FRED 67 Draft amendments to FRS 102 – Triennial review 2017 – Incremental improvements and clarifications

ICAEW welcomes the opportunity to comment on *FRED 67 Draft amendments to FRS 102 – Triennial review 2017 – Incremental improvements and clarifications*, published by the FRC on 23 March 2017, a copy of which is available from this link.

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MAJOR POINTS

We support the FRC's approach to the triennial review

1. We are supportive of the FRC's decision to focus on incremental improvements and clarifications to FRS 102 at this stage. The standard is still bedding down so this is not the time to make fundamental changes.

Undue cost or effort exemptions

2. While we are supportive of removing the existing undue cost or effort exemptions, we are not convinced by the FRC's arguments for disregarding the possibility of introducing any new ones in the future. In our opinion, the FRC should keep their options open as circumstances may arise in future where introducing such an exemption would be the best solution.

Directors' and intragroup loans

3. We are pleased that the FRC has taken the concerns of our members seriously and that it is proposing that small entities will be able to account for loans from director-shareholders at transaction price rather than at present value. This is a pragmatic solution that reflects the unique nature of such loans and will be widely welcomed by our members.

4. Some have argued on a number of grounds that this exemption should be extended to intragroup loans within groups, and we have some sympathy with this point of view in relation to small groups. Although the balance of views we heard in formulating this submission was not in favour of the introduction of any additional exemption for intragroup loans, many of our members have expressed strong doubts about the value of the information that would be provided by this accounting. The issues are not clear-cut and we therefore strongly recommend that the FRC weighs very carefully the comments it receives from constituents in relation to intra-group loans within small groups. We would be pleased as the FRC does this to facilitate discussions with ICAEW members who are close to this debate if that would help to ensure that all of the cost: benefit and other issues are fully understood before the FRC finally determines the way forward.

Investment properties

5. We have in the past highlighted concerns about intragroup investment properties and suggested introducing an accounting policy choice that would allow such properties to be measured at either cost or fair value. We are pleased to note that the FRC has taken up this suggestion.

Goodwill and intangibles

6. The current model is clearly not working well in practice as there is considerable diversity when it comes to which intangibles are and are not being recognised separately from goodwill. A pragmatic solution is therefore needed. We are not, however, convinced by the proposals set out in the exposure draft. A better answer may be to give a straight accounting policy choice that would require entities to account for **all** intangible assets acquired as part of a business combination either (1) according only to the recognition criteria in paragraph 18.4 of FRS 102 or instead (2) only if all three criteria are met as laid out in paragraph 18.8.

7. We accept that this approach is still not perfect and that it too would result in some diversity in practice. But we believe it to be a better solution as it would create more consistency by eliminating the 'cherry picking' that would inevitably arise under the proposals included in the exposure draft which would see each entity making their own judgement on which intangibles to recognise over and above those that are both separable and arise from contractual or other legal rights. It would mean that businesses that rely on intangible assets in their business – an increasing number in the modern economy – have the option of recognising a broader range of intangible assets where they think users would benefit from the information, but would require consistency from them in that respect.

8. We believe that additional guidance is needed on what forms of intangibles are expected to be recognised under the different accounting policies. Without further clarity we expect there to be diversity in practice.

9. We also encourage the FRC to require additional disclosures providing a qualitative description of the factors that make up any goodwill recognised. This would ensure that meaningful information about why the entity paid what it did to acquire its controlling interest in its new subsidiary was disclosed in the notes to the accounts even where fewer intangible assets were separately recognised.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

Overall do you agree with the approach of FRED 67 being to focus, at this stage, on incremental improvements and clarifications to FRS 102? If not, why not?

10. We are supportive of the FRC's decision to focus on incremental improvements and clarifications to FRS 102 at this stage. The standard is still bedding down so this is not the time to make fundamental changes.

11. As noted in our response (ICAEW REP 193-16) to the consultation document that preceded FRED 67, now is not the time to begin working on incorporating IFRSs 9, 15 and 16 into UK GAAP. We believe that it is better to learn lessons from the IFRS adopters who will apply these standards in 2018 and 2019, before crafting abridged or amended versions for use by UK GAAP adopters.

12. We are also pleased to note that the FRC has abandoned its plans to amend FRS 102 to reflect IFRS 10's control model or to incorporate IFRS 13's definition of fair value as part of this triennial review.

Question 2

FRED 67 proposes to amend the criteria for classifying a financial instrument as 'basic' or 'other'. This will mean that if a financial instrument does not meet the specific criteria in paragraph 11.9, it might still be classified as basic if it is consistent with the description in paragraph 11.9A.

Do you agree that this is a proportionate and practical solution to the implementation issues surrounding the classification of financial instruments, which will allow more financial instruments to be measured at amortised cost, whilst maintaining the overall approach that the more relevant information about complex financial instruments is fair value? If not, why not?

13. Overall, we agree that the proposals offer a practical short-term solution to the implementation issues surrounding the classification of financial instruments and that they are a proportionate solution at this stage.

14. The current rules-based approach to classifying debt instruments has caused a number of problems in practice, especially for those entities that discovered that some of their debt instruments unexpectedly failed to qualify as basic and therefore had to be measured at fair value through profit or loss rather than at amortised cost. We are pleased that the FRC has attempted to address these concerns.

15. The introduction of a principles-based description of a basic instrument in paragraph 11.9A is helpful as it encompasses situations that are not specifically envisaged by the more rules-based approach of paragraph 11.9. This will result in some instruments being more appropriately classified as basic rather than other. We therefore welcome this proposal.

16. The wording of the new principle could, however, be clearer. It would be useful to include some guidance to confirm that 'specified dates' can include any prepayment date. Further, the phrase 'other basic lending risks' could be interpreted differently as the guidance is rather vague. In particular, the reference to 'exposure to unrelated risks and volatility' could cause some confusion. It may be sufficient to simply refer to 'exposure to unrelated risks'.

17. The issue of loans with two-way compensation clauses highlighted concerns about the current approach to defining basic and other instruments and as such we believe that the final revisions to FRS 102 should unambiguously address their classification as a lack of clear guidance in this area will only serve to prolong the debate about how such loans should be classified.

18. We note that subsequent to FRED 67 being published, the IASB has issued an exposure draft addressing similar concerns as part of its ongoing project on 'prepayment features with negative compensation'. While these proposals should be taken into account when determining how FRS 102 should address the issue of loans with two-way compensation clauses, it should not automatically be assumed that the proposed IFRS solution is appropriate or proportionate for FRS 102 adopters. Our response (ICAEW REP 61/17) to this consultation suggests a better – and simpler – solution would be to clarify that the accounting is the same regardless of whether positive or negative compensation is payable on early termination.

Question 3

FRED 67 proposes that a basic financial liability of a small entity that is a loan from a director who is a natural person and a shareholder in the small entity (or a close member of the family of that person) can be accounted for at transaction price, rather than present value (see paragraph 11.13A). This practical solution will provide relief to small entities that receive non-interest-bearing loans from directors, by no longer requiring an estimate to be made of a market rate of interest in order to discount the loan to present value. Do you agree with this proposal? If not, why not?

19. Our response (ICAEW REP 177-16) to the FRC's call for feedback to help inform the first triennial review highlighted that many of our members had significant concerns about the impracticalities of the requirement to determine an appropriate discount rate for loans from directors by reference to the market rate for a similar debt instrument with an unrelated party. We also highlighted that, in the context of owner-managed businesses in particular, many questioned the information value of the notional interest charge debited to profit or loss in such circumstances, especially where the notes adequately disclosed the nature and terms of outstanding directors' loans.

20. We are pleased that the FRC has taken these concerns seriously and that it is proposing that small entities will be able to account for such loans at transaction price rather than at present value. This is a pragmatic solution that reflects the unique nature of loans from director-shareholders to small companies and will be widely welcomed by our members. Some have, however, suggested that this exemption should be made more widely available and that it should be extended to include certain loans to small LLPs and intragroup loans within small groups.

21. We believe that the FRC should give due consideration to extending the exemption to loans from members to small LLPs as in many ways such loans are comparable to loans from director-shareholders. Further consultation should, perhaps, be undertaken on this matter. If the FRC decides not to extend the exemption in this way it should explain why it is not appropriate to do so. We do not think that it would be appropriate – or indeed possible – for the SORP-making body to consider this is as doing so would be beyond its remit.

22. Those in favour of extending the exemption to intragroup loans within small groups point inter alia to the fact that determining a market rate of interest for such loans can sometimes be as challenging as for directors' loans. Those taking the opposite view point out that groups are typically more sophisticated arrangements than simple standalone owner-managed entities and that it would therefore be inappropriate to extend the exemption to them.

23. A case could, perhaps, be made for allowing an exemption for at least some intragroup loans if adequate disclosure about the loans was provided in the notes, just as they are for directors' loans at non-market rates. But small companies are not currently required to make such disclosures. Nor can they be – for now - as the EU Accounting Directive is applied on a maximum harmonisation basis, meaning that member states are prohibited from requiring additional disclosures over and above the statutory requirements in either national legislation or accounting standards. In our view, going ahead with an exemption without being able to mandate additional disclosures would mean that in some circumstances at least useful information would be lost.

24. Although we have sympathy for both points of view, the balance of views we heard in formulating this submission was not in favour of the introduction of any additional exemption for intragroup loans, many of our members have expressed strong doubts about the value of the information that would be provided by this accounting. The issues are not clear-cut and we therefore strongly recommend that the FRC weighs very carefully the comments it receives from constituents in relation to intra-group loans within small groups. We would be pleased as the FRC does this to facilitate discussions with ICAEW members who are close to this debate if that would help to ensure that all of the cost: benefit and other issues are fully understood before the FRC finally determines the way forward.

25. More generally, we continue to believe that there should be a very high hurdle for introducing recognition and measurement exemptions for small entities. Subject to decisions about intra-group loans, the FRC should be clear that further recognition and measurement exemptions will not be provided unless there are similarly exceptional circumstances. We would not want to encourage further encroachments on the principle that all entities within the scope of FRS 102 are subject to consistent recognition and measurement requirements.

Question 4

FRED 67 proposes to amend the definition of a financial institution (see the draft amendments to Appendix I: Glossary), which impacts on the disclosures about financial instruments made by such entities. As a result, fewer entities will be classified as financial institutions. However, all entities, including those no longer classified as financial institutions, are encouraged to consider whether additional disclosure is required when the risks arising from financial instruments are particularly significant to the business (see paragraph 11.42). Do you agree with this proposal? If not, why not?

26. The definition of a financial institution has caused much consternation as it is not clear why it is intended to capture a number of organisations that many would not normally consider to be financial institutions.

27. Much of the confusion has related to the existing references to entities that use financial instruments to ‘generate wealth’ and ‘manage risk’. We therefore welcome the removal of these terms as doing so will mean that a number of entities currently – perhaps inadvertently – captured by the existing definition will no longer be within its scope and will therefore not be burdened with the additional disclosures required of financial institutions.

28. The revised ‘catch-all’ element of the definition is an improvement on what went before but it will still be open to interpretation. Matters are also rather confused by the Accounting Council advice issued alongside the original version of FRS 102 which says that ‘a subsidiary entity engaged solely in treasury activities for the group as a whole is likely to meet the definition of a financial institution’ as this does not necessarily sit well with the revised definition. We recommend deleting or updating that advice or making it clear that is has now been superseded.

29. Group treasury companies can vary widely – some are quite limited and have relatively straightforward operations, others can act like mini-banks. So there can be no one size fits all solution. We therefore accept that, ultimately, judgement will always need to be applied. But the standard could make it clearer that some group treasury companies will continue to meet the definition of a financial institution, for example those that accept deposits or hold other assets in a fiduciary capacity. While this is already implicit in the revised standard, we suggest that it provides more explicit guidance on how the new definition applies to group treasury companies.

30. While we welcome the revised ‘catch-all’ element of the definition, the deletion of references to entities that use financial instruments to ‘generate wealth’ and ‘manage risk’ raises questions about what types of entities would be considered ‘similar’ to a ‘stockbroker’. Some have argued that any company that is a broker – such as an insurance broker – would now meet the definition of a financial institution. While presumably this was not the FRC’s intention, it seems that in fixing one problem it may have inadvertently created another. Perhaps the best solution would be to simply delete ‘stockbroker’ from the list of financial institutions as such entities – which typically buy and sell shares and other securities on behalf of their customers in return for a commission – are quite unlike the other entities on the list.

31. The additional text in paragraph 11.42 encouraging all entities to consider whether additional disclosure is required when the risks arising from financial instruments are particularly significant to the business is helpful and we are supportive of its introduction. We note, however, that qualifying entities are exempt from applying paragraph 11.42 and wondered whether it was the FRC’s intention that such entities should also be exempt from applying this new requirement.

Question 5

FRED 67 proposes to remove the three instances of the ‘undue cost or effort exemption’ (see paragraphs 14.10, 15.15 and 16.4) that are currently within FRS 102, but, when relevant, to replace this with an accounting policy choice. The FRC does not intend to introduce any new undue cost or effort exemptions in the future, but will consider introducing either simpler accounting requirements or accounting policy choices if considered necessary to address cost and benefit considerations.

As a result, FRED 67 proposes:

a) an accounting policy choice for investment property rented to another group entity, so that they may be measured at cost (less depreciation and impairment) whilst all other investment property are measured at fair value (see paragraphs 16.4A and 16.4B); and

b) revised requirements for separating intangible assets from the goodwill acquired in a business combination, which will require fewer intangible assets to be recognised separately. However, entities will have the option to separate more intangible assets if it is relevant to reporting the performance of their business (see paragraph 18.8 and disclosure requirements in paragraph 19.25B).

Do you agree with these proposals? If not, why not?

Undue cost or effort exemptions

32. While we are supportive of removing the existing undue cost or effort exemptions, we are not convinced by the FRC’s arguments for disregarding the possibility of introducing any new ones in the future. In our opinion, the FRC should keep their options open as circumstances may arise in future where introducing such an exemption would be the best solution.

Investment property

33. ICAEW REP 177-16 highlighted concerns about intragroup investment properties and suggested introducing an accounting policy choice that would allow such properties to be measured at either cost or fair value. We are pleased to note that the FRC has taken up this suggestion.

34. We are aware, however, that some of our members have concerns about the proposals that would require all other investment property to be measured at fair value as it is sometimes difficult to obtain fair values for overseas or specialised investment properties. We therefore encourage the FRC to consider what – if anything – can be done to alleviate those concerns.

Separating intangible assets from goodwill acquired in a business combination

35. ICAEW REP 177-16 highlighted that opinions are divided when it comes to whether and which intangible assets acquired in a business combination should be recognised separately from goodwill. Some believe that – in a world where more and more businesses derive their value from intangible assets – the current requirements are valuable as they not only provide users with additional useful information about the business combination but also encourage management to rigorously examine the proposed purchase price and as such drives better business practice. Others argue that much of the information produced by the current model is of questionable value in the context of most private company business combinations and that ascertaining the value of these additional intangibles involves significant extra cost and effort but reaps little if any benefits for users of the financial statements, particularly as FRS 102 requires both goodwill and separately identifiable intangibles to be amortised.

36. Against this backdrop, it seems that the FRC has attempted to take a conciliatory approach. The solution proposed in the exposure draft may please people in both camps but it comes at a potentially hefty price as entities would be given too much flexibility when it comes to deciding which intangibles should and shouldn't be recognised separately from goodwill. By introducing such wide-ranging flexibility, the proposals would make it almost impossible to make meaningful comparisons between entities.

37. The current model is clearly not working well in practice as there is considerable diversity when it comes to which intangibles are and are not being recognised separately from goodwill. A pragmatic solution is therefore needed. We are not, however, convinced by the proposals set out in the exposure draft. A better answer may be to give a straight accounting policy choice that would require entities to account for **all** intangible assets acquired as part of a business combinations using either (1) according only to the recognition criteria in paragraph 18.4 of FRS 102 or instead (2) only if all three criteria are met as laid out in paragraph 18.8.

38. We accept that this approach is still not perfect and that it too would result in some diversity in practice. But we believe it to be a better solution as it would create more consistency by eliminating the 'cherry picking' that would inevitably arise under the proposals included in the exposure draft which would see each entity making their own judgement on which intangibles to recognise over and above those that are both separable and arise from contractual or other legal rights. It would mean that businesses that rely on intangible assets in their business – an increasing number in the modern economy – have the option of recognising a broader range of intangible assets where they think users would benefit from the information, but would require consistency from them in that respect.

39. We believe that additional guidance is needed to ensure that in practice the standard is applied as consistently as possible. Including a list of intangibles that typically meet the criteria set out in paragraph 18.4 would be helpful. Similarly, it would be useful to include a list of intangibles that typically meet all three of the criteria laid out in paragraph 18.8. Diversity in practice will continue unless there is further clarity on which intangibles fall into each category.

40. We also encourage the FRC to require additional disclosures providing a qualitative description of the factors that make up any goodwill recognised. This would ensure that meaningful information about why the entity paid what it did to acquire its controlling interest in its new subsidiary was disclosed in the notes to the accounts even where fewer intangible assets were separately recognised.

41. In the longer-term, we believe that the FRC should revisit this issue, perhaps drawing on the distinction between 'wasting' and 'organically replaced' intangible assets highlighted by its own research into investor views on intangible assets and their amortisation. We would not, however, advocate undertaking any such work as part of this triennial review as it is important to maintain the correct balance between stability and continuous improvement. Moreover, it would be better to wait until the IASB has completed its own research project on goodwill and impairment which includes, among other things, considering the extent to which other intangible assets should be separated from goodwill.

Investments in associates and joint ventures

42. We agree that the exemptions relating to investments in associates and joint ventures serve no practical purpose and should be removed.

Question 6

Please provide details of any other comments on the proposed amendments, including the editorial amendments to FRS 102 and consequential amendments to the other FRSs.

Our approach to this question

43. In responding to this question we have highlighted a small number of proposed amendments which we disagree with or which we believe could result in unintended consequences. We have also suggested some further changes to the standard that we think would be helpful. We are aware that a number of our member firms and other organisations will be raising a number of detailed drafting points. While we have not sought to duplicate these points, we encourage the FRC to give them careful consideration.

Revenue

44. As noted in our response (ICAEW REP 193-16) to the consultation document that preceded FRED 67, we do not believe that there is anything in FRS 102 as it stands that would stop entities allocating revenue to performance obligations in a manner similar to that required by IFRS 15. We therefore do not support the proposed addition of paragraph 23.3A. Instead, we recommend leaving the standard as it is for now and considering the whole issue of implementing IFRS 15 as part of the next triennial review. We understand that many respondents to the consultation that preceded FRED 67 shared this view.

Directors' remuneration

45. We welcome the proposed paragraph 33.7A as it provides a practical solution to avoid duplication of information on directors' rewards for their services. We note the proposals will result in inconsistencies between the disclosures made by entities that have key management personnel other than directors and those that do not. This is due to the differences between the calculation of the remuneration figure for UK regulatory purposes and the definition of 'compensation' in FRS 102, which includes all employee benefits, including those in the form of share-based payment and national insurance. Some have suggested that, where the disclosure of total key management personnel compensation has to be provided, the FRC might require that entities provide a simple reconciliation between the amount disclosed in respect of directors' remuneration for legal or regulatory purposes and total 'compensation' disclosed under FRS 102.

Financial instruments

46. It is unclear under the current requirements whether a debt instrument with variable rate which is below zero (eg, a simple LIBOR loan when LIBOR falls below zero) breaches the condition in paragraph 11.9(a). This issue is compounded by the proposed amendments to the sixth example following paragraph 11.9A which can be read as implying that debt instruments with an interest rate below zero can never be basic and, as such, must always be measured at fair value through profit or loss. We do not believe that this was the FRC's intention, particularly as it seems to contradict the Corporate Reporting Council's advice to the FRC that an interest rate below zero can still be reasonable compensation for the time value of money if the prevailing economic conditions were such that market rates were to fall below zero. Further clarification is required. It may be worth being explicit about this point in the standard itself or including a specific example clearly showing that a loan with interest rate of LIBOR plus a margin does not breach the condition in paragraph 11.9(a) and so remains a basic instrument even if LIBOR falls below zero.

47. On a separate note, we have heard an increasing number of concerns about the disclosure requirements of paragraph 11.41 in recent months. Uncertainty about what should and should not be included in the various categories of financial assets and financial liabilities detailed in this paragraph has, we understand, resulted in considerable diversity in practice. For example, some entities are including amounts relating to cash, bank overdrafts, prepayments, accruals and obligations under finance leases in this analysis while others are excluding some or all of these items. Many of our members have told us that the time and effort required to produce this note far outweighs the benefits arising and that users of their financial statements find little of value in analysing financial assets and financial liabilities in this way. They also note that these disclosures do not reconcile back to the balance sheet. We therefore suggest that this disclosure requirement is pared back so that all that remains is the company law requirement to disclose financial assets and financial liabilities measured at fair value through profit or loss.

Intragroup investment properties

48. We note that paragraph 16.4A says that the proposed exemption is only available in the entity's individual financial statements. This is presumably included to make it clear that the exemption cannot be applied in the group's consolidated financial statements, which is perfectly reasonable. However, this means that this exemption would also not be available in the consolidated financial statements of a sub-group that rents an investment property from or to another group company. We are unclear if this was the FRC's intention.

Leased investment properties

49. Paragraph 16.3 has been amended to remove the existing undue cost or effort exemption in this area. However, we are concerned that more text than was intended may have been inadvertently deleted. We believe that it is important that the option to treat an interest in an operating lease as investment property continues to be available only where the lessee is able to measure the fair value of the property interest on an ongoing basis. These words have, however, been deleted. We suggest that they are reinstated.

Question 7

FRED 67 includes transitional provisions (see paragraph 1.19). Do you agree with these proposed transitional provisions? If not, why not?

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

50. We welcome the FRC's decision to issue an optional interim measure permitting small entities to initially measure loans from director-shareholders and their close family members at transaction price rather than at present value, pending the finalisation of the proposals in FRED 67. This will avoid entities having to measure such loans at fair value for one year only. It will also mean that all entities will be able to benefit from this simplification at the same time, whereas the original timetable for issuing the amendments to FRS 102 would have disadvantaged entities with December year ends.

51. We are, however, concerned that similar issues may arise in relation to the other proposed changes. For example, it would seem odd for a small entity to have to fair value an intragroup investment property for one year only or to have to separate certain intangibles from goodwill on a business combination in its first year of applying FRS 102 but not its second.

52. We therefore wonder whether anything can be done to expedite the completion of these amendments so that they can be applied by those small entities transitioning to FRS 102 for the first time in periods ending on 31 December 2016. We would not normally advocate short circuiting due process but in this instance doing so may be necessary given that the alternative of many entities simply ignoring the standard on the basis that the standard-setter has suggested that the costs of doing so outweigh the benefits is even less palatable.

53. On the whole we are supportive of the transitional provisions set out in the exposure draft. However, we do not think that there is any need for the transitional provision allowing intragroup investment properties to be measured at deemed cost when the new exemption is applied for the first time. Entities will have typically measured such properties at cost under old UK GAAP anyway so reverting to doing so will involve little in the way of cost or effort. We therefore believe that full retrospective application would be more appropriate in this instance. Having said that, this would – of course – be a non-issue if the FRC finds a way to expedite the introduction of this exemption as suggested paragraph 52 above.

54. Finally, we believe that additional guidance is needed to explain what an entity should do when it transitions from being small to medium-sized or vice versa. A step up in size will mean that the relief available in relation to loans from director-shareholders will cease to be available, while a step down in size will mean that the option not to discount such loans becomes available for the first time.

Question 8

Following a change in legislation the FRC is now required to complete a Business Impact Target assessment. A provisional assessment for these proposals is set out in the Consultation stage impact assessment within this FRED.

The overall impact of the proposals is expected to be a reduction in the costs of compliance. In relation to the Consultation stage impact assessment, do you have any comments on the costs or benefits identified? Please provide evidence to support your views of the quantifiable costs or benefits of these proposals.

55. While we have made no attempt to formally quantify costs and benefits, we agree that the proposals – which are designed to simplify existing requirements – are likely to result in a reduction in costs of compliance.