

Jenny Carter
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

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Direct line: 020 7951 2025

Email: aclifford@uk.ey.com

Dear Ms Carter

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

Introduction

Ernst & Young LLP welcomes the opportunity to comment on FRED 58 issued by the Financial Reporting Council ("the FRC").

Overall comments on FRED 58

We agree that it is appropriate to issue an accounting standard applicable to the micro-entities regime, and to base its requirements on those in FRS 102, with simplifications to reflect the types of transactions that micro-entities may face in practice (as well as adaptations to reflect the prohibitions in the micro-entities regime over fair value accounting and revaluations set out in company law). However, we have the following observations for improvements to the draft standard:

- ▶ We consider that changes to the structure of (draft) FRS 105, even if that means small departures from the structure of FRS 102, can be made to improve its comprehensibility and reduce its length.
- ▶ We also consider that the language used in Sections 11 and 12 (and some of the accounting) should be clarified or illustrated with examples. Some micro-entities may have interest rate swaps or forward contracts. Therefore, we agree that it is appropriate to address the accounting for derivatives in the standard. However, we consider that the accounting should be better explained and that preparers would benefit from examples of what might be acceptable accounting. In particular, it would be helpful to clarify (assuming this is the case) that a derivative financial liability forming part of a hedging relationship is not necessarily an onerous contract, i.e. that previous UK GAAP practice (under FRS 12) continues to remain appropriate under FRS 105.
- ▶ We strongly encourage the FRC to replace the performance method for government grants with the accruals model. This is better understood and therefore simpler to apply. It is also likely to be the dominant practice under FRS 102 if entities prefer to maintain their current accounting, and is required under IFRS.
- ▶ One key area of potential further simplification is in relation to impairment, where the requirements in Section 27 look prescriptive for this size of entity (considerably more so than the current FRSSE).

Our responses contain a number of further drafting points for the FRC to consider. One recurring theme is that it would be helpful if FRS 105 addressed company law and accounting requirements in the same comprehensive way that the FRSSE did, and avoided paraphrases of the company law that are sometimes not fully accurate. Given the close association of the draft standard's requirements with the statutory requirements under the micro-entities regime, company law references should be sidelined in the margin to help preparers.

If you have any matters arising concerning the content of our response, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'T.P. Clifford', with a large, sweeping flourish above the name.

Tony Clifford
Partner, Financial Reporting Group

Responses to FRC questions

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

Question 1 – Structure and language of draft FRS 105

Do you agree with this approach? If not, why not? What alternative presentation do you propose?

FRS 105 is drafted in a way that will be helpful to practitioners with clients using both FRS 102 and FRS 105, since they can easily see the differences. However, in our view, the current structure does not meet the needs of preparers and the length is somewhat daunting (particularly given that certain sections have been omitted, instead cross referring to FRS 102).

The inclusion of entire unused sections of FRS 102 in FRS 105 adds unnecessary length. If entire sections are not applicable, these could simply be listed at the beginning of the standard and related sections could be grouped together in a more coherent way where there are similar or related accounting requirements.

For example, Sections 9, 11, 12, 14 and 15 could be restructured into only two sections. To establish that an investment in a subsidiary is carried at cost, the user has to read 9.1, 9.26A, and then identify the relevant paragraph in Section 11 (which is 11.14(b) but is not cross referred). These sections in particular should be restructured to have

- ▶ a section dealing with the treatment of investments in subsidiaries, associates and joint ventures (of all types) and intermediate payment vehicles in individual accounts (distinguishing between separate financial statements and individual accounts here is unnecessary complexity), and
- ▶ a section addressing other financial instruments (combining appropriately, Sections 11 and 12).

Section 25 could also be deleted by making clear (for the avoidance of doubt) in 11.16-11.16A and 20.11 that interest is expensed and lease finance charges are expensed and do not qualify for capitalisation.

We agree that common language with FRS 102 should be applied in FRS 105. This is generally the case in draft FRS 105, although the financial instruments described in 12.3 appear to meet the definition of a derivative financial instrument and it would be more helpful to identify them as such.

It would also be helpful to add the company law references in the margin by the relevant paragraphs of the standard.

By restructuring in this way, we suspect the requirements of the standard can be made simpler and more comprehensible to follow.

Question 2 – Legal Requirements

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?

Scope

The definition of a micro-entity in the Glossary should add '(and not excluded from the micro-entities regime by section 384B)' and the scope of the standard, as set out in paragraphs 1.2 and 1.2B, should reflect the exact requirements of s384B.

The exclusions described in 1.2A are not fully accurate (for instance, not all financial institutions are excluded). The Accounting Council Advice 19 and 20 states that the micro-entities regime does not apply to public benefit entities and financial institutions. However, not all public benefit entities and financial institutions (as those terms are used in FRS 102, say) are excluded from this regime. It would also be helpful if A3.6 set out the scope of the standard in full (based on s384B and paragraph 3 of SI 2013/3008).

1.2B (and A3.6) state that a company whose accounts are included in consolidated financial statements are excluded. Section 384B excludes a 'company that is not a parent company but its accounts are included in consolidated group accounts for that year'. The term 'group accounts' may be intended to refer to 'group accounts prepared by another company' (as indicated by the explanatory note appended to SI 2013/3008 and the accompanying Explanatory Memorandum) which could imply group accounts prepared by a UK company. If this was the case, it would extend the scope of entities eligible to apply FRS 105. We acknowledge the scope is not clear in the legislation and this may be an area where legal advice may be necessary.

Presentation and format of financial statements

We agree with the balance sheet and profit and loss account formats provided in FRS 105 but it would be appropriate to explain that there is no requirement to present the 'capital letters' preceding each line item and to provide other summary details of the general rules governing formats (akin to 2.16 to 2.22 and the footnotes to the formats provided in the FRSSE). It may also be appropriate to explain that the same format must be applied consistently unless there are special reasons for a change (1 Sch 2A, SI 2008/409), although this company law requirement is consistent with 3.11-3.12 of the standard.

Prohibition of fair value accounting and alternative accounting rules

We note that A3.10 concludes that measurement of assets at fair value on initial recognition is a method of estimating cost at initial recognition and does not breach the prohibition against fair value accounting. Given that, we agree that FRS 105's requirements do not make use of the fair value or alternative accounting rules.

Disclosures

In respect of the notes to the accounts, 8.8(c) paraphrases the requirements of 1 Sch 57(3)-(4) and 8.9 paraphrases section 413. To be fully accurate, these paragraphs should keep close to the original statutory requirements. For example, 8.9 does not fully describe the scope of section 413 (e.g. directors of the company, at any time in the financial year), the fact that details are required for each advance or credit, or guarantee, or fully set out the details required.

The micro-entity provisions make clear that the statutory disclosures are presumed to give a true and fair view (s393(1A)). This should be included in Section 8 (and then there would be no reason for 19.1B to clarify that FRS 102's disclosures on business combinations are not required). We note that other sections in FRS 105 appear to include disclosures. While these all relate to some extent to 1 Sch 57, the disclosures often ask for further details that are not set out in the statutory requirements. For instance, 17.32 and 18.28 ask for the contractual commitments for acquisitions of property, plant and equipment and intangible assets (1 Sch 57 asks for the total amount of financial commitments etc. not the breakdown between, say, intangible assets and property, plant and equipment). Similarly, 28.40A asks for more detailed disclosure than required by 1 Sch 57. In our view, the FRC must limit the disclosures to those required by statute which should be set out in full in Section 8. If the FRC considers it helpful to provide examples of situations that could give rise to a need to make disclosures under 1 Sch 57, the context of such guidance should be clearly explained.

Section 393(1A) explains that 'where the accounts contain an item of information additional to the micro-entity accounting items, the directors must have regard to any provision of an accounting standard which relates to that item'. The FRSSE includes this company law requirement. However, unlike the FRSSE, FRS 105, which is the accounting standard being applied, is not intended to contain disclosures beyond the micro-entity accounting items (although see paragraph above). It would be helpful to address the implications of section 393(1A) in the Legal Appendix, e.g. is it the FRC's view that, since FRS 105 does not contain further disclosures, if a micro-entity provides voluntarily additional information (say in relation to disclosures included in FRS 102), there is no accounting standard disclosures to have regard to?

Question 3 – Principles for simplifications

Do you agree with these overarching principles and the resulting simplifications proposed in draft FRS 105? If not, why not?

Yes.

We are not convinced it is necessary to eliminate policy choices that are permitted under FRS 102 (and not prohibited by the Micro-entity Regulations) given the FRC's intention to align FRS 105 with FRS 102 recognition and measurement principles. Policy choices add flexibility rather than increasing the regulatory burden.

However, we understand why the FRC have come to the view that policy choices should be eliminated given that accounting policies are not required to be disclosed and there is limited information in the formats presented to users to determine the policies applied. This concern would be particularly relevant in respect of the treatment of borrowing costs as the formats do not require separate identification of loans, but potentially less significant in an area such as government grants. We make this point as

Question 6 suggests that alternatives for the accounting in Section 24 on government grants could include introducing the policy choice permitted by FRS 102.

Question 4 – Financial instruments

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.

As noted in our response to question 1, we consider that the structure of Sections 9, 11, 12, 14 and 15 should be revisited by the FRC. Our comments in response to this question focus solely on the content of Sections 11 and 12. However, our main concern is the clarity of the requirements, particularly in relation to impairment and the accounting for derivatives, rather than further simplifications. Our comments are as follows:

- ▶ 11.13A – states that 'normally' the transaction price is the amount borrowed. If this is the intention also for below market interest or interest free loans, this should be made clear.
 - ▶ 11.13A, 11.13C – the references to 'cash price receivable/payable' for trade receivables and trade payables are difficult to understand without the examples in 11.13 of FRS 102 explaining how this 'cash price' is to be determined (assuming the intention is that a similar basis is used for initial recognition of trade receivables/payables in FRS 102 and FRS 105).
 - ▶ 11.25(b) does not specify how the present value of cash flows is computed in respect of determining whether there is impairment of an asset held at amortised cost. In particular, it is not clear from the drafting whether it is (a) the current market rate or (b) the original interest rate implicit in the loan (or for a variable interest rate loan, the current interest rate implicit in the loan) – as would be the case in FRS 102 -that is to be applied in computing present value. Note that 11.25(a) of FRS 102, if used, would need to be adapted (because the concept of an effective rate has not been included in draft FRS 105).
- 11.22(f) highlights declining market values of the asset or similar assets as an impairment indicator, and therefore, without clarification, there is a risk that entities may conclude that a loan asset earning an interest rate that subsequently falls below market rates is impaired (although this would not lead to impairment under FRS 102 or IFRS).
- ▶ 11.37 – This gives 'the life of the loan is substantially extended' as an example of 'substantial modification'. However, many significant loan extensions would likely not qualify as a 'substantial modification' under FRS 102 (or IFRS) and we would suggest deleting this example. There is scope for micro entities to determine how to account for any modification that does not qualify as a substantial modification, particularly as the requirements in 11.20 of FRS 102 on recomputing amortised cost when cash flow estimates change are not included in the draft standard. We do not disagree in allowing this flexibility to determine appropriate accounting policies.
 - ▶ 12.3 – It would be helpful to use the word 'derivative financial instrument, as this is what Section 12 is addressing.

- ▶ 12.5(g), (h) and 22.2(c) – It is conceivable that a micro-entity may enter into contingent consideration arrangements / forward contracts in a business combination (covered by Section 19). These arrangements should be scoped out of Section 12 by reinstating these paragraphs from FRS 102 (which have been deleted in draft FRS 105).
- ▶ 12.8A – This paragraph provides insufficient clarity for the preparer of a micro-entity's financial statements on how to account for the contractual payments of a derivative financial instrument. In practice, if micro-entities use derivatives at all, these are likely to be interest rate swaps and forward rate contracts.

We would encourage the FRC to include some simple examples of what might be acceptable accounting and to provide more guidance on when such derivative financial instruments become onerous (for instance, if a derivative financial liability forms part of a hedging relationship, even if not formally documented, can it be left 'off balance sheet' with accruals accounting rather than recognising an onerous contract?). This was previous UK GAAP practice (under FRS 12) but if this remains appropriate under FRS 105, it is important to clarify this since previous UK GAAP has been withdrawn. As FRS 105 is a new GAAP with no established practice, there may otherwise be uncertainty amongst preparers as to what is acceptable accounting. Micro-entity preparers are unlikely to have access to the same level of specialist accounting expertise as large companies, and it is particularly important that FRS 105 is clearly expressed.

Question 5 – Capitalisation of development costs and borrowing costs

Do you agree with this approach? If not, why not?

Yes.

Question 6 – Government grants

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 model and the performance method) or to require the accruals method.

No. If a single accounting treatment is to be selected, we consider that the accruals method should be mandated. We expect that this will be the predominant accounting adopted by FRS 102 reporters, who may want to continue with an accounting aligned with previous UK GAAP (and required by IFRS). While the performance model may be of interest to charities, the latter are excluded from the micro-entity provisions. Moreover, the performance model is not necessarily simpler to apply (as claimed by the FRC- see Accounting Council Advice 3), given that it requires more judgement in assessing what are the performance-related conditions and when they are met.

However, while we recognise that the FRC has good reasons for eliminating policy choices, we could support a policy choice in this area. See our response to question 4.

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

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 102 or

for draft FRS 105 is silent.

FRS 105 ideally would be a single document that addresses company law and accounting relevant to micro-entities in a 'one stop shop' in the same way as the FRSSE.

However, the approach of cross referring to another standard is already one seen in FRS 102, in areas that only affect a small number of FRS 102 reporters and where the requirements of the relevant IFRS is instead applied (e.g. segmental reporting, extractives, earnings per share). If that same approach is followed in FRS 105, however, we believe that trade and asset acquisitions and impairment of cash generating units may not be uncommon and should be reinstated in FRS 105. As noted in our response to question 8, we consider there is scope to simplify the impairment provisions in FRS 105, perhaps by using the FRSSE's current requirements as a base.

Given that FRS 105's hierarchy does not refer to FRS 102, FRS 105 should only be silent in significant areas if diversity of practice is accepted.

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.

The main area of simplification we would propose relates to Section 27. Section 27 on impairment has been included in full (or cross referred, in respect of cash generating units and goodwill, to FRS 102). This section is considerably more complex and detailed than its predecessor requirements in the FRSSE (which could be a model to build on) and seems disproportionate for a micro entity. However, if included, we do not understand the deletion of 27.18 (which clarifies that tax and financing cash flows are excluded).

Other simplifications to FRS 105 might include:

- ▶ Deletion of 22.5(a) which requires that an instrument is classified as a liability if the distribution of net assets on liquidation is subject to a maximum amount.
- ▶ 23.9 on award credits has been omitted. Since this is the case, we suggest that the FRC also delete Example 13 in paragraphs 23A.16-17 which illustrate the detailed accounting for award credits
- ▶ Deletion of 28.6-28.7, given that it was not uncommon under previous UK GAAP not to recognise accrued holiday pay and any accrued liabilities are expected to reverse quickly.

However, the following areas should be clarified:

- ▶ 23.13 has been omitted. As this paragraph explains the accounting for revenue where an insignificant risk of ownership is retained and the treatment of returns, we consider that this should be included as such transactions are relevant to micro-entities.
- ▶ The asterisked footnote to 28.3 should be reinstated, given that intermediate payment vehicles are included in FRS 105 (because it was considered that EBTs are used by micro-entities).

- ▶ Section 30 – While most micro entities are likely to have a sterling functional currency (or Euros, if in Ireland), it seems odd to exclude the concept of functional currency in its entirety.
- ▶ 35.10(a) should be retained as relevant to business combinations of trade and assets. Its removal could be problematic for micro-entities that have undertaken such transactions pre-transition.

Question 9 – Residents’ management companies (FRED 50)

Do you agree with this approach? If not, why not? What alternative approach do you propose?

Yes.

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?

No.

