



DRAFT FRS 105 THE FINANCIAL REPORTING STANDARD APPLICABLE TO THE MICRO-ENTITIES REGIME

ICAEW welcomes the opportunity to comment on FRED 58 *Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime* published by the Financial Reporting Council (FRC) in February 2015, a copy of which is available from this [link](#).

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MAJOR POINTS

Setting aside our concerns

1. ICAEW has previously expressed some serious concerns over the UK micro-entities regime which enables very small companies to produce highly simplified accounts that, provided they include the minimum accounting items required by law, are 'presumed' to give a true and fair view. A principal concern has been the adverse impact that a radical simplification of accounts may have on a micro-entity's ability to access credit. On the other hand, we acknowledge that this is an optional regime, and recognise that it is not yet possible to assess with any certainty the true impact of the regime over the longer-term, not least as it is still unclear how many entities will take it up. Therefore, while we continue to have concerns over the micro-entities regime, our focus on reviewing draft FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* has been on its quality and suitability as a financial reporting standard.
2. In general, we support the Financial Reporting Council's (FRC) proposal to introduce the new accounting standard, FRS 105. As noted, financial statements prepared under the UK micro-entities regime are subject to significant simplifications and legal restrictions. Therefore companies choosing to adopt this regime are likely to find a separate, simplified standard very helpful.

Clear and concise

3. We also agree with the decision to develop the new standard from FRS 102 The Financial Reporting Standard applicable in the United Kingdom and Republic of Ireland, amended as required to meet the legal requirements and to reflect the size and nature of micro-entities. This approach will bring important advantages, including reduced training costs, improved comparability between different-sized entities and an easier transition in accounting terms as businesses grow.
4. However, we do not believe that the FRC has yet achieved the right balance between maintaining consistency with FRS 102 and developing a standard that will be sufficiently accessible for preparers. Indeed, we believe that too rigorous a focus on maintaining consistency with the layout, structure and terminology of FRS 102 has limited the overall clarity of the standard. In our view, there should be a greater emphasis on ensuring that FRS 105 is an accessible document tailored to the needs of micro-entities.

RESPONSES TO SPECIFIC QUESTIONS

Question 1:

"The FRC anticipates that entities that do not expect (or wish) to grow outside the qualifying limits of the micro-entities regime are more likely to favour simplicity of structure and language and will not be concerned with consistency with FRS 102; whereas entities that do expect to grow and move through the different reporting frameworks over time, and practitioners and advisors that have a range of clients reporting under different frameworks, are more likely to favour consistency of structure and language across the suite of UK standards.

Draft FRS 105 has been developed with this consistency 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?

5. In developing draft FRS 105, the FRC has sought to strike a balance between an accounting standard which is accessible and understandable for preparers and one that is as consistent as possible with the language, terminology and structure of FRS 102. We agree that consistency with the principles of FRS 102 is important, especially for those micro-entities that grow over time and for practitioners and advisors that have a range of clients reporting under different frameworks.
6. However, as acknowledged by the FRC, there will be many micro-entities applying FRS 105 that do not expect or plan to grow beyond the micro-entities regime. In our view, the need for the final standard to be as clear and accessible as possible for these entities is of paramount importance, and we are concerned that the focus on maintaining consistency with the layout, structure and terminology of FRS 102 has limited the overall clarity of the standard. For example, FRS 102 paragraphs which do not appear in draft FRS 105 are replaced with the words '[not used]'. Yet those paragraphs and sections which are used in draft FRS 105 are not necessarily consistent with their counterparts in FRS 102. As an illustration, as discussed in question 4 below, the accounting treatment for amortised cost in proposed paragraph 11.15 of draft FRS 105 differs significantly from the corresponding paragraph 11.15 in FRS 102.
7. In our view, this approach is confusing and likely to be open to misinterpretation, possibly suggesting a greater level of consistency with FRS 102 than is in fact the case. This would be an unfortunate outcome given that accounts prepared under FRS 105 will be radically different from those prepared under FRS 102 because of the greatly reduced disclosures, and also certain differences in accounting treatment. In our view, the extent and nature of simplifications in FRS 105 are of such significance that a more flexible approach is required. For example, those paragraphs of FRS 102 that are not used in FRS 105 should simply be deleted, with FRS 105 following its own self-contained system of referencing.
8. There is a similar issue with the five sections of FRS 102 not reproduced in FRS 105. In these instances, we find the inclusion of a blank page showing the 'unused' section title followed by the words '[not used]' to be unhelpful. It also adds unnecessarily to the length of the standard. While we agree that it is helpful to keep the numbers and section titles of each chapter consistent with FRS 102, we believe this could be more simply achieved by inserting the words '[not used]' alongside the appropriate section title in the table of contents.
9. To summarise, we believe there should be a much greater emphasis on ensuring that FRS 105 is an accessible document tailored to the needs of micro-entities, with less focus on consistency with the structure, layout and terminology of FRS 102. Any comparisons between the requirements of FRS 102 and FRS 105 would, in our view, be better addressed as an appendix. For example, a table showing how each FRS 105 requirement relates to, or is amended from, the corresponding FRS 102 requirements, and vice versa.

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 (d) the disclosure exemptions? If not, why not? What further amendments are required?

10. In general we agree that draft FRS 105 accurately reflects the legal requirements and exemptions of the micro-entities regime. However, we have some concerns over the proposed scope as outlined in paragraph 1.2, in particular the statement that 'entities excluded from being treated as micro-entities...are not permitted to apply this FRS.' This paragraph does not appear to reflect the position taken in paragraph A3.2 of Appendix III, which states that 'the

requirements of draft FRS 105 may also be appropriate for the preparation of financial information by other reporters of a similar size if appropriate in the circumstances.'

11. Our understanding of paragraph A3.2 is that entities that would meet the qualifying conditions if they were companies would be permitted to apply FRS 105, subject to any restraints of the legal regime within which they operate. If this is the case, we recommend that the FRC first amends proposed paragraph 1.2 to ensure consistency with the position outlined in paragraph A3.2. It must then clarify what it is meant by 'if appropriate in the circumstances.' For example, the proposed definition of a 'small entity' included in the glossary to revised FRS 102 (outlined in FRED 59) includes 'any other entity that would have met the criteria in (a) had it been a company incorporated under company law.' Similar wording with the added proviso that it would also be subject to any other legal regime within which it operates may also be appropriate for FRS 105. However, before doing this it might be helpful for the FRC to discuss with HMRC the acceptability for tax purposes of numbers prepared by unincorporated businesses applying the measurement and recognition requirements of FRS 105.
12. We also note that paragraph 19 of the Accounting Council's Advice states that the micro-entities regime cannot be applied by public benefit entities. For this reason, all the paragraphs and sections of FRS 102 specific to public benefit entities have been removed from draft FRS 105. However, while we agree that some public benefit entities are indeed excluded from the micro-entities regime, for example charities, there are other non-charitable public benefit entities which are not, for example community interest companies. We recommend that the FRC clarifies the status of such non-charitable public benefit entities within Section 1 *Scope* of FRS 105, and considers whether it should cross refer such companies to the relevant sections of FRS 102.

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?

13. Yes, we agree with the overarching principles used to determine the additional accounting simplifications in draft FRS 105. As a result, we are broadly supportive of the resulting simplifications, although we would like to point out that there is a strongly held minority view amongst our members that the elimination of accounting for deferred tax is inappropriate and may lead to uncertainty amongst directors of micro-entities about the level of funds that should be retained in the business to meet future tax liabilities
14. Other issues identified in relation to the proposed amendments are discussed in our responses below and in the Appendix.

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.

15. We agree with the additional simplifications to the accounting requirements for financial instruments. However, we do not find the layout or structure of Sections 11 and 12 to be very clear. For example, proposed Section 11 outlines how the subsequent measurement of certain financial instruments will be at 'amortised cost'. However, the term 'amortised cost' is defined differently from in FRS 102. We believe it would be more helpful and clear to refer simply to 'cost' in this instance. Indeed, we believe the FRC should endeavour to use plain English and familiar terminology throughout these two sections in order that they are as clear and accessible to users as possible. It may also be helpful to include a couple of simple examples of financial instruments such as a bank loan, intra-group loan or transaction deferred beyond normal credit terms.
16. In addition, while Section 12 is called *Other Financial Instruments*, it appears to outline the accounting treatment only for derivatives. We have therefore considered whether it would be more useful if this section were simply called *Derivatives*. Alternatively, the FRC might consider combining Sections 11 and 12 to form one *Financial Instruments* section, with Section 12 becoming 'unused' so as not to disrupt the overall numbering of the chapters compared to FRS 102.
17. We also find proposed paragraph 12.8A on *Contractual Payments* unclear and have struggled to identify the type of situation it is intended to cover. If the FRC has a particular situation in mind we believe it would be more useful to simply explain this within the standard. Otherwise, a preparer may not understand when the paragraph is intended to apply or, when it does apply, what accounting treatment is required. If it has not been drafted with a particular situation in mind, we question the purpose of this paragraph within the standard.

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?

18. Yes. In principle our preference would be to keep the accounting policy options in relation to the capitalisation of borrowing costs and development costs. However, we are acutely aware of the restriction on disclosures that can be required by law in micro-entity accounts. This means that it would not be possible to *require* a company applying the micro-entities regime to disclose details of its accounting policies. As a result, users of those accounts may not have adequate information to understand and differentiate between different policy options. Therefore, on balance, we agree with the decision to remove the accounting policy options.

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.

19. We think the FRC ought to consider this issue again because we have received some very divergent views as to what is the best approach, including whether an accounting policy choice ought to be retained. Some have highlighted how the performance method is the more straight forward approach and therefore more appropriate for micro-entity accounts. Furthermore, this option would be consistent with the principle behind the decision on the accounting policy for borrowing and development costs – that is, the recognition of income and expenses in the

income statement, rather than the deferral of assets/liabilities in the balance sheet. In contrast, however, some view the accruals method as more appropriate in some circumstances. It is also more consistent with the FRSSE and will therefore be more familiar to users.

- 20.** We have also been told in particular that there are some sector specific considerations. The two main ones we have considered are:
- a.** Adopting the accruals method would result in major divergence between charities (which cannot use the micros regime) and non-charitable public benefit entities such as community interest companies (which can).
 - b.** We are aware that some think that the adoption of the performance method would present particular difficulties for the agricultural sector.
- 21.** These sector-specific issues may lead the FRC to determine that this is an area where it would be better to retain an accounting policy choice (ie, accruals and immediate recognition). If, however, the FRC does not believe it possible to allow a policy choice (for the reasons discussed in question 5), we believe the FRC should carefully consider again the effect of restricting the accounting to only one of the options, including the particular impact on specific industry sectors, and hence which approach ought to be deemed the most appropriate. ICAEW would be happy to facilitate further discussions in relation to the sector specific issues referred to in this response.

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.

- 22.** We broadly agree with the detailed requirements that the FRC has chosen to remove and replace with a cross reference to FRS 102. However, we believe that the requirements for intermediate payment arrangements (eg ESOPs) should remain in FRS 105. It is our understanding that these types of transactions are not uncommon in a micro-entities context and they have been subject to controversy in recent years. It may therefore be advisable to set out the accounting treatment for these arrangements clearly in FRS 105.

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.

- 23.** In general we believe that the proposed accounting simplifications are appropriate to the size and nature of micro-entities. However, in our view, there may be scope for a further optional exemption from the requirement to separate out intangibles from goodwill on a business combination.

Question 9:

The FRC's Consultation Document proposed that a new sub-section is added to Section 34 Specialised Activities of FRS 102 for residents' management companies, setting out

requirements that would be developed from the proposals set out in FRED 50 Draft FRC Abstract 1 – Residential Management Companies’ Financial Statements. Only some 32% of respondents to this question agreed with the proposal, with the rest disagreeing (50%) or providing some other response (18%). The most compelling reasons given for not proceeding with the proposal were that:

(a) the issue is too narrow and industry-specific to be dealt with in an accounting standard and inclusion in Section 34 of FRS 102 would open up the FRC to specific requests that could result in the standard becoming unwieldy and difficult to apply; and

(b) interpretations of law and accounting standards should be issued by other means with a significant number of respondents calling for an alternative solution such as sector-specific guidance developed by the FRC or the development of a Statement of Recommended Practice (SORP) by parties outside of the FRC.

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?

24. This question raises a number of issues not strictly relevant to the detailed discussion on draft FRS 105. For this reason, we have addressed this issue separately and will provide the FRC with our comments in a separate representation letter.

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?

25. As noted in paragraph 2, we agree that introducing an accounting standard for micro-entities which is based on the same framework as that used by larger entities has some important advantages. For example, reduced training costs, improved comparability between different-sized entities and an easier transition in accounting terms as businesses grow.

26. Nonetheless, we continue to have concerns over the underlying micro-entities regime, particularly the impact that the simplification of information in accounts will have on the ability of those companies choosing to apply the regime to access credit. We accept that this is a matter of law, and not therefore within the control of the FRC. However, we do believe it is of paramount importance for the FRC to produce an accessible and clear standard which assists in the preparation of these accounts.

APPENDIX

We have reviewed each section of draft FRS 105 and noted a number of additional specific matters, as outlined below:

Section 3 Financial Statement Presentation

1. We are surprised to note that proposed paragraph 3.23 specifies disclosures which are not required by the micro-entities regime. We would not expect this to be problematic given that the disclosures relate to the name of the reporting entity, the date and period covered by the financial statements, and details of the presentational currency. Nonetheless, it may be advisable for the FRC to discuss this point with the Department for Business, Innovation and Skills.

Section 4 Statement of Financial Position and Section 5 Income Statement

2. The statement of financial position and income statement formats outlined in proposed paragraphs 4.2 and 5.2 do not show comparative figures.

Section 8 Notes to the Financial Statements

3. We believe the final sentence of proposed paragraph 8.8 should be redrafted to read 'Micro-entities that participate in defined benefit pension plans ~~multi-employer pension plans~~ may be required to provide the disclosure set out in paragraph 28.40A'.
4. The word 'management' should be replaced with 'directors' in proposed paragraph 8.9 dealing with disclosure of information on advances and credits.

Section 17 Property, Plant and Equipment

5. It is unclear why paragraph 17.21 of FRS 102, which provides guidance on determining the useful life of an asset, has been deleted.

Section 20 Leases

6. We believe that Section 20 could be simplified by removing the paragraphs on sale and leaseback transactions (20.32 to 20.35). In our view, these areas of accounting are likely to be of less relevance to micro-entities and could be replaced with a cross reference to relevant sections of FRS 102.

Section 21 Provisions and Contingencies

7. We do not believe that proposed paragraph 21.16 which sets out the disclosure requirements for contingent assets is a requirement of the micro-entities regime, and it should therefore be removed.
8. We are not convinced by the inclusion of the numerous examples in this section. We believe it might be more useful and concise to cross refer to the examples in FRS 102. Alternatively, the FRC might consider keeping only those examples that are likely to be more directly relevant to micro-entities, for example warranties, cross referring to any further examples in FRS 102.

Section 22 Liabilities and Equity

9. We believe that proposed paragraph 22.5(a) should be deleted. This paragraph has been taken from the equivalent paragraph in FRS 102 and outlines how an 'instrument is classified as a liability if the distribution of net assets on liquidation is subject to a maximum amount'. However, the equivalent paragraph in FRS 102 specifically refers to 'an instrument of the type

described in paragraph 22.4(b)'. Yet proposed paragraph 22.4 in FRS 105 has been completely rewritten compared with its equivalent in FRS 102 and no longer deals with the specified instrument. That is, proposed paragraph 22.5(a) gives an example of something which does not meet the special rule in paragraph 22.4(b) of FRS 102 and therefore lacks meaning without it. Indeed, when considered outside that context, the answer it gives is incorrect.

Section 23 Revenue

- 10.** We believe that the appendix to Section 23 outlining revenue recognition examples should only include those examples likely to be most relevant to micro-entities, cross referring to any further examples in FRS 102.

Section 28 Employee Benefits

- 11.** We believe that references to a defined benefit multi-employer plan should be replaced with 'defined benefit pension plans' in proposed paragraph 28.40A.

Section 29 Income Tax

- 12.** Proposed paragraph 29.6 on deferred tax states that a micro-entity 'is not required to account for deferred tax arising on timing differences at the reporting date.' This wording suggests that while it is not mandatory, a micro-entity could choose to account for deferred tax. For clarity, we suggest that the wording is amended to state that a micro-entity is not permitted to account for deferred tax under FRS 105. Notwithstanding the need for this clarification, we point to our response to question 3, which explains that there is a strongly held minority view that the accounting for deferred tax should not in fact be eliminated from FRS 105.

Section 33 Related Party Disclosures

- 13.** The word 'management' should be replaced with 'directors' in the footnote to Section 33 on page 104.

Section 34 Specialised Activities

- 14.** Please refer to our comments in paragraph 12 of question 2 regarding the need to clarify the scope of FRS 102 for non-charitable public benefit entities. Also, please see our comments in response to question 6 regarding the impact of the government grants accounting policy option on agricultural companies and non-charitable public benefit entities.

Section 35 Transition to this [draft] FRS

- 15.** We believe there is scope to make this section more UK focused, perhaps by making more specific reference to old UK GAAP and the FRSSE.