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Our Ref: NNS/MPC

Dear Sirs

FRC CONSULTATION ON IMPLEMENTATION OF EU ACCOUNTING DIRECTIVE

We write to offer our comments on your Consultation Document on the implementation of the EU Accounting Directive.

Our responses to your specific consultation questions are given in the Appendix to this letter. In general we agree with the proposals put forward in the Consultation Document, but there is one particular issue which we would like to bring to your attention.

Financial instruments at non-market rates of interest
We believe that the FRS 102 treatment of long-term loans at non-market rates of interest will cause significant difficulties for all entities which have previously adopted existing UK GAAP (without the adoption of FRS 26). This issue is relevant to this consultation because such loans are likely to be more prevalent in small entities. Leaving aside the difficulties of application, we also do not believe that the treatment set out in FRS 102 makes sense.

Question 4 of the Consultation Document asks if there should be recognition or measurement differences for small entities. While in practice (as explained in more detail below) this treatment may be particularly burdensome for small entities, we believe that there are sound arguments from principle that they should be amended for all entities.

We note the FRC's intention (as stated at 1.5 of the Consultation Document) not to revisit any of the more general requirements of FRS 102, but we believe that the general principle (as stated at 3.18 of the Consultation Document) that there is no case for differences in the recognition and measurement requirements which apply to different sizes of entity (other than when required by legislation) justify consideration of amending the requirements for all entities in this area prior to the full implementation of FRS 102.

We also believe that this is an issue which meets the FRC's stated criteria for urgent action (as presented to the FRF UK GAAP Conference on 24 October 2014) in that the current FRS 102 treatment would lead to:

a) *Unnecessary costs*: apart from the cost of compliance in the financial statements, it is probable that there will be tax implications arising from this treatment, at least in some cases.
b) *Significant confusion* since, as argued further below, the treatment makes no economic sense and will lead to the inclusion of amounts in the accounts which have no real meaning.
c) *Inappropriate/unacceptable accounting treatment*, for the reasons given under b).

Applicable principles

We accept the principle that, in a commercial transaction, the specific terms of the transaction may not always reflect commercial reality. We agree that in the example given in the text of 11.13 of FRS 102 a company supplying goods on extended credit terms is effectively lowering the price for those goods, or, in another example, a bank making a loan may adjust the amounts to be advanced or to be recovered so as to set an unrealistic headline rate of interest during the term of the loan. In both cases the amortised cost method gives a better representation of the commercial reality the transaction.

However, the treatment gives anomalous results when the underlying transaction is not an arm's length commercial transaction. The assumption of IFRS, and hence FRS 102, appears to be that in general all transactions should be assumed to be at arm's length and commercial. This is often not the case in small entities. Transactions which are: within a group; between entities with common ownership; or between an owner and the owned entity, may be undertaken in the general interest of the owners without particular regard being paid to the separate interests of the individual entities involved. In particular it will often be commercially justified not to charge interest between such parties to avoid the complications of calculating these amounts when there is no overall effect on the owner’s interests.

There is a precedent in FRS 102 for treating transactions between companies in common ownership differently from other transactions in the permission in paragraphs 19.27 to 19.33 to use merger accounting for group reconstructions.

Difficulties with current treatment

In the cases we are discussing, the treatment of financing transactions within the amortised cost method creates a difficulty because, if interest must be charged, there is no logical place to post the other side of the accumulated entries. In the two examples described above, the amounts would reasonably adjust the recorded selling price of the goods or the carrying value of the loan. Where there is no arm's-length transaction, there is no logical place to make this adjustment. The suggestion appears to be that the granting of an interest-free loan should be reflected as the granting of an interest bearing loan with a “gift” of the accumulated interest. This is nonsense, the transaction should simply be accounted for with no interest charge.

If the argument for the FRS 102 treatment is that highlighting the fact that a company may be financed through interest-free loans aids comparison with entities which do not have this advantage, a better solution would be to simply mandate disclosure of the existence of any such interest-free loans. Such disclosure would already be required under paragraph 11.42 of the standard, and in addition would often be required as part of the disclosure of related party transactions and balances.

The application of the amortised cost model to interest-free loans does not apply where the loans are repayable on demand. It will not always be appropriate for such loans to be made on this basis. One particular example is the funding of a new venture through a subsidiary. A holding company, or other owner, may fund initial losses with an interest-free loan (not wanting to add to the losses with an interest charge). The owner anticipates receiving these amounts back, if and when the new venture becomes profitable, but is prepared to take on the risk of failure and to ensure that the company remains a going concern in the meantime. (The holding company must, of course, provide against the value of the amounts advanced if there is a doubt over recovery.) In such cases the owner may be prepared to accept a postponement of their entitlement to repayment so as to maintain the company's current asset position, but under FRS 102's requirements would be prevented from reflecting this situation legally so as to avoid the need for the new venture to show a notional interest charge.

<u>Comparison with Public Benefit Entities</u>
FRS 102 (in PBE 34.87 – 97) already accepts that in the case of a Public Benefit Entity there may be transactions for which the amortised cost basis is not appropriate. The accounting treatment set out in PBE 34.90 - 92 would be a more appropriate treatment for the loans which we are describing and the related disclosures in PBE 34.93 - 97 could be adapted. However concessionary loans as defined in PBE 34.88 are different in nature from the sort of financing transactions which we are describing and such transactions need not be exempted from the more general requirements of amortised cost (albeit that in most cases the effect will be similar to the cost basis). The issue is with FRS 102's additional requirement regarding initial measurement. Therefore we suggest that the scope of these paragraphs within Section 34 of FRS 102 remains unchanged.

<u>Proposed solution</u>
A solution to the problem could be achieved quite easily with an amendment to FRS 102 paragraph 11.13. At present this section sets out a basic requirement for the initial recognition of financial assets or liabilities in this category, but then sets out an exception for financing transactions. All that is required is to take the financial instruments that we are describing out of the exception from the normal treatment to allow initial recognition of them at transaction price. This could be achieved easily by adding a qualifying phrase such as “commercial” or “arm's-length” to the description “financing transactions”.

One option would be to supplement this with further requirements based upon PBE 34.90 - 92, but this should not be necessary if the above change simply moves the transaction into the normal treatment of paragraph 11.13. It would be useful to add further explanation as to what is meant (see our suggested paragraph 11.13A below). The existing disclosures in paragraph 11.42 are probably sufficient to alert the reader of the financial statements to the existence of loans which are interest-free or below a commercial rate of interest, but it may be useful to apply a simple additional disclosure (see suggested paragraph 11.42A below). The explanations here need not be extensive as the requirements would largely follow from existing definitions. We would therefore suggest that paragraph 11.13 be amended as follows:

11.13 When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price (including transaction costs except in the initial measurement of financial assets and liabilities that are measured at fair value through profit or loss) unless the arrangement constitutes, in effect, a *commercial* financing transaction. A *commercial* financing transaction may take place in connection with the sale of goods or services, for example, if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate. If the arrangement constitutes a *commercial* financing transaction, the entity shall measure the financial asset or financial liability at the present value of the future payments discounted at a market rate of interest for a similar debt instrument.

Amendments would also be required to Example 1 on the treatment of financial assets in the table below 11.13, and the phrase “commercial financial transaction” should replace the phrase “financial transaction” in two places in 11.14 a) and one in the final paragraph of 11.15.

The two sections which we suggest are added are as follows:

11.13A A financing transaction between the entity and:

a) another member of the same group;
b) another entity with which the entity is under common control;
c) a shareholder of the entity;
d) a director of the entity;

should be presumed not to be a commercial financing transaction and should initially be recognised at transaction price. For such transactions the effective interest rate described in paragraph 11.16 may be nil.

11.42A The fact that any financial instrument classified as a financing transaction is not regarded as commercial (in accordance with 11.13A) should be disclosed.

We hope that you find this suggestion to be helpful.

Yours faithfully

Michael Comeau
Technical Principal

APPENDIX

RESPONSES TO SPECIFIC QUESTIONS RAISED

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
The difference between the requirements applying to micro-entities and those of FRS 102 appear to justify the issue of a separate standard. An approach whereby a single FRS 102 standard sets out requirements which clearly distinguish between those applying to:
a) all entities
b) non-small entities
c) small entities
d) micro-entities
would, in our view, give the clearest and most usable presentation. However, we anticipate that the general preference will be for a separate document and accept that this is also a reasonable approach.

One problem with the existing FRSSE is that many of the requirements deriving from the full standards are stated in an abbreviated form. The result is that uncertainty is introduced as to whether the intention was to simplify the requirements or only to simplify their expression. If a separate FRSME is to be prepared, we would suggest that those requirements which derive directly from FRS 102 without change are stated in the same words with a the cross reference to the original FRS 102 provision. Different wording should only be used where it is intended that there is a different requirement.

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?

Yes
We agree with the proposed simplifications.

One area where we believe that further simplification should be considered is in the treatment of interest-free long-term loans. This is considered in more detail in our covering letter and in our response to question 4 below. We believe that a change should be made to the full version of FRS 102. But if the case for such a change is not accepted a different treatment for small or at least micro-entities would reduce the difficulties which the current requirements of FRS 102 would cause.

Question 3
The accounting standard that is applicable to small entities (not just small companies) (ie 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
The assumption of the FRC (and of BIS) is that accounting standards are covered by the prohibitions in the EU Accounting Directive from giving detailed guidance on what is necessary for a true and fair

view. The difficulties that this conclusion will cause to the preparation of small company financial statements will be substantial and we would suggest that the legal position is further investigated. On the face of it, it would appear that accounting standards only have the force of law as interpretations of what is necessary to give a true and fair view and should not be regarded as accounting rules within the meaning of the Accounting Directive, but we accept that the FRC and BIS have so far come to the opposite conclusion.

On the assumption that the FRC and BIS conclusion is correct, we agree with the FRC's reservations (as set out in s1.8, and elsewhere, within the Consultation Document) about the effect of the Accounting Directive's restriction on the number of disclosures that can be made mandatory.

The addition of guidance on which disclosures small non-corporate entities might consider to be required in order to give a true and fair view, could form the basis of best practice for all small entities, but we agree that it would unnecessarily complicate the standard to apply additional requirements to non-companies.

The more general suggestion at 3.10 of the discussion paper that directors should have regard to the full requirements of FRS 102 would achieve a similar purpose more simply, but there may be scope for indicating which aspects of the full requirements of FRS 102 are most likely to be relevant, to better assist the directors in making these judgements. However this approach:

a) would probably best be achieved in a separate document (i.e. a new version of the FRSSE, which the FRC has already indicated a preference against); and
b) may cause legal difficulties if the prohibitions within the Accounting Directive are correctly seen as applying to the FRC, so that this approach could be seen as attempt to bypass them.

For these reasons, if the FRC and BIS interpretation of the legal position is correct, we do not think that this alternative suggestion should be pursued.

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?

Yes
Overall we support the withdrawal of the FRSSE. In our response to question 1 we outlined some of the difficulties caused by the existing FRSSE. These will be alleviated by bringing small companies within the scope of FRS 102.

Nonetheless the adoption of FRS 102 as currently drafted will cause significant difficulties to small companies which we believe should be addressed.

The need to recognise derivatives (3.22 a)) and to measure more complex financial instruments at fair value (3.22 c)) will cause difficulties, but we accept the general arguments made for the inclusion of these amounts in small company accounts.

We accept that consistency justifies the different (i.e. updated) treatment set out in most of the remaining points set out in section 3.22 and 3.24 of the Consultation Document, but there are two particular issues which will cause particular difficulties. These are:

a) the FRS 102 treatment of long-term financial instruments at non-market rates of interest; and
b) the FRS 102 (and existing full UK GAAP) treatment of equity settled share-based payment transactions.

In both cases these treatments, which derive from IFRS, will (and in the latter case already do) cause significant difficulties for all entities which will be subject to FRS 102.

Financial instruments at non-market rates of interest
We have set out more detail of the changes we believe to be necessary in this area in our covering letter. We believe that this is an area where urgent action is required.

Equity settled share-based payment transactions
We are pleased to note that micro-entities are to be exempt from these requirements, but we think that the reasoning behind this requirements only really applies where the equities in question have a readily ascertainable market value and that this would normally only be the case for listed companies.

Employee share option schemes are not uncommon in unlisted entities. They are normally set up in anticipation that there could be a sale of the company to a third party in the future. Their primary objective is to give the employees a stake in the company in anticipation of this event. Option holders seldom have the ability to (readily) sell their options, or the resulting shares, so that for such companies, the accounting assumption that employee share option schemes are a form of remuneration results in accounting entries which are misleading.

It is hard to make sense of these options being reflected as an expense in the profit and loss account. Such schemes affect the ownership of the company only, and only the exercise of the option should be reflected in the accounts. Between grant and exercise date it would be useful to disclose that such options exist, but no accounting entry is appropriate.

An amendment should be made to FRS 102 so that the requirement to reflect a charge only applies where the relevant shares are quoted on an active market.

Conclusion
We believe that it would be logical to make these changes for all entities eligible to use FRS 102. These will both constitute differences from requirements of IFRS but these differences are not likely to cause problems or differences of treatment in practice because in the case of companies following IFRS:

a) there will normally be a range of owners, so that the sort of non-arm's-length transaction which we propose to be exempted, would not (and should not) arise; and
b) the equities involved are more likely to have a readily ascertainable market value so that the original logic of this requirement would hold true.

If the FRC is unwilling to make these amendments to the general requirements of FRS 102, although the problem is not limited to small companies, an exemption from both requirements should be considered for small companies alone.

If the requirement to account for interest on non-arm's-length interest-free loans which are not repayable on demand is to remain, it would be helpful if the FRC could expand the guidance in SEN 2 to state more clearly how in practice the FRC envisage the notional “gift” element being treated. We believe that the statement on page 6 of SEN 2 that “Each entity should consider the particular facts of the underlying transaction in order to record [the shortfall between the amounts of cash received or advanced and the initial carrying value of the loan] appropriately.” to be particularly unhelpful.

In some cases it may be possible to regard the amount described as a capital contribution, but the notion of a capital contribution is not defined or explained within FRS 102. We are aware that there is already divergence of opinion over the circumstances in which this treatment is available. If this method is to be used it would be useful for the FRC to give guidance on the circumstances in which this would be an appropriate treatment, otherwise differences in practice are bound to arise. Where the amount is not a capital contribution, there does not seem to be an appropriate way to record the transaction. We believe that this demonstrates that the existing requirements of paragraph 11.13 have not been adequately thought through, presumably because neither the FRC, nor the IASB before them, recognise that such transactions are likely to occur. In fact they are common.

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 publicised 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 have no particular comments to make on this issue.

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? FRS 101

Yes
We see no advantage in trying to include the existing company law requirements within FRS 102. The company law requirements are not under the control of the FRC and it is clearer to refer to these requirements in their original enactment.

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 see no particular downsides to this approach.