

Association of Accounting Technicians response to FRED 58 Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime

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1. Introduction

- 1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the exposure draft FRED 58 Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime (condoc) released on 19 February 2015.
- 1.2. AAT is submitting this response on behalf of our membership and to support AAT's objective "to advance public education and promote the study of the practice, theory and techniques of accountancy" and for the wider public benefit.
- 1.3. AAT has added comment in order to add value to the process-in-hand or to highlight aspects that need to be considered further.
- 1.4. AAT has focussed on the operational elements of the proposals and has provided opinion on the practicalities in implementing the measures outlined. Furthermore, the comments reflect the potential impact that the proposed changes would have on SMEs and micro-entities, many of which employ AAT members or would be represented by our operationally skilled members in practice.

2. Executive summary

- 2.1. Financial reporting in the UK and Republic of Ireland is undergoing significant changes due to the introduction of FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland. AAT recognises that the need for consistency across UK GAAP is important as this will, in turn, affect the consistency and comparability of financial statements that are prepared by reporting entities of different sizes.
- 2.2. Current UK GAAP does not achieve such consistency and comparability due to the disparate accounting treatments found in the FRSSE and FRS 102. For example the accounting treatment in relation to fair value fluctuations in investment properties are taken to profit or loss under FRS 102 principles, but taken to a revaluation reserve under the FRSSE (effective January 2015).
- 2.3. AAT is in agreement with the FRC's approach in having a separate FRS for micro-entities on the basis that, whilst the recognition and measurement principles largely follow FRS 102 principles they are not entirely the same as further simplifications have been made. In addition, the disclosure requirements are significantly different from the small companies' regime and therefore it is sensible to have micro-entities reporting under a separate framework.

3. AAT response to the Exposure Draft “Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime”

Question 1

In adapting FRS 102 to create draft FRS 105, it is necessary to strike a careful balance between developing an accounting standard that:

- (a) is easily accessible and understandable for preparers of financial statements of entities of this size; yet**
- (b) maintains consistency with:**
 - (i) the language and terminology of FRS 102 (where the underlying recognition and measurement requirements of the two standards are the same); and**
 - (ii) the structure (ie the section and paragraph numbering) of FRS 102 upon which draft FRS 105 is based.**

The advantages of maintaining consistency of structure and language with FRS 102 include:

- (a) increasing comparability in financial reporting between entities reporting under different UK accounting standards; and**
- (b) reducing education and training costs for preparers, advisors, auditors and users of financial statements.**

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 sections 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?

- 3.1. AAT supports the proposal to maintain consistency with the language and terminology of FRS 102 as well as the structure of FRS 102 in the creation of FRS 105.
- 3.2. Furthermore, AAT believes that developing a standard for micro-entities which is based on the language, terminology and structure of mainstream FRS 102 will reduce the number of reporting-complexities encountered by micro-entities as they grow.
- 3.3. AAT concurs that practitioners and advisors will also favour consistency within the UK and Republic of Ireland suite of standards as this will potentially reduce the number of errors within financial statements due to different accounting methodologies. As stated in the Executive Summary (2.1, above), the inconsistency currently present between FRS 102 and the small companies’ regime in the form of the FRSSE (effective January 2015) may cause confusion among practitioners and advisors as well as their clients due to the inconsistency of accounting methodologies within the two standards.

- 3.4. AAT has concerns over the use of the deleted sections as 'not used' within draft FRS 105. This may be confusing to users of FRS 105 and may not be viewed as particularly user-friendly.
- 3.5. While AAT considers that consistency of approach is beneficial, the need to match each paragraph exactly is not considered by AAT to be essential. This concern is further accentuated by the fact that some of the paragraphs in both standards are different in FRS 105 than in FRS 102 and therefore do not cross-refer.
- 3.6. It has been acknowledged in the Exposure Draft in Question 1 that the FRC anticipates that entities that do not expect (or wish) to grow and are therefore more likely to favour simplicity of structure and language, rather than consistency with FRS 102. However, AAT believes that consistency is an important characteristic within the financial statements so that investors (and potential investors) are able to arrive at reasoned and balanced decisions concerning the financial position and performance of the reporting entity.

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?

- 3.7. AAT agrees that draft FRS 105 accurately reflects the legal requirements and exemptions of the Micro-entities Regime.
- 3.8. AAT supports the proposal to emphasise in the Scope section at paragraph 1.2 (con doc) the fact that entities which are not established under company law are not eligible to apply the micro-entities regime.
- 3.9. AAT believes this to be important because the term 'micro-entity' or 'micro-entities' may not necessarily be interpreted by preparers as being applicable to only those entities that are incorporated companies under the Companies Act 2006 and the term could otherwise cause the restrictive eligibility criteria to be misunderstood.
- 3.10. AAT agrees that Section 4 *Statement of Financial Position* and Section 5 *Income Statement* in draft FRS 105 accurately reflect the legal requirements of the micro-entities legislation. However, it may be worthwhile including reference in Section 5 to the fact that under the micro-entities regime, only Format 2 is permitted for the income statement and AAT suggests that the wording in 5.2 (con doc) might be better stating (suggested text underlined):

*"A micro-entity shall present its profit or loss for a period in an **income statement** in accordance with Section C of Part 1 of Schedule 1 to the **Small Companies Regulations** (a Format 2 income statement), as follows:"*

- 3.11. AAT believes that making reference to the Format 2 income statement will provide more clarity for practitioners and advisors who may not be familiar with the layout of a Format 2 income statement as traditionally in practice Format 1 profit and loss accounts have been more commonly applied in the financial statements of small entities. Practitioners

not familiar with the Format 2 income statements may, on first glance, be unfamiliar with the layout and question the correctness of the statement.

- 3.12. AAT agrees that draft FRS 105 accurately reflects the prohibition of the use of the Alternative Accounting Rules and Fair Value Rules.
- 3.13. AAT agrees that draft FRS 105 accurately reflects the minimum disclosures legally required in paragraphs 11.46, 12.30, 12.31, 21.15, 21.16 and 28.40A of draft FRS 105.

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 frequently 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?

- 3.14. AAT is broadly supportive of the principles adopted by the Accounting Council in considering whether further simplifications over and above the legal requirements would be appropriate in draft FRS 105.
- 3.15. AAT supports the principle that if the burden of applying the accounting treatment in FRS 102 is not outweighed by the benefits for micro-entities then an alternative, more straightforward, treatment could be identified. Given that micro-entity financial statements are inherently less complicated than those of a larger reporting entity, then if more straightforward alternatives can be identified, it will be of significant benefit to the micro-entity.
- 3.16. However, consideration will have to be given to the impact of any differing accounting treatments in FRS 102 for small entities which might affect the micro-entity as it grows, for example the recognition of additional financial instruments such as derivatives relating to forward foreign currency contracts, or the need to account for deferred tax.

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.

- 3.17. The Accounting Council's Advice in 45 (condoc) states that, "The Accounting Council advises that micro-entities should not be required to impute a market rate of interest

where transactions are conducted at below market rates of interest". Small companies will be less experienced in the application of the amortised cost and effective interest method that is contained in FRS 102 and AAT supports the proposal that micro-entities should not be required to impute a market rate of interest where transactions are conducted at below market rates of interest because this would cause an unnecessary burden on the directors of a micro-entity who may possibly have no experience in arriving at such interest rates.

- 3.18. AAT is concerned that the definition of 'amortised cost' within draft FRS 105 would be fairly difficult to understand by micro-entities. Essentially as the use of fair values is prohibited within the standard, the term 'amortised cost' amounts to 'cost' and it may be beneficial to simplify the definition of amortised cost within the Glossary to reflect the fact that amortised cost is equivalent to actual cost.
- 3.19. AAT agrees with the Accounting Council's Advice in 46 (condoc) in relation to transaction costs which are to be expensed immediately where they are considered to be immaterial. Where such costs are not considered to be immaterial, AAT supports the proposal that they are to be recognised on a straight-line basis over the term of the contract.
- 3.20. AAT believes that it is likely that the directors of micro-entities will rely on advice from their accountancy firms to determine when such costs are immaterial and when they are material.

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?

- 3.21. AAT supports the proposal to remove the accounting policy options in relation to the capitalisation of borrowing costs and development costs on the basis of both the condensed format of the financial statements and the lack of associated disclosure requirements.
- 3.22. AAT agrees with the Accounting Council's Advice in that the removal of such accounting policy options will not only provide less complex accounting requirements for preparers, but it will also allow for consistency across micro-entities that have borrowing and development costs inherent within their businesses.
- 3.23. The only issue which AAT believes withdrawing accounting policy choices for borrowing and development costs might become problematic where the micro-entity is a growing business and hence will report under a more comprehensive framework in the future and therefore will have accounting policy options available to them for such costs. However, such issues should be taken into consideration by the directors, in consultation with their professional advisors, when establishing the most appropriate framework for the reporting entity.

Question 6

Draft FRS 105 remove 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.

- 3.24. AAT does not agree with the outlined approach and has reservations (3.25, below) in respect of the proposed mandatory requirement for micro-entities to immediately recognise government grants in profit or loss under the performance method. Paragraph 24.5B of FRS 102 says that under the performance method, an entity recognises grants 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.*
- 3.25. There may be occasions when a micro-entity receives a government grant which seeks to impose specified future performance-related conditions on the entity and hence to the extent that the performance-related conditions have not been met, some, or all, of the grant may become repayable and hence a liability recognised in the financial statements to comply with the *Concepts and Pervasive Principles* in Section 2 of draft FRS 105.
- 3.26. AAT believes that making the performance method the mandatory accounting treatment in FRS 105 may conflict with the substance of the transaction where the reporting entity still has performance-related conditions to meet at the reporting date and hence AAT would suggest that the accruals method of grant recognition is incorporated within FRS 105 at Section 24 which will allow an entity to defer some, or all, of the government grant if performance-related conditions have not been met.

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 Statements*);**
- (b) trade and asset acquisitions (Section 19 *Business Combinations*);**
- (c) puttable instruments and examples of compound financial statements (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 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 FRS 105 to be silent.

- 3.27. AAT supports the proposal to include cross-referencing to FRS 102 in respect of the above.
- 3.28. Whilst AAT acknowledges that relatively few micro-entities will have such transactions the employment of cross-referencing would seem to be the most sensible option. Notwithstanding the fact that micro-entities are the smallest types of businesses in the UK, there may well be situations where a micro-entity business will encounter such types

of transactions and hence AAT considers it important to have some guidance within the standard as to how the micro-entity should deal with such transactions. This will also help to reduce divergent practices in these areas.

- 3.29. AAT has concerns in respect of reproducing the requirements of FRS 102 within draft FRS 105 on the basis that the standard itself is already quite voluminous. Albeit, due to the additional guidance contained in draft FRS 105. It is AAT's concern that reproducing the requirements of FRS 102 in respect of the transactions listed in (a) to (e) in Question 7 (a) to (e) would only add to this volume as well as adding complexity to a standard which is designed to be deregulatory. As mentioned in 3.27 (above), it is expected that relatively few micro-entities will experience such transactions referred to in Question 7 of the Exposure Draft, and therefore AAT considers the most sensible approach would be to insert cross-referrals to the mainstream FRS 102 for additional guidance.
- 3.30. AAT does not consider it appropriate for FRS 105 to be silent in respect of the treatment of the transactions in Question 7. While relatively few micro-entities will encounter the transactions listed (a) to (e) in Question 7, some may well during their life-cycle. Hence, in such instances, preparers will look to the standard for guidance on dealing with such issues in their financial statements. Thus, it is AAT view, that it would be beneficial to include referencing to the mainstream FRS 102 for ease of use.
- 3.31. Ultimately, AAT is concerned that if the draft FRS 105 were to remain silent, divergent practices are likely to arise and if this proved to be the case it would result in a need for the FRC to provide suitable clarification at some point in the future.

Question 8

Do you believe that any further 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.

- 3.32. AAT does not consider that any further simplifications are needed to draft FRS 105. AAT believes that the micro-entities legislation already makes significant simplifications in major areas, such as the prohibition of the Alternative Accounting Rules and Revaluation model.
- 3.33. The additional simplifications made to FRS 105 by the FRC are considered to be sufficient. To a large extent, simplifications entail removing certain accounting treatments and AAT believes that any further simplifications to draft FRS 105 are likely to create wide disparities between FRS 105 and FRS 102 resulting in increased accounting changes where micro-entities experience growth.

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 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) 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 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?

- 3.34. AAT supports the notion that the issue concerning residents' management companies is too narrow and industry-specific to be dealt with in Section 34 of FRS 102 and AAT also supports the Accounting Council's Advice that no change be made to draft FRS 105 to include residents' management companies.
- 3.35. As residents' management companies are so industry-specific, AAT considers that it would be appropriate to have specific guidance developed in the form of a Statement of Recommended Practice (SORP). However, AAT supports the FRC's intention to include the Accounting Council's Advice to clarify the legal position which would serve to reduce diversity in practice and therefore when an entity enters into transactions as a principal, such transactions are recorded in the accounts.

Question 10

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

- 3.36. AAT supports the introduction of the draft FRS 105 for the reasons set out in the *Consultation Stage Impact Assessment* at paragraph 7(a). While AAT does have some reservations about the deeming provisions contained in the legislation, which states that financial statements prepared under the micro-entities legislation are presumed to give a true and fair view, AAT agrees that the proposals contained in FRS 105 meets the overriding objective for micro-entities choosing to apply the micro-entities regime.
- 3.37. AAT is not in support of the view that draft FRS 105 provides opportunities for cost-savings in the preparation of the financial statements outlined in paragraph 7(b) of the *Consultation Stage Impact Assessment*.
- 3.38. While it is acknowledged that the accounting policy choices are limited in draft FRS 105, reporting entities and/or their advisers must still prepare the primary financial statements (income statement and statement of financial position) in accordance with GAAP requirements (i.e. under the accruals method) and AAT considers the time-saving and hence associated costs of preparing the figures themselves to be negligible. The disclosure requirements in draft FRS 105 are limited to those required by the Companies Act 2006. However, AAT believes that the scope for cost-saving opportunities is likely to be limited due to the wide spread reliance on automated accounts production software systems that historically would have generated generic disclosure notes. Even though the disclosure notes would no longer be required under draft FRS 105 in reality it took very little manual intervention and as a result time to produce.
- 3.39. The limited disclosures inherent in the micro-entities regime may also give rise to a requirement to produce non-statutory information for stakeholders such as banks or HMRC. If this proved to be the case it would inevitably lead to the entity incurring significant additional costs and ultimately negate any negligible cost-savings that might arise as a result of the reduced disclosures.

4. Conclusion

- 4.1. AAT is broadly supportive of the introduction of FRS 105 into the suite of standards which form UK GAAP.
- 4.2. However, AAT believes that micro-entities should have an accounting policy choice in respect of government grants (Q6, FRED 58) as any performance-related conditions may well have to be fulfilled at the reporting date. Therefore inclusion of the full grant in the income statement would contradict the concept of substance over form, i.e. where the micro-entity still has an obligation at the reporting date to perform certain conditions and hence the recognition of some, or all, of the grant as a liability would represent this obligation at the reporting date (3.24-3.26, above). In light of this, AAT would suggest that the accruals method is the mandatory treatment in FRS 105.
- 4.3. In addition, AAT views the cost-savings of FRS 105 cited in the *Consultation Stage Impact Assessment* at paragraph 7(b) to be negligible; particularly in light of the fact that the figures to be included in the primary financial statements would still be prepared to GAAP requirements under the accruals basis of accounting. In addition, third parties (such as HMRC) may also approach the micro-entity seeking further clarification on amounts recognised in the financial statements, thus the need for the entity or their advisor to prepare non-statutory information to fulfil this request will invariably incur additional costs (3.37-3.39, above).

5. About AAT

- 5.1. AAT is a professional accountancy body with over 49,800 full and fellow members and 78,400 student and affiliate members worldwide. Of the full and fellow members, there are over 4,100¹ Members in Practice who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.
- 5.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

6. Further information

If you have any questions in respect of our response or you would like to discuss any of the points that we have made in more detail then please contact AAT at:

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¹ Figures correct as at 31 March 2015