



Article topic: Financial Reporting

UK GAAP vs. FRSME

November 2010

On 29 October 2010, the UK Accounting Standards Board (ASB) issued a proposal to introduce an international-based financial reporting framework for companies who are not eligible to apply the *Financial Reporting Standard for Smaller Entities (FRSSE)* and those who currently apply full IFRS (notably listed companies). *FRSME* is proposed to replace current UK GAAP for accounting periods commencing on or after 1 July 2013, and is based on the principles in the IASB *International Financial Reporting Standard for Small Medium Entities (IFRS for SMEs)*. *IFRS for SMEs* is based on the principles in full IFRS, which have been heavily condensed in recognition of the standard's target audience.

Looking at the proposed *FRSME*, there are some notable differences which will affect practitioners who deal with those clients who could potentially fall under its scope.

Investment properties

Current GAAP (SSAP 19 *Accounting for Investment Properties*) requires investment properties to be carried in the balance sheet at their fair (market) value, with changes being recognised in the statement of total recognised gains and losses (STRGL) as opposed to the profit and loss account.

FRSME at paragraph 16.7 requires fair values to be obtained where they can be obtained without undue cost or effort, with any changes in fair value being recognised directly through the profit and loss account (income statement). There would not be any effect on the tax liability as no gain or loss for tax purposes would arise until disposal of the asset.

Fixed asset (Non-current asset) revaluation

Current GAAP allows classes of fixed assets to be revalued to market value and FRS 15 *Tangible Fixed Assets* requires these valuations to be kept up to date where the revaluation model is adopted.

Under *FRSME* at paragraph 17.15, revaluation of property, plant and equipment is not permitted.

Borrowing costs

If an entity constructs its own asset (for example its own building), FRS 15 *Tangible Fixed Assets* permits borrowing costs to be capitalised as part of the cost of the asset.

FRSME at paragraph 25.2 prohibits borrowing costs being capitalised and such costs must, therefore, be written off to the profit and loss account (income statement) as they are incurred.

Intangible assets – development costs

SSAP 13 *Accounting for Research and Development* allows development costs to be capitalised if, and only if, certain criteria are met:

- Clearly defined project.
- Related expenditure is separately identifiable.
- Technically feasible.
- Commercially viable in light of factors such as likely market conditions, public opinion and consumer and environmental legislation.
- Adequate resources exist to complete the project.
- Further development costs to be incurred on the same project will be more than covered with related revenues.

Paragraph 18.14 of *FRSME* requires internal development costs to be written off as they are incurred, unless they meet the recognition criteria at paragraph 18.4 of *FRSME* which says an intangible asset can be recognised if, and only if:

- It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity.
- The cost or value of the asset can be reliably measured.
- The asset does not result from expenditure incurred internally on an intangible item.

Goodwill and intangible assets

FRS 10 *Goodwill and Intangible Assets* allows an entity to amortise goodwill and intangible assets if the useful economic life of these assets are deemed to not exceed 20 years. Where the useful economic life is deemed to be longer than 20 years, non-amortisation must be supported by annual impairment reviews to ensure the assets are not carried in the balance sheet at any more than their recoverable amount.

FRSME allows amortisation of goodwill at paragraph 19.23 (A) and other intangibles at paragraph 18.20. However, goodwill will be amortised over a default period of five years unless the goodwill has a longer life (19.23 (A)), whilst intangible assets will be amortised over a default period of ten years if the entity is unable to make a reliable estimate of the intangible asset(s) useful life (18.20).

Revaluation of intangible assets

FRS 10 *Goodwill and Intangible Assets* only permits the revaluation of intangible assets in circumstances where readily ascertainable market values can be obtained. In reality, hardly any intangible assets will have a readily ascertainable market value.

FRSME does not allow intangible assets to be revalued. Paragraph 18.18 states that the entity will continue to measure intangible assets at cost less accumulated amortisation and any accumulated impairment losses. Section 27 of *FRSME* deals with impairment of assets.

Leases

SSAP 21 *Accounting for Leases and Hire Purchase Contracts* contains a 90% 'yardstick' test (amongst other principles) to determine whether the risks and rewards of ownership of the leased asset has passed to the lessee.

FRSME follows the similar principles in IAS 17 *Leases* by saying capitalisation of the lease, and recognition of a liability will occur when substantially all of the risks and rewards have been passed to the lessee

(paragraph 20.4). *FRSME* does not contain the 90% 'yardstick' test. It is also worth pointing out that there are proposals in place to overhaul the area of lease accounting.

Business combinations

FRSME requires the use of the 'purchase method' for all business acquisitions at paragraph 19.6. *FRS 6 Acquisitions and Mergers* also considers the use of 'merger accounting' where specified criteria are met and is to be used only for business combinations that are not acquisitions in substance, but instead the creation of a new entity where no party is dominant.

Revenue recognition

UITF 40 (Application Note G to *FRS 5*) requires revenue to be recognised when a 'critical event' has passed (usually referred to as a 'milestone'). These critical events generally mean when the right to consideration has passed.

FRSME is worded slightly differently and does not specifically refer to a 'right to consideration'. *FRSME* at paragraph 23.14 suggests that the outcome of a transaction can be reliably estimated when all of the following criteria are met:

- The amount of revenue can be reliably estimated.
- It is probable that the economic benefits associated with the transaction will flow to the entity.
- The stage of completion of the transaction at the end of the reporting period can be measured reliably.
- The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

Deferred taxation

FRS 19 Deferred Taxation and *FRSSE* refer to 'timing differences' which recognise the mismatch between the accounting periods in which gains and losses are reported in the financial statements compared to when the tax effects arise. *FRSME* at paragraph 29.15 refers to 'temporary differences' which are concerned with the carrying amount of assets and liabilities in the financial statements compared to the effect on taxable profit if the associated assets or liabilities had been sold or settled at the balance sheet date. This approach is more complex than the *FRS 19* approach and will give rise to many more deferred tax provisions being made.

FRS 19 also allows deferred tax balances to be discounted to present day values, whereas *FRSME* prohibits such a practice (paragraph 29.53).

Associates and joint ventures (consolidated financial statements)

FRS 9 Associates and Joint Ventures requires joint ventures to be accounted for using the gross equity method whilst associates are accounted for under the equity method.

FRSME (sections 14 and 15 respectively) allows three choices - the cost model, the equity method and the fair value model. However, where there is a quoted price (for example on a recognised stock exchange) *FRSME* requires the fair value model to be adopted.

Defined benefit pension schemes

FRSME provides a number of simplifications where the valuation basis (the Projected Unit Credit Method) would require undue cost or effort. *FRSME* also does not require the use of an independent actuary to provide a triennial valuation as current UK GAAP does, provided the entity is able to do so without undue cost or effort (paragraph 28.18).

Stock (inventory) valuation

SSAP 9 *Stocks and Long Term Contracts* allows stock to be valued using a 'last-in first-out' (LIFO) method.

Paragraph 13.18 of *FRSME* follows the same treatment in IAS 2 *Inventories* and prohibits the use of LIFO as a basis for inventory valuation.

Accounting policies

The *FRSSE* runs in conjunction with full FRS/SSAP and Task Force Abstracts and requires the preparer of the financial statements to default back to full FRS or another financial reporting framework (for example IFRS or US GAAP) to decipher the accounting treatment (or best practice) of an issue which is not specifically addressed.

As UK standards, in their current form, will no longer exist, *FRSSE* users will fall back to *FRSME* if *FRSSE* does not cover a transaction or event.

FRSME, however, is a stand-alone standard and in the event that a transaction or event is not covered in *FRSME*, it would require the directors to develop an accounting policy for an issue not addressed by it having regard to the concepts and pervasive principles within *FRSME* detailed at paragraph 10.4.

Specialised activities

FRSME gives specific guidance on the accounting treatment of agricultural assets, extractive industries and service concessions at section 34 *Specialised Activities*.

Steve Collings is the audit and technical director at Leavitt Walmsley Associates Ltd. He is also the author of 'The Interpretation and Application of International Standards on Auditing' (published February 2011) and lectures on financial reporting and auditing issues.