

## **FRS 102 versus FRS 105 (Lecture A841 – 8.39 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 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 contains 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 an entity eligible to report under Section 1A. Recognition and measurement principles are dealt with in full FRS 102.

The idea of this is that if a small company outgrows Section 1A (ie, it becomes, say, 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 having to restate prior year comparatives (ie, do a transition).

FRS 102, Section 1A contains the 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.

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. You cannot 'cherry pick' between standards so a micro-entity that chooses to report under FRS 102 cannot then apply certain provisions of FRS 105.

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 person who is within a director's group of close family members (as defined in the Glossary to FRS 102), when that group of close family contains a least one shareholder, to recognise the loan at transaction price (ie, at cost).

In practice, this would apply to a loan provided by a director-shareholder/a member of the close family of the director, 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 an accounting policy choice, and a small entity can choose to apply discounting to the loan if it wishes.

FRS 102, Section 1A contains five **encouraged** disclosures which preparers cannot disregard which are found in Appendix E *Additional disclosures encouraged for small entities* as follows:

- (a) *a statement of compliance with this FRS as set out in paragraph 3.3, adapted to refer to Section 1A;* FRS 102, para 1AE.1
- (b) *a statement that it is a **public benefit entity** as set out in paragraph PBE3.3A;*
- (c) *the disclosures relating to **material** uncertainties 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;*
- (d) *dividends declared and paid or payable during the period (for example, as set out in paragraph 6.5(b)); and*
- (e) *on first-time adoption of this FRS an explanation of how the transition has affected its **financial position** and financial performance as set out in paragraph 35.13.*

#### **Proposed amendments via the periodic review**

As noted in previous updates, the FRC is proposing to extend the mandatory disclosures for small entities in the UK. It is now able to do this given that the UK has now left the EU and hence is no longer subject to the EU Accounting Directive. The disclosures expected to become mandatory are as follows:

- A requirement to make an explicit and unreserved statement of compliance with FRS 102, including Section 1A. Currently this is an encouraged disclosure (FRS 102, para 1AE.1(a)).
- Mandatory going concern disclosures to comply with para 3.8A, which states:

*When an entity prepares financial statements on a going concern basis, it shall disclose that fact, together with confirmation that it has considered information about the future as set out in paragraph 3.8. It shall also disclose, in accordance with paragraph 8.6, any significant judgements made in assessing the entity's ability to continue as a going concern.*

FRS 102, para  
3.8A

In addition, the small entity will be required to provide disclosures relating to material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern as set out in paragraph 3.9. Currently, this is an encouraged disclosure (FRS 102, para 1AE.1(c)).

- Disclosures in respect of leasing arrangements, including short-term leases, leases of low-value assets and variable lease payments.
- Disclosures in respect of:
  - provisions and contingencies;
  - share-based payment transactions;
  - promises in contracts with customers; and
  - deferred tax.
- Dividends declared and paid or payable during the period. Currently this is an encouraged disclosure (FRS 102, para 1AE.1(d)).
- Transition information on first-time adoption of FRS 102. Currently this is an encouraged disclosure (FRS 102, para 1AE.1(e)).

Currently, these additional mandatory disclosures are expected to apply to small entities preparing their financial statements under FRS 102, Section 1A for accounting periods commencing on or after 1 January 2026.

## **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 to be presented.

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 following table:

Transaction	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 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 using fair values (see above) and the lack of disclosures.
Defined benefit pension plans	These are accounted for in the same way as defined contribution pension plans, ie, contributions into the plan are accounted for as an expense. A liability is recognised in respect of any agreement to fund a deficit (a Schedule of Contributions) because the pension obligation is not presented on the 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 rather than the closing rate.
Borrowing and development costs	All borrowing and development costs must be expensed to profit or loss when they are incurred. There is no option to capitalise such costs as micro-entities are afforded no accounting policy choices.
Government grants	These are recognised under the accrual model. The performance method of grant recognition is prohibited under FRS 105.
Financial instruments	Micro-entities are not required to use the effective interest method as this is considered to be too onerous for micro-entities. Financial instruments are recognised and measured at transaction price (ie, cost).
Imputed market rates of interest	Imputed market rates of interest are not required. The costs of applying this treatment would outweigh the benefits for micro-entities.

Recognition of separately identifiable intangible assets in a trade and asset acquisition	This is not required under FRS 105 because they are not required items in the financial statements.
Hyperinflation	The accounting issues relating to hyperinflation are not included as it is likely to be irrelevant for micro-entities.
Specialised activities	This consists only 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.

A micro-entity (which is eligible to use FRS 105) should consider all the benefits and drawbacks of the standard before deciding on applying the standard. 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, FRS 105 will not be appropriate because 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 they wish.

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 (ie, 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 exchange 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 effective interest method is 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 that have not yet been issued.	Recognise equity-settled share-based payment transactions even if the shares have not yet been 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 (ie, 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.