

6 FRS 102 EMERGING ISSUES: PART 2

(LECTURE A610 – 13.40 MINUTES)

We continue to examine some of the issues faced by practitioners as they transition to 'new' UK GAAP as a means of assisting firms produce financial statements under the new regime which can stand up to scrutiny and are technically correct. As noted in the previous accounting and audit update course, the introduction of new accounting standards invariably brings some uncertainties as to accounting treatments and disclosures and in all cases it is advisable to seek advice from a reputable training organisation or your professional body's technical helpline to ensure the financial statements reflect the correct accounting treatment or disclosure requirement.

In this quarter's update, we examine the following emerging issues:

- Goodwill
- Government grants
- Adjusting versus non-adjusting events
- Tax reconciliation note
- Abridged financial statements

6.1 **Goodwill**

Goodwill continues to be a contentious issue in terms of its treatment under FRS 102. Section 19 *Business Combinations and Goodwill* deals specifically with the issue of goodwill at paragraphs 19.22 to 19.24 with cross-references to paragraphs 18.19 to 18.24 in respect of amortisation (Section 18 deals with Intangible Assets other than Goodwill). A cross-reference to Section 27 *Impairment of Assets* is also included in paragraph 19.23(b) for measuring impairment of goodwill.

The Glossary to FRS 102 defines 'goodwill' as:

*'Future economic benefits arising from **assets** that are not capable of being individually identified and separately recognised.'*¹

Goodwill arises when the cost of a business combination exceeds the net assets acquired. In addition, purchased goodwill can also arise in the financial statements of a company; for example, when a company acquires the net assets from the old sole trader business.

6.1.1 **Amortisation**

FRS 102 does not allow goodwill to have an indefinite useful life. In contrast, previous UK GAAP contained a rebuttable presumption that the useful economic life of goodwill was 20 years. In some cases, goodwill was not amortised because management deemed it to have an indefinite useful life. For some smaller companies that have recognised goodwill on the balance sheet when the entity first incorporated, goodwill is still recognised at its original amount as it has never been amortised. It is this sort of treatment which must change under FRS 102.

¹ FRS 102 Glossary **goodwill**

Under previous UK GAAP, if goodwill was judged to have an indefinite useful life, it should have been tested for impairment at each balance sheet date. Where goodwill was being amortised, it was commonplace to amortise it over 20 years due to the rebuttable presumption contained in FRS 10 *Goodwill and intangible assets*. The 20-year amortisation method was also popular because if the entity chose a longer period, or assigned an indefinite life to goodwill, impairment provisions were triggered which can be arduous.

While there may have been some uncertainty when management chose the 20-year useful economic life, the uncertainty would have been around whether the life was longer, rather than shorter. On transition to FRS 102, entities are required to assess their accounting policies for compliance with FRS 102 and also assess whether they continue to remain appropriate. Where goodwill has, say, 15 years left to run at the date of transition, it would not be appropriate to reduce the useful life to a maximum of 10 years unless there was clear evidence that goodwill only has a remaining useful life of 10 years at the date of transition. If there is a need to reassess the useful life of goodwill, the new estimate is applied prospectively from the date of transition as changes in useful lives are changes in estimation which are accounted for prospectively (i.e. going forwards) under Section 10 *Accounting Policies, Estimates and Errors*.

6.1.2 Internally generated goodwill

Some entities have recognised internally generated goodwill on the balance sheet on the grounds that the business is successful and is worth more than the value of the net assets under the control of the company. Management justify this treatment by saying they have an efficient management structure, good customer relationships, a well-established reputation and increasing sales year-on-year.

While this may be true, recognising internally generated goodwill is not permitted under FRS 102 (paragraph 18.8C(f)), nor was it permitted under previous UK GAAP at FRS 10 (paragraph 8). Therefore, where internally generated goodwill has been recognised, it should be removed.

6.2 Government grants

Government grants are often provided to entities for various reasons, such as setting up operations in a deprived part of the country, towards the cost of an asset or to reimburse previously incurred costs. Government grants are dealt with in Section 24 *Government Grants*. Section 24 is based on the provisions in *IFRS for SMEs* which introduced a performance model (that was not contained in previous UK GAAP at SSAP 4 *Accounting for government grants*) but the FRC made amendments to Section 24 by introducing an accounting policy choice for entities so they can use either the performance model or the accrual model (the latter being the model used in old UK GAAP).

Micro-entities reporting under the provisions of FRS 105 cannot use the performance model; they must only apply the accrual model.

There appears to be some confusion as to the new performance model; presumably because it did not feature in old UK GAAP.

The performance model allows some grants to be recognised immediately in profit and loss, even if they relate to assets, provided that the 'performance-related conditions' have been met. The phrase 'performance-related conditions' is defined in FRS 102 as:

'A condition that requires the performance of a particular level of service or units of output to be delivered, with payment of, or entitlement to, the resources conditional on that performance.'

The performance model works as follows:

- (a) A grant that does not impose specified future performance-related conditions on the recipient is recognised in income when the grant proceeds are received or receivable.
- (b) A grant that imposes specified future performance-related conditions on the recipient is recognised in income only when the performance-related conditions are met.
- (c) Grants received before the revenue recognition criteria are satisfied are recognised as a liability.

Care must be taken, therefore, to ensure that the entity receiving the grant has complied with **all** the performance-related conditions attached to the grant prior to recognising it in the profit and loss account.

6.2.1 Accrual model

The accrual model works in the same way as it did under previous UK GAAP.

Under previous UK GAAP, some entities had incorrectly credited a capital-based grant to the cost of the asset to which it relates. This meant that the grant would have been recognised in the profit and loss account by way of reduced depreciation charges. The problem with this accounting treatment is that the Companies Act 2006 says that fixed assets measured under the historical cost accounting rules are to be stated at their purchase price or production cost. The statutory definitions of 'purchase price' or 'production cost' make no provision for any deduction from that amount in respect of grants.

FRS 102 does clarify at paragraph 24.5G that capital-based grants which relate to fixed assets must be recognised as deferred income and not deducted from the carrying amount of the asset.

For practitioners acting for academy schools which receive capital grants to acquire fixed assets, these must be recognised in the statement of financial activities and not deferred over the life of the asset (see paragraph 5.27 of the Charities SORP (FRS 102)).

6.3 Adjusting and non-adjusting events

Section 32 *Events after the End of the Reporting Period* provides the guidance an entity should follow where post balance sheet events are concerned. There are no differences between the requirements of Section 32 and previous UK GAAP (FRS 21 *Events after the balance sheet date*).

Adjusting events are those events which provide evidence of conditions that existed at the end of the reporting period. Classic examples include the bankruptcy of a customer shortly after the balance sheet date; sale of stock which confirms that estimated selling price is lower than cost (hence a write-down); and the discovery of fraud or error which show the financial statements are incorrect. Such adjusting events are reflected in the financial statements regardless of the fact that they arise after the balance sheet date but before the financial statements are authorised for issue (as their conditions were in existence at the balance sheet date).

Non-adjusting events are those which are indicative of conditions which arose after the end of the reporting period; i.e. their conditions did not exist at the balance sheet date. Paragraph 32.11 of FRS 102 outlines some examples of what it considers to be non-adjusting events including plans to discontinue an operation, the classic case of a fire destroying a production plant and commencement of major litigation arising out of events that occurred after the balance sheet date.

6.3.1 Dividends

Dividends frequently cause issues for practitioners in either recognising them as a liability or when it comes to disclosing them in the financial statements.

Paragraph 32.8 of FRS 102 confirms that dividends cannot be recognised in the financial statements until they are appropriately authorised and are no longer at the discretion of the entity.

When dividends are declared prior to the balance sheet date, but paid after the balance sheet date, it is necessary to consider whether the declaration is legally binding. In the case of a final dividend, the dividend becomes legally binding when it is declared in general meeting (for private companies by way of the passing of a written resolution). Interim dividends authorised under common articles of association will normally become legally binding when the dividend is paid. Therefore, if an interim dividend is announced before the balance sheet date, but paid after the balance sheet, this will usually not result in a liability being recognised at the balance sheet date (although measures may be put in place which create a legally binding liability for an interim dividend, hence it is important to establish whether such steps have created a liability for an interim dividend).

There are no disclosure requirements in FRS 102 concerning dividends declared after the balance sheet date. However, paragraph 43 of Schedule 1 to the Accounting Regulations requires the following to be disclosed:

- (a) any amount set aside or proposed to be set aside to, or withdrawn or proposed to be withdrawn from, reserves,
- (b) the aggregate amount of dividends paid in the financial year (other than those for which a liability existed at the immediately preceding balance sheet date),
- (c) the aggregate amount of dividends that the company is liable to pay at the balance sheet date, and
- (d) the aggregate amount of dividends that are proposed before the date of approval of the accounts, and not otherwise disclosed under subparagraph (b) or (c).

6.4 *Abridged financial statements*

SI 2015/980 amended the filing requirements for small and micro-entities and this continues to cause confusion among the profession. As practitioners will be aware, abbreviated financial statements are no longer with us. Some practitioners are under the impression that abridged financial statements are the new abbreviated accounts – which is not the case.

Abridged financial statements are those financial statements which are prepared for the shareholders, following unanimous consent by all the shareholders and a statement is made on the balance sheet that the shareholders have unanimously consented to the entity preparing abridged financial statements. The abridged profit and loss account (assuming a Format 1) will start with gross profit or loss; the abridged balance sheet will still look the same as if a full balance sheet had been prepared and the notes will be condensed as those items preceded by Arabic numerals will not feature in the notes (for example the fixed assets reconciliation table).

6.4.1 Approval protocol

The Act requires the shareholders to unanimously agree to the entity preparing abridged financial statements each year; in other words, one agreement cannot cover all subsequent accounting periods. This is because the shareholders can only agree to preparing abridged financial statements for the preceding financial year and the approval must be sought **BEFORE** the abridged financial statements are prepared.

Some practitioners are under the impression that abridged financial statements only need one approval by the majority of the shareholders (after the abridged financial statements have been prepared). This is not the case for the reasons stated above; nor is it a majority vote – if there are six shareholders, five agree to the entity preparing abridged financial statements and the one shareholder does not, the company cannot prepare abridged accounts.

Some practitioners are obtaining resolutions from the shareholders confirming their approval for the entity preparing abridged financial statements; others are requesting other forms of agreement such as letters. The important point is to ensure that you have a copy of the agreement of all the shareholders to protect yourself against any comeback if the shareholders are involved in a dispute.

6.5 *Tax reconciliation note*

Under previous UK GAAP, FRS 19 required a reconciliation of the current tax charge (credit) per the profit and loss account to the profit before tax multiplied by the applicable corporation tax rate. Reviews of files indicate the new requirements under FRS 102 are misunderstood.

FRS 102 at paragraph 29.27(b) requires a reconciliation between:

- (i) the tax expense (income) per the profit and loss account; and
- (ii) the profit or loss before tax multiplied by the applicable tax rate.

The relationship between the two can be affected by various items, such as tax-free income, disallowable expenditure, differing tax rates, adjustments to prior year tax values, changes in corporation tax rates and utilisation of tax losses.

The starting point for the tax reconciliation note is to determine the applicable tax rate. Paragraph 29.27(d) also requires an explanation of changes in the applicable tax rate(s) compared with the previous accounting period (again, small companies need not disclose this information).

Example – Tax reconciliation note

8. Tax on profit

The tax charge is made up as follows:

	2017 £'000	2016 £'000
UK corporation tax at 19% (2016: 20%)	758	529
Adjustments to tax in previous years	(71)	(7)
Deferred tax:		
Origination and reversal of timing differences	(302)	(111)
Effect of decrease in tax rate on opening provision	(1)	-
Tax on profit	384	411
	2017 £'000	2016 £'000
Profit before tax	1,247	1,191
Profit before tax multiplied by the standard rate of corporation tax in the UK of 19% (2016: 20%)	237	238
Expenses not deductible for corporation tax purposes	302	108
Decelerated capital allowances	(84)	72
Adjustments to tax in respect of previous years	(71)	(7)
Total tax expense	384	411