

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

FRED 58, issued by the Financial Reporting Council in February 2015

Comments from ACCA

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Further information about ACCA' s comments on the matters discussed here may be obtained from the following:

Paul Cooper

Corporate Reporting Manager, ACCA

Email: paul.cooper@accaglobal.com

ACCA welcomes the opportunity to provide comments on FRED 58. UK and Ireland-based members of our Global Forum for Corporate Reporting, along with representatives of ACCA' s UK member networks, have considered the questions raised, and their views are reflected in the following comments.

GENERAL COMMENTS

Draft FRS 105 reflects the much-reduced statutory disclosure requirements for micro-entities. Many of the recognition and

measurement requirements of FRS 102 are retained, with some simplifications and the removal of options to avoid confusion (as the micro-entity cannot be required to explain which option it would have taken).

While supporting a number of the proposals in the FRED which are based on the above approach (such as in our response to Question 7 below), we would also question this overall approach by the FRC, which seeks to preserve linkages to FRS 102, and does not result in sufficient guidance on the meaning and application of the 'presumed true and fair view', which is a specific concept in law for micro-entities.

Our reasons for questioning the overall approach are set out in more detail principally in our response to Question 1 below (suitability of draft FRS 105 for the circumstances of micro-entities), to Question 2 (with respect to the presumption of a true and fair view) and Question 10 (costs versus benefits of the proposals).

We agree with the FRC's proposals with regard to Residents' Management Companies (Question 9), but believe that the accounting by these companies still needs to be fully tackled, as a separate project to FRED 58.

SPECIFIC COMMENTS

We now comment on the specific questions raised in the ED (paraphrased below), as follows:

Question 1

In creating draft FRS 105, the FRC has aimed to balance accessibility and understandability for micro-entities with keeping consistency with FRS 102 (to ensure comparability between entities of different sizes, and to minimise education and training costs). It is usually easy to ‘map’ draft FRS 105 to the content of FRS 102.

Do you agree with this approach, or do you prefer another?

ACCA response

Our consideration of this question focussed on the extent to which micro-entities and their advisors (such as ACCA’s practitioner members) benefit from the linkages to FRS 102, compared to an alternative format.

We prefer a shorter Standard, which ‘stands alone’ from FRS 102, but also contains essential information not in draft FRS 105 (such as the size limits for the entities covered). The linkages to FRS 102 are potentially useful for a growing company which is likely to have to adopt FRS 102 in the future. However, we would question the importance of this factor, as most micro-entities will remain within the

micro-category. An alternative would be to include the linkages in the Standard for micro-entities within a separate table of derivations.

The FRC should also consider whether further simplifications can be made for micro-entities, thereby departing further from the principle that in general, micro-entities are subject to the same recognition and measurement requirements as other companies.

Practically, the timing of a re-write and re-exposure of draft FRS 105 might present difficulties for the FRC at this stage. However, it is important that the end result is the most appropriate one for micro-entities and their advisors. The FRC may in fact have more time than might appear to be the case, as take-up of the micro-entity regulations currently appears to be low, whilst the FRSSE remains in effect.

In certain areas, such as deferred tax and the cost of share-based payments, FRED 58 states that a micro-entity 'is not required to recognise', although the intention appears to be a prohibition on recognising. We believe that the wording of FRED 58 should be altered to make clear that there is a prohibition rather than an option, to avoid a potential hidden inconsistency between entities.

Unlike the small company proposals in FRED 59, those in FRED 58 are limited to qualifying incorporated entities, as only these can legally take advantage of the micro-entity regime. For the sake of a common reporting platform, ACCA supports a standard which is also applicable to unincorporated entities and (subject to legislation) LLPs. At that

point, the FRC can make clear that these other micro-sized entities can also use the Standard, and are encouraged to do so. This would entail including the point made in para. A3.2 of Appendix III to FRED 58 (Note on legal requirements) within Section 1 (Scope) of the Standard itself.

We intend to ask HMRC to support a similar approach.

Legal

Question 2

Does draft FRS 105 accurately reflect the legal requirements for micro-entities?

ACCA response

The simplified set of disclosure requirements for micro-entities should be readily reflected in an accounting standard. In considering this question, we are more exercised by the ‘presumed’ (rather than deemed) true and fair view given by compliance with the regulations for micro-entities. It is unclear what this concept will mean in practice, and what an entity might do if compliance alone with the limited list of disclosure requirements appears to result in misleading financial statements.

In our responses to FRED 59, we have also raised the need for an updated Counsel’ s opinion on the true and fair concept, in the light of the changes proposed for small entities. Such an update would be

an essential initial step towards considering the ‘presumed’ true and fair view.

We believe that FRS 105 will be incomplete without guidance from the FRC on the ‘presumed true and fair view’. This guidance needs to tackle questions currently being asked about micro-entity financial statements, including whether they can ever actually be ‘true and fair’ in view of the limited disclosure requirements, or conversely, to what extent a true and fair view can, in fact, be safely implied due to the size and usually very straightforward nature of micro-entities. The guidance would furthermore need to tackle the above question of what micro-entities should do if the presumption of a true and fair view is in doubt, despite full compliance with legal requirements.

These matters are also important for professional advisors, who might otherwise deal with the current uncertainty by not allowing their names to be associated with the micro-entity financial statements that they prepare on behalf of clients. In view of the general lack of knowledge within micro-entities about what constitutes ‘true and fair’, professional advisers are likely to be unduly burdened by the absence of guidance on what the presumption of a true and fair view means.

Additional simplifications to recognition and measurement requirements

Question 3 – Principles for simplifications

The Accounting Council used overarching principles in considering whether further simplifications over and above the legal requirements would be appropriate in draft FRS 105.

Do you agree with these principles?

ACCA response

In summary, the principles include the cost versus the benefit of applying the relevant provisions of FRS 102, whether a more straightforward alternative treatment is available, whether a simplification would detract from the information provided by the financial statements, and / or whether the transactions in question occur infrequently amongst micro-entities.

We have focussed on the high-level question of whether these overarching principles are generally appropriate, and agree that they are.

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

The Companies Act prohibits re-statements at fair value after initial recognition, and so any requirement or option to do so has to be removed for micro-entities. The FRC is proposing further simplifications: are these necessary and sufficient?

ACCA response

These simplifications concern, in order to reduce complexity, no requirement to make adjustments for a below-market rate of interest (para 11.13A), or where settlement is deferred beyond normal credit terms (para 11.13C). There is also some streamlining of the requirements regarding impairment assessments, de-recognition and the debt versus equity classification criteria.

ACCA welcomes these simplifications. We also note that Section 11 still appears to be complex with respect to onerous contracts, especially as no 'upside re-measurement' to fair value is permitted in law. We believe that both Sections 11 and 12 should be further simplified, without however undermining fundamental principles, such as in this case, that of measurement at the lower of cost and net realisable value.

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

Views are sought on the FRC' s proposal to require the expensing of development and borrowing costs.

ACCA response

We agree with this proposal, which is intended to reduce complexity, and will remove an option which is likely to cause confusion under the much-reduced disclosure requirements for micro-entities (as it would be unclear whether the option has been taken up).

Furthermore the proposed required accounting treatment will match the tax treatment. While some smaller entities do engage extensively in development activities, it is likely that very few micro-entities, due to their size, will do so to the extent that it will be important for them to capitalise development costs. We believe that similar reasoning applies to borrowing costs, due to the extent and nature of lending to micro-entities (being often simple loans from a related party).

Question 6 – Government grants (Section 24)

Views are sought on the proposal to require government grants to be recognised via the performance model, with no option to adopt the accrual model.

ACCA response

The reasons for removing the ability to opt (for either the performance or accrual model) are as for development and borrowing costs in the preceding question.

Contrary to the FRC's proposal, we prefer a requirement for the accrual model. As a result, government grants will be recognised not on receipt or (if relevant) when the related performance conditions are met, but will be recognised over time (such as over the useful life of the asset for which the grant is given). We do agree that micro-entities should not have the choice of treatment in FRS 102, due to the disclosure issues thereby created.

Our concerns about the performance model relate to the risk that it potentially inflates distributable profits (so by implication, the accrual model is more prudent), and is incompatible with full IFRS (although it is permitted by the IFRS for SMEs).

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

Rather than reproduce relevant parts of FRS 102 (or include nothing), it is proposed to encompass certain areas by cross-reference to FRS 102 only.

The FRED asks whether this approach is appropriate for the areas concerned.

ACCA response

We agree that the areas set out in the FRED should be dealt with ‘by cross-reference’, because they involve transactions which are considered to occur infrequently amongst the majority of micro-entities. We support the use of cross-references in this way to sections of FRS 102 which do not offer a choice of accounting treatment, or do not otherwise indicate that such choice is possible. Where an accounting treatment should be prohibited (as with deferred tax above), a cross-reference to FRS 102 would be inappropriate as an alternative or as guidance.

On a more routine editing matter, we would point out an issue identified in respect of puttable instruments and examples of

compound financial instruments (Section 22). The cross reference in respect of the compound financial instruments is clearly shown in para 22.15, but not in respect of puttable instruments – **FRS 102**, paras 22.4(a) and para 22.5(b) and (d)).

Question 8 – Other simplifications

Are there any further accounting simplifications appropriate for micro-entities, which should be included in draft FRS 105?

ACCA response

With regard to draft FRS 105 as currently drafted, we do not have further suggestions for simplifications.

The simplifications proposed in the FRED are of several types, such as to comply with legal requirements, and to avoid complexity and ambiguity in the absence of disclosure requirements. A further category of simplification is where it would be of more benefit to micro-entities to exclude the provisions of FRS 102. For example, we have previously suggested that for micro-entities, goodwill should not be separated from other intangibles on an acquisition.

The above category of simplification is furthermore likely to be of particular relevance to our overall comments on the optimal structure of an accounting standard for micro-entities, as explained in our response to Question 1 above.

Residents' management companies (RMCs) (FRED 50)

Question 9

The FRC now proposes that a clear statement of the legal position set out in FRED 50, issued in August 2013 (i.e., that residents' management companies [RMCs] 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 in FRED 58). This will not be placed within the body of proposed FRS 105 (in section 34 Specialised Activities).

ACCA response

Notwithstanding the fact that most RMCs are micro-entities, we agree that the legal position should not be covered for them in Section 34 Specialised Activities. This section has been subject to significant reduction from the equivalent section in FRS 102, to the extent that FRED 58 only includes the material on Agriculture.

We did not regard FRED 50 as a comprehensive accounting solution for RMCs, as explained in our response submitted to the FRC in November 2013 (<http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2013/november/frsse-amendments.html>). In practice, RMCs still need to prepare an additional set of accounts to those required by companies legislation and landlord & tenant legislation, and FRED 50 would not change this situation. Furthermore, the reductions in disclosure provided by the micro-company regime are likely to increase the need for additional accounts.

FRS 105 will therefore not remove the issue that a common and comprehensive framework for RMCs still needs to be tackled. This may now have to take place through amendments to landlord & tenant legislation.

Consultation Stage Impact Assessment

Question 10

Comments are requested on the costs or benefits discussed in the Consultation Stage Impact Assessment (IA).

ACCA response

In the IA, the FRC concludes that its proposals are proportionate, and are considered to be cost-effective for the preparation of the financial statements of micro-entities.

It is possible to reach the above conclusion if the overall approach which the FRC has taken to FRS 105 is judged to be the only feasible one. In our response to Question 1, we have questioned whether a different approach is possible and preferable, resulting in a more straightforward standard which can be complied with more readily, and at a lower cost.

Our response to Question 2 raises the need for guidance to be produced on what the 'presumed true and fair view' is considered to mean in practice. Suitable, practical guidance on this matter is likely to be of great benefit to preparers and their professional advisors when applying the micro-entity regulations.

