UK accounting standards

Response to the FRC's exposure draft FRED 82

The Association of Investment Companies (AIC) is a trade body for the closed-ended investment company sector. We represent 349 investment companies, managing assets of over £244 billion on 28 February 2023. The AIC's members are predominantly listed on the Premium Segment of the Main Market of the London Stock Exchange. Some have shares on the Specialist Fund Segment (SFS); others are quoted on AIM.

The AIC's members, collectively called investment companies, include investment trusts, Venture Capital Trusts (VCTs), UK Real Estate Investment Trusts (REITs) and non-EU companies. Our non-EU members are primarily domiciled in Guernsey and Jersey.

Investment companies are collective vehicles which pool their shareholders' capital and hold a portfolio of assets to spread risk and generate an investment return. Investments include listed securities, private equity, debt, property and infrastructure. Investment in property can be direct or take the form of investment in a company owning property. Investment companies are 'closed-ended' funds, that is, they have a fixed number of shares.

Approximately 45% of our members, by number, use FRS 102. The majority of others use IFRS.

The AIC welcomes the opportunity to respond to FRED 82 published by the Financial Reporting Council (FRC) proposing draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs.

Section 1: Disclosure

Q1 Do you have any comments on the proposed overall level of disclosure required by FRS 102?

Overall, the AIC supports the changes being proposed.

However, please refer to our other specific comments set out below, in particular the comment regarding faithful representation in response to question 2 in Section 2.

Q2 Do you believe that users of financial statements prepared under FRS 102 will generally be able to obtain the information they seek? If not, why not?

Overall, the AIC supports the changes being proposed and considers that it will provide users with the information they require from financial statements.

However, please refer to our other specific comments set out below.

Section 2: Concepts and pervasive principles

Q1 Do you agree with the proposal to align FRS 102 and FRS 105 with the 2018 Conceptual Framework? If not, why not?

The AIC agrees that it is useful to have FRS 102 broadly aligned with the concepts and pervasive principles set out by the IASB and used in international standards. However, please see the comments in the next question and question 1 in Section 9.

Q2 Do you have any other comments on the proposed revised Section 2?

Characteristics of users

The proposed paragraph 2.14 requires entities to "*consider the characteristics of … users*". Whilst entities will take into account the characteristics of their shareholders and key stakeholders, they do not always know who all the users are nor why they are using the accounts.

The AIC **recommends** this paragraph is revised to clarify that entities should consider the characteristics of users that the entity would reasonably expect to be users of the accounts.

Faithful representation

The proposed paragraph 2.19, included under the heading "*Faithful representation*" states:

> "*Free from error means there are no errors or omissions in the description of the events, and the process used to produce the reported information has been selected and applied with no errors. In this context, free from error does not mean perfectly accurate in all respects.*"

This is more onerous than the current concept of reliability which states that "*Information is reliable when it is free from material error and bias and represents faithfully that which it purports to represent or could reasonably be expected to represent.*"

The current description is proportionate and effective. In contrast, the proposed definition does not take materiality into account and, although it does refer to the fact it does not mean "*perfectly accurate*", this is not the same as materially correct. This could result in companies incurring increased time and cost burdens for no material benefit.

The AIC **recommends** the proposed definition is revised, and shortened, to include the concept of materiality. The process used is not an accounting consideration, it is one of corporate governance, therefore references to this should be deleted. The AIC **recommends** the following revisions (insertions shown in underlined text, deletions shown in struck-through text):

> "*Free from error means there are no <u>material</u> errors or omissions in the description of the events~~, and the process used to produce the reported information has been selected and applied with no errors. In this context, free from error does not mean perfectly accurate in all respects.~~*"

Current value

The proposed paragraph 2.81 discusses fair value. It states that "*Because fair value is not derived, even in part, from the price of the transaction or other event that gave rise to the asset or the liability, fair value is not increased by transaction costs incurred when acquiring the asset and is not decreased by transaction costs incurred when the liability is incurred.*"

This is ambiguous and could be made clearer. It could be read simply as though fair value is not derived, even at the point of the transaction, by the price of the transaction. This is not correct and would conflict with the paragraph on initial measurement, paragraph 11.13 ,which states that "*When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price … unless…*".

The AIC **recommends** this paragraph is rephrased to make it clear that it is talking about the charge incurred to perform the transaction.

Accruals

It is proposed that references to the accruals basis of accounting (previously in paragraph 2.36) are deleted and only used for micro-entities. This is a well understood and established concept, and whilst recognition criteria are provided in individual sections, this is a useful overarching principle which the AIC **recommends** is maintained.

Section 3: Fair value

Q1 The proposed Section 2A Fair Value Measurement of FRS 102 would align the definition of fair value, and the guidance on fair value measurement, with that in IFRS 13 Fair Value Measurement. Do you agree with this proposal? If not, why not?

Common valuation techniques

The AIC does not agree with the proposal to remove references in the current paragraph 2A.2 to commonly used valuation techniques. This provides that "*If there is a valuation technique commonly used by market participants to price the asset and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.*"

For companies holding alternative assets, such as property or private equity, there are well established and well-respected market valuation guideline techniques. For example, the Royal Institute of Charter Surveyors publishes a Red Book, which sets out global standards in valuation for property. Similarly, there are International Private Equity and Venture Capital Valuation (IPEV) Guidelines which represent best practice on the valuation of private equity and venture capital investments.

These industry recognised valuation guidelines promote transparency and consistency across the sectors they apply to. The guides are invaluable for professional valuers and others.

It is important that reference to such valuation techniques "*commonly used by market participants*" remains in FRS 102 to ensure such industry guidelines continue to be recognised and used by those involved with fair valuing assets for financial reporting.

The proposed paragraph 2A.14 (a) does not adequately address this. It states that valuation techniques shall be consistent with the market approach which "*uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business*."

The AIC **recommends** this paragraph is amended as follows (insertions shown in underlined text):

> *"An entity shall use valuation techniques consistent with one or more of these approaches:*
>
> *(a) The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business. If there is a valuation technique commonly used by market participants to price the asset and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.*
>
> *(b) …"*

Use of bid and ask prices

The proposed new paragraph 2A.17 states that "*The use of multiple techniques, can often produce a range of reasonable valuations. The selection of the most appropriate fair value within the range requires judgement, considering qualitative and quantitative factors specific to the measurement. The use of bid prices for asset positions and ask prices for liability positions is permitted, but is not required*."

This is a departure from the current position set out in paragraph 2A1 (a) which states that "*The best evidence of fair value is a quoted price for an identical asset (or similar asset) in an active market. This is usually the current bid price.*"

The proposed new paragraph is derived from paragraph 70 of IFRS 13, but it does not include the other useful part of that paragraph which states that "*If an asset or a liability measured at fair value has a bid price and an ask price (eg an input from a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value.*"

The AIC is concerned that the proposed new paragraph could be open to misinterpretation. No example has been provided demonstrating when the bid price, being the exit price, would not be the most appropriate price to be used. This will result in a divergence of practices, resulting in less comparability. It is unclear, for example, why different funds could use different practices when pricing an identical portfolio of assets.

The AIC **recommends** the FRC provides further detail to explain when and why it would not usually be appropriate to use a bid price for an asset position and an ask price for a liability position and the implications of this change for investors. It would also be helpful to set out the implications for investors were market practice to change so that the mid price was used. In the absence of this analysis, the AIC **recommends** that the current position is retained.

Q2 Do you agree with the proposed consequential amendment to Section 26 Share-based Payment of FRS 102 to retain the extant definition of fair value for the purposes of that section? If not, why not?

Yes, the AIC agrees with this proposal and **recommends** the extant definition remains for Section 26.

Section 4: Expected credit loss model

Q1 Do you agree with the FRC's proposal to defer its conclusion as to whether to align FRS 102 with the expected credit loss model of financial asset impairment from IFRS 9 pending the issue of the IASB's third edition of the IFRS for SMEs Accounting Standard? If not, why not?

The AIC has no comment on this question.

Q2 Do you agree with the FRC's preliminary view that, , in the context of FRS 102, it may be appropriate to require certain entities to apply an expected credit loss model to their financial assets measured at amortised cost, but allow other entities to retain the incurred loss model? If not, why not?

The AIC has no comment on this question.

Q3 Do you have any comments on which entities should be required to apply an expected credit loss model?

The AIC has no comment on this question.

Section 5: Other financial instrument issues

Q1 In preparation for the eventual removal of the IAS 39 option, the FRC proposes to prevent an entity from newly adopting this accounting policy. Do you agree with this proposal? If not, why not?

Yes, the AIC agrees with this proposal and **recommends** the proposed additional wording in 11.2 and 12.2 is adopted. However, companies that are already using the recognition and measurement provisions of IAS 39 and the disclosure requirements of Sections 11 and 12 should be allowed to continue to do so.

Q2 Do you support the deletion of temporary amendments made to FRS 102 in December 2019 and December 2020 in relation to interest rate benchmark reform? If so, when do you think they should be deleted? If not, why not?

Yes, the AIC supports this and **recommends** the FRC makes the proposed deletions.

Section 6: Leases

Q1 Do you agree with the proposals to revise Section 20 of FRS 102 to reflect the on-balance sheet lease accounting model from IFRS 16, with simplifications? If not, why not?

The AIC has no comment on this question.

Q2 Have you identified any further simplifications or additional guidance that you consider would be necessary or beneficial?

Please see our response to question 1 in Section 9.

Section 7: Revenue

Q1 Do you agree with the proposals to revise Section 23 of FRS 102 and Section 18 of FRS 105 to reflect the revenue recognition model from IFRS 15, with simplifications? If not, why not?

The AIC has no comment on this question.

Q2 Have you identified any further simplifications or additional guidance that you consider would be necessary or beneficial?

The AIC has no comment on this question.

Section 8: Effective date and transitional provisions

Q1 Do you agree with the proposal that the effective date for the amendments set out in FRED 82 is accounting periods beginning on or after 1 January 2025, with early application permitted provided all amendments are applied at the same time? If not, why not?

The AIC recognises that for some companies, including SORP making bodies, the proposed amendments to FRS 102 may be significant.

The FRC needs to ensure that all stakeholders have sufficient time to update their relevant systems and controls before the new standards are implemented. For companies that follow SORP guidance, this time will be reduced as SORP making bodies will require time to consult on relevant changes to the SORP after the revisions to FRS 102 have been finalised.

Given these time constraints the AIC **recommends** that the amendments set out in FRED 82 apply to accounting periods beginning on or after 1 January 2026, with early application permitted.

Q2 In respect of leases, do you agree with the proposal to permit an entity to use, as its opening balances, carrying amounts previously determined in accordance with IFRS 16? If not, why not?

The AIC has no comment on this question.

Q3 Otherwise, FRED 82 proposes to require the calculation of lease liabilities and right-of-use assets on a modified retrospective basis at the date of initial application. Do you agree with this proposal? If not, why not?

The AIC has no comment on this question.

Q4 In respect of revenue, FRED 82 proposes to permit an entity to apply the revised Section 23 of FRS 102 on a modified retrospective basis with the cumulative effect of initially applying the revised section recognised in the year of initial application. However, FRED 82 proposes to require micro-entities to apply the revised Section 18 of FRS 105 on a prospective basis. Do you agree with these proposals? If not, why not?

The AIC has no comment on this question.

Q5 Do you have any other comments on the transitional provisions proposed in FRED 82?

The AIC has no comment on this question.

Q6 Have you identified any additional transitional provisions that you consider would be necessary or beneficial? Please provide details and the reasons why.

The AIC has no comment on this question.

Section 9: Other comments

Q1 Do you have any other comments on the proposed amendments set out in FRED 82?

The current version of FRS 102 is generally well written, easy to read and understand, and fairly concise. These qualities should not be overlooked. Some of the proposed revisions represent a backwards step. Some proposed paragraphs, including the new section on leases and revenue from contracts with customers are difficult to understand and lengthy. They have been incorporated using more as a copy across approach rather than re-writing them in a more concise manner. This is not consistent with the current version of FRS 102 which is designed to be a proportionate set of standards. In time, taking such an approach will result in FRS 102 becoming a very lengthy and less usable document.

The AIC **recommends** the FRC considers whether any of the proposals could be re-written to make them more clear and concise.

In addition, as identified in our response to question 2 in Section 2, it does not seem appropriate to move away from a traditionally well used and understood accounting principle such as accruals accounting.

Section 10: Consultation stage impact assessment

Q1 Do you have any comments on the consultation stage impact assessment?

The AIC has no comment on this question.

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To discuss the issues raised in this paper please contact:

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