

5 MICRO-ENTITIES: EMERGING ISSUES

(LECTURES A609 - 11.26 MINUTES)

FRS 105 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* is an optional standard for the smallest of companies which can meet two out of the following three criteria for two consecutive years:

- turnover not more than £632,000
- balance sheet total not more than £316,000
- not more than 10 employees

The rules in FRS 105 are prescriptive in that they do not allow micro-entities any accounting policy options; for example, there is no option to capitalise borrowing or development costs – such costs must be written off to the profit and loss account as they are incurred.

5.1 *Investment property in a micro-entity*

Two of the most common questions asked by practitioners at the current time where investment properties and micro-entities reporting under FRS 105 are:

- (a) Can I use a previous UK GAAP revaluation as deemed cost?
- (b) Must I depreciate investment property and, if so, could we not say that the residual value is equivalent to cost?

Investment property in a micro-entity is accounted for under the historical cost accounting rules as the micro-entities' legislation does not allow the use of the alternative accounting rules or the fair value accounting rules. As a consequence, all fair value and revaluation amounts **must** be removed on transition and the asset restated to the value it would be carried at had it always been accounted for under the historical cost accounting rules. Where investment property is concerned, there is a transitional option available in Section 28 *Transition to this FRS* at paragraph 28.10

- (c) which allows a first-time adopter an exemption from paragraph 12.15 of FRS 105 which requires component accounting to be applied. First-time adopters using the exemption in paragraph 28.10(c) can instead:
 - (i) Determine the total cost of the investment property including all of its components. Where no depreciation had been charged under the micro-entity's previous financial reporting framework, this can be calculated by reversing any revaluation gains or losses previously recorded in equity reserves.
 - (ii) The cost of land, if any, shall be separated from buildings.
 - (iii) Estimate the total depreciated cost of the investment property (excluding land) at the date of transition to this FRS, by recognising accumulated depreciation since the date of initial acquisition calculated on the basis of the useful life of the most significant component of the item of investment property (eg the main structural elements of the building).

- (iv) A portion of the estimated total depreciated cost calculated in paragraph (iii) shall then be allocated to each of the other major components (ie excluding the most significant component identified above) to determine their depreciated cost. The allocation should be made on a reasonable and consistent basis. For example, a possible basis of allocation is to multiply the current cost to replace the component by the ratio of its remaining useful life to the expected useful life of a replacement component.
- (v) Any amount of the total depreciated cost not allocated under paragraph (iv) shall be allocated to the most significant component of the investment property.¹

5.1.1 Previous GAAP revaluation as deemed cost

A previous GAAP revaluation must not be used as a deemed cost on transition as this will effectively be a revalued amount which the legislation prohibits. As the micro-entities regime requires the historical cost accounting rules to be applied, all assets (including investment property) must be included at purchase price or production cost. This is reflected in the *Accounting Council's Advice to the FRC to Issue FRS 105* at paragraph 32 of the July 2015 edition of the standard.

If practitioners have inadvertently used a previous UK GAAP revaluation as deemed cost for a micro-entity client, this must be corrected by way of a prior period adjustment if the effect of the difference is material.

5.1.2 Depreciation charges

Depreciating investment property does somewhat sit at odds with some practitioners. If investment property had been depreciated under previous UK GAAP, this would have been incorrect as the FRSSE required such properties to be measured at open market value at each balance sheet date. Changes in open market value were taken to a revaluation reserve.

Revaluations and fair value amounts cannot be used for investment property and the historical cost accounting rules require all tangible fixed assets to be depreciated.

Many practitioners ask whether depreciation should be charged if residual value is equal to cost? 'Residual value' is defined in the Glossary to FRS 102 as:

*'The estimated amount that an entity would currently obtain from disposal of an **asset**, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its **useful life**.'*²

Therefore, under FRS 105, the residual value of an investment property would be based on current prices, i.e. the amount which would currently be obtained on disposal of the asset, as opposed to the amount that is expected to be obtained at the end of the asset's useful life.

¹ FRS 105 paragraph 28.10(c)(i) to (v)

² FRS 105 Glossary **residual value**

For this purpose, expectations as to future increases or decreases in those disposal proceeds are ignored.

FRS 105 defines 'residual value' by referring to the **potential disposal value** of the asset if it were already of the age and in the condition expected at the end of its useful life. This is very much separate from the current fair value of the asset and in instances where the fair value of an asset may exceed its carrying amount, this does not remove the requirement to recognise depreciation.

5.2 **Additional disclosures**

The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 SI 2015/980 made changes to the reporting requirements for small and micro-entities. FRS 105 only currently requires two disclosures to be made at the foot of the micro-entity's balance sheet in respect of:

- advances, credits and guarantees to directors; and
- guarantees and other financial commitments.

When SI 2015/980 was transposed into company law, the amendments made to sections 410A and 411 removed references to the phrase '*In the case of a company that is not subject to the small companies regime, if in any financial year...*'. Section 410A requires disclosure of off-balance sheet arrangements and section 411 requires disclosure of employee numbers. The effect is that these should be disclosed in the micro-entity's financial statements along with the section 413 disclosures.

As a consequence, off-balance sheet arrangements and employee numbers are a required disclosure in a micro-entity's financial statements for periods commencing on or after 1 January 2016.

Therefore, the revised disclosure requirements under FRS 105 will be:

- (a) information about off-balance sheet arrangements as required by section 410A of the Act;
- (b) information about employee numbers;
- (c) advances, credit and guarantees to directors as required by section 413 of the Act; and
- (d) 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.

While disclosures relating to off-balance sheet arrangements and employee numbers are not currently in FRS 105 (July 2015), which micro-entities are currently reporting under, it is advisable to include them in current years' financial statements to ensure the financial statements are prepared in accordance with the legal requirements and hence the true and fair presumption will apply. It should also be noted that while the current edition of FRS 105 does not include the disclosures, company law prevails over FRS 105 and hence accentuates the recommendation to disclose off-balance sheet arrangements and employee numbers for periods starting on or after 1 January 2016.