

MICRO-ENTITIES: WHEN TO USE FRS 105 OR FRS 102

(Lecture A615 – 11.41 minutes)

(contributed by Steve Collings)

With more degree of flexibility under the new reporting regime, many practitioners question whether their micro-entity clients are better off using FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* or FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Ultimately, it must be borne in mind that it is the company directors who are responsible for the financial statements; not the practitioner and the decision to use FRS 105 or FRS 102 (Section 1A *Small Entities*) should be the client's; although, in practice, the client is likely to be advised by the accountant.

FRS 105 is not as complex a standard as FRS 102 due to its target audience and contains a number of simplifications in comparison to FRS 102. At the outset, this may seem like a no-brainer for a micro-entity client that meets the eligibility criteria to use FRS 105. However, consideration has to be given to client-specific issues because while FRS 105 may be suitable for the vast majority of micro-entity clients, including micro-entity LLPs and (more recently) companies in the Republic of Ireland, it will not be suitable for them all. The message, certainly from some of the professional bodies, is to consider FRS 105 on a case-by-case basis. Some of the key technical points that are encountered in practice where micro-entity clients and FRS 105 are concerned and should be considered by practitioners and micro-entity clients when deciding which standard to use include the following:

1.1 Accounting policy choices

One of the most notable features of FRS 105 is that it offers no accounting policy choices to micro-entities. When the FRC developed FRS 105, they concluded that allowing accounting policy choices for micro-entities would add complexity for preparers and would cause confusion for the users due to the lack of detail in the formats of the financial statements as well as the lack of supporting disclosures. The EU Accounting Directive prohibits the FRC from mandating any additional disclosures which are outside its scope.

Transactions such as development costs and borrowing costs must therefore be written off to the profit and loss account. They cannot be capitalised on the balance sheet as capitalisation of such costs is an accounting policy choice. Where a micro-entity wishes to capitalise borrowing or development costs (which, in practice, is not significantly common), they will have to report under FRS 102.

1.2 Fair value and revaluation amounts

FRS 105 does not allow the application of the fair value or alternative accounting rules found in the Companies Act 2006. Therefore, a micro-entity is unable to measure any assets at revaluation or at fair value and hence a revaluation reserve should never be presented in a micro-entity's balance sheet (all revaluation or fair value amounts used under previous UK GAAP must have been removed on transition to FRS 105).

Many practitioners have asked whether they are able to use a previous UK GAAP revaluation as deemed cost and then measure the asset using the historical cost accounting rules going forward. This is not possible, as the asset has to be measured at cost ('cost' being the purchase price or production cost according to the Companies Act 2006) less depreciation less any impairment. As previous revaluation amounts are not the purchase price or production cost, the use of a previous UK GAAP revaluation would be inconsistent with the law.

1.3 Disclosure notes

The significantly reduced disclosure regime found in FRS 105 is proving to show a split between those practitioners which favour it and those which do not. In addition to the s396(A) general information which has to be disclosed (see 1.16 above), there are now four disclosure requirements under FRS 105 (two of which have recently been introduced as part of the FRC's triennial review) as follows:

- Advances, credit and guarantees granted to directors as required by section 413 of the Companies Act 2006.
- Financial commitments, guarantees and contingencies as required by Regulation 5A of, and paragraph 57 of Part 3 of Schedule 1 to, the Small Companies Regulations.

The two additional ones which have to be included in a micro-entity's financial statements for periods commencing on or after 1 January 2017 (note the effective from date is sooner than the other amendments arising as part of the triennial review) are:

- Off-balance arrangements; and
- Employee numbers.

The reasons why these have been introduced into FRS 105 have been examined in section 1.16 of these notes.

For UK micro-entities, the disclosures are shown at the foot of the balance sheet; they are not presented as a separate section of the financial statements as is the case with small companies reporting under FRS 102, Section 1A. Micro-entities in the Republic of Ireland have more comprehensive disclosures to make in their financial statements within a separate section of the financial statements, 'Notes to the financial statements'. Micro-entities in the Republic of Ireland cannot place the notes at the foot of the balance sheet as is the case in the UK.

Some practitioners have expressed concern about how useful such a limited number of disclosures actually are. The significantly reduced disclosure regime was borne out of the EU Accounting Directive, although a micro-entity is permitted, but not required, to make additional disclosures as they feel necessary. Some lenders (e.g. Santander) have also been known to make a request for additional information in respect of micro-entity financial statements, so this is worth keeping in mind if the client is reliant on, or is perhaps seeking, bank finance.

1.4 *Deferred tax*

This simplification has been widely welcomed. Micro-entities are prohibited from accounting from deferred tax. Therefore, there should be no provision for deferred tax in the micro-entity's financial statements on the grounds that the lack of disclosure in a micro-entity's financial statements means it is impossible to distinguish between current and deferred tax; hence only current amounts of tax are shown.

1.5 *Off-rate loans*

There is no requirement to impute market rates of interest for off-rate loans (i.e. loans at below market rates or at zero rates of interest); nor is there a requirement to use the effective interest method which is used in FRS 102. Such loans will simply be measured at cost and this will prove a welcome simplification from potentially having to discount loans to present value using a market rate of interest under FRS 102. In practice, most off-rate loans in a small company (e.g. intra-group loans and loans to directors) have no terms attached to them and are therefore repayable on demand, thus presented as current assets/liabilities under FRS 102 at cost.

1.6 *Financial statement formats*

Only a Format 2 profit and loss account is allowed under FRS 105. In practice, a Format 1 profit and loss account is usually prepared for a limited company client which analyses expenses by function (cost of sales, distribution costs, administrative expenses and such like). The Format 2 profit and loss account (expenses by nature) is structured as follows:

Turnover		X	
Other income	X		
Cost of raw materials and consumables			(X)
Staff costs		(X)	
Depreciation and other amounts written off assets			(X)
Other charges		(X)	
Tax	(X)		
Profit or loss		<u>X/(X)</u>	

Some practitioners have also expressed concern about the lack of detail where some of the balance sheet amounts are concerned. Under FRS 105, either a Format 1 or Format 2 balance sheet can be prepared provided there is consistency (a change from one format to another would constitute a change in presentation, hence should be applied retrospectively). However, there is no disaggregation of the balance sheet in the notes to the financial statements because the statutory formats of the micro-entity financial statements are only preceded by letters; they are not followed by Roman or Arabic numerals. Therefore, items such as fixed assets, current assets and current liabilities are not broken down in the notes.

This could result in requests for additional non-statutory information such as a breakdown of current assets (possibly in an attempt to identify any overdrawn directors' current accounts).

1.7 ***Other factors that should be considered***

Some practitioners argue that FRS 105 is 'the way forward' for micro-entities; whereas others do not like the standard due to the lack of information conveyed in the accounts. Each argument has its own merits, but some additional factors which should be considered when deciding on whether the client should be advised to use FRS 105 or FRS 102 include:

- **The pace of growth of the client.** If the micro-entity is expected to grow rapidly in a short period of time, it may outgrow FRS 105 fairly quickly. This will then result in a transition to FRS 102 having to be done; hence for a new start-up client that is expected to grow very fast, it may be worth 'biting the bullet' and going straight onto FRS 102 (and applying Section 1A *Small Entities*). In addition, if the client wants to see more detailed information in the financial statements, FRS 102 should be used. The client can still file 'filleted' financial statements with Companies House if it chooses to report under the small companies' regime which, as a minimum, requires the balance sheet plus the balance sheet-related notes.
- **Ease of use of the standard.** FRS 105 is the least complex standard in the suite of UK GAAP and where a micro-entity has a relatively stable amount of revenue and assets, is owner-managed and is not expected to outgrow FRS 105, then it may be worthwhile advising the client to report under FRS 105.
- **Companies House filing requirements.** The micro-entity is only required to file the balance sheet and the notes (which are located at the foot of the balance sheet) with Companies House. UK micro-entities are not required to file the profit and loss account. Directors' reports are no longer required for a micro-entity in the UK, hence this is not an issue for such clients.
- **Revaluation of assets.** If the client wishes to revalue an asset (e.g. a building) or has an investment property which it wishes to measure at fair value, then it will not be able to report under FRS 105; it must apply FRS 102 as a minimum. Conversely, some clients may not want any disclosure about the value of its properties and hence may wish to take a restatement to historical cost accounting rules as the price to pay for reduced disclosure.
- **Impact on distributable profit.** Certain transition adjustments may have an impact on distributable profit (e.g. restatement of amounts to historical cost accounting rules values) which may meet with disapproval by the client, so FRS 102 may be the way to go.
- **Client discussions.** The client may want to see more detailed information in the financial statements rather than the limited information produced by FRS 105 and hence FRS 102 may be a more suitable standard.