

THE FUTURE OF  
FINANCIAL REPORTING  
IN THE UK AND REPUBLIC OF IRELAND

REVISED FINANCIAL  
REPORTING EXPOSURE  
DRAFTS

FINANCIAL REPORTING  
EXPOSURE DRAFT

ALTERNATIVE VIEW



ACCOUNTING  
STANDARDS  
BOARD

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*We will publish a summary of the consultation responses, either as part of, or alongside, our final decision.*

# ALTERNATIVE VIEW TO FINANCIAL REPORTING EXPOSURE DRAFT 48 (DRAFT FRS 102)

## 1 EXECUTIVE SUMMARY

- 1.1 This document sets out the alternative view of a member of the ASB to the proposals set out in FRED 48. In summary, the member believes that:
- (a) accounts are prepared solely to communicate information to users. Users' information needs for the entities that will be subject to FRED 48 primarily revolve around whether an entity has sufficient funding to remain a going concern and execute its business plan, with other stewardship issues being of a secondary concern;
  - (b) the objective of this project should be redrafted as being "to provide users of accounts with the information that they need, in an accessible format, subject only to cost/benefit constraints";
  - (c) the ASB should have set out a clear exposition of the nature of information that major classes of users find useful; in the absence of this benchmark, the ASB is unable to assess whether its proposals meet the objective set out by the FRC in "Louder than Words" that regulation should be "targeted"; and
  - (d) as a consequence of focussing on the information needs of users, FRED 48 should be redrafted, particularly in the areas of financial instruments, defined benefit pension schemes, deferred tax and equity settled share-based payments.
- 1.2 The member believes that a redrafting of these sections in terms that the vast majority of both users and preparers can understand will lead to improved confidence in accounts, significantly enhance their usability, and consequently substantially increase the benefits that can flow from such high quality financial reporting.
- 1.3 The member considers that by eliminating unnecessary complexity and cutting clutter in such a manner the ASB would also have:
- (a) reduced the burden of regulation significantly further; and
  - (b) provided an evidence base to influence the future development of IFRS.

### **Question 9**

Do you support the alternative view, or any individual aspects of it?

## 2 PROJECT OBJECTIVE

- 2.1 The member holding the alternative view considers that the primary purpose of financial statements is to provide useful information to users. The ASB has defined the project objective as being:
- to enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.*
- 2.2 The member considers that the ASB's project objective has led the ASB off at a tangent because:
- (a) users' information needs have been subordinated to "high-quality, understandable financial reporting"; and

- (b) the phrase “high-quality, understandable financial reporting” should be taken as a given. Information that is either not high quality or not understandable will not be “proportionate..... to users’ information needs”.

2.3 The member considers that the project objective should have been:

*“to provide users of accounts with the information that they need, in an accessible format, subject only to cost/benefit constraints”.*

### **3 EVIDENCE BASE FOR PROPOSED AMENDMENTS TO THE IFRS FOR SMES**

- 3.1 The member holding the alternative view considers that the ASB should have formed a view on the types of information that would be useful to the various groups of users of accounts which it has identified, and should have focussed FRED 48 on providing such information. Consultation on these issues at the project definition stage would have provided an evidence base in support of the types of information that are useful to users.
- 3.2 The member acknowledges the work of the ASB in its outreach activities, but despite the extensive outreach programme the ASB has not formed a view on the types of information that would be useful to the main classes of users. In the absence of such a benchmark against which these proposals can be judged, the member considers that the ASB cannot assess whether its proposals meet the objective set out by the FRC in “Louder than Words” of being “targeted”.
- 3.3 The member agrees on a pragmatic basis that the IFRS for SMEs should form the basis of a replacement for current FRS. In the member’s view, significant further amendments to the IFRS for SMEs would be incorporated in FRED 48 if the ASB had identified, and focussed on meeting, “users’ information needs”.

### **4 FURTHER CHANGES TO THE IFRS FOR SMES**

- 4.1 The member considers that the main amendments that would arise from a focus on identifying and meeting users’ information needs would be significant changes in the following areas:
  - (a) financial instruments;
  - (b) defined benefit pension schemes; and
  - (c) deferred tax.

It would also lead to rationalisation of requirements for equity settled share-based payments.

- 4.2 A redrafting of the above sections in terms that the vast majority of both users and preparers can understand will lead to improved confidence in accounts and significantly enhance their usability and consequently the benefits that can flow from such high quality financial reporting.
- 4.3 The member considers that, particularly in small and medium sized businesses, “cash is king”. It is not useful if information about past and future cash flows is obscured by notional accounting entries arising from an overly rigid application of accounting theories. A degree of pragmatism is required in order to ensure that useful information can be presented clearly and that clutter can be avoided
- 4.4 The member wishes to avoid, in so far as is possible, the principle drivers for complexity in accounts, which he considers are as follows:
  - (a) The recognition of a point value in the statement of financial position for an asset or liability which has a wide range of potential values can provide spurious accuracy and may be misleading. The recognition in the income statement (or elsewhere) of changes in such point values can therefore be very subjective and arguably meaningless. In such uncertain

circumstances the best way that users can obtain the information that they require will often be from disclosure in the notes. The hurdles for recognition should be (i) whether any additional useful information content is provided by a point value in the statement of financial position and (ii) whether changes to such values can be recorded in a meaningful manner. Many “mark-to-model” valuations fail in this respect.\*

- (b) A value associated with an asset or a liability is normally not useful if it provides no meaningful information about either the entry or exit cash flows. A specific example is the discounting of a liability, because a discounted figure gives no indication of how much is going to be paid and when. For stewardship purposes a discounted value can be useful, but users with a stewardship perspective will also require information about the magnitude, timing and risk associated with underlying cash flows. Where discounted values are of use to a subset of users, the notes can either include a discounted value or provide sufficient disclosure to allow users to estimate a discounted value.
- (c) Rules written to prevent abuse serve to make life more difficult for the vast majority of diligent preparers. Standards should be principles based. Where standard setters have justifiable concerns about the risk of abuse, their approach should not be to write rules to prevent such abuse, but to ensure transparency, so that any abuse is highlighted, and the proper checks and balances within the system for preparing and reviewing accounts can take effective action to prevent or penalise such abuse. Highlighting abuse in a clear manner is a more effective deterrent than an extensive rule book.

- 4.5 The suggestions that follow are of necessity pitched at a high level and do not cover all of the areas of detail that would need to be covered in a final accounting standard.

*Financial instruments:*

- 4.6 The member considers that sections 11 and 12 of FRED 48 should be replaced with requirements that do not apply to financial institutions and which focus on four distinct uses of financial instruments:
- (a) fixed assets,
  - (b) working capital,
  - (c) financing, and
  - (d) hedging.
- 4.7 Standards on accounting for financial instruments by financial institutions need to take into account that the above categories are less distinct for such entities, for which individual instruments can move much more easily and frequently between categories. To assist in the removal of technical language and to further reduce complexity, accounting for financial instruments by financial institutions should have been covered in the section on “Specialised Activities”, and the financial instruments sections should have been re-written to apply to entities other than financial institutions. Alternatively, financial institutions could have been required to apply some or all of IAS 39 (and subsequently IFRS 9) and IFRS 7. Additional accounting requirements relevant for recognition of financial instruments by financial institutions would then not have been applied to all entities.
- 4.8 Redrafting the financial instruments sections of FRED 48 to focus separately on the four areas set out in 4.6 will reduce the need for complex guidance, allow categorisation of financial instruments that is more meaningful for users and preparers, and be consistent with business models.

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\* Mark-to-model approaches also generate clutter through the need to disclose model inputs.

- 4.9 Financial instruments held as fixed assets are those instruments that are held for the long term to generate income. The accounting for such financial instruments should be similar to the accounting for other fixed assets. Such financial instruments should be valued in the statement of financial position at a value which reflects their income earning potential or, if this cannot be determined with sufficient certainty, at cost less any necessary impairment. The disclosures that supplement the accounting should be similar in nature to those for other fixed assets and should include appropriate risk disclosures.
- 4.10 Financial instruments used as part of an entity's working capital should be held at anticipated exit value, with disclosure in the notes of cost where different, thereby assisting a user of the financial statements in assessing the entity's short term funding position.
- 4.11 The useful information relating to financial instruments held for financing purposes relates to the amount payable on maturity, maturity dates, early redemption options and the financing cost (or income) associated with those financial instruments. Such instruments should therefore be valued in the statement of financial position at their undiscounted amount payable on maturity. The notes should provide users with sufficient information to determine other values attributable to such instruments, for example net present values. Such an approach has already been adopted in FRED 48 for concessionary loans of PBEs.
- 4.12 Derivatives (e.g. interest rate swaps, foreign currency options or forward contracts) that are used for hedging assets or liabilities recognised in the statement of financial position should not be recognised separately but should determine the value in the statement of financial position of the asset or liability being hedged. In this way the value in the statement of financial position will reflect the net cash flow expected on settlement of the asset or liability.
- 4.13 Non-derivative financial instruments that are used for hedging assets or liabilities recognised in the statement of financial position should be accounted for in a similar manner to the asset or liability being hedged.
- 4.14 Financial instruments held as hedges of items that are not assets or liabilities recognised in the statement of financial position (e.g. to fix the cost of future purchases) will need to be recognised at their market value with changes in value included in the income statement, and with the reason for these hedges explained in the notes to the accounts.
- 4.15 The nature and quantum of financial instruments used for hedging will need to be disclosed in the notes to the accounts along with sufficient information about counterparty and other risks.
- 4.16 Where hedging instruments expire or are closed out in a different period to the point of settlement of the asset or liability which was being hedged, the reasons for this, and the effect of this on the income statement, need to be disclosed in order to deter manipulation of profits.
- 4.17 The accounting that follows from such a redrafting may not be substantially different in many areas from current standards or existing proposals, but the re-written chapters should be able to use more accessible language, be much easier to apply, and be much easier for users to interpret correctly.

*Defined benefit pension schemes*

- 4.18 Reporting of defined benefit pension schemes includes extensive disclosures which many, if not most, users (and preparers) do not understand. As such, the bulk of existing reporting is clutter rather than useful information. These extensive disclosures are required to explain the significant volatility in pension valuations that occurs because the assumptions underpinning long-term forecasts of cash flows are updated at each reporting date using volatile model inputs.
- 4.19 A new approach to accounting for defined benefit pension schemes should focus on meeting users' information needs in an understandable and uncluttered manner. Such an approach should result in greater prominence being given to undiscounted liabilities for funding deficits

(or assets relating to surpluses) and any contingent liability for future shortfalls in funding. Recognition requirements could then be determined from the valuations required for funding purposes, avoiding the need for additional valuations purely for accounting purposes.

- 4.20 Disclosures will still be required regarding contribution rates and how the scheme valuation has been arrived at.

*Deferred tax*

- 4.21 In the view of the member holding the alternative view, the deferred tax number recognised in the statement of financial position does not usually provide any useful information to most users of financial statements.
- 4.22 The member believes that in this area users' information needs revolve around the question: "will future cash payments of tax differ materially from the standard rate of tax on future profits, and, if so, by how much and why?" By requiring an answer to this question as a disclosure requirement, the ASB could justify deletion of the vast majority of the section on deferred tax. Provision would still be required for the anticipated amount of tax payable on realisation on assets carried at revalued amounts. The alternative is to analyse deferred tax provisions in a different manner to clearly provide the answer to this question.
- 4.23 The proposals on deferred tax in FRED 48 need to be refined, so that the information required matches users' information needs more closely, and does not generate clutter.

*Equity settled share-based payment*

- 4.24 FRED 48 requires equity settled share-based payments to be valued using an observable market value or, if a suitable market value is not available, by using fair value derived from an "alternative valuation model such as an option pricing model". This fair value is then "recognised" in the primary financial statements, and disclosures are required to explain this value.
- 4.25 The member holding the alternative view considers that, where a meaningful value is not available, "recognition" of an equity settled share based payment in the primary financial statements does not add to the information content of accounts. In these circumstances it is not proportionate to 'recognise' such payments in the financial statements as this would fail a cost/benefit test and also clutter up the notes with an explanation of how a fair value is derived. Instead, information about equity settled share based payments can best be communicated by way of the notes to the accounts.
- 4.26 The member holding the alternative view is not aware of any alternative valuation models which will generate a value that is of relevance to users. For example, and setting aside problems associated with determining other inputs, option pricing models cannot provide a meaningful value for entities required to use FRED 48 because they use a "risk free interest rate". Use of a risk free interest rate is only appropriate where either the net cash flows being discounted are "risk free" or the interest rate is subsequently adjusted to factor in risk. The approach adopted by most, if not all, option pricing models is to generate risk free net cash flows by hedging the long position in the option using a short position in the company's shares. To simplify the maths, most if not all models assume that this short position can be set up and maintained at negligible cost. Whereas this assumption is valid for the largest companies, where it is relatively simple and cheap to borrow stock and buy/sell spreads are relatively small, it is open to challenge for all but the largest companies. Compensating for these invalid assumptions can quickly lead to significant changes in the value of model outputs (and even negative values).

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