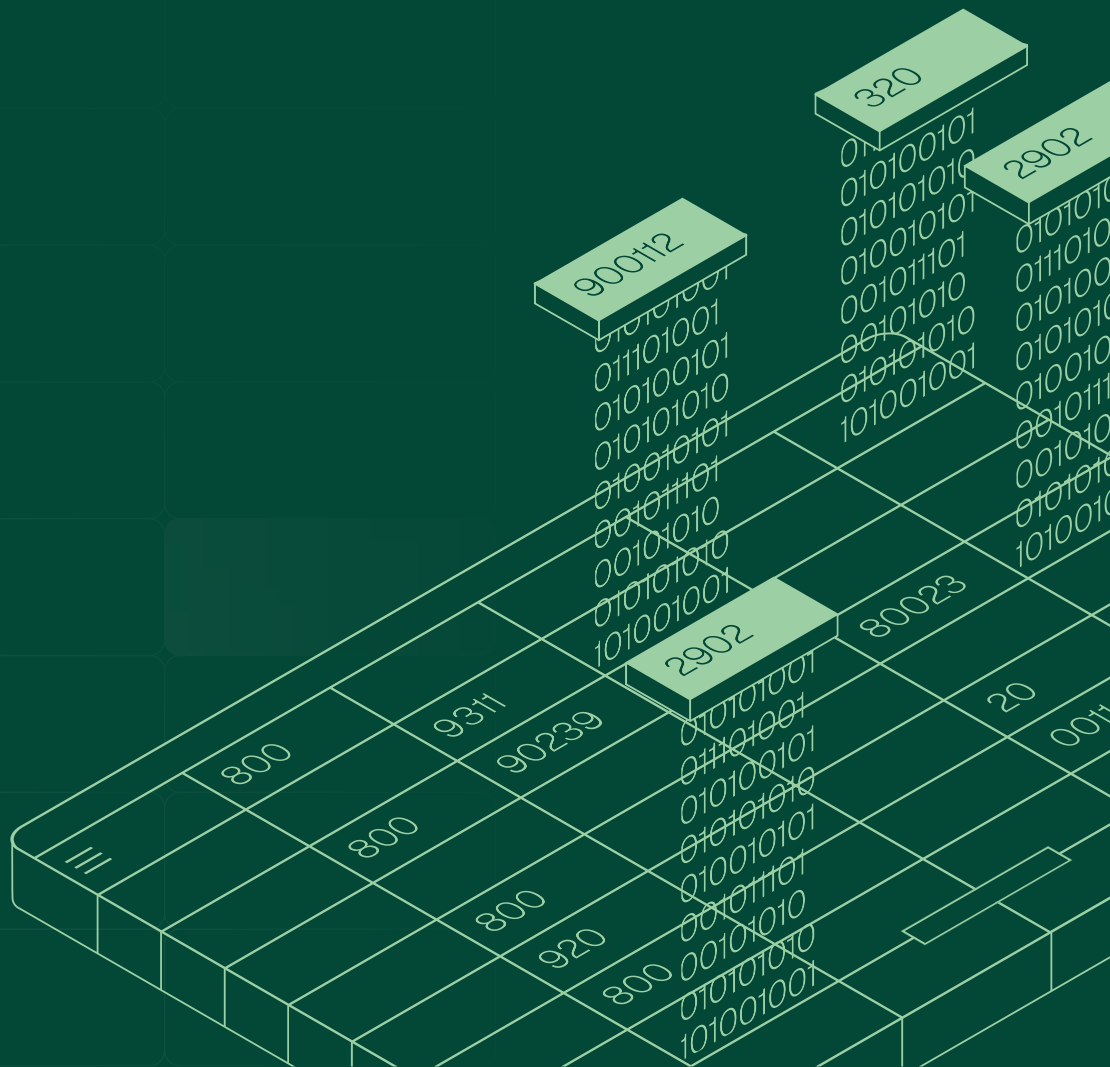
TRULLION

Understanding FRS 102

Demystifying the latest compliance changes



Introduction to FRS 102

Over the past 10 years, companies around the world have experienced several waves of changes to important financial reporting standards. In March 2024, companies in the UK and Ireland were hit with a wave of their own as the Financial Reporting Council (FRC) released amendments to FRS 102.

These changes have rightly focused the attention of finance and accounting teams, auditors, and other stakeholders. To clarify what these changes entail and their impact on organizations, this ebook will help demystify the updated regulations and address some of the most frequently asked questions from those seeking compliance.

FRS 102 changes set to affect 3.4 million businesses, according to Accountancy Daily.

Level set: what is FRS 102?

FRS 102 is the comprehensive financial reporting standard developed by the FRC, the body responsible for financial reporting in the UK and the Republic of Ireland. The standard first came into place in 2015 and was designed to bring UK Generally Accepted Accounting Practice (GAAP) for private entities in line with international financial reporting standards.

While some companies operating in the UK and Ireland opt to adhere to International Financial Reporting Standards (IFRS), most use FRS guidelines because the requirements are simpler and less demanding, and they cost less to implement.

How does FRS 102 compare to other accounting standards?

The requirements in FRS 102 are based on IFRS with some significant adjustments made for use in the UK and Ireland. Over time, FRS 102 has been moving closer to IFRS, although some important differences remain (learn more about the individual differences here.) In general, FRS has been designed to require much less disclosure than IFRS. As noted above, FRS 102 is less complex, takes less time to prepare, and is more cost-effective to apply. For example, with FRS 102, unlike IFRS, it is not necessary to restate prior periods when transitioning to the new standards.

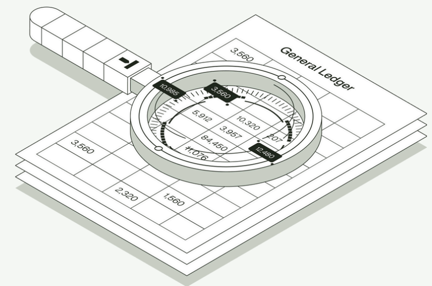
What are the recent updates to FRS 102?

FRS guidelines are subject to periodic review at least every five years. The most recent review was completed in March 2024 and includes significant changes meant to bring UK GAAP into closer alignment with IFRS. Private and public businesses using the FRS 102 financial reporting standard that are not adopting IFRS, FRS 101, or FRS 105 must implement the new FRS 102 amendments outlined in the Periodic Review 2024 by January 1, 2026.

The goal of the most recent amendments is to enhance transparency, comparability, and quality of financial reporting, as well as to enhance compatibility with IFRS.

Highlights of the amendments include:

- On-balance sheet lease accounting for lessees, aligned to IFRS 16: Leases, but with certain practical exemptions
- A new five-step model for how companies recognise revenue from customer contracts, aligned to IFRS 15
- Updates across various sections of FRS 102, including small entities disclosures, fair value measurement, supplier finance arrangements, share-based payments, income tax, and specialized activities



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What are the early adoption provisions for FRS 102?

The effective date for the amendments to FRS 102 is accounting periods beginning on or after January 1, 2026. Early application is permitted, provided that all the amendments are applied at the same time. In most cases, if a company applies the new standards early, they need to disclose that fact to the FRC.

How will the changes to FRS 102 affect companies?

First, it may be helpful to identify which companies will be affected by the amendments to FRS 102. Publicly traded UK companies are required to adhere to IFRS, so this discussion does not apply to those entities, in most cases.

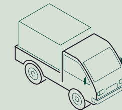
Large private companies that are not publicly traded may choose to apply IFRS or FRS 102, FRS 101, and FRS 105. Small and medium-sized entities (SMEs) have the option to apply either full IFRS standards or to use the FRS, specifically FRS 102.

With the types of changes being proposed, and the types of businesses that typically use FRS 102, it is likely that SMEs with multiple loans will be most affected.

While these are the companies likely to be most affected, any entity with a lease longer than 12 months will be affected to some degree.

Businesses most affected:

Companies with multiple locations and office leases



Companies with vehicle fleets

Construction and other companies who lease large equipment

The importance of FRS 102 for financial reporting

The changes to lease accounting and, to a lesser extent, revenue recognition are likely to have an impact on financial reporting and key financial metrics. For example, as more leases move onto the balance sheet as financing transactions, total assets and total liabilities will increase, while operating expenses will decrease. Overall, expect changes to EBITDA, debt, and statements of cash flows.

Downstream, these changes will likely impact debt and pension covenants, as well as remuneration schemes that are linked to specific financial targets. Because these impacts are going to be felt outside the finance team, it is vital to engage and explain in advance, as early as possible, how the changes to financial reporting will affect other stakeholders.

Key changes in lease accounting

Many have heard the headline for the amendments to FRS 102—leases are coming on balance sheets—but what does that actually mean?

Under the previous set of rules, operating leases were recognized as an expense on the profit and loss (P&L) statement. Under the new guidance, all leases will be accounted for as financing transactions, as if funds had been borrowed to obtain the use of an asset for a period of time. These lease obligations are recorded on the balance sheet.

A key material determination for accounting and finance teams will be whether a given contract represents a lease under the new rules, or whether it is a service that is recorded against the P&L. The definition of "lease" has broadened considerably beyond the obvious items, such as land and vehicles, to include things like IT contracts, service arrangements, and supplier contracts with embedded leases.

The expected benefits of this change are:

- Improved financial information through enhanced transparency
- Consistency with international accounting principles, enhancing comparability
- Potentially improved access to capital
- More relevant details about assets and liabilities that accurately reflect the economics of significant lease arrangements

Lease exemptions under FRS 102

FRS 102 provides exemptions for leases that are considered either short-term or for which the underlying asset is low value.

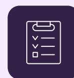
- A short-term lease is a lease with a duration less than 12 months.
- The general rule for a low value asset is one worth less than £5,000 or $5,000, determined on an absolute basis with no reference to the value of the lease payments.

There are additional considerations when applying these criteria to a lease.

- When determining the term of a lease, the term is not always completely straightforward. For example, a lease could be a rolling one-month contract, but if a company reasonably expects the lease to last more than 12 months, that would not be considered a short-term lease.
- When valuing the underlying asset, FRS 102 also sets out certain guidelines that supersede the monetary value. The guidelines state that certain assets like vehicles, construction equipment, land, boats, and aircraft do not qualify as low value. Any asset that is subleased also does not qualify.

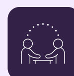
Roadblocks for finance and accounting teams: implementation challenges

More qualitative judgments. Companies will have to analyze contracts and make careful material judgments, such as determining which contracts meet the definition of a lease and which leases are exempt.

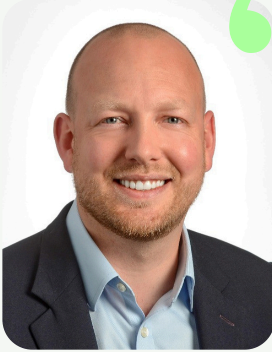


Complex contract changes. Because leasing arrangements evolve over time, the assumptions that underlie leasing contracts will need to be revisited every year, which will require companies to manage complex changes across hundreds or even thousands of contracts.

Large amounts of data. Meeting the standards will require companies to extract and manage large amounts of data from all of their leasing contracts.

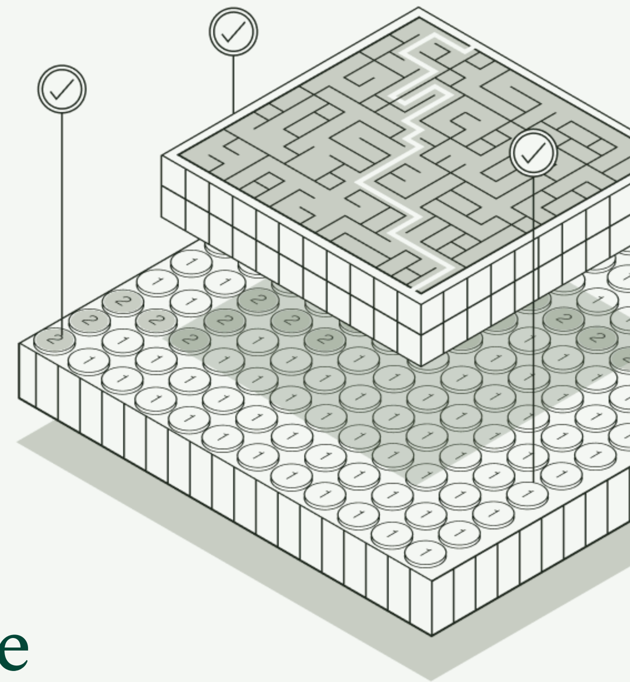


Stakeholder expectations. Under the new accounting standards, key financial metrics will change. Finance and accounting teams will need to manage the expectations of other stakeholders, who may be affected by the new numbers.



Determining whether a contract is a lease can be complex. It's important to note that something doesn't have to literally say "lease" in the contract to be accounted for as a lease under FRS 102. The definition is quite broad. So the first technical hurdle when adopting the new changes is to look at all of your contracts and determine which ones fall into scope."

-Ian Greenwood, Partner, Accounting Advisory Services, KPMG



Drilling down on the need for accounting judgments, there will be a need for qualitative assessment around which contracts meet the definition of a lease. For example, a power purchase agreement may appear on the surface to be a straightforward service agreement that should apply directly to the P&L. But what if the agreement contains a number of embedded leases where the company is leasing the right to all of the energy output?

Finance and accounting teams should not underestimate the complexity of judgments related to leases.

Strategies for compliance

The first step toward compliance with FRS 102 will be to review all leases and contracts that could contain a lease. Once all leases and potential leases are gathered, they need to be evaluated:

01. Determine which contracts count as leases.
02. Calculate the liability for each lease based on the term of lease and payments due. Then discount those future payments and bring them back onto the books as a liability.
03. Because all leases now have right-of-use assets, companies must calculate depreciation of those assets and apply that value to the P&L.

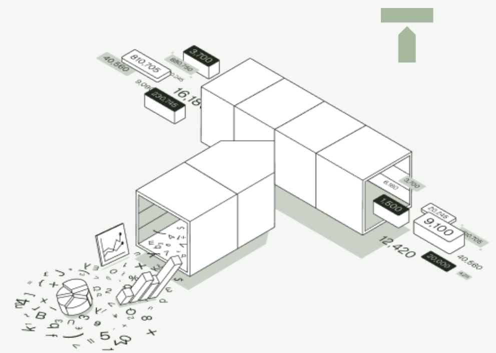
This new process will require complex judgments. For example, a company may have a 10-year lease for office space, but with a quit clause at year 5 and a 5-year extension option at year 10. How many payments should be brought back on the balance sheet as a liability?

The importance of data management

A big part of tackling this challenge is data management—extracting all of the data out of dozens, hundreds, or even thousands of contracts. This is important during the transition when evaluating all existing contracts and applying the new standards to them. But it is perhaps even more important after the transition as complex changes are managed on an ongoing basis.

At the beginning of an implementation of new standards, many companies start by building an Excel model. Excel may work during the transition, but often breaks after the first year as complex term changes, payment changes, and recalculation begin to roll in.

“There’s a tipping point when managing assets—if you have 10 or more, it’s time to consider a technology solution. While Excel might work initially, as complexities grow, so does the risk of error. That’s when technology becomes essential,” says Isaac Heller, CEO and Co-Founder, Trullion.



Excel may work during the transition, but often breaks after the first year as complex term changes, payment changes, and recalculation begin to roll in.

> These assets and liabilities aren’t “set and forget.” As contracts evolve and judgments change, assumptions must be revisited annually, making a robust technology system essential.
>
> -Ian Greenwood, Partner, Accounting Advisory Services, KPMG

Role of AI in accelerating implementation

Managing leases manually is not only time-consuming, it is also prone to error. AI-driven automation can play a pivotal role in accelerating the transition to the new lease accounting rules for FRS 102. AI-driven automation can easily and quickly import leases, contracts, and other essential files, and then extract key information needed to make key judgments.

A big thing is the data. How are you going to extract the data? Where are you going to put it during the transition, and then how are you going to manage it after the transition?"

-Ian Greenwood, Partner, Accounting Advisory Services, KPMG

Data extraction is the most common challenge for companies when adopting new lease accounting standards. Optical character recognition (OCR) technology converts images of text into a machine-readable text format. This tool is extremely valuable when managing leases and other contracts. Rather than manually outputting data from a spreadsheet, OCR enables error-free extraction with one click. And once you have extracted data with OCR tagging, it is clearly documented and easily accessible within the audit trail.

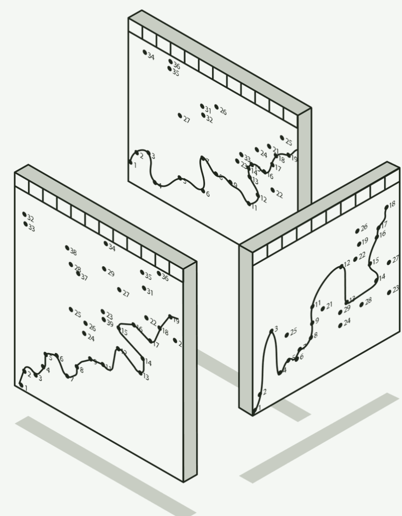
"FRS 102 represents a unique opportunity for companies to deploy AI-enabled, OCR-based data extraction tools," says Heller.

Changes to revenue recognition under FRS 102

Previously, FRS 102 contained a relatively light set of guidance on recognising revenue, which resulted in both flexibility and inconsistency for companies who used the standards. With the new changes, FRS 102 is now more in line with standards like ASC 606 and IFRS 15.

The expected benefits of adopting the new five-step model are:

- Simplified process for companies to accurately and uniformly account for revenue transactions
- Enhanced reliability and utility of information regarding the nature, amount, and timing of revenue and cash flows from customer contracts
- Potentially improved access to capital
- Consistency with international accounting principles, enhancing comparability



The five-step model

Under FRS 102, revenue recognition is accomplished in five clear steps:

Step 1

Identify the contracts that have been made with a customer

While this seems straightforward, correctly identifying contracts can be challenging. Some contracts may not be enforceable. A contract bundle may need to be combined into one contract for the purpose of revenue recognition.

Step 2

Identify the performance obligations in each contract

For many companies, a performance obligation will be a new unit of account that must be clearly defined within a contract. This may require collaboration with other stakeholders within the company to ensure that expectations are aligned.

Step 3

Determine the transaction price

In some cases, pricing may be a simple, single amount, but in other cases there is variability. An additional constraint is that revenue cannot be counted unless it is highly unlikely to be reversed.

Step 4

Allocate the transaction price to the performance obligations in the contract

Even once you have clearly defined prices and performance obligations, allocating them will likely require careful judgments.

Step 5

Recognise revenue when (or as) the entity satisfies a performance obligation

When is a performance obligation truly satisfied? At what point in time has the company transferred control of good or service? The new five-step model means that revenue recognition has moved from a risk-and-reward model to a control model that requires quite a few judgments.

Challenges in implementation

As companies reassess their contract terms and how they account for revenue in the context of the five-step model, there will likely be changes in the timing and amount of revenue recognised. The process of assessing the impact may be complex and time-consuming, so it is advisable to begin as early as possible.

For most companies adopting the five-step model for the first time, the biggest challenge will be the bundling or unbundling of individual elements within a contract.

As discussed earlier, a single contract may have bundled together a number of goods and services, which now need to be separated into individual performance obligations, and then priced accordingly. In many cases, this is the most difficult challenge associated with the new revenue recognition model.

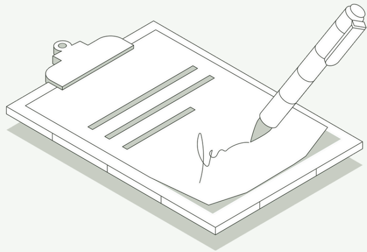
On the other end of the contract is the challenge of variable pricing and how best to make an appropriate estimate of price as it relates to the satisfaction of the performance obligations. Variable consideration, contract modifications, discounts and rebates, and other complexities can wreak havoc on revenue estimates.

We say it every time a new standard comes out, but it's very important to take the adequate time to prepare and to seek out the right resources, including external partners like KPMG, to set up a good framework for adoption, and technology tools."

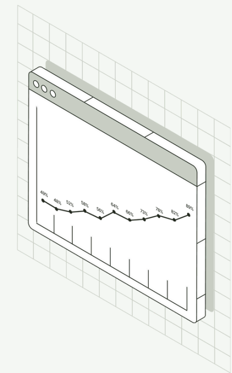
-Isaac Heller, CEO and Co-Founder, Trullion

Conclusion

Significant changes are coming to financial reporting practices in the UK and Ireland, aligning more closely with IFRS while maintaining some flexibility.



Lease accounting:
Most leases will now be reflected on the balance sheet as both a lease asset and liability, enhancing transparency but requiring more judgment an data management.



Revenue recognition:
A new five-step model will require accounting professionals to handle performance obligations and variable considerations differently, necessitating increased judgment and data analysis.

These changes don't have to be stressful. Starting early and implementing the right systems will make the transition smoother. AI-driven automation can assist in managing data, spotting patterns, and handling routine tasks, allowing finance professionals to focus on strategic work.

Clarity ahead: implementing best practices

With a clearer understanding of FRS 102, your company can confidently navigate the complexities of compliance, leading to enhanced financial visibility and better alignment with industry standards. For further guidance, sign up for free access to part two of our FRS 102 series, "From theory to practice: implementing FRS 102 effectively" - coming soon.

About Trullion

Trullion is an AI-powered accounting platform that automates financial workflows for finance teams, accountants, and auditors, enhancing efficiency, accuracy and collaboration. Founded in 2019 and headquartered in New York, with offices in Tel Aviv and London, Trullion is backed by Aleph, Third Point Ventures, Greycroft, StepStone Group, and leading global CFOs.

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