Grant Thornton

An instinct for growth™

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

National Office

Grant Thornton UK LLP
Grant Thornton House
Melton Street
London NW1 2EP.

T +44 (0)20 7383 5100
F +44 (0)20 7383 4715
DX 2100 EUSTON
www.grant-thornton.co.uk

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Dear Ms Carter

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

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) consultation 'FRED 58 Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime'.

Grant Thornton UK LLP is a leading financial and business adviser with offices in 26 locations nationwide and more than 25,000 individual and 15,000 corporate and institutional clients. The Grant Thornton global organisation is one of the world's leading organisations of independent assurance, tax and advisory firms. Grant Thornton member firms operate in over 100 countries.

Grant Thornton supports the growth agenda and believes that the application of reason combined with instinct will allow dynamic businesses to unlock their potential for growth. We therefore support the FRC's overall proposal to develop a new accounting standard for micro entities and, in general, we agree with the proposed recognition and measurement simplifications that are being considered in this new accounting standard.

As drafted, the scope of FRS 105 will apply only to companies that qualify as micro-entities. In our opinion, unincorporated businesses such as sole traders and partnerships that meet the relevant size criteria should also be able to apply the principles of FRS 105 voluntarily for the same reasons that companies eligible under the micro-entities regime can. Therefore we believe that the scope of FRS 105 should be widened to such sole traders and partnerships too. This would help to bring consistency between different trading structures and would help provide a suitable financial reporting framework for such unincorporated businesses once the Financial Reporting Standard for Smaller Entities (FRSSE) is withdrawn.

We set out our detailed responses to each of the questions raised in the attached Appendix.

If you have any questions on our response, or wish us to amplify our comments, please contact Ashley Clarkson (telephone: 01604 707248, email ashley.clarkson@uk.gt.com) or Neil Parsons (telephone: 0121 232 5385, email neil.b.parsons@uk.gt.com).

Yours sincerely

Mark Cardiff
Head of Audit
For Grant Thornton UK LLP

T 020 7728 2580
E mark.cardiff@uk.gt.com

Reponses to specific questions

Question 1 – Structure and language of draft FRS 105

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?

We agree with the above approach.

In our opinion, it is important to have a Financial Reporting Standard that is not only easily accessible and understandable for those able to apply the micro-entities regime, but also maintains consistency with FRS 102. Micro-entities are typically small, owner-managed businesses that do not have a dedicated, sophisticated financial management team and do not generally enter into complex transactions. We believe it is important to maintain consistency with FRS 102 to allow dynamic organisations with an instinct for growth to move through the different reporting frameworks over time.

Question 2 – Legal requirements

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?

We are in general agreement that draft FRS 105 accurately reflects the legal requirements and exemptions for micro-entities.

However, as drafted, the scope of FRS 105 will apply only to companies that qualify as micro-entities. In our opinion, subject to the FRC confirming the suitability of such a position with HMRC under tax legislation, unincorporated businesses such as sole traders and partnerships that meet the relevant size criteria should also be able to apply the principles of FRS 105 voluntarily for the same reasons that companies eligible under the micro-entities regime can. Extending the scope of FRS 105 in this manner would help to bring consistency between different trading structures and provide a suitable financial reporting framework for such unincorporated businesses once the FRSSE is withdrawn.

We agree with the presentation and formats of the financial statements.

We agree that draft FRS 105 should prohibit a micro-entity from applying the Alternative Accounting rules and Fair Value Rules. This is consistent with our understanding that the Micro-entities Accounts Regulations do not permit a micro-entity to apply the Alternative Accounting Rules or the Fair Value Rules as set out in company law.

We agree with the disclosure exemptions and that management can make additional voluntary disclosures at their own discretion.

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?

We agree with the principles that the FRC has used in order to identify simplifications. We have identified some further matters below and in our response to Question 8 that we believe would also help further simplify the application of FRS 105.

We agree that there should be no requirement to recognise deferred tax. However, consistent with other areas of draft FRS 105, there should be no accounting policy choice. Therefore, we believe that the wording of paragraph 29.6 should be amended so that an entity "shall not" recognise deferred tax.

We agree that there should be no requirement to account for equity-settled share-based payments prior to the issue of the shares.

We agree with the proposed simplification of accounting for defined benefit pension schemes. When a micro-entity has entered into a schedule of contributions to fund a defined benefit plan (that is not a multi-employer plan) in specific situations it is theoretically possible for a micro-entity to reflect a larger defined benefit pension liability under FRS 105 than it would by applying FRS 102. However, it might be the case that only a very small number of micro-entities operate their own defined benefit scheme and as such this instance would be rare.

We agree with the proposed simplification to the accounting for foreign currency transactions.

We agree with the proposed deletion of Section 31: Hyperinflation and all subsections of Section 34: Specialised Activities except for Agriculture, as these are unlikely to apply to micro-entities.

We do not agree with the revisions in respect of government grants and explain this further in our response to Question 6 below.

We agree with the proposed simplifications in relation to the measurement of financial instruments on a cost basis and the accounting for transactions with non-market interest rates. This is covered further in our response to Question 4 below.

We agree with the proposed simplified principles for classifying financial instruments as equity or debt.

Question 4 – Financial Instruments
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.

We are in general agreement with the recognition and measurement simplifications. However, we have the following observations and recommendations.

The definition of amortised cost in paragraph 11.15 of Section 11 of Draft FRS 105 is different to that in FRS 102. We suggest that Sections 11 and 12 of FRS 105 avoid reference to 'amortised cost' and use the term 'cost' or 'cost basis' instead.

We also recommend that the FRC include additional examples in Section 11 of FRS 105 dealing with topics such as bad debts, transactions deferred beyond normal credit terms, intra-group balances and third party loans.

Where transaction costs are material, paragraph 11.14A requires recognition of those costs on a straight line basis. Paragraph 11.16A requires in some cases interest income and expense to be recognised at a constant rate. This appears to be an inconsistency as a constant rate if applied to a carrying amount of a financial asset or financial liability does not result in recognition on a straight-line basis. We therefore recommend that the wording of paragraph 11.14A to 11.16A is reviewed to ensure that there is consistency.

We observe that paragraph 12.3 effectively applies to derivatives without using the term "derivative". This term could be used up front to clarify the scope of Section 12. The whole of Section 12 could also be entitled 'Derivatives' on this basis.

Further, we note that, as drafted paragraph 12.3 does not make grammatical sense. We therefore suggest that the first sentence of paragraph 12.3 is amended to read "This section applies to a financial instrument with the following three characteristics:"

With regard to contractual payments, we believe that the wording of the first sentence of paragraph 12.8A of Section 12 is not clear or helpful to the preparers of micro-entity accounts. If there is a specific matter or situation that the FRC is contemplating, it would be helpful if this could be reflected more clearly. We believe that the preparers of micro-entity accounts would benefit from clearer guidance on how to apply the concepts of Section 2 to financial instruments. Without such guidance, there might be divergence in the accounting treatment of financial instruments in the scope of Section 12.

Question 5 – Capitalisation of development costs and 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?

We agree that borrowing costs and development costs should be expensed.

Question 6 – 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 (ie FRS 105 would allow a choice between the accruals method and the performance method) or to require the accruals method.

In our opinion, capital grants should be deferred over the life of the asset. We therefore favour the accrual method rather than the performance method.

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.

We believe that the particular accounting matters listed in (a) to (e) above are unlikely to affect micro-entities in practice and we therefore agree with the proposed approach in draft FRS 105.

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.

We have identified the following areas where, in our opinion, further simplifications should be considered:

1 In the limited situations where FRS 105 requires a transaction to be recognised initially at fair value paragraph 2.46A(c) sets out a hierarchy to help best estimate such fair value. Paragraph 2.46A(c) appears vague and does not add sufficient information on how to measure fair value. If this paragraph were to contain a helpful cross reference to those parts of FRS 102 that include specific guidance on fair value without introducing complexity to FRS 105, we believe that it would provide additional help to preparers.
2 Paragraph 3.22 allows the use of different titles for the financial statements. We suggest that this is simplified through the use of consistent, mandatory titles.
3 We believe that when accounting for a business combination a micro-entity should apply the recognition and measurement criteria of Section 19 with the exception that it shall not recognise intangible assets separately from goodwill and not recognise deferred tax on a business combination.

Other observations

Given the legal restrictions that severely reduce the disclosures imposed on micro-entities we question whether the disclosures in paragraph 3.23, whilst being sensible disclosures (company name and change of name, year end, presentation currency and level of rounding) can actually be mandated.

For the same reasons we also do not believe that the disclosure requirements in paragraph 21.16 in respect of contingent assets legally can be imposed on a micro-entity.

In respect of disclosure of advances, benefits and guarantees, we believe that that the wording of paragraph 8.9 should refer to directors in the case of companies and not to management because the legal disclosure requirement for companies relates specifically to directors. However, if FRS 105 is to be available for unincorporated entities to adopt, a broader reference to 'management' is also needed.

We question why paragraph 17.21 which provides useful guidance in determining the useful life of an asset has been deleted.

We believe that paragraph 22.5(a) in isolation is not correct and should be deleted. The equivalent wording in FRS 102 contains a particular reference to an instrument of a type described in paragraph 22.4(b) of FRS 102. In order to arrive at the requirements of Section 22 of FRS 105 paragraph 22.4(b) has been deleted.

We believe that, given the above point, following paragraph 22.5 there should be a sentence stating "Further requirements regarding classification of equity and financial liabilities are addressed in Section 22 of FRS 102 and are relevant to micro-entities."

Paragraphs 8.8 and 28.40A should be drafted to refer to defined benefit pension plans, ie not just multi-employer pension plans as the disclosures could be relevant beyond multi-employer plans.

Question 9 – Residents' management companies (FRED 50)
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?

We agree with the approach of not including a sub-section to Section 34 of FRS 102. However, we believe that in addition to reflecting the matter in the Accounting Council's Advice, the clarification of the legal position should also be included in the Appendix III: Note on legal requirements to FRS 105.

Question 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?

We have no comments on the Consultation Stage Impact Assessment which accompanies FRED 58.