

**DISCLOSURE SOLUTIONS LIMITED**  
The Old Smithy, Radwinter Road, Ashdon, CB10 2ET  
**Telephone 01799 584053**

Jenny Carter  
FRC  
8<sup>th</sup> Floor  
125 London Wall  
LONDON  
EC2Y 5AS

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**ACCOUNTING STANDARDS FOR SMALL ENTITIES**

Please see below for our response to your consultation document.

We doubt that Exposure Drafts will be issued in time for due process and rigorous cost benefit analyses before they are turned into standards, which again calls into question whether FRC is fit for purpose.

**Question 1.**

No –Micros should be dealt with by a very short new chapter at the front of FRS 102. That chapter should specify the variations from the measurement and recognition rules already in FRS102- hopefully significantly less than you propose, cross refer to an Appendix listing the statutory disclosures and specify that all of the disclosures in FRS 102 are not required..

Putting things into one document would also be extremely beneficial when standards need updating. It might stop FRC from repeating the dreadful mistakes of its predecessors, whereby profits were sometimes measured differently according to which standard regime is chosen, either permanently or simply because of years of delay in dragging the rest into line with the big regime. Common changes from common dates, is also efficient for educating preparers and users and avoids many needless tax disputes, given that accounting profits drive the tax calculations. In our view, a big standard is usually not fit for purpose, if its recognition and measurement rules need simplifying, for what are by volume the overwhelming majority of enterprises. If an IFRS needs simplifying, that should be tackled at a UK- wide standard level in FRS 102-not just at the micro level.

We would prefer that FRS 102 is revised to become the only measurement and recognition standard used by UK entities that are not using IFRS profit measures. At the same time, all disclosures should be moved out of the FRS 102 chapters into separate checklist appendices organised by type of entity e.g

Appendix A micros

Appendix B small companies

Appendix C other small entities

Appendix D medium entities

Appendix E large entities

## **Question 2**

We disagree with three of the five proposed FRSME recognition and measurement departures from normal GAAP, and doubt that some of them really are simplifications. When it suits FRC, you argue that there are benefits in having all entities on the same framework with consistent, comparable reporting and reduced education and training costs. That all goes out of the window when you propose the complexity of different profit measurement rules. You apparently do this without performing any comprehensive cost benefit analysis on your alleged simplifications. Instead you propose the circulation in the UK of over a million misleading company balance sheets every year, that omit, what all other entities have to recognise as liabilities. This is apparently because you imagine that it is simpler for micro-entities, than inserting the liabilities of a type that they have managed to include in their earlier year accounts.

The reality is that micro-accounts are produced by accounting professionals who already know the existing UK GAAP profit recognition and measurement rules. Creating special profit measurement rules for different classes of entity, adds complexity and increases the training costs of those professionals, and the burden of that will inevitably be passed on to their micro-entity clients. There are also substantial costs involved for almost all existing micro entities through prior year adjustments to restate old accounts onto the new micro profit measures. In due course, entities that outgrow the size limits will have to make similar adjustments in the opposite direction to comparative figures, as they move off your proposed micro regime onto FRS 102. All of those accounting adjustment costs will be passed onto the micro entities.

### **1. Valuations**

We accept that you have to act within the law and that those using the statutory micro-entities regime are banned from using the Alternative Accounting Rules and Fair Value Rules in other legislation. That means they cannot follow some FRS 102 mandatory treatments, and are not allowed some of the FRS 102 accounting options. In our experience, it was very rare for micros to have used the now barred rules, so there will be hardly any accounting restatements.

### **2. Deferred taxation**

By contrast, deferred tax provisions are very common amongst micro entities. We consider it foolish for the FRC to deliberately misstate the deemed true and fair net assets of micros by omitting deferred tax liabilities. We have no doubt that inappropriate dividends and directors' remuneration will arise if your proposals on deferred tax go through. We believe that the benefits to users of accounts from having liabilities recognised in the balance sheet, far outweighs the tiny cost to micro-entities of computing those provisions.

It is regrettable that our standards setters are from big firm backgrounds and have virtually no recent experience of micro entity accounts. If they had, they would be aware that micro company deferred tax calculations these days are usually extremely simple and use data already available.

A typical micro-entity only has two sources of timing difference:

A) accelerated capital allowances and

B) corporation tax losses carried forward.

A) is normally the net book value of fixed assets in the balance sheet, because micros will have used annual investment allowances, and already written off for tax purposes all of their fixed assets.

B) is shown on the corporation tax computation.

If B is greater than A there is no deferred tax asset on existing GAAP -on grounds of prudence.

Any deferred tax provision is usually A-B multiplied by the small profits corporation tax rate.

We estimate that the average accountant could perform and process about 30 such deferred tax calculations for the annual cost of one manual prior year adjustment to remove an existing GAAP deferred tax provision. Hence your proposed micro simplification is not really a cost saver.

By contrast one prior year adjustment involves changing at least five previously published numbers:

- a) provisions
- b) net assets
- c) capital and reserves
- d) shareholders' funds
- e) the tax charge
- f) profit after tax

Overstating net assets only for micros is unacceptable, as it will often be the omission of a liability of approximately 1/5 of their fixed assets. Such an overstatement of net assets elsewhere in the balance sheet is not permitted- so why make an exception for deferred tax?

It is sad that FRC contains patronising people that are unofficially explaining the proposal for micros to overstate net assets by omitting deferred tax provisions, as being because users will not understand the provision if there is not an accounting standard requiring disclosures about how it was calculated. In our view it is better to have the right number without explanation than to have no number. Annual accounts are a communications exercise and those micros that want to explain their deferred tax provision should be allowed to do so, even if the law does not permit a standard setter to mandate the explanation.

### **3. Equity settled share based payment**

This is the one area where we genuinely feel that the costs of arriving at a proper profit and loss expense are onerous and therefore we accept, as with the current FRSSE, that micros should be spared the effort. At least the current FRSSE has disclosures to put the reader on warning about such transactions. Your legal inability to mandate disclosures for micros in standards is regrettable, as it turns the clock back to the days where the old myth that share options are cost free, will be perpetuated for those that deal with micros.

### **4. Defined benefit plans**

We acknowledge that there are costs involved in employers accounting properly under normal GAAP for defined benefit plans. However, for the few that have them, we consider it would be foolish to deliberately misstate the deemed true and fair net assets of micros by omitting the actuarial deficit on any defined benefit pension plan, to the extent that it has not resulted in contributions payable. It is only once deficits came on balance sheet (either when FRS 17 came in or via the Appendix to the

FRSSE) that the average UK company appreciated the scale of the problem arising from their pension promises. Moving the deficits off balance sheet for micros, is a backward step, which will result in overdistributions, and excessive directors' remuneration and in due course insolvencies in the micro sector, when the omitted liabilities come home to roost. FRC should take its responsibilities for such consequences more seriously. To ban an EU adopted IFRS required treatment, seems wrong.

Again there are substantial training and education costs for preparers and users of introducing the complexity of a different accounting treatment for defined benefit pensions- just for micros. Micro profit trends will be distorted typically by the sudden release of the provisions for deficits that they have made under previous normal GAAP.

The complexity of having to reinstate pensions provisions when the entity outgrows the micro regime, also has to be taken into account.

It would be more appropriate, if you insist on having a short FRSME, for that document to state that defined benefit schemes are rare for micro entities, but those that have them, should refer to the appropriate part of FRS 102 for the recognition and measurement requirements.

## **5. Capitalising borrowing costs**

Your proposal regarding capitalising these costs is:

Mandatory- for listed groups and others on IFRS

Optional -for companies on FRS 102

Banned for companies using the micro-regime.

We see no legitimate reason for having the complexity of three different rules in three different standards and the transitional complexity this creates as entities grow. You should not ban capitalisation, instead it should be an optional treatment, as with the rest of UK GAAP. To ban an EU adopted IFRS required treatment brings standard setting into disrepute, particularly as it is so easy to permit, but not require capitalisation, which is the UK GAAP status quo and already the rule in FRS 102. A similar ban was previously proposed by the FRC and was quite properly rejected in finalising FRS 102.

If a micro wants to incur the apparent cost and complexity of capitalisation, it should be allowed to do so, without getting dragged into the further costs of a larger disclosure regime en bloc. They should have that freedom, even though we think that few micros will use it.

## **6. Deletion of sections unlikely to be applicable**

FRC should be above conjuring tricks such as pretending there is a low burden on micros because they have a thin rule book created by inserting cross references out of it to FRS 102. To do so, for such common transactions as a micro-company taking over the trade and assets of its predecessor unincorporated business is foolish.

A micro either has material transactions of a type or it does not. It is not FRC's role to speculate on how unlikely it is for a micro to have those transactions. In our opinion, those micros that do have them should read the relevant parts of FRS 102 and follow its recognition and measurement rules.

**Question 3.**

We do not agree. A properly constituted standard setter should be able to impose disclosures that pass a size-related cost benefit test, onto entities regardless of their legal form. Two wrongs do not make a right. Just because our politicians are foolish enough to prevent standard setters from mandating disclosures that they feel are necessary for a company of a certain size, is no reason for FRC to opt out of imposing such disclosures on non-companies of similar size. Their different legal status triggers different disclosure checklists to companies anyway, so having different disclosure requirements to companies is not much of a burden, given that profits are to be measured in the same way.

**Question 4.**

We agree that the FRSSE should be withdrawn and that small entities should apply the recognition and measurement requirements of FRS 102. We generally consider that if it is withdrawn, having three measurement and recognition standard regimes is complex enough namely:-

1. IFRS
2. FRS 102
3. Micros

However, FRC needs to think small first and amend the terminology in FRS 102 so that the terms that millions of small entities are used to using under the FRSSE and UK legislation replace the transatlantic drivel you lazily imported from the IFRS for SME's into FRS 102. There is no good reason for having one set of words in the legislation on accounts that most of your customers have to comply with and using a different set of long winded words in your standard, that they are also expected to comply with. FRC should use a word search in FRS 102 and replace revenue with turnover, income statement with profit and loss account, statement of financial position with balance sheet, inventory with stock, receivables with debtors, payables with creditors etc. You only have to do it once, to save millions of users from having to make the mental adjustments.

Before the FRSSE is withdrawn, we also wish to see FRS 102 amended so that unrealised gains on investment properties are not included in profit for the year-they should go directly to revaluation reserve instead-regardless of whether an entity is small, medium or large.

Equity settled share based payment is another issue where we would consider FRS 102 rules to be unsatisfactory. We would only impose an expense on non-small entities, which is the current rule, rather than your proposal where it is imposed on non-micros. Whilst we recognise the size limits are to be increased, we are not convinced that the costs of this imposition on small entities is justified. It seems FRC are imposing an unnecessary burden on non-micro small entities.

Deferred tax accounting for revaluation gains is something we have always been in favour of for all sizes of entity, as strengthening the balance sheet with a revaluation is misleading if the balance sheet ignores the tax consequences of recovering the revalued amount. Achieving that by dropping the FRSSE is acceptable.

We consider it wrong for you to mention holiday pay accruals as a profit measurement difference from the FRSSE or old UK GAAP. In our experience where the number really was material it was accrued, even going back to the days of SSAP 2. Those that failed to accrue often paid the price when they sold their business on a net assets deal, as the purchasers asserted the accounts missing the accrual were not in compliance with UK GAAP (as warranted).

**Question 5 RMC.**

The vexed issue of RMC's should not be dealt with in Section 34. It will not receive the attention it needs if it is lost in a larger project. In our opinion, there are sufficient problems in the sector for a SORP to be the appropriate way forward given the subject's tortious history.

**Question 6 FRS 102.**

We agree that it is not appropriate to clutter the text of FRS 102 with company law disclosures for medium and large entities. There are so many other bodies that issue disclosure requests that go beyond law and standards, that even if FRS 102 did insert the legal ones, it would still not be a one-stop shop for disclosures for companies. Once you start putting extra disclosures into standards, you have to keep them up to date, and you already seem to be struggling to do that and follow normal due process, even on your own disclosures.

**Question 7 FRS101**

We would be happy to see subsidiaries reporting in the same format as their parent's IFRS group accounts, as it is more efficient. However, we would expect full consultation and due process to be followed before any changes are made to FRS 101.

We believe that users currently see accounts with UK formats and assume profit recognition is on UK GAAP or they see accounts with an IAS 1 format and assume IFRS profit recognition. If IAS 1 presentations are to be allowed for accounts that use non-IFRS profit measures, it needs to be flagged on the face of the primary statements. Such a requirement should be included in the new FRS 101.

There would be a loss of comparability with competitors that are on the usual statutory formats and some trend data would be lost, but they are minor disadvantages compared to the cost of keeping multiple formats going.

Should you require any clarification of the answers please contact Stuart Hastie. Our primary interest is as users of accounts and as an accountancy firm specialising in financial reporting issues.

Yours faithfully

Disclosure Solutions Limited

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