



Response to FRC FRED 58:
Draft FRS 105 –
The Financial Reporting Standard
applicable to the Micro-entities Regime

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INTRODUCTION

ICAS welcomes the opportunity to comment on the FRC's FRED 58 – Draft FRS 105: The Financial Reporting Standard applicable to the Micro-entities Regime.

Our CA qualification is internationally recognised and respected. We are a professional body for over 20,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK's and the world's great companies.

Our Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

The ICAS Accounting Standards Committee has considered FRED 58 and I am pleased to forward their comments.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Technical Policy and Secretary to the Accounting Standards Committee.

RESPONSE TO THE CONSULTATION QUESTIONS

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 (i.e. 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 accounting 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?

Response:

We believe the key consideration in the drafting of draft FRS 105 is that it is easily accessible and understandable for preparers of financial statements of entities of this size. It is most likely that the standard will be used by entities that do not expect to grow and move to different accounting frameworks over time, therefore the issue of consistency with FRS 102 is less important. We agree with maintaining the language and terminology of FRS 102, but do not believe it is necessary to strictly follow the numbering of sections and paragraphs. The overall accessibility of FRS 105 could be improved by streamlining this aspect.

Given that the introduction of the micro-entity regime was intended to reduce complexity, the fact that draft FRS 105 is longer than the FRSE may be off-putting to micro-entities and their advisers. We believe the draft standard would benefit from a brief executive summary or accompanying staff education note which sets out the key features, including the main differences from the FRSE (as currently set out in the consultation overview document). We recommend that the FRC should also include paragraph 3.8 of the consultation overview document within this section – we believe it is important that entities are encouraged to consider which accounting framework is most appropriate to their respective circumstances.

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?

Response:

We agree that draft FRS 105 accurately reflects the legal requirements and exemptions of the micro-entities regime. We believe it would be helpful if Appendix III: note on legal requirements also set out in detail the types of entities that are specifically excluded from using the micro-entity regime rather than cross-referring to the Companies Act. This would simplify the decision-making process for entities in determining which standard is available to them. Alternatively, in order to minimise the need to amend the standard, this information could be included separately on the FRC's website. There is a real need for this information to be easily accessible as the current online version of the Companies Act 2006 is not being kept up to date.

Question 3 – Principles for simplifications

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?

Response:

We agree with the overarching principles and simplifications proposed in draft FRS 105. Given the very simplified format of micro-entity accounts, and the limited number of disclosures required, it is appropriate that the FRC make the accounting as simple and consistent as possible. This will help to ensure that micro-entity accounts are understandable and comparable.

Question 4 – Financial Instruments (Section 11 Basic Financial Instruments and Section 12 Other Financial Instruments Issues)

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.

Response:

We agree with the simplifications made in relation to financial instruments. If micro-entities have financial instruments that would not be adequately accounted for under this regime, they should opt to use another accounting framework available to them.

Question 5 – Capitalisation of development costs (Section 18 Intangible Assets other than Goodwill) and borrowing costs (Section 25 Borrowing Costs)

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?

Response:

We agree with the decision to remove the accounting policy option for borrowing costs and development costs to be capitalised as the lack of accounting policy disclosures would otherwise make it impossible to determine what approach an entity has chosen. If an entity wishes to use one of these options, they can opt to use a different accounting framework.

Question 6 – Government grants (Section 24 Government Grants)

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 (i.e. FRS 105 would allow a choice between the accruals method and the performance method) or to require the accruals method.

Response:

We do not agree with the proposal that the mandatory treatment for government grants should be to apply the performance method. This method is likely to result in useful information in relation to revenue grants, however for capital grants, we do not think this is the case. Under existing UK GAAP a grant related to a fixed asset would usually be recognised over the life of the asset. Similarly under FRS 102, an entity is most likely to account for a capital grant using the accruals method. Given the limited disclosures in micro-entity accounts, we believe the application of the performance method to a grant for a fixed asset could result in confusing information being presented, and may also be inconsistent with the way a similar grant would be accounted for under FRS 102. Therefore, we suggest that the mandatory treatment should be the performance method for revenue grants and the accruals method for capital grants.

Question 7 – Simplifications via cross-referencing to requirements in FRS 102

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.

Response:

As the FRC notes, these types of transactions are expected to occur infrequently amongst the majority of micro-entities. In the interests of ensuring that draft FRS 105 is as simple as possible, we would prefer the standard to be silent on these topics – the FRC should consider whether it should include some wording similar to paragraph 10.6 of FRS 102 e.g. ‘management may also consider the requirements and guidance in FRS 102 for similar transactions.’

Question 8 – Other simplifications

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.

Response:

We do not believe any further simplifications are necessary.

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?

Response:

We agree that the issues of residents’ management companies should not be addressed in the main body of the standard for the reasons above.

However, we do not consider that adding a statement of the legal position into the Accounting Council’s Advice to the FRC is appropriate as this can only be one interpretation of the legal position in one circumstance and we believe that the Accounting Council’s Advice to the FRC should not become part of GAAP. Looking purely at the legal position also fails to consider the substance of the individual arrangements which should have greater influence on the accounting treatment in each RMC. By starting to use this approach the FRC will be setting GAAP outside the framework that has been established for such purposes.

Question 10 - Consultation Stage Impact Assessment

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

Response:

We have no comments on this assessment.

OTHER COMMENTS

One further issue we would like to highlight is the availability of draft FRS 105 to unincorporated businesses i.e. sole traders and partnerships. It is important that such businesses, which otherwise meet the size criteria for micro-entities (but are not eligible to use the cash basis of accounting), are able to use FRS 105 for the calculation of their profits for tax purposes, in order to maintain consistency with incorporated businesses of the same size. Such businesses are currently likely to use the FRSSE, therefore being required to use the recognition and measurement principles of FRS 102 would represent a significant administrative burden, add complexity disproportionate to the size of entity, and impact on reported profits.

We note that paragraph A3.2 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.' It would be much more useful if the scope of FRS 105 was widened such that the standard is more obviously accessible to micro-entities that are not companies, but are not specifically barred from applying it.