

29 April 2015

For the attention of Jenny Carter  
Financial Reporting Council  
8<sup>th</sup> Floor  
125 London Wall  
London  
EC2Y 5AS

Dear Sirs

**FRED 59: Draft amendments to FRS 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'.**

We are pleased to respond to your invitation to comment on the recently issued FRED 59 proposing various amendments to FRS 102, which arise largely (although not entirely) as a result of the need to set out the accounting regime for small entities in the future in accordance with the Accounting Directive. We have responded to the questions posed in the consultation in turn in the attached appendix, but also have some overall observations.

Whilst we recognise that the FRC's hands are tied in some respects due to the introduction of the Accounting Directive – in particular the restriction on the number of notes to the financial statements a small company can legally be obliged to prepare – we remain seriously concerned that there will be increased judgement required to ascertain which additional disclosures are required to give a true and fair view. This will potentially increase the occurrence of differences of opinion arising in respect of the required disclosure between the directors and the auditors/accountants of small entities.

As a consequence we do not believe that there will be any real cost saving for small businesses. In addition we remain concerned that this measure – and indeed any further measures which potentially reduce the quality of small company financial statements – will affect the ability of small businesses to access finance and therefore potentially restrict growth.

We also remain of the opinion that £10m turnover and £5m total assets is simply too high for the small company threshold, particularly if the audit exemption threshold remains aligned with it. Companies of this size are far more likely to have more complex accounting transactions than smaller entities and also to have external stakeholders. This means that potential problems arising from the implementation of the Accounting Directive – e.g. access to credit as a result of poorer quality financial statements – could be far more wide ranging than if the threshold were retained at a lower level with the audit threshold remaining aligned. However, the raising of the limit now appears, at least in accounting terms, to be a *fait accompli*.

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In respect of the proposed revisions to FRS 102, our main concern is that section 1A, as currently drafted, is difficult to understand and far from user friendly. In particular it is not clear how the legal requirements of the Accounting Directive (the mandatory notes small companies must still prepare) relate to the disclosures small companies are asked by the draft Standard to provide. In our view the linkage needs to be clearer in the final revised Standard so that there is reduced scope for confusion about what disclosures are legally required and what are simply 'encouraged' or alternatively are not mandated but may be required in order for the accounts to give a true and fair view.

We hope that our comments are useful to you. If you have any questions on the contents of this letter then please contact Tessa Park.

Yours faithfully



**Kingston Smith LLP**

**1. Do you agree that the proposed section 1A ‘Small Entities’ adequately reflects the new small companies regime set out in company law and that the disclosure requirements for small entities are clear? If not, why not and what alternative approach would you propose?**

We appreciate that the FRC was given a difficult task in trying to incorporate the requirements of the Accounting Directive into the new UK financial reporting framework in a sensible fashion, not least given the short time frame for adoption.

***Overall approach taken***

We agree with the FRC’s decision that now is the time to withdraw the FRSSE and to align the financial reporting regime for small entities with FRS 102. Indeed we had taken the view that it would have been preferable to withdraw the FRSSE at an earlier stage with small entities adopting FRS 102 with additional exemptions. However we recognise that the final direction of travel for small company financial reporting at EU level was not then known and therefore we understand the FRC’s reasons for waiting. We also agree with the FRC’s decision to permit small entities that are not companies (for instance LLPs) to adopt the small company reduced disclosures despite this not being mandatory under EU law.

***Structure of section 1A***

Whilst we agree in principle with the FRC’s decision to set out the disclosure requirements for small entities in a separate section of FRS 102, we have serious reservations about the way this has been done.

Firstly, as noted in our introductory remarks, it is not clear how the legal requirements of the Accounting Directive link to the disclosures that the redrafted FRS 102 appears to require. This linkage needs to be clearly expressed so that there is reduced scope for confusion about what disclosures are legally required and what are simply ‘encouraged’ or alternatively are not mandated but may be required in order for the accounts to give a true and fair view.

Secondly, section 1A, as currently drafted, is very difficult to read and is not user friendly. It contains a significant amount of cross referencing to other sections of the Standard, and a preparer of the financial statements of a small entity may need to spend a significant amount of time jumping between different sections of the Standard when trying to establish what disclosures are needed.

As an example, paragraph 1A.2 starts by stating ‘*A small entity is not required to comply with the requirements of paragraphs 3.3, PBE 3.3A, 3.9, 3.17, 3.18, 3.19 and 3.24b*’. Whilst we can see that it would add length to the section to spell out what these requirements are, and therefore what a small entity does not have to comply with, we believe it would have the benefit of clarity.

For instance, the remainder of that paragraph could perhaps be deleted and paragraph 1A.3 then be re-worded as:

*‘A small entity is not required to present the following information:*

- a) A statement of financial position in accordance with section 4;*
- b) A statement of comprehensive income and income statement in accordance with section 5;*

- c) *A statement of changes in equity and statement of income and retained earnings in accordance with section 6, although a small entity is encouraged to do so; or*
- d) *A cash flow statement in accordance with section 7.*

*Instead, a small entity shall present a statement of financial position as at the reporting date in accordance with paragraph 1A.5 and an income statement for the reporting period in accordance with paragraph 1A.9. A small entity shall also present notes in accordance with paragraphs 1A.12 to 1A.15.*

Paragraph 1A.4 could then be deleted.

The section which sets out the required notes also contains a great deal of cross referencing where we believe it would be preferable to spell out what an entity is, or is not, required to do. For instance paragraph 1A.12 states 'A small entity shall apply paragraphs 8.3 and 8.4 to the structure of the notes'. We think it would have the benefit of clarity to summarise in this paragraph what structure is required.

We do appreciate that reducing the amount of cross referencing would significantly increase the length of section 1A but we think the benefits of clarity would outweigh any disadvantages of increased length. If significant cross referencing is retained in the final revised Standard, we would encourage the FRC to include relevant hyperlinks in the online version, but clearly this is not possible in a printed copy.

### ***Complying with the requirement to present a true and fair view***

We agree with the FRC's approach set out in paragraph 1A.12 and 1A.13 of encouraging a small entity to consider what other disclosures are needed to give a true and fair view. In our opinion it would be useful to strengthen these paragraphs, if possible in the context of the legal framework, for instance by stating that an entity 'shall' consider and provide any of those other disclosures that are required to give a true and fair view. Whilst we understand that the FRC cannot mandate that additional disclosures are given, the term 'shall' is used in paragraph 1A.12 and we do not therefore understand why similar language therefore cannot be used in paragraph 1A.13 given that the accounts of a small entity are required to show a true and fair view, not simply encouraged to do so.

- 2. In developing these proposals the FRC has applied the principle that there should not be differences between the recognition and measurement requirements applicable to small entities and those applicable to larger entities. This principle has been determined after taking account of the generally positive response to a similar proposal in the Consultation Document. Do you agree with this principle? If not, why not and what alternative principle or specific exceptions to this principle would you propose?**

In general, we agree with this principle but there are a few areas where we believe that small entities may face practical difficulties and where additional exemptions may therefore be beneficial. The difficulties may be particularly pronounced because for many small entities the date of transition has already passed and therefore we believe there is a case for additional transitional exemptions for small entities even if the FRC are not minded to grant further exemptions for small entities 'across the board'. Whilst we can see that there may be an argument that if a small entity enters into a complex transaction – e.g. an interest rate swap – it should be prepared to accept the resulting complex accounting, we believe there are some areas where the complexity of the accounting is out of proportion with the complexity of the underlying situation and will therefore create problems for small entities in practice.

### ***Intercompany and other loans at a below market rate of interest***

The most obvious example where, in our view, the complexity of the accounting under FRS 102 appears disproportionate to the complexity of the underlying transactions is the treatment of intercompany and other loans at a below market rate of interest. It is very common in smaller groups for intercompany loans to be made at a zero or below market rate of interest. It is also very common for finance to be provided to small entities on similar terms by related parties, for instance directors who often, indeed usually, are owner-managers.

As we have stated in our response to various consultations, we believe that there are a number of issues that will arise from the requirement to measure such 'financing transactions' at the present value of the repayment amount, including difficulties in determining a comparable market rate of interest and in some cases determining what the term of the loan truly is and therefore the period over which any discounting should be unwound. In addition, there are many 'grey areas' at present including the accounting treatment of the balancing entry when discounting such loans for the first time.

We would urge the FRC to consider whether small companies should be exempted from the requirement to discount such balances and instead present them at face value, in the same way as the FRC already permits for public benefit entity concessionary loans, dormant companies and micro-entities (as proposed in FRED 58).

### ***Share-based payment***

We also believe that the requirement for small entities to account for share-based payment arrangements at fair value will create additional burdens in practice; it is relatively common for smaller entities to have such arrangements in place to incentivise staff. It can be quite a complex process to determine the fair value of a share-based payment arrangement unless the entity has some expertise in applying option pricing models or has obtained relevant software; usually assistance will be required from professional advisers leading to additional costs for the business.

In our opinion the disclosure only approach in the FRSSE was a proportionate solution to reduce complexity and costs for smaller entities. Whilst we understand that mandating such an approach is impossible under the revised legal framework we believe that a recognition exemption, with encouragement to give sufficient disclosure of the arrangements as is necessary for the accounts to give a true and fair view, would be a proportionate approach.

### **3. Do you agree that the transitional provisions in FRS 102 are sufficient for small entities, or have you identified any further areas where transitional provisions should be considered? If so, please provide details.**

No, we believe that additional transitional exemptions are required, not least because the date of transition for many small companies has already passed, and will have passed for more companies by the time the final version of the revised Standard is released. In particular we would welcome the following transitional exemptions in the event that on-going exemptions are not granted:

- An exemption to permit accounting for derivatives at fair value prospectively, i.e. for derivative instruments entered into subsequent to the date of transition. This would avoid the need to obtain fair values of such instruments for dates that have already passed.

- For similar reasons, an exemption to permit only those share-based payments entered into subsequent to the date of transition to be subject to the requirement to recognise the share-based payment arrangement at fair value.
- An exemption to permit long-term intercompany or similar balances at a zero or below market rate of interest to be accounted for at face value if the date of inception of the arrangement was prior to the date of transition. This would allow small companies some time to consider whether they wished to revise such arrangements (for instance charge a market rate of interest, or agree the loan to be repayable on demand) having not had the opportunity to do so in advance of the date of transition because of the timing of the relevant legislation and consultations.

**4. Do you agree with the other amendments proposed to FRS 102 for compliance with company law? If not, why not?**

***Goodwill***

We agree with the decision to change the useful life of goodwill to a maximum of ten years in the event a reliable estimate cannot be made. We also agree with the amendment to the wording of paragraph 18.20 to make it clear this should be an exceptional situation. This is useful in clarifying to entities that the period given in this paragraph is not, and never was, intended to be a 'default'. Similarly, we agree with the change to paragraph 19.25 such that disclosure is no longer required where the UEL exceeds five years, unless the UEL cannot be reliably measured in which case an explanation for the period chosen is required. This is a sensible and welcome change which should alleviate many of the concerns about this area of the Standard.

However, we do have some concerns about the change to prohibit reversals of impairments of goodwill. Whilst this has the benefit of consistency with the IFRS for SMEs and full IFRS it introduces an inconsistency with the treatment of other intangible assets as well as an additional difference from 'old' UK GAAP. Whilst goodwill impairment reversals are relatively rare there are situations in which the circumstances which led to a need for impairment genuinely no longer apply and therefore a reversal of impairment would be justified. We do however accept that this change may be required due to legal reasons.

The other amendments for compliance with company law appear appropriate.

**5. This FRED is accompanied by a Consultation Stage Impact Assessment. Do you have any comments on the costs or benefits discussed in that assessment?**

We have concerns that any cost savings that small entities might have obtained from applying a reduced disclosure framework will be outweighed by the requirement to account for (and obtain valuations for) certain items such as share-based payments or to discount long term, below market rate loan balances. In addition, time will need to be spent in determining what additional disclosures will be required to give a true and fair view in a set of small entity financial statements. As we have noted in our introductory remarks, we are also concerned that the quality of financial reporting for small entities may be adversely affected.

We do believe that there is a clear benefit in all entities being on a consistent financial reporting framework and therefore agree with the FRC's overall approach – we simply have concerns as to some of the detail of application and ensuring that the resulting financial reporting framework as applied to small entities is both proportionate and useful to users of the accounts.