HW Fisher
& Company

CHARTERED
ACCOUNTANTS

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Financial Reporting Council
by email to ukfrs@frc.org.uk

Our Ref: NNS/MPC

Dear Sirs

COMMENTS ON FRED 67: "DRAFT AMENDMENTS TO FRS 102"

We write to offer our comments in response to FRED 67, which forms part of the first Triennial Review of FRS 102.

We continue to be strongly supportive of FRS 102, and we welcome the majority of the changes proposed. Detailed responses to the eight points raised for discussion are set out in an Appendix to this letter.

The one area which we believe still requires further consideration concerns long-term interest free, or below market rate, loans between related parties. While we welcome the concessions proposed (and subsequently temporarily given) to loans from director/shareholders to small entities, we do not believe that this should be given as a limited scope concession. The problems which the concession addresses indicate a point of principle which should be applied more widely wherever FRS 102 is used.

The justification that is given for making the concession is the difficulty that smaller entities have in establishing a relevant interest rate (particularly since such loans are often made because no commercially based loan is available), as well as a more general objective to lessen the accounting burdens on smaller entities. We do not agree that these difficulties are limited to smaller entities, or to loans which are provided by natural persons who happen to be director/shareholders. In fact the issues arise because these are transactions between related parties which may not be subject to normal commercial considerations. The generally required accounting treatment for financing transactions attempts to uncover an underlying commercial logic to these transactions which does not actually exist (or at least the commercial logic can only be seen across a number of entities and individuals, and cannot be applied to a single entity).

The solution is to replace the proposed concession with a more general exclusion of loans which are not agreed on commercial terms from the category of "financing transactions". More detail on how this would work was set out in our comment letters of 4 November 2014 and 29 April 2015, relevant extracts from which were incorporated in our further comments on the implementation of FRS 102 dated 31 October 2016.

A further advantage of our proposed solution would be to reinstate consistency between the measurement provisions applying to all sizes of entity that apply FRS 102. Although we do not favour losing the concession without the implementation of our proposed solution, it would be a shame to abandon consistency of measurement.

Apart from consistency with IFRSs, there are two further, related, arguments which are sometimes given to support the imputation of interest in relation to such transactions.

The first is to observe that granting an interest free loan over a period of time to an entity is giving something of value to that entity. We agree. However, it does not follow from this that the best way to reflect this value is to make a notional interest charge and then make a further adjustment to balance these amounts. Where no further transactions, other than the repayment of the loan, are envisaged, the clearest method of accounting for the loan is to show no interest charge and to simply state that none is reflected. (There is no barrier to the FRC requiring such disclosure for non-small entities, if disclosures beyond those required in paragraph 1AC.35 cannot be required for small entities that is a problem with the legislation which has no bearing on this particular issue.)

Secondly, it is said that there are legal precedents to suggest that in some cases the granting of an interest-free loan can be regarded as a kind of distribution. The FRC has not made this case in detail (or indeed formally addressed the arguments previously raised against the more general treatment of non-commercial loans as financing transactions), but some details of the relevant considerations are summarised in paragraphs 2.6 to 2.6 C of the ICAEW/ICAS Technical Release TECH 02/17BL: "Guidance on realised and distributable profits under the Companies Act 2006".

We do not find the argument that the case law justifies the more general approach to these transactions in FRS 102 convincing, for the following reasons:

a) Although accounting must take account of the legal position, the courts will normally take account of accounting standards in determining what should be reflected in accounts, rather than limiting the judgement that the standard setters have. The treatment of financing transaction was not present in previous UK GAAP, is not currently present in FRS 105 and it is now proposed to be the subject of an exemption for some items in FRS 102. It is therefore inconsistent to claim that these precedents require the more general treatment in this context.
b) The cases cited all concern the possible identification of a distribution of capital by a company to its shareholders. In practice the majority of non-commercial interest-free loans are made to an entity, and only sometimes by shareholders. The application of the case law to these transactions by analogy has no real basis. (It would create no particular problem if, on the basis of these precedents, the existing treatment were to remain in place for loans <u>made by</u> entities only. These are comparatively rare and in such cases the need to charge some level of interest would be more understandable.)
c) There seems to be no suggestion in the case law quoted that this principle should result in accounting entries, the case law focuses on whether some individual transactions might be an illegal distribution of profits. The FRC has elsewhere been quite adamant that there is no legal requirement for accounts to reflect the distinction between realised and unrealised profits. If these cases required an undervalue to be reflected in the accounts, then a similar argument would preclude the inclusion of other unrealised profits (such as revaluation gains on investment properties) being recognised in profit or loss.
d) These cases arise where a third party has been disadvantaged by a particular transaction and sets out the basis for remedies to be made, they should not determine the more general accounting principles which should apply in cases where the interests of third parties may not be affected.

We accept that the treatment of financing transactions derives from IFRSs, but, as we have argued before, IFRSs are primarily applied by large entities where non-commercial transactions with related parties would be rare. It is therefore no surprise that no separate provision is made for such transactions in the IFRSs. FRS 102 is intended to cater for a wider set of entities and should reflect that in practice small entities will sometimes enter into transactions which are not at arm's length. Trying to impose a commercial logic on such transactions will not result in a true and fair view being given.

We support the FRS 102 analysis of financing transactions which are completed on a commercial basis.

Yours sincerely

Michael Comeau
Technical Principal

APPENDIX

RESPONSES TO SPECIFIC POINTS RAISED IN FRED 67

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?

Yes, we agree with this general approach.

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?

Yes, we agree with this approach, although the classification of a financial instrument as "basic" or "other" will remain difficult in some cases.

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?

As explained in our covering letter, although we welcome the FRC's recognition that there is an issue here, we do not think that offering a limited exemption to a sub group of relevant transactions is the most helpful approach. The difficulties which arise for those transactions which are the subject of the exemption are a symptom of the problems with the more general definition of financing transaction. A better solution would be to identify all transactions whose inclusion within this concept causes difficulties, i.e. all transactions which are not completed on a commercial basis, and to remove this from this definition.

Although it would be better to have the limited exemption proposed then to make no change at all, the proposed solution creates further difficulties:

a) generally in creating differences in measurement criteria between different sizes of company;
b) in particular there would be a difficulty with a company which no longer has small company status having previously claimed it, further guidance would be required to determine whether the required changes would be reflected as a prior year adjustment or whether this would be best reflected as a kind of transitional adjustment (presumably in either case reflecting the position as if the exception had never been claimed), either way this might produce unhelpful tax effects.

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?

Yes, we agree with this proposal.

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?

Yes, the "undue cost or effort exemptions" were often difficult to apply in practice and a simple accounting policy choice is much preferable.

We are aware that comments have been made to the effect that the FRC should not rule out the possibility that undue cost or effort should be used as a principle in future and agree that there is little point in making a firm commitment to this. However, given the difficulties of applying this principle we agree that it is best avoided if possible.

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.

As mentioned in previous comment letters we continue to believe that the treatment of share-based payments is based upon an analysis which assumes that the relevant shares can readily be sold and have a market value. This is not the case for the majority of unlisted companies, who nonetheless enter such arrangements. For unlisted companies the required treatment results in accounting entries which do not readily make sense.

Although not highlighted in the discussion points, it is proposed to remove the requirements of paragraph 13.22 c) re the amount of inventories recognised as an expense. We welcome this change. There is also a proposal to amend paragraph 13.22 d) which requires a reconciliation of impairment losses relating to inventories, but this is only a clarification. In practice the calculation of these amounts (and the more general requirements of paragraph 27.33) is difficult and the costs of calculating (or estimating) them may not be proportionate the value of these disclosures.

Question 7
FRED 67 includes transitional provisions (see paragraph 1.19). Do you agree with these proposed transitional provisions? If not, why not?

Yes, we agree with the proposed transitional provisions.

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

As mentioned above, the proposed exception of some interest free loans from the normal treatment may create particular difficulties when a small company breaches the thresholds in a subsequent year. We believe that guidance should be given on the correct approach in this circumstance (whether or not this is correctly seen as a transitional provision).

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.

We accept that the completion of an impact assessment is now a requirement. Although in principle we believe that an impact assessment should be very useful, it is our experience that the impact assessments currently prepared, although often extensive, are too broad brush, and to rely on estimates too uncertain to be informative.