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Audit & Accounting Bulletin November 2010



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Financial Reporting Standard for Medium Sized Entities (FRSME)

Will the move to the FRSME impact my company financial statements?

Introduction

On 29 October 2010, the accounting standards board issued its proposal to introduce an international based financial reporting framework for UK companies which are not publicly accountable. It is likely that your business will be impacted by this proposed change unless it has already adopted full International Financial Reporting Standards (“IFRS”) or is small enough to be able to adopt the existing Financial Reporting Standard for Smaller Entities (FRSSE).

When will the changes kick in?

The change is currently planned for accounting periods beginning on or after 1 July 2013. Since financial statements require comparatives, this means that, at changeover, comparatives in respect of accounting periods beginning on or after 1 July 2012 will also need to comply with the FRSME. In practical terms the planning process needs to be thought about sooner rather than later.

What exactly is the FRSME?

FRSME is proposed to replace current UK GAAP and is based on the principles of the IFRS as adapted for Small and Medium Sized Entities. At present the FRSME is only a proposal but one that is expected to become fact in due course following consultation.

The proposed adoption of the FRSME will impact disclosures, format, and, most importantly, *for many companies, changes to the numbers as well.*

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Will my company be affected?

All publicly accountable entities

These will continue to follow the current full International Financial Reporting Standards

Non publicly accountable entities

Will need to apply FRSME

Small entities without public accountability

Can continue to apply the FRSSE or voluntarily adopt FRSME

In short, unless your company has listed securities or qualifies under the Companies Act “small” rules, the FRSME will apply. As a reminder, small companies are those which meet at least two of the following:

- + annual turnover must be not more than £6.5 million;
- + the balance sheet total must be not more than £3.26 million;
- + the average number of employees must be not more than 50.

What is the likely impact of the FRSME on financial statements?

As you might expect that are numerous differences, some major and many others not so.

As well as changing the format of and disclosure in financial statements there will be:

- + changes in how and when certain gains and losses are recognised;
- + different rules in respect of the recognition of some assets and liabilities; and
- + changes in the actual measurement basis of some items.

This bulletin does not try to give detail on all of the changes that are proposed but the table overleaf sets out what we believe are the main areas where the differences in treatment could have an impact on the financial statements.

Impact assessment

The costs and benefits of applying the FRSME will vary considerably between companies.

Initial costs will include the following:

- + initial training;
- + updating/new software;
- + internal preparation costs;
- + external advice on preparation;
- + costs of auditing the change;
- + more complex calculations in certain instances due to the use of fair value.

Want to know more?

This bulletin only introduces the main issues. If you need further details or advice on the impact on your company please call your relevant Audit or Accounts Manager.



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| What? | Main differences |
|----------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Tangible fixed assets - becomes Property, Plant and Equipment. | <p>No option to revalue at all. All such assets must be measured at cost less depreciation and any impairment.</p> <p>No longer able to capitalise finance costs attributable to the construction of an asset - must be expensed as incurred.</p> <p>Transition rules are expected to allow existing revaluations and capitalised finance costs to remain in place.</p> |
| Investment Property | <p>The FRSME requires annual revaluation to fair value with all ups and downs recognised in the income statement.</p> |
| Investments | <p>Will make it mandatory to revalue listed investments each year to fair value - all such movements will be recognised in the income statement. UK GAAP allows a choice of cost or valuation.</p> |
| Goodwill and intangibles | <p>No longer allowed to justify an indefinite life. If unable to reliably estimate useful life then must default to ten years.</p> <p>For goodwill the useful life is presumed to be 5 years unless a longer life can be adequately justified. Currently, UK GAAP deems a maximum life of 20 years unless longer can be justified.</p> <p>No revaluation of intangibles allowed.</p> <p>Development expenditure internally incurred must be expensed and cannot be capitalised.</p> <p>On business acquisitions also more likely that separate intangibles will be identified outwith goodwill.</p> |
| Deferred taxation | <p>More complex to calculate than UK GAAP with many more deferred tax provisions being made. Further, the practice of discounting deferred tax is prohibited.</p> |
| Financial instruments | <p>Many financial instruments that would be disclosed but not recognised on the balance sheet under UK GAAP will be recognised in the financial statements and will require to be measured at fair value each year with movements recognised in the income statement.</p> |
| Forex and forward forex contracts | <p>Must be recognised as financial instruments and put on the balance sheet.</p> |



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| What? | Main differences |
|------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Final salary / defined benefit pension schemes | Introduces a number of simplifications compared to UK GAAP. Also does not require the use of an independent actuary whereas UK GAAP requires a qualified actuary to value the scheme at least every three years. |
| Government grants | Where there are performance conditions attaching to the grant, the income is only recognised when such conditions are satisfied in full. Likely to mean grant revenue will need to be recognised in a single period when the conditions are met, rather than spread to match the related expense. |
| Leases | Leases must be capitalised and the related liability recognised when substantially all the risks and rewards have been passed to the lessee. Not dissimilar to UK GAAP except no 90% yardstick test in determining "substantially". |
| Business combinations | Not allowed to use merger accounting. All business combinations must use acquisition accounting. |
| Revenue recognition | UK GAAP requires revenue to be recognised when a critical event or milestone has passed - usually meaning the right to receive consideration has passed. FRSME is slightly different and does not refer to a right to consideration. Revenue must be recognised when the outcome of a transaction can be reliably estimated. |
| Stocks/Inventories | Prohibits the use of LIFO as basis for stock valuation. |
| Presentation currency | Unlike UK GAAP, the FRSME allows the translation of financial statements in to any currency. |
| Accounting policies for FRSSE accounts | The FRSSE runs in conjunction with UK GAAP and where FRSSE is silent on how to treat an item the financial statements must follow full UK GAAP. With the introduction of FRSME, UK GAAP will no longer exist and the requirement will therefore be to follow FRSME if the FRSSE does not deal with a transaction or event. |

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