

CONSULTATION

FINANCIAL REPORTING COUNCIL

FRED 58: DRAFT FRS 105 THE FINANCIAL REPORTING STANDARD APPLICABLE TO THE MICRO-ENTITIES REGIME

ABOUT AIA

The Association of International Accountants (AIA) was founded in the UK in 1928 as a professional accountancy body and from conception has promoted the concept of 'international accounting' to create a global network of accountants in over 85 countries worldwide.

AIA is recognised by the UK government as a Recognised Qualifying Body for statutory auditors under the Companies Act 2006, across the European Union under the mutual recognition of professional qualifications directive and as a Prescribed Body under the Companies (Auditing and Accounting) Act 2003 in the Republic of Ireland. AIA also has supervisory status for its members in the UK under the Money Laundering Regulations 2007.

AIA promotes and supports the advancement of the accountancy profession both in the UK and internationally. The AIA exams are based on international financial reporting and international auditing standards and are complemented by a range of variant papers applicable to local tax and company law in key jurisdictions together with an optional paper in Islamic accounting.

AIA members are fully professionally qualified to undertake accountancy employment in the public and private sectors.

SUMMARY

AIA is pleased to respond to the FRC's request for comment on its Exposure Draft FRED 58 which will apply to micro-entities for accounting periods commencing on or after 1 January 2016. Financial reporting in the UK and Republic of Ireland is undergoing a significant period of change with the introduction of an IFRS-based financial reporting framework, namely FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland. It is envisaged that all entities in the UK and Republic of Ireland will report under the recognition and measurement principles contained in FRS 102, although the disclosure and accounting requirements will become more comprehensive and complex the further up the suite of standards reporting entities go.

The incorporation of the EU Accounting Directive (the Directive) into the Companies Act 2006 has resulted in the very smallest entities (termed 'micro-entities') being subject to their own reporting regime as a result of the Directive.

AIA have responded to the specific questions laid down in the FRED as follows:

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 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?

AIA supports the proposal for consistency with both language and terminology in FRS 102. Disparities with both language and terminology exist in UK GAAP at present and it would seem sensible in the new regime to introduce consistent language and terminology.

Having a UK GAAP which is based on a consistent financial reporting framework will reduce the costs of training and education as the micro-entity grows because consistent language and terminology will be used in full FRS 102 and EU-adopted IFRS and whilst disclosure requirements will clearly increase the further up the suite of standards an entity goes as it grows, the fundamental language and terminology will not change.

FRC have suggested that for those micro-entities that do not foresee growth and wish to maintain their status as micro-entities will not be concerned with the consistency of FRS 105 with FRS 102. However, AIA believes that consistency should be maintained as far as possible across all the standards to ensure that financial statements are both consistent and comparable – traits which investors actively look for in financial statements to enable them to make reasoned and economic decisions about the reporting entity.

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?

AIA has looked in detail at draft FRS 105 and would agree that it accurately reflects the legal requirements and exemptions of the micro-entities’ regime, including the prohibition of the use of the Alternative Accounting Rules and Fair Value Rules. The term ‘micro-entities’ could be somewhat misleading for preparers of financial statements who may not understand that the standard can only be applied by incorporated companies (subject to the limitations in the legislation for incorporated companies).

AIA also agrees that the disclosure requirements contained in Sections 11, 12, 21 and 28 of draft FRS 105 accurately reflect the requirements of legislation.

AIA would suggest that more emphasis be included in either the Scope section of Section 5 Income Statement or within the Presentation of profit or loss paragraph relating to the fact that only a Format 2 profit and loss account (income statement) is permitted under the legislation.

AIA also supports the FRC's attempts at expanding the legally required disclosure requirements within the main body of FRS 105 in Section 8 Notes to the Financial Statements as this will serve to help the directors of a micro-entity fully understand what needs to be included within the relevant disclosures.

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?

AIA is supportive of the principles adopted by the Accounting Council in respect of the further simplifications which are over and above the legal requirements. We also support 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. Inherently, micro-entity financial statements are less complex and hence the AIA agree that it is sensible where more straightforward alternatives can be identified then this will clearly benefit micro-entities.

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.

The requirement to account for basic financial instruments at amortised cost and use the effective interest method is, in the opinion of AIA, going to cause an element of difficulty for preparers of financial statements until the concept has become more established. Notwithstanding this difficulty, it is a requirement of FRS 102, but for micro-entities the accounting for financial instruments should be less complicated due to the fact that micro-entities are unlikely to enter into financial instruments with complex terms.

The Accounting Council has advised that micro-entities should not be required to impute a market rate of interest where transactions are conducted at an interest rate which is below market rate. AIA supports this proposal on the grounds that it would be unduly burdensome for micro-entities to arrive at an imputed market rate of interest and the majority of directors of micro-entities may not have the experience or knowledge to arrive at such a rate of interest.

AIA also supports the Accounting Council's advice that transaction costs are to be immediately expensed if immaterial. Where such costs are immaterial, AIA also supports the proposal that they should be recognised in profit or loss on a straight-line basis over the term of the contract. AIA supports this notion on the grounds that the straight-line basis is inherently less complex than other methods of recognition and hence would be deemed appropriate in a micro-entity's particular circumstances.

AIA is broadly supportive of the simplifications made by the FRC over and above the legal requirements, although AIA has concerns about the immediate recognition of government grants in profit and loss (see Question six).

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?

AIA supports the proposals to remove accounting policy choices in respect of borrowing and development costs. The disclosure requirements contained in the micro-entities legislation is extremely minimal and there would be no requirement to make transparent disclosures for a micro-entities concerning their accounting policy choices over borrowing and development costs. Hence AIA are of the opinion that having one prescribed accounting treatment for such costs is appropriate in the circumstances of a micro-entity. This support is further accentuated by the fact that fixed assets will not be disaggregated on the face of the balance sheet.

Consistency will also be maintained across micro-entities by having one accounting treatment for borrowing and development costs. The only concern AIA has is in relation to the accounting treatment of such costs is if the micro-entity grows to the extent that it is required to apply FRS 102 for small entities, full FRS 102 or even EU-adopted IFRS as these standards will allow a choice of accounting treatment (although additional disclosures will be required). However, AIA also acknowledges that the directors of micro-entities must take into consideration the pace at which their micro-entity will grow and should consider a more comprehensive framework if the pace of growth is expected to be rapid.

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.

AIA has concerns about prescribing a fixed accounting treatment for government grants received by a micro-entity (i.e. immediate recognition in profit or loss) as it feels that this may be a departure from the substance over form concept. When a micro-entity receives a government grant, there may be performance-related conditions attached to the grant and Section 24 would otherwise require a liability to be recognised at the reporting date if an entity had not achieved the performance-related conditions attached to the grant – which would accord with the Concepts and Pervasive Principles insofar as recognition of a liability is concerned. Draft FRS 105 does not make any provisions for the fact that a micro-entity might not have achieved all of the performance-related conditions attached to the grant and would instead still require the grant to be recognised in profit or loss which, in the opinion of AIA, contradicts the Concepts and Pervasive Principles in Section 2 of FRS 102 which outlines when a liability should be recognised by a micro-entity.

AIA would suggest that the accruals method of accounting be incorporated within draft FRS 105 so that a micro-entity that has not yet achieved all of the performance-related conditions attached to a government grant would only recognise the grant in income to the extent that the performance-related conditions are met.

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 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 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.

AIA agrees with the FRC's proposal to include cross-references to FRS 102 in respect of the transactions in question seven (a) to (e). This is on the grounds that, whilst relatively few micro-entities might encounter such transactions, the mere fact that an entity is a micro-entity does not preclude them from entering into such transactions. In light of this, AIA believes that having cross-references is a sensible approach and should be incorporated within FRS 105.

AIA does not agree that reproducing the requirements of FRS 102 into FRS 105 would be appropriate because this would result in FRS 105 becoming larger in size and hence be off-putting to those entities that may wish to use FRS 105 and the standard would become cumbersome for its intended users.

AIA also does not agree that FRS 105 should remain silent on the treatment of those transactions contained in question seven (a) to (e) because this will result in confusion on the part of the preparer in establishing appropriate treatment in the absence of any guidance within FRS 105 as well as the emergence of divergent practices where such transactions are entered into.

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 SIMPLIFICATIONS SHOULD BE MADE.

The introduction of the EU Accounting Directive has already made significant simplifications to the way in which financial statements of a micro-entity are prepared, including reduced accounting policies and vastly reduced disclosure requirements. These simplifications have been accentuated by the FRC in not requiring a micro-entity to account for deferred tax or equity-settled share-based payment transactions among other simplifications.

AIA does not consider that any further simplifications to FRS 105 are required. AIA are concerned that any further simplifications will dilute the meaningfulness of the financial statements of a micro-entity which may incur further costs by producing additional information for external stakeholders, such as banks and HM Revenue and Customs. Direct stakeholders have to be provided with meaningful information on which to form reasoned conclusions on the company and any additional simplifications would not be helpful to such stakeholders.

Additional simplifications to FRS 105 may also increase costs for entities that have to apply a more comprehensive framework as they outgrow the micro-entities framework because additional training and educational requirements would be needed so as to correctly apply a more comprehensive reporting standard.

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?

AIA agrees that the issue concerning residents' management companies is too narrow and industry-specific for inclusion within FRS 102 at Section 34. The Accounting Council's Advice to clarify the legal position with the objective of reducing diversity in practice is a proposal that is supported by the AIA and hence it would follow that where an entity enters into transactions as a principal, those transactions are recognised in the accounts.

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?

In the opinion of AIA, the proposals contained in draft FRS 105 do meet the overriding objectives for micro-entities which choose to apply the micro-entities regime in the preparation of their financial statements.

In practice, however, AIA is of the opinion that cost-savings are likely to be minimal (if indeed they exist) because preparers must still prepare financial statements for a micro-entity under the accruals basis of accounting. It is merely the disclosure requirements that are vastly reduced in the financial statements, most of which were produced automatically by accounts production software systems and hence the same amount of work will still be required to arrive at the figures to be included in the profit and loss account (income statement) and balance sheet (statement of financial position), but with reduced disclosure requirements.

In addition, AIA is also of the view that due to the significantly reduced level of disclosure, and condensed line items on the face of the primary financial statements, micro-entities are more likely to require additional and non-statutory information to be produced (such as a detailed trading and profit and loss account) or other information to satisfy the information needs of external stakeholders such as banks, financiers and HM Revenue and Customs and hence any cost-savings which may be achieved by a micro-entity are likely to be eradicated by the production of additional information over and above those required by companies' legislation.

FURTHER INFORMATION

The above replies represent our comments upon this consultation document. We hope that our comments will be helpful and seen as constructive. AIA will be pleased to learn of feedback, and to assist further in this discussion process if requested.

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