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Dear Ms Carter

Consultation Document – Accounting standards for small entities: Implementation of the EU Accounting Directive

Introduction

Ernst & Young LLP welcomes the opportunity to comment on The Consultation Document – Accounting standards for small entities issued by the Financial Reporting Council ('the FRC').

Overall comments on the Consultation Document - Accounting standards for small entities: Implementation of the EU Accounting Directive

We agree with the overall FRC proposals that there should be a separate standard for micro-entities, and that the FRSSE should be replaced with FRS 102 (for small entities). However, we consider that there is scope for further simplifications for micro-entities. See our response to Question 2 in the main letter.

We also encourage the FRC to provide guidance to small entities on the meaning of a 'true and fair view', given that only the limited set of statutory disclosures will be mandated. As noted by the FRC, this 'places an even greater onus on directors of small companies to stand back and consider whether financial statements give a true and fair view and, if not, to provide additional disclosures'. Both preparers and auditors need to assess whether the accounts give a true and fair view, and it would be helpful to have a framework to evaluate this. This will be a particularly difficult assessment should the legislation allow for small entities to prepare statutory accounts using abridged formats. We consider that the additional information provided should be an area of judgement for the directors in the context of the company's circumstances. In particular, there should be no presumption that complying with FRS 102's disclosures is normally needed to achieve this. The comments in paragraph 3.10 of the Consultation that entities may find FRS 102's disclosures 'helpful guidance' might lead some directors to conclude that inclusion of FRS 102's disclosures in relevant areas is necessary in order to be confident that the accounts give sufficient disclosure for a true and fair view. We would encourage the FRC to ensure that any guidance provided is consistent with the deregulatory intention of the Directive.

We note that the FRC cannot determine the amendments to be made to FRS 102 until the legislation to implement the Accounting Directive has been finalised and this means that small entities will have limited time to implement the new accounting standards. However, we would strongly encourage the FRC to allow early adoption of the amendments made to FRS 102 should this be permitted by the legislation. This would enable small entities to take advantage of deregulatory measures and avoid unnecessary changes in accounting that derive from implementation of the Directive. It would also be helpful if the FRC could explain whether there will be transitional provisions for the accounting changes noted in paragraph 4.3 of the Consultation or whether these will be implemented fully retrospectively. Given that the transition date will have passed by the time the final FRS 102 is issued, we support the FRC in its commitment to carefully consider the need for transitional provisions for small entities preparing their first FRS 102 financial statements.

As there is limited time for small companies to implement the new accounting standards, we encourage the FRC to communicate the detail of its proposals as soon as practicable so that preparers can take these into account. We would also encourage the FRC to work closely with BIS during the process of implementing the Directive in order to identify any other changes needed to, or apparent incompatibilities with accounting standards, and consider the implications. In this regard, we have concerns that the Directive is not entirely compatible with application of IFRS 9 'Financial Instruments' (which is available as a policy choice under FRS 102 for the recognition and measurement of financial instruments) and whether changes to the Directive have implications for accounting for group reconstructions. See 'Other comments – implementation of the Directive' in the main letter.

If you have any matters arising concerning the content of our response, please do not hesitate to contact me.

Yours sincerely

Tony Clifford
Partner, Financial Reporting Group

Responses to FRC questions

Question 1

Do you agree with the proposal to develop a new accounting standard, the Financial Reporting Standard for Micro-entities (FRSME), for entities taking advantage of the micro-entities regime (see paragraph 2.4)? If not, why not?

Yes.

Question 2

Do you agree with the proposed recognition and measurement simplifications that are being considered for the FRSME (see paragraph 2.6(b))? If not, why not? Are there any further areas where you consider simplifications could be proposed for micro-entities?

We agree with the recognition and measurement simplifications for micro-entities proposed in paragraph 2.6 of the Consultation Paper except for paragraph 2.6(b)(iv) in relation to accounting for defined benefit plans.

We do not consider it appropriate for companies that are members of a defined benefit plan not to account for the defined benefit liability or asset. Article 6.1(c) of the new Accounting Directive requires that ' all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up'. A defined benefit plan deficit would, in our view, meet the definition of a liability. The FRC's proposal requires companies to use defined contribution accounting, but to recognise contributions payable arising from an agreement to fund the deficit for past service. This would mean the recognition of a liability could be delayed where a schedule of contributions is agreed some time after a funding valuation reveals a deficit. A conceptually superior but similarly pragmatic alternative might be to recognise a liability on the basis of the funding valuation. However, where the defined benefit plan is a multi-employer scheme (including a scheme sharing risks between entities under common control), we consider that an approach similar to that for multi-employer schemes in section 28.11-11A of FRS 102 could be applied.

We have the following further observations on the FRC's proposals, as outlined in the Consultation Paper:

- Companies taking advantage of the micro-entity provisions are not permitted to use the alternative or fair value accounting rules. Consequently, investment property and biological assets must be accounted for using the cost model. While not noted specifically in the Consultation Paper, amendments will be necessary to remove section 16 (Investment property) and amend sections 17 (Property, plant and equipment) and 34 (Specialised activities). Care needs to be taken to identify any consequential amendments, for example to transition, in other sections of FRS 102.

- Since companies taking advantage of the micro-entity provisions are not permitted to prepare group accounts, there is scope to significantly reduce the content included in sections 9 (consolidated and separate financial statements), 14 (associates) and 15 (joint ventures), while retaining the requirements relevant to individual financial statements in these sections. We would recommend that investments in subsidiaries, associates and joint ventures are carried using the cost model currently set out in these sections. In addition, we would recommend that the requirements in FRS 103 on insurance contracts are omitted.

- We support the FRC's proposals that derivative financial instruments are recognised as a liability when onerous. We encourage the FRC to provide guidance on when derivative financial instruments are onerous, particularly where an out-of-the-money contract is part of a hedging relationship and to clarify whether it remains possible to accrual-account, for example, an interest rate swap.

- In respect of accounting policy choices available in FRS 102, we recommend that:

  - the performance model option for government grants is deleted, particularly as this accounting treatment exists only in FRS 102 (and not in previous UK GAAP or IFRS). While this model is of interest to charities, the latter are excluded from the micro-entity provisions.

  - the policy option to capitalise borrowing costs is deleted.

  - there is a continuation of a policy choice for capitalising or expensing development costs. Entities in a start-up phase may qualify for a short period as micro-entities but might intend to apply a capitalisation of development costs policy (if later applying FRS 102) or be required to capitalise development costs (if later applying FRS 101 or IFRS).

- The FRC could consider whether section 27's requirements on impairment could be simplified for application to micro-entities. While the FRSSE includes a requirement not to carry assets at above their recoverable amount, being the higher of value in use and net realisable value, it does not contain (or cross refer to) the detailed requirements in FRS 11. Similarly, simpler impairment rules could be appropriate for micro-entities.

We agree that the FRSME should be available for immediate use, once issued.

Question 3

The accounting standard that is applicable to small entities (not just small companies) (i.e. currently the FRSSE) is being revised following changes to company law. Company law, which will limit the disclosures that can be made mandatory, may not apply to entities that are not companies. Do you agree that the accounting standard for small entities should continue to be applicable to all entities meeting the relevant criteria, not just companies? This will have the effect of reducing the number of mandatory disclosures for all small entities, not just small companies (see paragraph 3.11). If not, why not?

Yes. However, we note that BIS may update legislation over a period, e.g. the regulations for companies are likely to be updated first with those for other entities, such as LLPs following later. As explained in our general observations, we strongly support the FRC permitting early adoption of the amended FRS 102. The transition requirements in the standard will need to explain how adoption of the amendments to FRS 102 interacts with the legislation for entities that are companies and other entities, if this is being updated at different times.

Question 4
Do you agree that the FRSSE should be withdrawn and small entities should be brought within the scope of FRS 102 so that they apply recognition and measurement requirements that are consistent with larger entities, but with fewer mandatory disclosures (see paragraph 3.15)? If not, are there any areas where you consider there should be recognition and measurement differences for small entities and why?

We agree that implementation of the Directive means that the FRSSE must be replaced in its current form, in particular since Member States cannot mandate additional disclosures for small companies.

The FRSSE is based on previous UK GAAP rather than FRS 102 and it is preferable for the accounting by small entities to be aligned with FRS 102 as far as possible. Consequently, we support the FRC's approach to align the recognition and measurement requirements of FRS 102 (for small entities) with the full FRS 102. However, as explained in our overall comments, we encourage the FRC to provide guidance to small entities on the meaning of a 'true and fair view', given that only the limited set of statutory disclosures will be mandated.

Question 5
FRED 50 *Draft FRC Abstract 1 – Residential Management Companies' Financial Statements* was issued in August 2013. After considering the comments received, the FRC published its intention to roll this project into the work required to implement the new EU Accounting Directive. Do you agree, in principle, with adding a new subsection to section 34 *Specialised Activities* of FRS 102 to address the principles of accounting by residential management companies (RMCs) (see paragraph 3.27)? If not, do you consider this unnecessary, or would you address the issue in an alternative way?

We note that the FRC did not proceed to a final Abstract based on FRED 50 and that differing views were received in response to this FRED. The responses raise substantive matters including: clarity over the scope; whether the requirements of a final standard or Abstract which differ to current practice (albeit diverse) would be a change in accounting policy (or correction of error), a distinction which may be relevant to tax consequences; and asking for further clarity over the illustrative examples. We also note the FRC has stated that no new disclosures will be required, as most RMCs will be micro-entities or small entities.

This is a narrow scope issue and there is a relatively short period to make amendments to FRS 102 deriving from the UK's implementation of the Directive. Therefore, we consider that any proposals should be separately re-exposed and dealt with as a separate work stream from the main consultation, even if that means that the proposals on RMCs are not finalised on the same timetable. We consider the priority should be to finalise the amendments to FRS 102 required due to implementation of the Directive as soon as practicable, allowing early adoption if permitted by the related legislation. Should the FRC, following further consultation, proceed to finalise its proposals on RMCs, these should be finalised as an Abstract or further amendment to FRS 102. Since most RMCs are expected to be micro-entities, any final requirements should also be included in the FRSME either as an amendment or as an Abstract.

Question 6

FRS 102 does not currently include all of the disclosures specified in company law. Other than in relation to the new small companies regime within FRS 102, it is not proposed that this will change. Do you agree that FRS 102 should not include all the disclosure requirements for medium and large companies from company law (see paragraph 4.6)? If not, why not?

We have mixed views on this question and, ultimately, it is a matter of whether the convenience to users is sufficient to justify the increase in size of the Standard and the cost to the FRC of updating the document as company law requirements change. We believe that it would be helpful for preparers if FRS 102 included the applicable company law disclosures in the relevant sections of the standard as most preparers will be subject to UK or Irish law. However, as FRS 102 may also be used by other entities, it is important to clarify that these additional disclosures are only required by entities subject to these statutory requirements. It may be best to include these requirements as an appendix to each section, to help distinguish the UK or Irish law requirements from the FRS 102 requirements.

Question 7

Do you agree that, if UK and Irish company law is sufficiently flexible, FRS 101 should be amended to permit the application of the presentation requirements of IAS 1 *Presentation of Financial Statements*, rather than the formats of the profit and loss account and balance sheet that are otherwise specified in company law (see paragraph 5.4)? Do you agree that this will increase efficiency of financial reporting within groups? If not, why not? Do you foresee any downsides to this approach?

Yes, we agree that if the legislation is sufficiently flexible, FRS 101 should be amended to permit the application of the presentation requirements of IAS 1.

Article 11 of the Directive allows Member States to permit or require items to be presented in the balance sheet on the basis of a distinction between current and non-current items in a different layout. Article 13 of the Directive allows Member States to permit or require a statement of performance to be presented instead of the profit and loss items in accordance with the prescribed formats. In both cases, this is provided the information is at least equivalent to that otherwise required to be provided in the prescribed formats.

We believe that applying formats based on IAS 1 may meet these requirements and would be welcomed by many groups that currently use IFRS for group reporting (but that are required by FRS 101 to amend the balance sheet and profit and loss account presentation to conform with the formats required in Companies Act accounts). It is important that the Legal Appendix makes clear that the IAS 1 formats are regarded as equivalent for the purposes of the legislation.

In terms of potential downsides, we note that the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 ('Regulations') still mandate certain reserves to be established, such as revaluation or fair value reserves or require additional information to be presented in the notes in respect of classes of fixed assets or in relation to creditors: amounts falling due or after more than one year or segmental information in respect of turnover. These disclosures are not necessarily aligned with the headings used in the IAS 1 formats, although it would generally be possible to identify what the corresponding items are. It is important that the Legal Appendix to FRS 101 makes clear that notes disclosures may be based around different categorisations.

We further note that the FRC has recently finalised taxonomies to be used for IFRS, FRS 101 and FRS 102 reporting in the UK. Should the formats change, the FRC may need to consider whether these taxonomies need to be updated to facilitate electronic reporting.

Other comments – Implementation of the Directive

Paragraph 4.3 identifies key changes to FRS 102 required as a result of implementation of the Directive. It would be helpful if the FRC clarify at an early stage whether the changes to the maximum life of goodwill (where this cannot be reliably estimated) and reversal of impairment of goodwill will be implemented retrospectively or whether transitional provisions will be available. We note that FRS 11 included legal advice explaining the restrictive circumstances in which reversals of goodwill impairment could be made. This legal advice was not carried forward to FRS 102. Given that the legislation has not changed and once the Directive is implemented, reversals of goodwill impairment will be prohibited, it would be helpful if the FRC could clarify whether reversals of goodwill impairment are expected to remain rare under FRS 102 (prior to its amendment).

We note that the FRC will consider whether amendments to the formats applied in FRS 102 will be made, should alternative formats with additional flexibility be permitted by legislation. If the intention is that formats based on IAS 1 will replace those currently required in FRS 102, this should be made clear to preparers at an early stage. While application of IAS 1 formats in FRS 102 makes sense (if permitted by the legislation), the case for change in the formats is strongest for FRS 101 reporters, since many FRS 102 reporters will previously have applied UK GAAP. We also note that FRS 102 does not have the same provisions on noncurrent assets and disposal groups held for sale as IFRS – and that the notes disclosures required by the Regulations are based on the headings in the prescribed formats.

We encourage the FRC to work closely with BIS during the process of implementing the Directive in order to identify any apparent incompatibilities with accounting standards, and consider the implications. Some matters, not intended to be comprehensive, are noted below:

- It is not clear how all the requirements of IFRS 9, where adopted for the recognition and measurement of financial instruments under FRS 102 (and in due course, once endorsed, under FRS 101), are consistent with the fair value or alternative accounting rules. An example is the measurement of financial liabilities at fair value with the effects of own credit risk recognised in other comprehensive income. This accounting would not appear to be consistent with the fair value accounting rules (Article 8.8 of the new Accounting Directive).

- Article 24.13 of the new Accounting Directive states that 'Deferred tax balances shall be recognised on consolidation provided that it is probable that a charge to tax will arise within foreseeable future for one of the undertakings included in the consolidation'. While not a new requirement of the Accounting Directive, it is not clear whether all deferred tax required by FRS 102 meets this requirement – indeed in some cases (e.g. raising deferred tax on fair value adjustments on an acquisition), there may be no tax charge for the consolidated undertakings expected in the foreseeable future.

- Article 25 of the new Accounting Directive restricts merger accounting to business combinations under common control, i.e. where the undertakings in the business combination are ultimately controlled by the same party (note the use of the singular) before and after the business combination and that control is not transitory. This scope of business combinations under common control is not fully aligned with the definition of a group reconstruction, for which FRS 102 permits merger accounting. In particular, inserting a new holding company above an existing group would not always meet the definition of a business combination under common control, since there will probably be more than one ultimate shareholder. Even if the rights of the ultimate shareholders are unchanged, the undertakings are not necessarily controlled by the same party before and after the transaction.

- The wording of the current paragraph 36(4) of Schedule 1 to the Regulations will change to allow financial instruments to be held at fair value where this is permitted by EU-adopted IFRS (rather than EU-adopted IFRS on or before 5 September 2006) (Article 8.6 of the new Accounting Directive). This may allow more financial instruments to be held at fair value. For example, contingent consideration in a business combination would not be barred from recognition at fair value, as currently required under IFRSs (although, as this would conflict with section 19 of FRS 102, this may be more relevant to FRS 101 reporters acquiring trades and assets). Appropriate amendments will be required in FRS 101 and FRS 102.

- Article 23.8(b) of the new Accounting Directive extends 'equivalence' for the purpose of the current section 401 of the Companies Act 2006, to mean 'in a manner equivalent to IAS as determined in accordance with Commission Regulation (EC) No. 1569/2007'. This change, when made in the Companies Act 2006, would provide more statutory underpinning to decisions made by preparers on 'equivalence' and it would be appropriate for the FRC to update the guidance on equivalence in FRS 100.

- The minimum statutory disclosures for small entities include a requirement (new for small entities) for disclosure of the nature and purpose, and financial effect of off-balance sheet arrangements. It may be helpful for small entities if the FRC includes guidance on this requirement in the presentation and disclosure sections of FRS 102 (for small entities). This is particularly important as FRS 102 (for small entities) will only specify the statutory minimum disclosures, which are less extensive than those required by accounting standards.