value of the equity instrument, the method used should reasonably reflect how the market could be expected to price the instrument. That expectation is likely to be met if the valuation model used makes maximum use of market inputs and relies as little as possible on entity-specific inputs. So, any valuation method applied should use market data to the greatest extent that it is practicable to do so. [FRS 102 para 26.10(c)].

26.57 There are a number of generally accepted techniques for valuing equity instruments. The most common valuation methods are: asset-based valuation methods for valuing stable, asset-rich businesses; P/E ratios for valuing businesses with an established profitable history; and discounted cash flows, which is the most technical and depends heavily on assumptions about long term business conditions and measurement of risk (used for estimating discount rates). Management should use its judgement to apply the most appropriate valuation method to determine the fair value of the shares. The valuation method selected should take into account all the terms and conditions on which the shares were granted, other than service and non-market vesting conditions that are excluded from the measurement of fair value (as explained in para 26.47 above).

26.58 For example, if the employee is not entitled to receive dividends during the vesting period, this factor should be taken into account when estimating the fair value of the shares granted. Similarly, if the shares are subject to restrictions on transfer after the vesting date, that factor is taken into account to the extent that the restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares to employees vest after three years of service, but the employees are not allowed to sell the shares for a further two-year period, the two-year restriction is a post-vesting restriction (treated as a non-vesting condition) that should be taken into account in the grant date fair value measurement.

Share options and equity-settled share appreciation rights

26.59 A similar three-tier hierarchy to that for shares (see para 26.53 above) should be used to ascertain the fair value of share options and equity-settled share appreciation rights:

- If an observable market price is available for the share options or equity-settled share appreciation rights granted, the entity should use that price.
- If an observable market price is not available for the share options or equity-settled share appreciation rights granted, fair value should be measured using entity-specific observable market data, such as a recent transaction in the entity's share options.
- If an observable market price is not available and obtaining a reliable measurement of fair value under the second point above is impracticable, the fair value of equity instruments granted should be estimated using an alternative valuation method, such as an option pricing model. The inputs to the option pricing model (see para 26.61 below) should use external market data to the greatest extent possible. The standard also requires the entity to derive an estimate of expected volatility that is consistent with the valuation methodology applied.

[FRS 102 para 26.11].

'Impracticable' is defined as "Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so". [FRS 102 Glossary of terms].

26.60 But the trading of private entity share options is not commonly encountered; so, for the majority of private entities, there will not be an observable market price for share options or equity-settled share appreciation rights granted. For that reason, private entities would normally apply an option pricing valuation methodology.

26.61 There are a number of option pricing models in use, such as Black Scholes, Binomial and Monte Carlo. The inputs for an option pricing model should use market data to the greatest extent possible. All option pricing models take into account, as a minimum, the following factors:

- The weighted average share price. Guidance for determining the fair value of shares used in determining the weighted average share price is set out at paragraph 26.53 onwards above.
- Exercise price of the option.
- Expected volatility of the share price. Management should derive an estimate of expected volatility consistent with the valuation methodology used to determine the fair value of the shares.
- Life of the option.

- Dividends expected on the underlying shares.
- Risk-free interest rate over the life of the option.

[FRS 102 para 26.11].

26.62 The first two items define the 'intrinsic value' of the option. The remaining four are relevant to its 'time value'. The time value of an option reflects the right of the holder to participate in future gains, if any. The valuation does not attempt to predict what the future gain will be, only the amount that a buyer would pay at the valuation date to obtain the right to participate in any future gains. In other words, option pricing models estimate the value of the share option at the measurement date, and not the value of the underlying share at some future date.

26.63 All other things being equal, a change in the expected volatility of the share price will have the greatest impact of the input assumptions listed above on the option's fair value (that is, an increase in volatility increases the fair value). A change to either the option's exercise price or its life has the next greatest impact on the option's fair value (in this case, an increase in the option's exercise price decreases its fair value, and an increase in the option's expected life increases its fair value). This will be the case, regardless of the option pricing model used.

26.64 The model selected should take into account all the terms and conditions on which the share options were granted, other than service and non-market vesting conditions that are excluded from the measurement of fair values (as explained in para 26.47 above). For example, a share option granted to an employee typically cannot be exercised during the vesting period.

26.65 Similarly, another factor common to employee share options is the possibility of early exercise of the option (for example, the option is not freely transferable, or the employee must exercise all vested options on cessation of employment). The effects of expected early exercise should be taken into account in the valuation.

26.66 Determining the fair value of shares and share options for entities is quite complex, particularly for those entities that are not listed. Preparers of financial statements might find it useful to refer to Chapter 12 of the 'Manual of Accounting, IFRS for the UK' for further guidance on estimating the fair value of equity instruments granted.

Modifications including cancellations and settlements

26.67 It is not uncommon for management to modify the terms and conditions of equity instruments awarded in a share-based payment transaction. This might happen, for example, where a share option's exercise price is significantly above the fair value of the shares, rendering the option worthless ('underwater' options). Similarly, a performance condition might have become so onerous that it is no longer achievable. The challenge for management is how to modify the terms of the award in order to continue to motivate and reward employees.

26.68 There are a number of ways in which management could revive share awards that have become valueless. For example, management could cancel awards, which would require the immediate recognition of any remaining expense. Or management might reduce the exercise price of options granted to employees (that is, re-price the options), reduce the vesting period, or modify or eliminate a performance condition. Alternatively, management could settle the award (that is, cancel it) in exchange for cash or other consideration. The approach taken would depend on a number of factors, such as meeting employee expectations, complying with legal and contractual obligations (for example, obtaining employees' approval to modify the terms and conditions) and managing the financial reporting consequences arising from the modification, cancellation or settlement.

Modifications

26.69 The manner in which modifications are accounted for depends on whether they are beneficial to the employee (for example, where the modified terms increase the fair value or the number of the equity instruments granted) or not (for example, where the modified terms reduce the total fair value or number of the equity instruments granted).

Modifications that are beneficial to employees

26.70 A modification is likely to be beneficial to the employee if it results in an increase in the fair value or number of equity instruments granted. Where a modification is beneficial to the employee, the entity should continue to recognise the amount based on the grant date fair value of the original equity instrument over the original vesting period, as if the award had not been modified. The entity should also recognise the incremental fair value of the award (that is, the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the modification date). This incremental fair value should be recognised for the services received over the period from the modification date until the date when the modified equity instrument vests. [FRS 102 para 26.12(a)].

26.71 Examples of modifications that increase the fair value of an equity instrument include:

- A reduction in the exercise price of the option.
- An increase in the number of equity instruments granted.
- A reduction in the vesting period.
- The modification or elimination of a performance condition.
- A combination of the above.

26.72 Accounting for share-based payment modifications is considered in the following examples.

- any goodwill allocated to the CGU.
- The amount of any reversal that can be recognised is restricted to the lower of:
 - the recoverable amount; and
 - the carrying value that would have been recognised if the original impairment had not occurred (that is, after taking account of depreciation or amortisation that would have been charged if no impairment had occurred).
- Any excess in the reversal amount that cannot be allocated due to the restriction (see previous bullet point) should be allocated, on a pro rata basis, to other assets of the CGU.
- Once the reversal of an impairment loss is recognised, the depreciation or amortisation amount is based on the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

[FRS 102 para 27.31].

Example – Reversal of impairment loss

Entity A operates trains in country X. Entity B operates bus services in the same country. To diversify its business, entity A acquired entity B for £200m on 31 December 20X0. The identifiable net assets and contingent liabilities (after fair valuing) of entity B are £150m on that date. Entity A recognises goodwill of £50m (£200m – £150m).

In June 20X1 the government announced that it would award a major bus contract to a competitor of entity A. This would have a significant adverse impact on entity B's business. Entity A's 20X1 consolidated financial statements disclosed that the goodwill of £50m relating to entity B was impaired, and an impairment loss of £50m was recognised.

During October 20X2 the competitor who had been awarded the major bus contract decided to abort the sector, because it had breached environmental laws. The government decided to award the major contract to entity B. This was a significant boost for entity B's business. Entity A's consolidated financial statements for the year ended 20X2 disclosed that previous impairment losses had been reversed, resulting in an increase in the carrying value of entity B (that is, £50m less 21 months (January 20X1 to September 20X2) of amortisation was added back to goodwill).

27.63 The requirement in FRS 102 to reverse previous impairments in some circumstances is consistent with company law, which states in SI 2008/410 that, where a company has made provision for a diminution in value, but the factors that gave rise to it no longer apply to any extent, the company must write back the provision to that extent. [SI 2008/410 1 Sch 19, 20].

Disclosures

27.64 For each class of assets, an entity should disclose the following:

- The amount of impairment losses recognised in profit or loss for the period, and the line item or items in the statement of comprehensive income (or income statement) in which the losses are included.
- The amount of reversals of impairment losses recognised in profit or loss for the period, and the line item or items in the statement of comprehensive income (or income statement) in which the reversals are included.
- A description of the events and circumstances that led to the recognition or reversal of the impairment loss.

[FRS 102 paras 27.32, 27.33A].

27.65 Examples of classes of asset are:

- inventories;
- property, plant and equipment (including investment property accounted for by the cost method);
- goodwill;
- intangible assets other than goodwill;
- investments in associates; and
- investments in joint ventures.

[FRS 102 para 27.33].

Companies Act disclosures

27.66 The formats in Schedule 1 to SI 2008/410 prescribe the headings under which depreciation of (and other amounts written off) tangible and intangible fixed assets are to be included in the profit and loss account. Under Format 1, where expenses are classified by function, an impairment loss would generally be charged under the same format heading as depreciation of (or other amounts written off) the relevant assets. Under Format 2, where expenses are classified by type, there is a separate heading 'depreciation and amounts written off tangible and intangible fixed assets'.

27.67 SI 2008/410 requires that provisions for diminution in value are made in respect of any fixed asset that has diminished in value if the reduction in its value is expected to be permanent (whether its useful economic life is limited or not). In addition, any such provisions made that are not shown in the profit and loss account must be disclosed (either separately or in aggregate) in a note to the financial statements. [SI 2008/410 1 Sch 19, 20]. Specific disclosure requirements are also given in SI 2008/410. The amounts to be disclosed are:

Impairment of assets

- The cumulative amount of provisions for depreciation or diminution in value of assets included under that item at the beginning of the financial year and at the balance sheet date.
- The amount of any such provisions made in respect of the financial year.
- The amount of any adjustments made in respect of any such provisions during that year in consequence of the disposal of any assets.
- The amount of any other adjustments made in respect of any such provisions during that year.

[SI 2008/410 1 Sch (51)(3)].

Transition issues

27.68 No special exemptions on impairment of assets are available to first-time adopters under section 35 of FRS 102. So, a first-time adopter must prepare its first financial statements as though the requirements of section 27 of FRS 102 had always applied.

27.69 However, entities transitioning from old UK GAAP (FRS 12) to FRS 102 are unlikely to face any significant issues on transition. This is because there are no differences in substance between the requirements of old UK GAAP and those in section 27 of FRS 102.

27.70 This means that amounts reported under old UK GAAP will be carried forward without any modifications in the opening balance sheet as of the date of transition. However, inevitably there are some differences in disclosure between the two.

The cumulative amount of provisions for depreciation or diminution in value of assets included under that item at the beginning of the financial year and at the balance sheet date. The amount of any such provisions made in respect of the financial year. The amount of any adjustments made in respect of any such provisions during that year in consequence of the disposal of any assets. The amount of any other adjustments made in respect of any such provisions during that year.

Chapter 28

Employee benefits

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Employee benefits

Introduction and scope

28.1 Section 28 of FRS 102 deals with the accounting for employee benefits. Employee benefits include all forms of compensation given by an entity to employees (including directors and management) in exchange for services rendered to the entity.

28.2 Section 28 of the standard divides employee benefits into four categories, as stated below. Each category has different characteristics and, therefore, different requirements:

- Short-term employee benefits (other than termination benefits), such as wages and salaries, holiday pay, sick leave and bonuses. To fall into this category, benefits must be expected to be settled within 12 months after the end of the reporting period in which the employees render the related service.
- Post-employment benefits (other than termination benefits and short-term benefits), such as pensions and post-retirement medical insurance that are payable after completion of employment.
- Other long-term employee benefits, such as long-term incentive plans (LTIPs), long-service awards and bonuses payable more than 12 months after the end of the period in which the employees render the related service. This category includes all employee benefits other than short term, termination or post-employment benefits.
- Termination benefits provided in exchange for the termination of an employee's employment as a result of either:
 - an entity's decision to terminate an employee's employment before the normal retirement date, or
 - an employee's decision to accept voluntary redundancy in exchange for those benefits.

[FRS 102 para 28.1].

28.3 Employee benefits include benefits provided to employees and their dependants and can be settled by payments (or the provision of goods or services) made directly to the employees, their spouses, children or other dependants, or to others (such as insurance companies). Also, an employee can provide services to an entity on a full-time, part-time, permanent, casual or

entitlements. But, in measuring non-vesting entitlements, the entity should take into account the possibility of the employees leaving before using their entitlements.

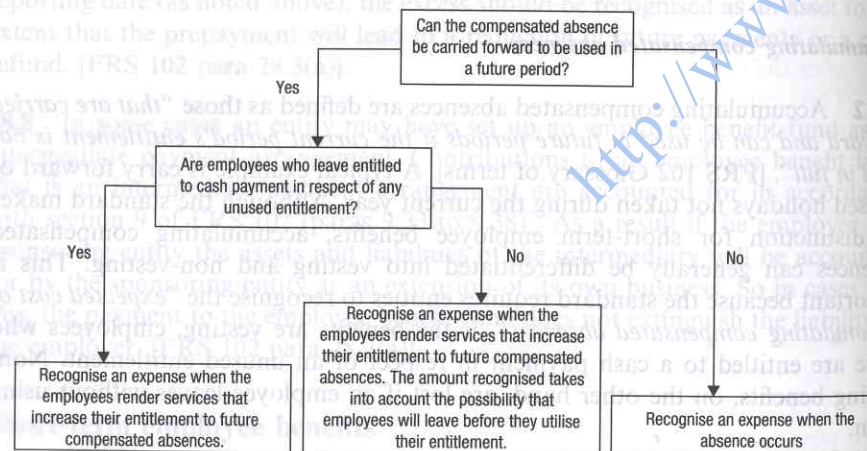
28.14 Accordingly, an entity should measure the expected cost of accumulating compensated absences at the undiscounted additional amount that the entity "expects to pay" as a result of the unused entitlement that has accumulated at the end of the reporting period. An entity should present this amount as falling due within one year at the reporting date. [FRS 102 para 28.6].

Non-accumulating compensated absences

28.15 Non-accumulating compensated absences, on the other hand, are those where there is no entitlement to carry forward unused days (that is, any unused entitlement not taken during the current period lapses without payment). They are not generally related to services. Of the examples listed above, sick leave, maternity leave and jury service are usually non-accumulating compensated absences.

28.16 An entity should recognise the cost of other (non-accumulating) compensated absences when the absences occur. The entity should measure the cost of non-accumulating compensated absences at the undiscounted amount of salaries and wages paid or payable for the period of absence. [FRS 102 para 28.4].

28.17 The flow chart below summarises the principles for compensated absences discussed above:



Example 1 – Holiday pay that lapses if employee leaves

Employees of entity A are entitled to 20 days of paid leave each year. The entitlement accrues evenly throughout the year, and unused leave can be carried forward to future periods. There is no cash payment in respect of an unused entitlement if an employee leaves the entity.

At 31 December 20X1, entity A has 100 employees, and the average unused holiday entitlement per employee is two days. Historically, 10% of employees who leave have never taken their unused holiday entitlement, and management expects this trend to continue.

At the reporting date (31 December), entity A should recognise a liability for the expected cost of accumulated absences. In doing so, it should take into account the possibility that employees will leave before they utilise their entitlement. Given that 10% of employees leave without taking their unused holiday, the number of days of accumulated entitlement that the entity expects to have to pay in the future is 180 days (that is, 90% of 200 days).

If entity A were to change its terms and conditions of employment, such that a cash payment was made in respect of unused holiday entitlement when an employee left the entity, the amount provided would be 200 days. This is because it would be irrelevant that 10% of employees never take all of their holiday entitlement, as they would receive a cash payment of equivalent value on leaving the entity.

Example 2 – Unused holiday carried forward for one year only

The facts are as in example 1, except that unused holiday entitlements can be carried forward for one year only. Each year, the current year entitlement is used before any balance is brought forward from the previous year.

At 31 December 20X1, all 100 employees have two days of unused holiday entitlement. Management expects that 75% of employees will take 22 days of holiday in 20X4 (that is, including two days each brought forward from 20X1), 15% will take 20 days (that is, they will lose their two days carried forward), and the remaining 10% will take 18 days (that is, they will lose their two days carried forward from 20X1 and be eligible to carry forward two days from 20X2's entitlement at 31 December 20X2).

How much should be recognised as a liability at 31 December 20X1?

As noted in paragraph 28.14 above, the expected cost (that is, liability) of the accumulated compensated absences is calculated at the level of individual employees, and is based on the additional amount that an entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period. On this basis, the liability would be based on only the 75% of employees who are expected to use their brought-forward entitlement. So, the liability recognised at 31 December 20X1 would be 150 days (that is, two days for each of 75 employees).

Example 3 – Non-accumulating sick leave

Entity B has 100 employees, each of whom is entitled to six working days of paid sick leave for each year. Unused sick leave cannot be carried forward to the next calendar year. Employees are also not entitled to a cash payment for unused entitlement of sick leave on leaving the entity's service.

An entity should not recognise an expense in respect of non-accumulating sick leave until the time of the absence, because employee service does not increase the amount of the benefit. Accordingly, entity B should not recognise a provision for unused sick leave. The use of sick leave is determined by an unpredictable future event (that is, the