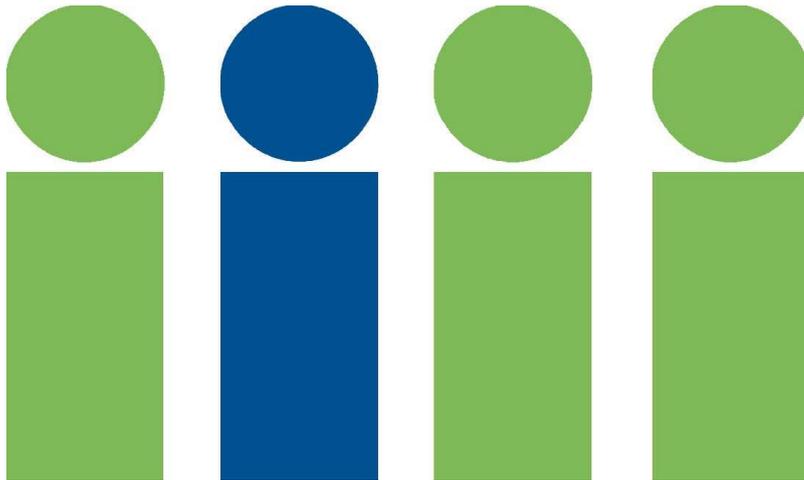


Technical Bulletin

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The new Micro-entity regime

The new Micro-entity regime

Overview - Introduction and purpose of the bulletin

Micro-entities have optionally been able to apply a significantly reduced reporting regime since 2013 when the new regulations were incorporated into both the 2008 and 2015 versions of the FRSSE.

FRS 105 was published in July 2015 as the new standalone accounting and reporting standard for micro-entities for periods beginning on or after 1 January 2016, replacing the FRSSE 2015 from that date.

Many qualifying entities will not currently be aware of the existence of the micro-entity regime, and fewer still will have adopted the regime already. The majority of micro-entities will therefore currently only be familiar with the FRSSE 2008.

From 1 January 2016, micro-entities electing not to apply FRS 105 will have to apply the full measurement and valuation provisions of FRS 102, optionally applying the disclosure exemptions set out in section 1A of the standard. Since the micro-entity provisions represent a significant simplification of these rules, they are certainly worth investigating.

This Bulletin aims to give a relatively detailed overview of the requirements of FRS 105, highlighting the key simplifications compared to FRS 102 and section 1A.

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<p>INTRODUCTION</p>	<p>Micro-entities have optionally been able to apply a significantly reduced reporting regime since 2013 when the regulations were incorporated into both the 2008 and 2015 versions of the FRSSE.</p> <p>FRS 105 was published in July 2015 as the new standalone accounting and reporting standard for micro-entities for periods beginning on or after 1 January 2016, replacing the FRSSE 2015 from that date. It may be adopted early, but provisions stemming from SI 2015/980 can only be applied to periods commencing on or after 1 January 2015.</p> <p>Most micro-entities are currently accounting under the full FRSSE 2008 and are not applying the micro-entity exemptions contained therein. The FRSSE 2015 contains the same provisions, which can continue to be applied up to periods commencing prior to 1 January 2016.</p> <p>From this date onwards, micro-entities electing not to apply FRS 105 will have to apply the full measurement and valuation provisions of FRS 102, optionally applying the disclosure exemptions set out in section 1A of the standard.</p> <p>This Bulletin aims to give a relatively detailed overview of the requirements of FRS 105, highlighting the key simplifications compared to the FRSSE 2008 and FRS 102. Unless otherwise stated, all references to FRS 102 are to the version published in August 2015.</p>												
<p>QUALIFICATION CRITERIA</p>	<p>Micro-entities are defined as companies that do not exceed at least two of the following three thresholds in relation to a financial year (the “two year rule” also applies in the same way as it does in respect of the small companies regime):</p> <ul style="list-style-type: none"> • Turnover not exceeding £632,000 per annum pro-rata • Balance sheet total not exceeding £316,000 • Average number of employees not exceeding 10 <p>LLPs, charitable companies, investment undertakings, financial institutions, consolidated subsidiaries and parent companies that prepare group accounts are all specifically excluded.</p>												
<p>OVERVIEW AND APPLICABILITY</p>	<p>FRS 105 runs to some 122 pages compared to FRS 102’s 378 pages. The internal structure is very similar, with separate chapters for each area of accounting. At a glance, some of the key simplifications are:</p> <table border="1" data-bbox="459 1570 1444 2042"> <thead> <tr> <th>FRS 102 chapters not included in FRS 105</th> <th>Reason</th> </tr> </thead> <tbody> <tr> <td>6 Statement of changes in equity and Statement of income and retained earnings</td> <td>Not required by FRS 105</td> </tr> <tr> <td>7 Statement of cash flows</td> <td>Not required by FRS 105</td> </tr> <tr> <td>14 Investments in associates</td> <td>Incorporated into chapter 7</td> </tr> <tr> <td>31 Hyperinflation</td> <td>Not expected to be relevant</td> </tr> <tr> <td>33 Related party disclosures</td> <td>Not required by FRS 105</td> </tr> </tbody> </table>	FRS 102 chapters not included in FRS 105	Reason	6 Statement of changes in equity and Statement of income and retained earnings	Not required by FRS 105	7 Statement of cash flows	Not required by FRS 105	14 Investments in associates	Incorporated into chapter 7	31 Hyperinflation	Not expected to be relevant	33 Related party disclosures	Not required by FRS 105
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	FRS 102 chapters combined in FRS 105	Reason
	11 Basic financial instruments 12 Other financial instrument issues	No different between the accounting for basic and other financial instruments
	16 Investment property 17 Property, plant & equipment	Accounting for fixed assets at fair value not permitted, hence no difference in accounting
	FRS 102 chapters condensed in FRS 105	Reason
	34 Specialised activities	Only the section on biological assets is retained, the others are not expected to be relevant
	<p>The key concepts and pervasive principles are largely the same as those in FRS 102. Where the former are shorter, this is usually because the latter refer to either disclosures or accounting choices not required or permitted by FRS 105. This consistency in approach should make it easier for growing micro-entities to transition to FRS 102 (with or without applying section 1A) in the future.</p> <p>Despite the number of simplifications to both accounting and disclosure rules, accounts prepared under the micro-entity regime are presumed in law to show a true and fair view. As a result, the directors of a micro-entity do not have to consider any additional information to enable the financial statements to give a true and fair view, in the same way as those of a small company do. Having said that, they are not prevented from making additional disclosures should they wish.</p> <p>Another key change is in terminology. FRS 105 has been drafted with a decidedly international favour, consistent with FRS 102. Appendix II contains table of equivalence for UK Companies Act terminology which some may find useful.</p> <p>As we will see, FRS 105 will not be suitable for all micro-entities due to its lack of choice and rigid approach.</p>	
PRIMARY STATEMENTS	<p>It can be seen from the table on page 2 above that the following primary statements are not required by FRS 105:</p> <ul style="list-style-type: none"> • Statement of changes in equity • Statement of income and retained earnings • Cash flow statement • Statement of comprehensive income <p>Thus the only primary statements needed are a straightforward income statement (profit and loss account) and a balance sheet. However there are some restrictions on the formats available, in that only a P&L format 2 may be used. This was not a restriction contained in Directive 2013/34/EU, and so presumably this was implemented in the UK in the interests of simplicity</p>	

	<p>and comparability. It therefore unfortunate that the government chose format 2 rather than the massively more popular format 1.</p> <p>Both the profit and loss account and balance sheet layouts for micro-entities are substantially simplified compared to the full versions. All the line items in a full format 1 or 2 balance sheet denoted with either Arabic or Roman numerals are omitted. The format 2 profit and loss account is also substantially condensed compared to the full version.</p> <p>The simplified layouts are shown in the Appendix to this Bulletin.</p>
<p>ACCOUNTING DIFFERENCES</p>	<p>The micro-entity regime as incorporated into the FRSSE includes substantial simplifications and removal of accounting policy choice; this is taken further still in FRS 105.</p>
<p>Valuation of fixed assets</p>	<p>FRS 105 requires all fixed assets and investments to be measured at cost less depreciation or amortisation and, if relevant, any charge for impairment. This is in stark contrast to both the FRSSE and FRS 102, which both permit the alternative accounting rules and revaluations.</p> <p>Where assets have previously been revalued, they must be restated to their depreciated historical cost at the date of transition and going forward. In contrast to when FRS 15 was introduced, it will not be possible to use a frozen revaluation as deemed cost at the date of transition. Paragraph 28.10(c) outlines the process to restate investment properties to cost.</p> <p>The removal of the valuation option has been made in the interests of simplicity, but may not suit, for example, property investment companies. If such a company is debt-free, then the shareholders may not mind, but an indebted company may well have banking covenants to comply with. It may be possible to get the covenant wording amended so that they refer to property valuations but not those incorporated into the financial statements, i.e. where a valuation is obtained solely for the bank.</p> <p>If not, then FRS 105 may be off the table for such companies. Since only two out of three thresholds need to be met, a qualifying property investment company could have a pretty large balance sheet with £632,000 of rental income, so this issue could affect a sizeable number of companies.</p>
<p>Residual values</p>	<p>Residual values are rarely given much thought, the default option usually being zero. However, FRS 105 (and 102) has a slightly different wording. FRS 105 states that,</p> <p style="padding-left: 40px;">“the residual value is the estimated amount that an entity would currently obtain from the 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”.</p> <p>Under current UK GAAP, the residual value refers to the estimated amount that would have been obtained at the date of acquisition if the asset were already of the age and condition expected at the end of its life.</p> <p>For assets with a non-zero residual value, this difference in the method of determination could have a significant impact on the depreciable amount.</p>

<p>Deferred tax</p>	<p>FRS 105 removes the requirement to account for deferred tax altogether; and deferred tax balances on the balance sheet will be reversed on first time adoption of the standard. This is in contrast to the FRSSE, which requires deferred tax to be recognised using the timing difference approach.</p> <p>This change alone may result in the opening of champagne by some! However, entities with a material deferred tax asset e.g. due to substantial tax losses, may view this very differently.</p> <p>Directors and owners of property investment companies may have read the section above and already written off the possibility of adopting FRS 105. However, from a measurement and valuation perspective the alternative is adoption of FRS 102, which requires deferred tax to be accounted for on revalued properties. This is also likely to result in a substantial hit to the balance sheet (although probably not as large as that resulting from a switch to depreciated historical cost), which again may adversely affect banking covenants.</p> <p>Owners of indebted property companies may therefore need to have a conversation with their bank manager, regardless of the size of their company.</p>
<p>Capitalisation of finance costs</p>	<p>The FRSSE and FRS 102 both permit finance costs such as interest that are directly attributable to the construction of a tangible fixed asset to be capitalised as part of the cost. FRS 105 does not contain this option, and such costs must be written off to profit or loss.</p>
<p>Capitalisation of development costs</p>	<p>Again, whilst permitted under the FRSSE and FRS 102, capitalisation of development costs is not permitted under FRS 105.</p>
<p>Equity-settled share-based payment</p>	<p>FRS 105 does not require micro-entities to account for equity-settled share-based payment transactions until shares are issued.</p>
<p>Financial instruments</p>	<p>We have already seen that the alternative accounting rules are not allowed to be applied to fixed assets. The same is also true for financial instruments such as foreign currency forward contracts and interest rate swaps, which do not have to be accounted for at fair value as they will under FRS 102. Instead, derivatives are recognised at cost (if any), and thus this is more akin to current UK GAAP.</p> <p>FRS 102 requires a market rate of interest to be calculated where a loan is granted at below market rate. This can be complicated in practice, and has tax implications. As fair value accounting is not permitted by FRS 105, no such adjustment needs to be made, a welcome simplification.</p> <p>FRS 102 also requires the effective interest method to be used to allocate interest charges to the profit and loss account. This is not included in FRS 105 on the grounds that it would be too onerous for micro-entities, who therefore stick to straight line interest where relevant.</p>

DISCLOSURE DIFFERENCES	FRS 105 really comes into its own re the minimal number of mandatory disclosures compared to both the FRSSE and section 1A of FRS 102.
Directors' report	Since their creation back in 2013, micro-entities have been required to prepare a directors' report in accordance with the Companies Act rules for small companies. SI 2015/980 removed this requirement, and this change has been reflected in FRS 105.
Notes to the financial statements	<p>There are, in fact, no mandatory notes to the financial statements at all! Instead, the foot of statement of financial position (balance sheet) must show, where relevant:</p> <ol style="list-style-type: none"> a) Advances, credits and guarantees granted to directors under s413 of the Companies Act; b) Financial commitments, guarantees and contingencies under regulation 5A and paragraph 57 of Part 3 of Schedule 1 to the Small Companies regulations (SI 2008/409); and c) An indication of the nature and form of any valuable security which has been provided in respect of (b) above. <p>The detail of these requirements is reproduced for ease of reference in the appendix to section 6. Any commitments concerning pensions and affiliated or associated undertakings shall also be disclosed separately.</p>
EARLY ADOPTION	<p>The key new simplifications introduced by FRS 105 compared to the previous micro-entity regime incorporated into both the 2008 and 2015 versions of the FRSSE are the removal of the requirements to:</p> <ul style="list-style-type: none"> • Account for deferred taxation; • Account for equity-settled share based payment before the issue of shares; and • Prepare a directors' report. <p>Whilst FRS 105 itself does not specify any time restriction on early adoption, it does incorporate the changes made to the micro-entity regime contained in SI 2015/980, and these cannot be adopted for periods commencing before 1 January 2015.</p> <p>Unless an entity has share based payment or a significant deferred tax balance, there appears to be little to be gained from moving to the micro-entity regime in the FRSSE 2015 for a year and then changing again to FRS 105 – most entities considering adopting the regime are likely to benefit from early adoption of FRS 105.</p>
FIRST TIME ADOPTION	Section 28 of FRS 105 contains a number of transitional rules and relaxations which can (and in some cases, must) be used on first time adoption of the new micro-entity regime. It is worth taking the time to work through the list, as the net effect will vary considerable from company to company depending on the specific transaction types and balances that are relevant.

<p>ACTION</p>	<p>The first step should be to examine the eligibility of a particular entity to apply FRS 105, as a significant number of entities meeting the size criteria will find themselves otherwise excluded.</p> <p>The second step should then be to assess the impact of the new accounting and disclosure rules. There are no short-cuts to be had here, as all entities vary and the net impact on a particular entity's financial statements will depend on the exact set of circumstances particular to that entity.</p> <p>Due to the lack of choice in the standard, adoption of the micro-entity regime is really a question of all or nothing; either adopt it in its entirety or else apply FRS 102. The cost of the latter is a considerable amount of extra disclosure, even if applying the small entity exemptions in section 1A.</p>
<p>SOURCES</p>	<p>FRS 105</p> <p>FRSSE 2008 and 2015</p> <p>FRS 102 (September 2015)</p> <p>Directive 2013/34/EU</p> <p>Companies Act 2006</p> <p>SI 2015/980</p> <p>SI 2008/409 (amended)</p>

Appendix – Mandatory Primary Statement Formats for Micro-Entities

Format 1 Micro-Entity Balance Sheet

	£	£
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)	<u> </u>	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)
		<u> </u>
		X
Capital and reserves		<u> </u>

Format 2 Micro-Entity Balance Sheet

	£	£
Assets		
Called up share capital not paid		X
Fixed assets		X
Current assets		X
Prepayments and accrued income		X
		<u> </u>
		<u> </u>
Capital, Reserves and Liabilities		
Capital and reserves		X
Provisions for liabilities		X
Creditors		
Amounts falling due within one year	X	
Amounts falling due after one year	X	
	<u> </u>	X
Accruals and deferred income		X
		<u> </u>
		<u> </u>

Format 2 Micro-Entity Profit and Loss Account

	£
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> </u>
	<u> </u>

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