Changes in financial reporting

Small entity consultations

The Department for Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) have published consultations that that have the potential to make sweeping changes to the legislative and accounting framework for small entities. In this commentary we look at an overview of the proposals made in each of the consultations and consider the impact for your small entity clients.

FRC and BIS consultations

Long awaited consultations have been published that will lead to important changes to the financial reporting framework for small entities.

Whilst the consultations cover a number of areas, they focus predominantly on changes for small and micro-entity companies. As such, in this summary, we provide an overview of some of the key proposals in each of these consultations and focus on the potential impact on your small company clients.

BIS consultation summary

UK Implementation of the EU Accounting Directive: Chapters 1-9 - Financial Statements and General Requirements for Audit

The BIS consultation is a wide ranging document that proposes changes in a number of areas affected by the new Accounting Directive adopted by the EU in June 2013. Whilst the UK is required to transpose the Accounting Directive into UK law no later than 20 July 2015, BIS are proposing to take up an option permitting the changes to first be applied to financial years beginning on or after 1 January 2016. BIS are consulting on whether early adoption should be permissible.

The consultation seeks views in the following areas:

- Increases to company size thresholds and amendments to definitions of criteria and exceptions
- Changes to small company notes disclosures
- Interaction of the Accounting Directive and the statutory audit framework
- Small companies being permitted to prepare an abbreviated balance sheet and profit and loss account
- Additional flexibility in the formats of the profit and loss account and balance sheet

- Changing the maximum goodwill and development cost amortisation period where no reliable estimate can be ascertained to 10 years
- Information on subsidiaries being included as a note to the consolidated financial statements only, rather than in separate returns
- Removing the requirement for micro-entity companies to prepare a Directors Report
- Implications of the revised accounting framework for charitable companies

We look at some of the detail and the potential implications of the first three of these areas.

Consultation overview

UK Implementation of the EU Accounting Directive: Chapters 1-9 - Financial Statements and General Requirements for Audit

Issued by	BIS
Consultation length	64 pages
Number of questions	44
Proposed implementation date	1 Jan 2016*
Consultation closing date	24 Oct 2014

Accounting Standards for Small Entities - Implementation of the EU Accounting Directive

Issued by	FRC
Consultation length	24 pages
Number of questions	7
Proposed implementation date	1 Jan 2016*
Consultation closing date	30 Nov 2014

*Legislative and accounting standards proposals effective for periods commencing on or after 1 January 2016. Proposal for micro-entity reporting standards to become effective when published.

Increases to company size thresholds

The EU Accounting Directive offers considerable flexibility at a local level when setting company size limits. BIS is therefore proposing moving size limits for small and medium-sized company size thresholds to the maximum amounts permissible.

Whilst micro-entity limits, already implemented in UK Law, remain consistent; the small and medium-sized company limits for turnover, for example, move from £6.5m to £10.2m and £25.9m to £36m respectively.

Proposed company size thresholds

	Micro	*Small*	*Medium*
Turnover	£0.632m	£10.2m	£36m
Balance sheet total	£0.316m	£5.1m	£18m
Average employees	10	50	250

BIS are also proposing changes to terminology which currently stops public companies or companies within a group containing a public company from using small and medium accounting exemptions. However, it is unclear whether this change, which refers to entities that are traded on a regulated market, will be implemented as there is currently resistance to allowing a company with an AIM listing to be within the scope of the small companies' regime.

The size threshold changes are being proposed in respect of accounting exemptions only and BIS anticipate that changes to the qualification criteria will bring approximately 11,000 additional companies into the small companies' financial reporting regime.

Small company notes disclosures

The EU Accounting Directive offers BIS limited flexibility in setting disclosure requirements within small company accounts. The Accounting Directive prescribes eight notes and gives member states the option of requiring five more. However, member states are not permitted to require information in excess of these 13 notes. Currently, accounts disclosures are driven by both legislative and accounting standards requirements. The EU Accounting Directive therefore also affects the FRC consultation on small entity accounting standards, as requirements for additional disclosures through standards are also prohibited.

BIS are therefore proposing legislative requirements for the maximum of 13 notes. These will cover the following areas:

- Accounting policies
- Fixed asset movements*
- Revalued fixed assets
- Financial instruments and other assets measured at fair value
- Financial commitments, guarantees or contingencies
- Security and amounts due after five years
- Average number of employees
- Advances and credits
- Related party transactions*
- Name and registered office of the undertaking drawing up the lowest level of consolidated financial statements in which the entity is included*
- Exceptional items
- Off-balance sheet arrangements*
- Post balance sheet events*

Items marked with an * are optional under the EU Accounting Directive, though BIS consider that they support the delivery of true and fair accounts, hence are proposing their inclusion in UK company law.

The proposals will generally lead to a reduction in the information provided in a set of small company accounts. Preparers of financial statements will need to consider whether the absence of other information, not required by law, will impact on the ability of a company to prepare accounts that show a true and fair view, and they may ultimately require advice on additional disclosures.

Some requirements will also be new, for example the requirement for a small company to disclose its average number of employees.

Requirements for audit

Whilst BIS are proposing to extend the 'entities that are traded on a regulated market' terminology into audit exemption exceptions, they are not proposing an increase to audit exemption size thresholds in line with those proposed for reporting exemptions.

BIS note that they will consider audit exemption limits 'in due course' though not as part of the Accounting (or Audit) Directive implementation.

The lack of evidence to support a change within the associated consultation impact assessment appears to suggest that this area will be subject to future consultation.

FRC consultation summary

Accounting Standards for Small Entities - Implementation of the EU Accounting Directive

Due to the restrictive nature of the EU Accounting Directive, in the context of small company accounting standards, the FRC remit is effectively restricted to recognition and measurement requirements.

The consultation asks questions about small company accounting, makes some relatively radical proposals for the recognition and measurement requirements for micro-entities, and also makes proposals in areas linked to previous consultations. We look at some of the detail and the potential implications below.

Financial reporting framework

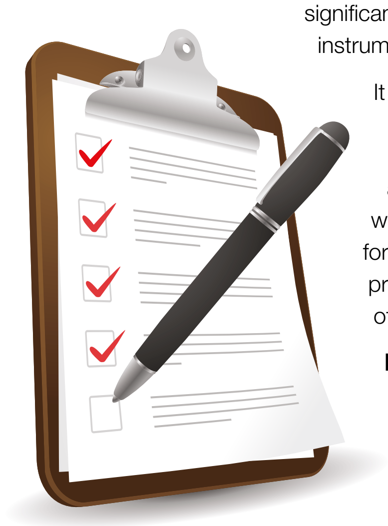
The FRC are proposing that for accounting periods beginning on or after 1 January 2016, small companies will be brought within the scope of FRS 102, though disclosure requirements will be driven by the legislative requirements being consulted on by BIS which are expected to be effective from the same date.

Proposed UK Financial Reporting Framework		
As required by legislation / regulation	IFRS	
	Qualifying group entities	FRS 101
Non-small	FRS 102	
Small	FRS 102 – Limited Disclosures	
Micro	FRSME	

They are also proposing a new accounting standard for qualifying micro-entities, a Financial Reporting Standard for Micro-Entities. This standard will offer recognition and measurement simplifications from FRS 102, which the standard will otherwise be based upon.

As is currently the case, an entity may choose to adopt a reporting framework in excess of that required.

The proposals for micro-entity and small companies are considered in further detail below.



Financial Reporting Standard for Micro-Entities

In 2014, the FRSSE was updated for legislation which permitted qualifying micro-entity companies to prepare and present simplified financial statements. The FRC are proposing, within their consultation, a new Financial Reporting Standard for Micro-Entities (a FRSME).

As micro-entity company legislation is already in place, the FRC are proposing that the FRSME will be effective, for qualifying entities, from the date of its issue. It should be noted that extension of the micro-entity regime to other types of entity (eg LLPs) was not within the scope of the BIS consultation, though is on the long-term agenda.

Whilst limited recognition and measurement and significant accounts disclosure exemptions for micro-entity companies have not been widely adopted to date; simplification proposals for the FRSME may offer genuine accounting benefits, when compared to FRS 102 accounting requirements.

Proposed simplifications are highlighted below:

Area	***Proposed FRSME simplification from FRS 102***
Financial instruments	• Measurement based on historical or amortised cost (fair values prohibited by law) • Where a derivative (eg an interest rate swap) becomes onerous, recognise at present value
Deferred tax	• Ignore for micro entities
Equity settled share based payments	• Not accounted for prior to issue of shares.
Pensions	• Account for defined benefit schemes as defined contribution schemes • Recognition of past service deficit funding contribution liabilities
Business combinations and goodwill	• FRS 102 section deleted • Refer to FRS 102 where trade and assets acquisition
Borrowing costs	• No option to capitalise
Hyperinflation	• FRS 102 section deleted
Specialised activities	• FRS 102 section reduced • Agriculture retained

Whilst some may suggest that a micro-entity would adopt the FRSME just to get away from deferred tax, there are a number of other recognition and measurement requirements that will significantly reduce complexity in respect of financial instruments and post-employment benefit accounting.

It should also be noted that, in addition to the simplifications in the FRC proposal, micro-entity legislation does not permit adoption of alternative or fair value accounting rules. This would therefore also prohibit the use of valuations for property, plant and equipment, investment properties and other investments as would otherwise be permitted or required by FRS 102.

FRS 102 for small companies

The FRC are proposing to bring non-micro-entity small companies within the scope of FRS 102. Whilst they will not be subject to the extensive disclosure requirements within the standard, it is proposed that FRS 102 recognition and measurement requirements will stand.

It is estimated that this will result in approximately 1.5 million companies that are currently eligible to report under the FRSSE moving onto the more complex FRS 102 (with a further 1.5 million being eligible for the simplified FRSME).

The current FRSSE (and the version effective 1 January 2015) makes a number of simplifications to the full recognition and measurement requirements within the current UK GAAP suite of SSAPs and FRSs. Areas that will see simplification in the FRSME proposals will be those likely to present the most difficulty to a FRSSE entity transitioning onto FRS 102 for the first time.

Whilst it could be argued that many small companies will be unaffected by accounting requirements for 'other' financial instruments, such as forward exchange contracts, or interest rate swaps; some will be, and this will not be the only area where calculation of the numbers will become more complex.

The FRC have noted that the improvements in financial reporting and the longer term benefits of a consistent framework outweigh the costs of transition. Practically, the longer term implications will also need to be considered by the FRC as part of the consultation. For example, affected companies will be subject to recurrent additional cost of compliance with FRS 102. Issues may also arise for some smaller entities that choose to have an audit, where auditors could find themselves prohibited from acting where they have also valued certain numbers that will be required in the financial statements.

FRC have noted that they will need to pay close attention to transition options available to small companies moving onto FRS 102.

Other areas

The FRC consultation also makes proposals in certain other areas. For example, it is proposed that Section 34 Specialised Activities of FRS 102 is amended to address principles of accounting by residential management companies. It is not expected, however that this will extend to additional disclosures previously proposed in FRED 50 Draft FRC Abstract 1 - Residential Management Companies' Financial Statements as most affected entities will be small or micro-entity companies where disclosure requirements will be limited by legislation.

Other proposals include a number of consequential amendments in FRS 102, and the FRC also appear keen for the government to permit FRS 101 adopters to follow IAS accounts formats, which would reduce the costs of compliance associated with adoption of FRS 101 to date.

Both the FRC and BIS consultations include a number of key questions that will particularly affect preparers of small and micro-entity company accounts.

The consultation periods are relatively short and it is recommended that you assess the impact for your clients as soon as possible. For those of you wishing to respond, details of the full consultation questions and contact details of the FRC and BIS are included within the respective consultation documents.

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- courses
- webinars
- client letters
- newswire
- blogs

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