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30 April 2015

Our ref: 01/JCC/FRED 58: Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime (February 2015)

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Dear Jenny,

FRED 58: Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime (February 2015)

We are pleased to have the opportunity to comment on the exposure draft "FRED 58: Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime (February 2015)" (FRED 58 or the Exposure Draft).

We support the general principle that, where possible, the language and terminology used in FRED 58 should be consistent with that used in FRS 102. We also agree that, in the context of an inability to require the disclosure of accounting policies, the only viable alternative is to eliminate any accounting policy choices from the Exposure Draft. In our view, however, there are transactions for which it would be more appropriate to opt for a requirement to capitalise, rather than to recognise them immediately in profit or loss, notwithstanding that the latter is undoubtedly the simpler treatment.

We have two principal concerns about the proposals set out in FRED 59, namely:

- Structure - We think that the extensive use of cross-referencing and the pursuit of the aim of consistency between FRED 58 and FRS 102 have caused the requirements in the Exposure Draft to be less accessible and understandable than may otherwise have been the case. Consequently, like the Financial Reporting Standard for Small Entities before it, we think that the structure and paragraph numbering in FRED 58 should have been drafted independently from FRS 102.
- Financial instruments - We are concerned that amortised cost is defined differently in FRS 102 and FRED 58. We think that the use of the same term to describe different measurement methodologies is potentially confusing and misleading. We also think that the level of simplification that has been required in sections 11 and 12 means that the financial instruments' provisions should no longer be split between two sections. In our view, the continuation of the 'two section' approach is an unnecessary complicating factor in an already complex area of the Exposure Draft.

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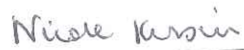
Our detailed responses to the questions raised in the Exposure Draft are set out in the attached appendix. If you wish to discuss any of the points further, please do not hesitate in contacting me.

Yours sincerely,



BDO LLP
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Appendix: Responses to the questions raised in ***FRED 58: Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime (February 2015)*** (the Exposure Draft or FRED 58)

Question 1

Draft FRS 105 has been developed with [consistency with FRS 102] in mind and this FRED presents the draft standard such that the language and terminology of FRS 102 (where the underlying recognition and measurement requirements of draft FRS 105 are the same), and the section and paragraph numbering of FRS 102, has been maintained. Those sections and paragraphs that have been deleted (either because of legal compliance (see Question 2) or because further recognition and measurement simplifications have been introduced (see Questions 3 to 8)) are replaced with the term "[not used]". Where the recognition and measurement requirements have been simplified in draft FRS 105, this consistency has not necessarily been maintained. Do you agree with this approach? If not, why not? What alternative presentation do you propose?

Whilst we support the general principle that, where possible, the language and terminology used in FRED 58 should be consistent with that used in FRS 102, we question the need for its structure also to mirror that used in FRS 102. Given that the proposed wording for paragraph 10.5 in the Exposure Draft (How to deal with transactions that are not specifically addressed in FRED 58), does not make any reference to FRS 102, we do not think that striving for consistency of structure between the two standards brings significant benefits. We note that the Financial Reporting Standard for Small Entities (FRSSE) did not attempt to match the structure adopted in "old" UK GAAP and that that approach did not give rise to significant difficulties in the interpretation of the FRSSE.

We think that the approach adopted to the section and paragraph numbering in the Exposure Draft has resulted in FRED 58 being less accessible and understandable than it otherwise might be. We think that the fact (noted in the introduction to question 1 in the Exposure Draft) that the bulk of entities opting to use FRS 105 will be those that do not expect to grow and move through the different reporting frameworks over time is a strong reason to seek to maximise the ease of use of the standard, on a stand-alone basis, even if it means that direct comparability with FRS 102 is lost. We do not believe that the structure suggested in FRED 58 achieves this aim. Our principal concerns regarding the structure of FRED 58 are set out below:

Maintenance of consistency with FRS 102

As you note in question 1, where the recognition and measurement requirements have been simplified in FRED 58, consistency with FRS 102 has not necessarily been maintained. Three different approaches to dealing with differences between the requirements of FRS 102 and FRED 58 have been adopted in the Exposure Draft, namely to:

a) Mark an existing FRS 102 paragraph as unused (eg FRS 102.1.2A contains guidance whereas it is proposed that FRS 105.1.2A will read "[Not used]");
b) Add a new paragraph into FRS 105 (eg FRS 105.1.2B contains guidance but there is no equivalent paragraph in FRS 102); or

c) Amend the wording in existing FRS 102 paragraphs (eg the wording in FRS 102.1.2 is different from that proposed included in FRS 105.1.2).

FRED 58 does not make the significance of each of these approaches clear and, as a result, it is not clear what conclusions, if any, should be drawn from the approach adopted for a particular paragraph. For example, is it the case that identically numbered paragraphs should be assumed to have identical meanings in both FRS 102 and FRED 58 notwithstanding that the language used in them may sometimes be very different, whereas new and deleted paragraphs acknowledge an intended GAAP difference between FRS 102 and FRED 58?

In our view, this lack of clarity on its own eliminates any benefit that the general approach to structure adopted in FRED 58 brings and, in consequence, we propose an alternative approach of numbering sections and paragraphs in the Exposure Draft on a basis that is independent from that used in FRS 102. However, if on finalisation of FRS 105 the FRC intends to continue with the approach adopted in the Exposure Draft, we would strongly recommend that either only paragraphs that are intended to be interpreted in the same way share the same paragraph number in both FRS 102 and FRS 105 or that the significance of the approach taken to the amendment or otherwise of an existing FRS 102 paragraph should be made clearer.

Practicality of approach

It is likely that the recognition, measurement and disclosure requirements in FRS 102 will be amended more frequently than those in FRS 105. Under the FRC's current approach, in order to maintain the objective of consistency, when FRS 102 is amended FRS 105 would also have to be amended, even if that means the insertion of new but "[Not used]" paragraphs and sections. Similarly, the numbering of new paragraphs resulting from amendments to FRS 102 would have to take into account any numbers used exclusively in FRS 105. An example of how this might soon become unnecessarily complicated is, if a new paragraph is required between paragraphs 1.2A and 1.3 of FRS 102, FRS 102 would have to have a "[Not used]" paragraph 1.2B (a paragraph that is currently included in FRED 58 but not in FRS 102) added along with the new paragraph 1.2C. FRS 105 may also need to be amended to show the new FRS 102.1.2C paragraph as "[Not used]".

The alternative approach of using independent numbering in FRS 105 would mean that FRS 105 could remain unchanged for longer periods of time. This would benefit both the users of FRS 105, who would not have to face the potentially confusing situation of having different versions of FRS 105 every time an amendment is made to FRS 102, and the FRC, who would not need to go through the unnecessary complexities described above.

General accessibility and clarity

Finally, irrespective of the points we raise above, we do not think the approach taken to paragraph numbering and cross-referencing maximises the general accessibility or clarity of FRED 58.

Finalising FRS 105 using the proposed approach to paragraph numbering would result in a standard that includes, even on its initial publication, a considerable number of unused sections and paragraphs, and paragraphs that are numbered in an unusual way (eg 1.1, 1.2,.1.2A, 1.2B and 1.3). We think that preparers of micro-entity financial statements will find this unnecessary and confusing.

We also think that there is an excessive use of cross-referencing in FRED 58, which adds to the complexity of the standard. An example where this seems particularly unnecessary is in section 9 of the Exposure Draft. This section includes four substantive paragraphs, one describing the scope of the section, one defining an "intermediate payment arrangement" and two directing the reader elsewhere (ie to section 11 of FRED 58 or to FRS 102). It also includes three separate references to "[Not used]" paragraphs. We think that deleting section 9, relocating the intermediate payment arrangement guidance and revising the scope of section 11 would have been the more accessible and understandable approach to the accounting for investments in subsidiaries and intermediate payment arrangement.

In our view, preparers of micro-entity financial statements would prefer to see a standard that is as short as possible (ie not lengthened through the inclusion of unused and unnecessary sections and paragraphs), which includes "clean" paragraph numbering on its initial publication and which uses cross-referencing only when absolutely necessary.

Question 2

The proposed amendments to align the requirements of draft FRS 105 with company law are discussed in more detail in paragraphs 19 to 31 of the Accounting Council's Advice. Do you agree that draft FRS 105 accurately reflects the legal requirements and exemptions of the Micro-entities Regime including: (a) Its scope; (b) the presentation and formats of financial statements; (c) the prohibition of the use of the Alternative Accounting Rules and Fair Value Rules; and (d) the disclosure exemptions? If not, why not? What further amendments are required?

We have the following comments on how the legal requirements and exemptions of the Micro-entities Regime are reflected in FRED 58:

- Similarly to our comments in part (d) of our response to question 1 of FRED 59, in our view it would be very useful for the final standard to include cross-references to the appropriate parts of the Companies Act 2006 (the Act) and Small Companies and Groups (Accounts and Directors Reports) Regulations 2008 (the Small Companies' Regulations) in order to facilitate a deeper analysis of the requirements included in FRED 58. This could be achieved either through the inclusion of footnotes or adjacent references in the margins to section 1A (an approach previously used in FRS 2) or the inclusion of a more detailed legal appendix.

- Paragraph 4.2 of FRED 58 includes an illustration of a "Format 2" balance sheet, which has been reproduced from the Small Companies' Regulations. Whilst we appreciate that the Small Companies' Regulations use the same approach, we do not think it was necessary to include the requirement that is set out in footnote 6 of FRED 58 in a footnote rather than either as a paragraph in the main body of section 4 or as an additional line item in the illustrative balance sheet. In our view, the use of a footnote increases the complexity of the standard unnecessarily.

- We have not identified an exemption for micro-entities in respect of the disclosures required by sections 410A(2)(a) and 411(1) of the Act. In both these cases, the legislation starts from a position of requiring full disclosure before allowing certain exemptions/requiring further disclosures for companies that are/are not "subject to the small companies' regime". Similarly, we think that the disclosures required by section 844 of the Act should be provided if developments costs are capitalised (as we have suggested in our response to question 5 below). In our view, given that there are so few disclosures that apply to micro-entities, all applicable disclosure requirements included in the Act should be included in FRED 58. We note that this approach has also been proposed for entities subject to the small companies' regime in FRED 59.

- We think that the disclosure required under paragraph 8.8 of FRED 58 is driven by the same company law requirement as has driven FRED 59's proposed disclosure requirement for paragraph 1A.14(l). Assuming that this is the case, we think that identical wording should be used in FRED 58 and FRED 59. Similarly, paragraph 8.9 of FRED 58 uses different wording to describe the same disclosure requirement as is proposed for inclusion in paragraph FRS 102.1A.14(m). We also note that paragraph 8.9 refers to "management" whereas the Act refers to "directors". We think that this change in terminology may be read to require the disclosure of information about a wider group of individuals than the Act requires.

- We think that referring to paragraph 8.8 in subsequent sections of FRED 58, where that disclosure requirement is relevant, is very useful. Without taking this approach, preparers may not form the linkage between the transactions covered by those sections and the related disclosure requirement in section 8.

Question 3

The Accounting Council used the following principles in considering whether further simplifications over and above the legal requirements would be appropriate in draft FRS 105: (a) If the burden of applying the accounting treatment in FRS 102 is not outweighed by the benefits for micro-entities and an alternative, more straightforward, treatment could be identified; (b) if the lack of detail in the formats of the financial statements and/or supporting disclosures would limit the understanding of the financial information presented; and/or; (c) if transactions occur infrequently amongst micro-entities. Paragraphs 32 to 35 of the Accounting Council's Advice provide further detail. Do you agree with these overarching principles and the resulting simplifications proposed in draft FRS 105? If not, why not?

Yes, we agree with the overarching principles used for assessing the need for further simplifications over and above the legal requirements. In particular, for the reasons set out in the Accounting Council's Advice, we see no realistic alternative other than to eliminate accounting policy choices from FRED 58. However, as discussed further in our responses to questions 5 and 6 below, we think there are occasions when the capitalisation and amortisation of some types of income and expense would provide a better depiction of the economic relationships between transactions without adding significantly to the complexity of application of the final standard. In consequence, we do not think that the default position should necessarily be to expense the item immediately, even though that treatment would undoubtedly be the simplest approach.

We agree with the proposed simplifications described in paragraphs 32 to 35 of the Accounting Councils Advice. We note, however, that in using the phrasing "...a micro-entity is *not required* to account for ..." in paragraphs 26.2A (Equity-settled share-based payments) and 29.6 (Deferred tax), FRED 58 may be read as allowing some accounting policy choices. This runs contrary to the stated intentions in the Accounting Councils Advice.

Question 4

The micro-entities regime prohibits the subsequent measurement of assets and liabilities at fair value, therefore financial instruments are measured at cost or amortised cost. Draft FRS 105 proposes a number of further simplifications over and above these legal requirements (see Section 11 Basic Financial Instruments). Paragraphs 44 to 50 of the Accounting Council's Advice provide further details. Do you agree with this approach? If not, why not? Do you believe further simplifications are necessary for micro-entities? If so, please provide further details.

In our view, the financial instruments' requirements in FRED 58 still require significant work. Our principal concerns are as follows:

- Sections 11 and 12 of FRED 58 are good examples of the issue noted in the "Maintenance of consistency with FRS 102" section of our response to question 1 above. In particular, there are several paragraphs in FRED 58 where the wording used differs substantially from that used in the equivalent paragraphs in FRS 102. This makes it difficult to identify substantive differences between the requirements of FRS 102 and those in FRED 58 and to assess whether they are intentional or unintentional. For example, we note that the definition of amortised cost in paragraph 11.15 and appendix 1 to FRS 102 and FRED 58 are different. In our view, if it is it is intended that the subsequent measurement of financial instruments should be different under FRS 102 and FRED 58, this should be made clearer through the use of different terminology (ie amortised cost should not be used to describe two different methods of calculation) and different paragraph numbers should be used.

- The Exposure Draft still requires a micro-entity to differentiate between financial instruments that are within the scope of section 11 and those that are within the scope of section 12. However, unlike under FRS 102 where (in broad terms, at least) section 11 financial instruments are measured at amortised cost and section 12 financial instrument instruments are measured at fair value through profit or loss, the ultimate treatment of financial instruments under sections 11 and 12 of FRED 58 is very similar (cost or amortised cost). In our view, splitting the requirements between two sections adds considerably and unnecessarily to the complexity of an already complex part of the Exposure Draft.

- We agree that micro-entities should not be required to impute interest charges on transactions conducted at below market rates of interest.

- We do not think that the introduction of two methods of calculating the interest charge on a financial liability (ie on a straight line basis for transaction costs (11.14A) and deferral beyond normal credit terms (11.16A) or on a constant rate for all other interest income or expense (11.16A)) is a simplification. In our view, once the financial instrument has been initially recognised interest should always be calculated at a constant rate; preparers would still be able to use a simplified straight line method to the extent that the difference between the two methods is immaterial.

- We think the allowance to expense immaterial transaction costs (which is included in paragraphs 11.13B and 11.14A) is unnecessary as the requirements set out in FRED 58 only apply to material items.

- Whilst we accept that the language used in FRS 102.11.22(e), which describes indicators of impairment, is somewhat opaque, we do not think that this is cause to delete it entirely from FRED 58. In our view to do so risks creating a difference in the circumstances that might be considered an indicator of impairment under each standard. If FRS 102's requirement is considered appropriate but in need of clarification, we think that the underlying wording in FRS 102.11.22(e) should be clarified or the indicators described in FRED 58.11.22(f) and (g) should be provided as examples of what circumstances the wording in FRS 102.11.22(e) is intended to capture.

Question 5

Draft FRS 105 proposes to remove the accounting policy options from FRS 102 in relation to the capitalisation of borrowing costs (Section 25 Borrowing Costs) and development costs (Section 18 Intangible Assets other than Goodwill). The proposed mandatory treatment will be to expense both borrowing and development costs. Paragraphs 42 to 43 of the Accounting Council's Advice provide further details. Do you agree with this approach? If not, why not?

As noted in our response to question 3 above, we agree with the decision to eliminate accounting policy choices.

In terms of the treatment of borrowing costs, we agree with the decision to require the simplest treatment available under FRS 102 (ie to immediately expense them). However, although this would also be the simplest treatment for development costs, we think it would be more appropriate to mandate capitalisation when the appropriate conditions are met.

In our view, where a micro-entity engages in development expenditure that would qualify for capitalisation, they are likely to be a specialist/niche business for which a substantial proportion of their expenditure would relate to the development activities. Matching these development costs to the associated income (through amortisation of a development cost asset) would provide a better depiction of their economic relationship without adding significantly to the complexity of the final standard. We think that mandating capitalisation of the cost of constructing intangible assets would ensure a degree of comparability with businesses that incur costs when constructing tangible assets.

Question 6

Draft FRS 105 removes the accounting policy option from FRS 102 in relation to the treatment of government grants (Section 24 Government Grants). The proposed mandatory treatment will be to apply the performance method. Paragraphs 42 to 43 of the Accounting Council's Advice provide further details. Do you agree with this approach? If not, why not? Alternatives would be to continue to permit the accounting policy choice (ie FRS 105 would allow a choice between the accruals method and the performance method) or to require the accruals method.

As noted in our response to question 3 above, we agree with the decision to eliminate accounting policy choices. However, similar to our suggestion in respect of development costs, we think that the most appropriate mandatory approach for government grants would be the accruals method. In our view, matching the recognition of the grant income with the associated costs would provide a better depiction of the economic relationship without adding significantly to the complexity of the final standard.

Question 7

There are a number of areas within draft FRS 105 where it is proposed that the detailed requirements for a particular type of transaction are removed but a cross- reference to FRS 102 is inserted for micro-entities that have these types of transactions, on the basis that these types of transactions occur infrequently amongst the majority of micro-entities. The areas where this approach has been proposed include: (a) intermediate payment arrangements (Section 9 Consolidated and Separate Financial Statement); (b) trade and asset acquisitions (Section 19 Business Combinations); (c) puttable instruments and examples of compound financial instruments (Section 22 Liabilities and Equity); (d) cash-generating units (Section 27 Impairment of assets); and (e) foreign branches (Section 30 Foreign Currency Translation). Do you agree with this proposed approach in general, and specifically for these types of transactions? If not, why not? Alternatives would be to reproduce the requirements of FRS 102 within draft FRS 105 or for draft FRS 105 to be silent.

Whilst we agree that the types of transactions listed in the question occur infrequently amongst the majority of micro-entities and that, in consequence, FRED 58 should not attempt to produce direct guidance on them, we do not agree with the approach of including specific cross-references to FRS 102 in each section of the Exposure Draft.

We are becoming concerned about the increasing use of cross-referencing which, as we have noted in our response to FRED 59, requires a reader of the standard to flick back and forth extensively within and between accounting standards. This is likely to be both time-consuming and confusing. In our view, if a transaction type is sufficiently rare for it to be considered appropriate to omit direct guidance from FRED 58, then the standard should not make direct reference to it.

An alternative approach to this including specific cross-references to FRS 102 for each unusual transaction type might be to introduce into FRED 58 the more general requirement included in FRS 102.110.5(a) for an entity to look to the requirements and guidance in an FRS or FRC Abstract dealing with similar and related issues.

Question 8

Do you believe that any further accounting simplifications should be made to draft FRS 105 that would be appropriate for micro-entities? If so, please provide specific details of the simplifications you propose and the reasons why the simplification should be made.

No, other than the points we have raised elsewhere in our letter, we do not believe that any further accounting simplifications should have been made in FRED 58.

Question 9

In light of feedback received, the FRC now proposes that a clear statement of the legal position (ie that residents' management companies act as principals) should be included in the Accounting Council's Advice to the FRC (see paragraphs 54 to 59 of the Accounting Council's Advice). This clarification of the legal position should reduce the diversity in practice that currently exists because when an entity enters into transactions as a principal, such transactions should be recorded in its accounts. Do you agree with this approach? If not, why not? What alternative approach do you propose?

Yes, we agree with the approach adopted in FRED 58 in respect of residents' management companies.

Question 10

This FRED is accompanied by a Consultation Stage Impact Assessment. Do you have any comments on the costs or benefits discussed in that assessment?

We have no comments on the Consultation Stage Impact Assessment that relate to FRED 58.