

FRS 105 The new standard for micro companies is on the way!

Robert Kirk takes a look at the changes introduced by FRS 105 – the Financial Reporting Standard applicable to the micro-entities regime.

Introduction

In my article in last December's issue of Accountancy Plus I referred to the requirement, that under EU law, member states were required to implement the EU Directive 2012/6/EU of the European Parliament and of the Council ("**the Micros Directive**"). The deadline was supposed to be 30th June 2015 but it was only in August 2016 that the Irish government published a bill to implement the new rules for micro companies. Once it is enacted it will probably be made retrospective so that reporting entities can apply the new rules for accounts commencing on the 1st January 2016 but that has still to be clarified.

This article will focus on the changes being introduced by FRS 105 *The Financial Reporting Standard applicable to the micro-entities regime* which effectively puts the flesh around the new impending legislation.

What are micro entities?

It is an entity that meets all of the following conditions:

- (a) it is a **company** established under company law;
- (b) it qualifies as a micro-entity in accordance with the Companies Act; and
- (c) it is not excluded from being treated as a micro-entity under the Companies Act.

Effectively this means that sole traders and partnerships are not covered under (b) and specific entities such as financial institutions as defined in FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland* (FRS 102) would be prevented from adopting the standard, regardless of size. It is also designed for individual companies and not groups.

In addition, to qualify as a micro company (under (c) above), the Bill has set down certain size criteria for a company to be classified as a micro. It must not exceed two out of these three thresholds:

Net turnover	€ 700,000
Balance sheet total and	€ 350,000
Employees	10

The criteria must be met in two consecutive years for a company to qualify as a micro-entity and similarly it must be exceeded in two consecutive years to cease to qualify.

Even, if the company does meet all the criteria it still has the option of reporting at a higher level and that may be an issue if banks and revenue commissioners were to demand more financial information from the entity. In addition, some companies may wish to revalue their property or even capitalise development costs to bolster up their balance sheets but they would have to opt for FRS 102 Section 1A *Small Entities* of that standard to avail of reduced disclosures or even adopt the full version of FRS 102.

In May 2016, the FRC issued amendments to FRS 105 to reflect the fact that the micro-entities regime has been extended to qualifying partnerships and LLPs in the United Kingdom only.

How does FRS 105 differ from FRS 102?

The micros standard is broadly based on FRS 102, the main new UK/Irish GAAP standard, largely following its structure and section numbering. However, there are only 28 sections compared to 35 sections under FRS 102 as a number have been removed in FRS 105. FRS 105 considerably simplifies and truncates the accounting and disclosure requirements down to its bare essentials in order to comply with the legislation.



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The standard only amounts to 97 pages compared to over 200 for FRS 102 so there are quite a number of major simplifications in the new standard. One of the most important is that accounts prepared under FRS 105 are deemed to provide a true and fair view under the legislation and therefore preparers need only follow the compulsory notes and formats required by the standard. That could result in a maximum of two pages to the annual report whereas financial statements under the new proposed Section 1A of FRS 102 for small entities requires the Directors to decide what additional disclosure over and above what is legally required needs to be provided in order to provide a true and fair view.

The new formats

The formats required for the balance sheet and profit and loss account are considerably truncated – assets may only be analysed between current and non-current and similarly for liabilities and no breakdown of these items are required apart from having to disclose accruals and prepayments separately. The formats provide two choices for the balance sheet and one for the profit and loss. However, the latter is based on a Format 2 nature of expense approach rather than the more popular functional analysis approach and, in addition, the line item descriptors on the Format 2 profit and loss account cannot be changed. There are also only two compulsory notes which cover:

- (a) advances, credit and guarantees granted to directors as required by the Act; and
- (b) financial commitments, guarantees and contingencies

However, if a micro-entity chooses to disclose information in addition to the minimum legal disclosure notes it must, in respect of that item, follow the disclosure requirements of the relevant accounting standard, probably FRS 102.

None of the other primary statements in FRS 102 are required such as the Statement of Cash Flows, The Statement of Comprehensive Income and the Statement of Changes in Equity. Also a micro-entity is not required to prepare a directors' report.

Format 1	CU	CU
Called up share capital not paid		X
Fixed assets		X
Current assets	X	
Prepayments and accrued income	X	
Creditors: amounts falling due within one year	(X)	
Net current assets/ (liabilities)		X/(X)
Total assets less current liabilities		X
Creditors: amounts falling due after more than one year		(X)
Provisions for liabilities		(X)
Accruals and deferred income		(X)
		X
Capital and reserves		X

Balance Sheet Format 1

Format 2	CU	CU
Assets		
Called up share capital not paid		X
Fixed assets		X
Current assets		X
Prepayments and accrued income		X
		X
Capital, Reserves and Liabilities		
Capital and reserves		X
Provision for liabilities		X
Creditors		
Amounts falling due within one year	X	
Amounts falling due after one year	X	
		X
Accruals and deferred and deferred income		X
		X

Balance Sheet Format 2

	CU
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	X/(X)

Profit and Loss Account

Revaluation of Property

The fair value accounting and alternative accounting rules cannot be applied in micro-entity accounts. This means that no revaluations or subsequent measurement at fair value is permitted under the micro-entities regime. FRS 105 is therefore based on historic cost accounting and no valuations of property are permitted for both owner occupied and also investment property. That has implications for those who previously had to revalue their investment property under SSAP 19 or the FRSSSE as there are no transitional arrangements on first time adoption so actual cost will have to be reinstated and the last valuation will not be permitted as its deemed cost. This could have a major impact on an entity's balance

sheet position and therefore should be taken into consideration when establishing the most appropriate financial reporting framework to report under. It may be advisable in some situations to opt for a higher level of reporting particularly if it has the effect of breaching banking covenants.

Capitalisation of development and borrowing costs

The Financial Reporting Council (FRC), who developed the standard, has decided to remove as many options as possible to help to simplify financial reporting. As a result FRS 105 does not permit micros to capitalise interest on the construction of property/maturation of whiskey nor are they permitted to capitalise development costs even if they pass the criteria for development under FRS 102. Again reporting entities must consider carefully the implications of having to remove these from the balance sheet and the impact on gearing and banking covenants.

Deferred tax

Micros will not have to worry about calculating deferred tax which will be welcomed by most practitioners and by their clients. On transition to FRS 105, however, these balances will have to be removed through retained earnings.

Share based payment

Micros will no longer have to record an expense each year during the period of vesting for share based payment arrangements and will only have to record their impact when exercised by the holders of those options.

Government grants

Grants are accounted for using the accruals model only. The original exposure draft had recommended the adoption of the performance (balance sheet) model but commentators felt that it would lead to excessive volatility in reporting income. As a result the FRC decided to completely reverse their original proposal and now there is no option to use the new performance method which is only available in FRS 102. The accruals model is the only method now permitted in FRS 105.

Financial instruments

There is considerable simplification in accounting for financial instruments. There is no use of the effective interest rate or the amortised cost method and hence financial instruments, such as non-market rate loans will be accounted for at transaction price. However, financing transactions (where the entity defers payment beyond normal trading terms) will, as per FRS 102, still be accounted for initially at the cash price charged for the goods by the seller on the date of the transaction and the difference between the eventual amount to be received and the initial transaction price will be treated as interest income.

Example

A Ltd sells €100 of goods to a customer on an interest free two year loan. Had they sold it at the cash price on that day the goods would have been sold for €85. Initially the sale would be reported at €85 and the difference of €15 reported as interest income over the next two years.

Consolidation

Consolidation is not permitted in FRS 105 as the standard is designed for single companies only and under company legislation it is likely that any micro group would be able to avail of exemption from preparing consolidated accounts. The sections, therefore, relating to consolidation, joint ventures and associates are basically dropped although there are references to the need to account for all investments in Section 11 Basic financial instruments. If a micro group, however, voluntarily wishes to prepare group accounts it will have to prepare them under FRS 102 instead. However Section 15 does cover the accounting treatment of jointly controlled assets and operations and the rules are the same as FRS 102.

Hyperinflation and related parties

These are not included in FRS 105 apart from the legal disclosures re advances and credits required by the new legislation.

Specialised activities

Section 34 of FRS 102 (now Section 27 of FRS 105) was the longest section in that standard. However, the Financial Reporting Council have removed 95% of it leaving only

the paragraphs on agriculture left but again insisting on the adoption of the cost model only for measuring biological assets.

Tax implications

The FRC has not explicitly permitted or prohibited the use of FRS 105 by unincorporated businesses or individuals (which, if set up as companies, would be eligible for the micro-entities regime) for the purpose of calculating trading profits for submission to the tax authorities. Instead, the FRC note that this is a matter for the tax authorities.

In the United Kingdom, HMRC has confirmed that it will accept calculations of trading profits for income tax purposes prepared under FRS 105 if the size criteria have been met but that still has to be clarified in Ireland by the Revenue Commissioners.

Statement of compliance

There should be a statement on the balance sheet, in a prominent place above the signature, to the effect that the accounts have been prepared in accordance with the micro-entities provisions.

Effective date

The FRSS has now been withdrawn for accounting periods beginning on or after 1 January 2016 and FRS 105 was to be implemented from that date. Hopefully the new legislation, when enacted, will permit companies to apply the standard retrospectively to accounting periods ending 31st December 2016 to avoid possible double changes in framework in a two year period. Please see the Law & Regulation News Section on page 15 for further information on the proposed legislation and keep an eye on our eBulletins for its progress.

Conclusion

Undoubtedly this is a major revolution in the way that micro companies prepare their annual financial accounts for submission to the CRO. However, even if a company meets the criteria under the standard, it may not be appropriate to adopt FRS 105 particularly if it involves removing certain assets and reserves from the balance sheet and thereby adversely impacting on gearing and banking covenant ratios. Each business must look carefully at the impact of switching to FRS 105 before jumping in too fast.