

Transitioning FRS 102 v FRS 105 (Lecture A802 – 11.48 minutes)

The two 'main' accounting standards in the suite of UK and Ireland GAAP consist of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. Both standards are applied widely throughout the UK and Republic of Ireland and questions often arise as to the suitability of each standard depending on whether the client is a micro-entity or small entity. This section of the course considers the differences between the two standards to help aid practitioners in advising clients as to the appropriateness of each one.

The section has been written in the context of a micro-entity that is eligible to apply *either* FRS 102 or FRS 105. It also looks at the factors to consider when a small company contracts so that it becomes eligible to use FRS 105.

At the outset it is worth noting that FRS 105 is an optional standard. Just because a micro-entity may be eligible to use FRS 105 does not mean it has to (and there are genuine reasons why FRS 105 may not be appropriate to a micro-entity). FRS 105 should therefore be considered on a case-by-case basis.

1.1 FRS 102

FRS 102 includes a separate section in the form of Section 1A *Small Entities*. FRS 102, Section 1A only deals with the **presentation** and **disclosure** requirements applicable to a small entity eligible to report under Section 1A. Recognition and measurement principles are dealt with in full FRS 102.

The idea is that if a small company outgrows Section 1A (say it becomes a medium-sized entity), then the disclosure requirements become more comprehensive as they are based on individual sections of FRS 102 rather than Section 1A. The recognition and measurement of amounts are still the same hence this avoids a transition to another alternative framework, or a transition to full FRS 102.

FRS 102, Section 1A currently contains the minimum disclosures required by company law. The section itself is optional – a small company need not apply Section 1A if they do not wish to, although most small entities do choose to apply Section 1A. If the company grows from small to medium-sized, Section 1A will not apply and the disclosures required by full FRS 102 will be applied.

FRS 102, Section 1A was drafted in line with the requirements of the EU Accounting Directive. As the UK has now left the EU, it is no longer subject to the Accounting Directive. This allows the FRC to change the disclosure requirements for small entities and this is something that could potentially be seen in the forthcoming Exposure Draft of amendments arising from the FRC's current periodic review (although at the time of writing, it was currently unknown what will be in the Exposure Draft). Reporting entities in the Republic of Ireland are still subject to the requirements of the Accounting Directive, so disclosures for Irish reporting entities will not change.

The same recognition and measurement principles apply to all entities, regardless of size, that report under FRS 102. Therefore, a micro-entity choosing to report under FRS 102 will use the same recognition and measurement principles as a large entity. Entities are unable to 'cherry pick' between standards so a micro-entity that chooses to report under FRS 102 cannot then apply certain provisions of FRS 105 (for example, by ignoring deferred tax).

There is one exception to full recognition and measurement principles which is available only to small entities (including small LLPs) in FRS 102, para 11.13A which relates to a loan to a small entity.

FRS 102, para 11.13A allows a small entity which receives a loan from a director who is also a shareholder, or a person who is within a director's group of close family members, when that group of close family contains a least one shareholder, to recognise the loan at transaction price (i.e. at cost). For clarity, the definition of 'close members of the family of a person' is:

Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:

(a) that person's children and spouse or domestic partner;

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner.

FRS 102
Glossary **close members of the family of a person**

In practice, this would apply to a loan provided by a director-shareholder (or, if the director is not a shareholder, a member of the close family of the director who is a shareholder), which is covered by formal terms and which is at below market rates of interest. The exception in paragraph 11.13A means the small entity does not have to impute a market rate of interest and then discount the loan on initial recognition. If the loan does not contain formal loan terms, then it need not be discounted in any event because it would be repayable on demand, so would be recognised as a current liability in the entity's financial statements. This is because where no formal loan terms exist, there is no agreement to defer settlement beyond 12 months from the balance sheet date.

FRS 102, Section 1A contains five **encouraged** disclosures which preparers cannot disregard which are found in Appendix E *Additional disclosures encouraged for small entities*. Over the last couple of years, the one that has been the most important one to consider is the going concern disclosure. FRS 102, Section 1A, para 1AE.1(c) encourages a small entity to provide the disclosures relating to **material uncertainties** [emphasis added] related to events or conditions that cast significant doubt upon the small entity's ability to continue as a going concern as set out in paragraph 3.9.

This paragraph is important because going concern is such a fundamental concept. The fact that the paragraph encourages the small entity to disclose material uncertainties means that if the directors choose not to (on the basis that the disclosure is encouraged rather than legally required), it will be difficult to justify that the financial statements give a true and fair view. Hence, in the absence of such disclosures the financial statements will contain material misstatement and will be misleading (even if those financial statements are

unaudited). Keep in mind that professional bodies do not allow member firms to have their names associated with financial statements which are misleading, so this is a particularly important issue to consider.

1.2 FRS 105

FRS 105 is viewed as a 'compliance framework' rather than a 'true and fair framework'. The standard is prescriptive and includes much simpler recognition and measurement principles and a vastly reduced disclosure regime (for UK-based micro-entities at least). There is only one format permitted for the profit and loss account (a Format 2 profit and loss account which presents expenses by nature) and there is no requirement for additional primary financial statements.

A notable feature of FRS 105 is the presumption in law that if the micro-entity's financial statements are prepared in accordance with the minimum legal requirements (i.e. FRS 105), the financial statements are presumed in law to give a true and fair view. This means the directors need not consider making any additional disclosures, beyond those required in the standard, to achieve a true and fair view.

Other notable simplifications in the standard are shown in the table below:

Topic	Simplification
Deferred tax	Micro-entities are prohibited from accounting for deferred tax.
Revaluations and the use of fair values	Micro-entities cannot revalue assets, nor can they apply fair value accounting. This is because application of the Alternative Accounting Rules and Fair Value Accounting Rules are prohibited in the micro-entities' legislation.
Equity-settled share-based payments	Micro-entities need not account for equity-settled share-based payments prior to the issue of the shares. This is because of the prohibition in the use of fair values and the lack of disclosure.
Defined benefit pension plans	These are accounted for in the same way as defined contribution plans, i.e. contributions into the plan are accounted for as an expense. A liability is recognised in respect of any agreements to fund a deficit (a schedule of contributions) because the pension obligation is not reported on the micro-entity's balance sheet.
Foreign currency	There is no distinction between functional and presentation currency and the micro-entity must use contracted rates to translate assets and liabilities denoted in a foreign currency as opposed to closing rate.

Borrowing and development costs	All borrowing and development costs must be expensed. There is no option to capitalise such costs on the balance sheet.
Government grants	These are recognised under the accrual model. The performance method of grant recognition is not recognised under FRS 105.
Financial instruments	Micro-entities are not required to use the amortised cost and effective interest method as this is considered to be too onerous for micro-entities. Financial instruments are effectively recognised and measured at cost.
Imputed market rates of interest	This requirement is removed in FRS 105 as the costs of applying this outweigh the benefits.
Recognition of separately identifiable intangible assets in a trade and asset acquisition	This requirement is removed in FRS 105 because they are not required items in the financial statement formats.
Hyperinflation	The accounting issues relating to hyperinflation are not included in FRS 105 as this is unlikely to be an issue for micro-entities.
Specialised activities	The only specialised activity is that of agriculture. Activities such as extractive industries, service concessions, heritage assets and funding commitments are unlikely to apply to micro-entities.

1.3 Transitioning between frameworks

Applying the correct financial reporting framework at the outset cannot be over-emphasised. Over the years, a common question asked by practitioners is whether FRS 102 could be applied in year 1, then if appropriate, FRS 105 in year 2, switch back to FRS 102 in year 3 and so on. This is not how the standards are designed to work and doing this is costly and inappropriate.

A micro-entity (which is eligible to use FRS 105) should consider all the benefits and drawbacks of the standard before concluding that FRS 105 is appropriate in its individual circumstances. If, for example, the micro-entity has an investment property on the balance sheet and the directors want to reflect the property's fair value at each reporting date in the financial statements, FRS 105 will not be appropriate. Under FRS 105, the investment property must be measured at cost less depreciation less impairment under that standard. Similarly, if an entity has a history of revaluing certain fixed assets, then FRS 105 will also not be appropriate and the micro-entity should be advised to report under FRS 102, including applying the presentation and disclosure requirements of Section 1A if it wishes.

Some micro-entities do outgrow FRS 105 and therefore will need to transition to FRS 102 (including Section 1A, if applicable). Conversely, some small entities will contract and hence become eligible to use FRS 105.

Whenever there is a switch between financial reporting frameworks, a transition must be carried out. This involves restating the transition date balance sheet (i.e. the opening balance sheet position at the start date of the comparative year) and then restating the closing comparative year to comply with the requirements of FRS 102 or FRS 105.

The table below provides some non-comprehensive factors to consider when switching between frameworks:

From FRS 102 to FRS 105	From FRS 105 to FRS 102
Remove any fair values and revalued amounts (a revaluation reserve should never be seen on a micro-entity's balance sheet).	Consider additional accounting policies permitted in FRS 102, such as revaluing fixed assets and capitalising development expenditure. Also FRS 102 requires all investment property (except intra-group investment property) to be measured at fair value.
Remove any deferred tax balances.	Recognise deferred tax balances.
Apply the disclosure requirements per FRS 105 (which does not include issues such as related party transactions and transitional information).	Consider whether the entity will apply the presentation and disclosure requirements of Section 1A or whether full FRS 102 disclosures are to be made (related party disclosures are limited under Section 1A but are more comprehensive under Section 33 <i>Related Party Disclosures</i> and the disclosure of transitional information is encouraged).
Restate foreign currency denominated assets and liabilities to contract rate where applicable.	Only use closing rate for such assets and liabilities. Contracted rates are not allowed under FRS 102.
Present the profit and loss account in Format 2.	Use a Format 1 (expenses by function) or Format 2 (expenses by nature) presentation.
Remove additional statements such as the statement of changes in equity and other comprehensive income statement.	Small entities are encouraged to present a statement of changes in equity and other comprehensive income statement.
Restate basic financial instruments as the amortised cost and effective interest method are not permitted.	Basic financial instruments are measured at amortised cost using the effective interest method. A small entity can apply the simplification in FRS 102, para 11.13A(a) for directors' loans to the entity at below market rates.
Remove transactions related to equity-settled share-based payment transactions where shares	Recognise equity-settled share-based payment transactions even if the shares have not yet been

have not yet been issued.	issued.
Remove the defined benefit pension liability and account for the defined benefit pension plan as a defined contribution plan but recognise a liability in respect of an agreement to fund a deficit in the form of a schedule of contributions.	Remove the liability in respect of an agreement to fund a deficit in the form of a schedule of contributions and apply defined benefit accounting (i.e. bring the defined benefit obligation onto the small entity's balance sheet).

This section has considered some of the more notable issues relating to FRS 102 and FRS 105 and how they interact with each other – especially when it comes to transitioning between the frameworks. The section has not covered every eventuality and preparers must, therefore, have a sound understanding of the differences of each framework in order to advise their client of the most appropriate framework correctly.

1.4 Filing issues for small entities

At the present time, there is an option for a small company to file 'filleted' or 'filleted abridged' financial statements. Abridged financial statements are not a 'replacement' for the old abbreviated accounts regime. In addition, abridging is not applicable to financial statements that have been prepared under the micro-entities regime.

Abridged accounts omit information in the financial statements which are preceded by Arabic numerals in the statutory formats of the financial statements, for example when abridged accounts are prepared:

- Turnover, cost of sales and other income are combined so the abridged profit and loss account starts with gross profit or loss
- There is no detailed breakdown of classes of fixed assets (just a total column)
- There is no detailed breakdown of debtors or creditors (although there are details of creditors falling due after more than five years)

Hence the information contained in abridged accounts is much less than in unabridged accounts. Where the entity elects to prepare abridged accounts, the shareholders and HMRC will also receive abridged accounts.

The small entity can only file filleted abridged financial statements if abridged financial statements have been prepared for the shareholders. If unabridged accounts have been drawn up, the small entity only has the option of filing filleted accounts. This is because the legislation requires that the shareholders **unanimously** agree to the small entity preparing abridged accounts.

The agreement referred to where abridged accounts are concerned is an annual process (i.e. one agreement cannot cover all subsequent years) and the agreement must be in place **before** the accounts are approved. The small entity can abridge either the profit and loss account **or** the balance sheet **or** both. There must also be a statement made above the signature on the face of the balance sheet confirming the shareholders have approved to the company preparing abridged financial statements, i.e.:

All the members have consented to the preparation of abridged financial statements for the year ended 31 March 2022 in accordance with Section 444(2A) of the Companies Act 2006.

Or, if only the balance sheet has been abridged:

All the members have consented to the preparation of an abridged balance sheet for the year ended 31 March 2022 in accordance with Section 444(2A) of the Companies Act 2006.

Example – Incorrect protocol followed

Smallco Ltd has prepared its financial statements for the year ended 31 October 2022 under FRS 102, including the presentation and disclosure requirements of Section 1A. The shareholders have not agreed to the entity preparing abridged financial statements.

The external accountant has prepared two versions of the accounts. The 'full' accounts will be distributed to the shareholders and HMRC. An additional filleted abridged version has been prepared for delivery to Companies House.

Smallco cannot file filleted abridged accounts with Companies House because the shareholders have not unanimously agreed to the entity preparing abridged accounts. Consequently, they can only file the full accounts or filleted accounts (i.e. remove the directors' report, profit and loss account and any notes relating to the profit and loss account and file the rest).

The shareholders would need to unanimously agree to the company preparing abridged accounts before they are approved in order to be able to file filleted abridged accounts.

Companies House reforms and the potential impact on filing requirements

In 2021, the government published its consultation on wide-ranging reforms to the powers and role of Companies House. The objective of these reforms is to improve business transactions and tackle fraud.

In March 2022, BEIS issued a White Paper on corporate transparency and register reform. This White Paper proposes to give new powers to the Registrar of Companies (and equivalents in Scotland and Northern Ireland) to maintain the integrity of the register. These new powers will include powers to query suspicious appointments or filings and, in some cases, request further evidence or reject the filing. These are just a couple of a number of reforms proposed.

For practitioners, a notable proposal comes in the form of the filing options that are currently available to small and micro-entities. Paragraphs 232 and 233 of the White Paper states:

We have reviewed the filing options available to small and micro companies and intend to simplify the framework by reducing the filing options to just two: micro-entities and small companies. Removing the abridged¹ and “filleted”² accounts options will make the options easier to understand, reduce fraud and error and increase transparency.

*Corporate
Transparency
and Register
Reform White
Paper, para 232*

All small companies will then be required to file a profit and loss account. This will ensure that key information such as turnover and profit or loss is available on the public register to help creditors and consumers make informed decisions. Small companies will be required to file all the constituent parts of their accounts, so they will actually file what they prepare with no additional effort required to “fillet out” certain information. This means that Companies House will receive a balance sheet and profit and loss account for all small companies including micro-entities. Small companies will also file a director’s report unless they meet the micro-entity thresholds, when they will still have the option to not prepare or file a director’s report. Although we will be asking for additional information to be filed by small companies, this will be information that they already hold and report to HMRC.

*Corporate
Transparency
and Register
Reform White
Paper, para 233*

Views on these proposals are mixed. Some preparers are in favour of Companies House requiring a full set of financial statements to be filed; whereas others are not. At the time of writing, there was no implementation date for these proposals and preparers are advised to keep abreast of developments in this area and advise clients accordingly.

¹ Abridged accounts allow a small company to prepare and file a shortened version of the balance sheet and profit and loss account which contains a subset of the information in full accounts. All shareholders must agree to the abridgement each year. No other version of the accounts should be prepared.

² “Filleted” accounts is a term used by the profession to describe accounts that do not contain the director’s report and/or the profit and loss accounts as the company has taken advantage of the small company’s option to remove them before filing.