UK GAAP and distributable profits: what your clients need to know

Any article on distributable profits has to start by pointing out that ICAEW's definitive technical release, TECH 02/10, is still the "go to" guidance on this subject. This article will consider some of the potential impact of FRS 102 on the distributable profits of the type of company typically encountered by small practitioners, against the backdrop of the well-established approach set out in TECH 02/10.

Investment property

Under FRS 102, fair value movements on investment property are recognised in the profit and loss account, rather than going to a revaluation reserve as required by "old" UK GAAP. This might lead you to think that they are realised profits available for distribution; in fact they are not. Fair value accounting profits can only be classified as realised if they are "readily convertible into cash", which means that the entity has an unrestricted ability to convert the asset to cash virtually instantaneously at the balance sheet date.

Fair value profits on investment properties are clearly not readily convertible into cash, and as such the fair value gains are not realised profits. In light of this, it can be useful to have these gains separately identified; therefore you might want to transfer fair value movements on investment properties out of retained earnings, into a separate subset of the P&L reserve, marked as a non-distributable reserve.

Lease incentives

Under old UK GAAP, lease incentives were spread over the shorter of the lease term and the period until the next rent review or break clause. Under FRS 102, the correct treatment is to spread the incentive over the entire lease term, which for these purposes is the non-cancellable period for which the lessee has contracted to lease the asset, together with any further terms for which the lessee has an option to continue to lease when, at the inception of the lease, it is reasonably certain that the lessee will exercise that option.

There is, however, a transitional exemption allowing the entity not to restate the treatment of lease incentives existing at the date of transition. This choice is available on a lease by lease basis.

All accounting adjustments connected with this do impact on distributable profits. If the entity applies FRS 102 retrospectively, the impact is net of any tax effect.

Goodwill

Under FRS 102, goodwill has a finite useful life and is amortised on a systematic basis over its life. In the exceptional circumstances where an entity is unable to make a reliable estimate of the useful life of goodwill, its life shall not exceed ten years. This is significantly different from old UK

GAAP which presumes a maximum useful life of 20 years but allows longer or indefinite lives in some circumstances.

Any changes to the goodwill amortisation period will impact on distributable reserves, both as a result of any transition adjustments where the useful economic life changes, and also in terms of the amortisation itself reducing distributable profits in the future. Only goodwill in individual financial statements has an effect on distributable profits – consolidation adjustments never do.

Derivatives

Under old UK GAAP it was possible to choose between recognising the fair values of derivatives in the balance sheet, with movements going to the profit and loss account, or simply disclosing their fair values in the notes to the accounts. Most entities took the latter option.

Derivatives include interest rate swaps, forward commodity and currency contracts and interest rate caps or collars. Under FRS 102, these derivatives, with a few specific exceptions, must always be brought onto the balance sheet and fair valued with gains and losses recognised in profit and loss. As already mentioned above, profits or losses arising from the use of fair value accounting, where the movement is readily convertible to cash ie, capable of being closed out or settled, are treated as realised. Every derivative will need to be considered separately in this context, but surprisingly the answer is often that the fair value gain or loss will be treated as realised. For example, the contract or risk position in relation to a typical “vanilla” interest rate swap can be offset in the market and it is normal market practice to do so, as the swap is valued using only observable market data and could be closed out immediately. Any profit or loss on re-measurement is therefore a realised profit or loss. This can have an enormous impact on distributable reserves, and is likely to cause some traps for the unwary.

Deferred tax

The way deferred tax is calculated under FRS 102 is often referred to as a “timing differences plus” approach, which is a combination of both balance sheet and P&L driven, whereas the old UK GAAP approach was much more P&L driven. This has the effect that more deferred tax will typically be recognised under FRS 102 than in the past. For example, additional deferred tax will need to be recognised on revaluations of property, plant and equipment and investment properties.

The distributable profit impact of deferred tax normally follows the treatment of the gain or loss to which it relates. Accordingly when assets are revalued to their fair value and the gain is regarded as unrealised, the deferred tax on that gain should be treated as a reduction in that unrealised gain rather than as a realised loss.

Conclusion

The effect of the changes to UK GAAP arising from FRS 102 on distributable profits are quite complicated, but once you understand and master the concepts involved, it should not present you or your clients with any significant difficulties.