FRED 82 Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and other FRSs

Comment letter to the Financial Reporting Council

27 April 2023

ancoram *(an-kor-am), Latin*

1. anchor
2. *(figuratively)* hope, support, refuge, shelter

We are a boutique consultancy practice helping small- and medium-sized enterprises who are grappling with new sustainability and accounting requirements. We create clarity out of chaos by providing simple, sustainable solutions that scale with the SMEs we serve.

Our planet is at the precipice. Humanity needs hope. We believe that every business should be empowered not only to measure its impact but also tell its story—in financial, environmental and social terms as well as governance—to stakeholders everywhere.

Please contact us if you have any questions or wish to discuss our responses further.

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Executive Summary

We commend the FRC on its updates to UK and Irish GAAP and believe the FRC should continue to align FRS 102 as closely as possible to IFRS, wherever feasible. We are however cognisant of the need to balance the improvements in comparability that this alignment brings, against the costs of implementation and the information needs of users of the financial statements. SMEs across the UK and Ireland are battling inflationary pressures and, in many cases, continue to fight for survival post-pandemic. While many of the amendments proposed are, in our view, overdue improvements, we would question whether there is a net benefit to the UK economy by forcing these measures through with an effective date of 1 January 2025. We encourage the FRC to delay the implementation date to 2026 or 2027 to provide reporting entities and their accountants sufficient time to prepare.

The glaring omission from UK GAAP as it stands today is the absence of any meaningful consideration of crypto / digital assets and 'as-a-service' products. IAS 38 *Intangible Assets* was issued in September 1998, the same month that Google was birthed. We do not believe that the current requirements of IAS 38 and FRS 102 are sufficient to address the accounting for these products, which are now routinely purchased or sold by many UK and Irish businesses. Among the international standard-setters, only the FASB can demonstrate any tangible progress in this regard. We encourage the FRC to address this critical area as a matter of priority, given the increasing trend towards central bank digital currencies. We recommend the FRC advocates for an overhaul of IAS 38 to include these matters and also a fundamental reconsideration of the accounting treatment for research costs, **which has been demonstrated to disincentivise investment in emerging net-zero technology**. At present, the accounting requirements are very much 'the tail wagging the dog', which we view as highly unsuitable at a time of climate crisis.

The IFRS *Financial Instruments* suite of standards, while providing decision-useful information for investors and other stakeholders of listed entities and financial institutions, is less meaningful for many owner-managed businesses. The expected credit losses model (ECL) of IFRS 9 is unlikely to be understood by the financial statement users and preparers at many SMEs. Indeed, to many accountants, a shift to an ECL model may seem a step backwards, to the days of 'general' and 'specific' provisions prior to the incurred losses model now widespread under UK GAAP. We are therefore relieved that the FRC has elected not to introduce the ECL model in FRED 82, and encourage the FRC to take a more pragmatic and principles-based approach to this matter, by considering the ownership and activities of a reporting entity. We have provided specific examples of where an ECL approach may be more or less appropriate **in our response to Question 4**.

We have provided our detailed analysis and comments on the following pages. If we can be of assistance in the further development of FRED 82, please contact **Tim Dee**.

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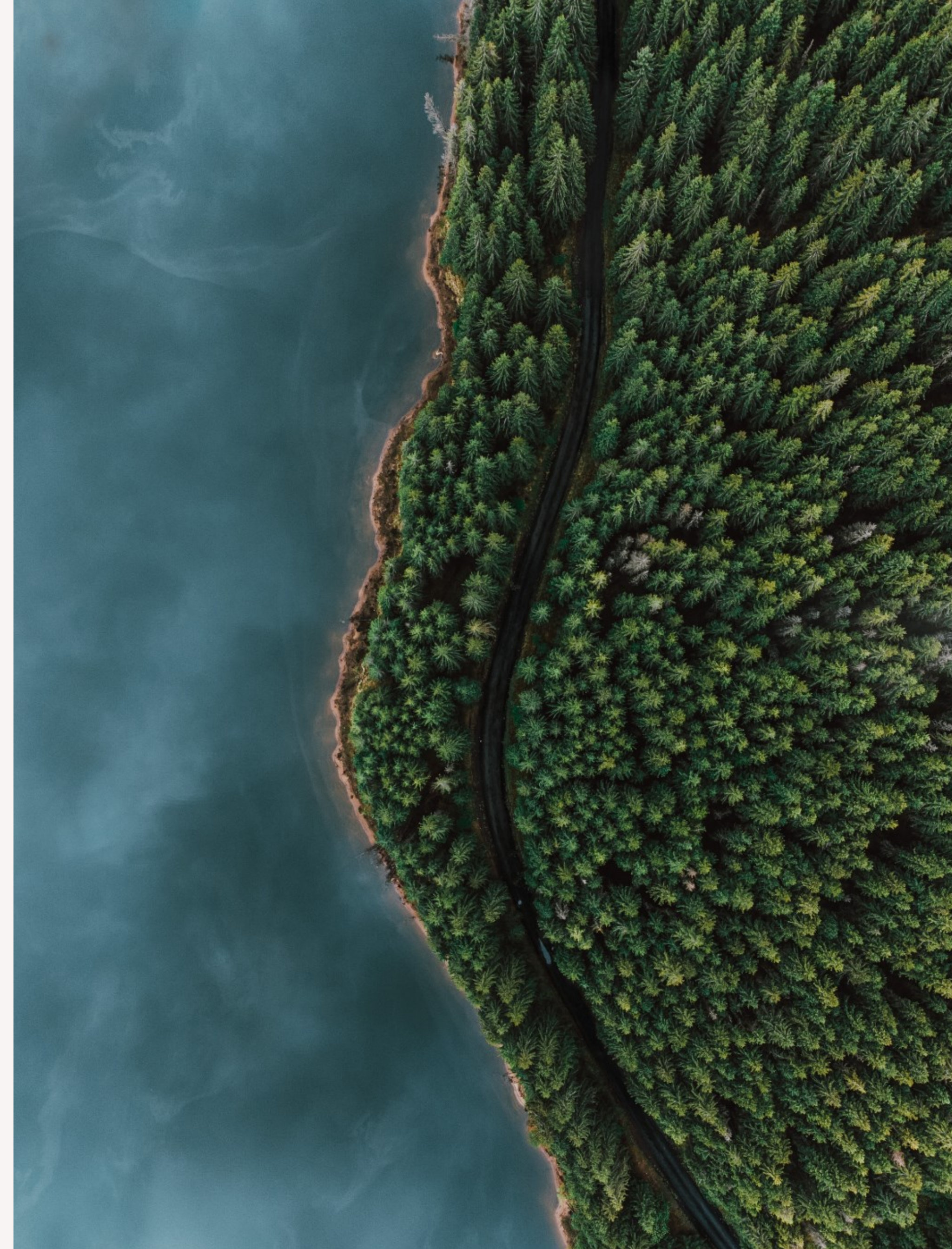
Question 1: Disclosure



Do you have any comments on the proposed overall level of disclosure required by FRS 102?

Taken collectively, we believe the proposed disclosure requirements of FRS 102 (as set out in FRED 82) are proportionate and will elevate financial reporting in the UK and Ireland. The closer alignment of FRS 102 to IFRS 15 and IFRS 16 and the resultant transition will naturally increase the burden on preparers on initial application; we believe such costs are unavoidable yet necessary to provide decision-useful information to users of the financial statements.

Do you believe that users of financial statements prepared under FRS 102 will generally be able to obtain the information they seek? If not, why not?

As was seen in listed entities on initial application of IFRS 15 and IFRS 16, users of the financial statements may experience a brief period of disorientation, particularly in the case of recognising certain operating leases on the balance sheet. This may prove particularly problematic for owner-managers with minimal accountancy knowledge.

Many UK lenders and financial institutions have themselves adopted IFRS 15 and IFRS 16, and hence will already be familiar with the concepts proposed in FRED 82. We are concerned however that some providers of trade and commercial finance may not recognise the impact of adopting the new lease accounting requirements proposed in FRED 82 and the resultant impact on EBITDA, gearing, and liquidity given the transitional requirements. We recommend that the FRLab prepares generic guidance that reporting entities can share with lenders where questions arise.

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Question 2: Concepts and pervasive principles

The proposed revised Section 2 *Concepts and Pervasive Principles* of FRS 102 and FRS 105 would broadly align with the IASB's 2018 *Conceptual Framework* for Financial Reporting. The IASB's Exposure Draft *Third edition of the IFRS for SMEs Accounting Standard* (IASB/ED/2022/1) contains similar proposals. The FRC considers it appropriate that FRS 102 and FRS 105 should be based on the same concepts and pervasive principles as IFRS Accounting Standards including *the IFRS for SMEs* Accounting Standard, given the FRC's aim of developing financial reporting standards that have consistency with global accounting standards. The FRC has made different decisions from the IASB in some respects in developing proposals to align FRS 102 and FRS 105 with the 2018 *Conceptual Framework* in a proportionate manner. Do you agree with the proposal to align FRS 102 and FRS 105 with the 2018 *Conceptual Framework*? If not, why not?

In our view, the 2018 *Conceptual Framework* provides a critical foundation to sound financial reporting and we agree with the FRC's proposal to align FRS 102 and FRS 105 more closely with this. We do not believe it is appropriate, nor is it desirable, for UK GAAP to apply thecomplete framework proposed in the IASB's Exposure Draft ED/2022/1, which, in our view, contradicts critical elements of the 2018 *Conceptual Framework*. We encourage the FRC to push the IASB for a more robust adoption of the 2018 *Conceptual Framework* in the final amendments to the *IFRS for SMEs* Accounting Standard.

This FRED, and IASB/ED/2022/1, propose to continue using the extant definition of an asset for the purposes of Section 18 *Intangible Assets other than Goodwill* and the extant definition of a liability for the purposes of Section 21 *Provisions and Contingencies* of FRS 102. This is consistent with the approach taken in IAS 38 *Intangible Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* which use the definitions of an asset and a liability from the IASB's 1989 *Framework for the Preparation and Presentation of Financial Statements*. Do you agree with this approach? If not, why not?

Yes, we agree with the FRC's decision to maintain consistency with IAS 37 and the 1989 *Framework for the Preparation and Presentation of Financial Statements*. The basis of identifying, determining and measuring intangible assets other than goodwill, and provisions, contingent liabilities and contingent assets, should remain consistent with full IFRS. While this may create some differences with the financial reporting of entities applying the *IFRS for SMEs* Accounting Standard, we do not believe this reduced comparability would pose a material threat to UK/Irish GAAP, given that SMEs' financial statements are less frequently benchmarked and compared across territories than quoted companies applying full IFRS.

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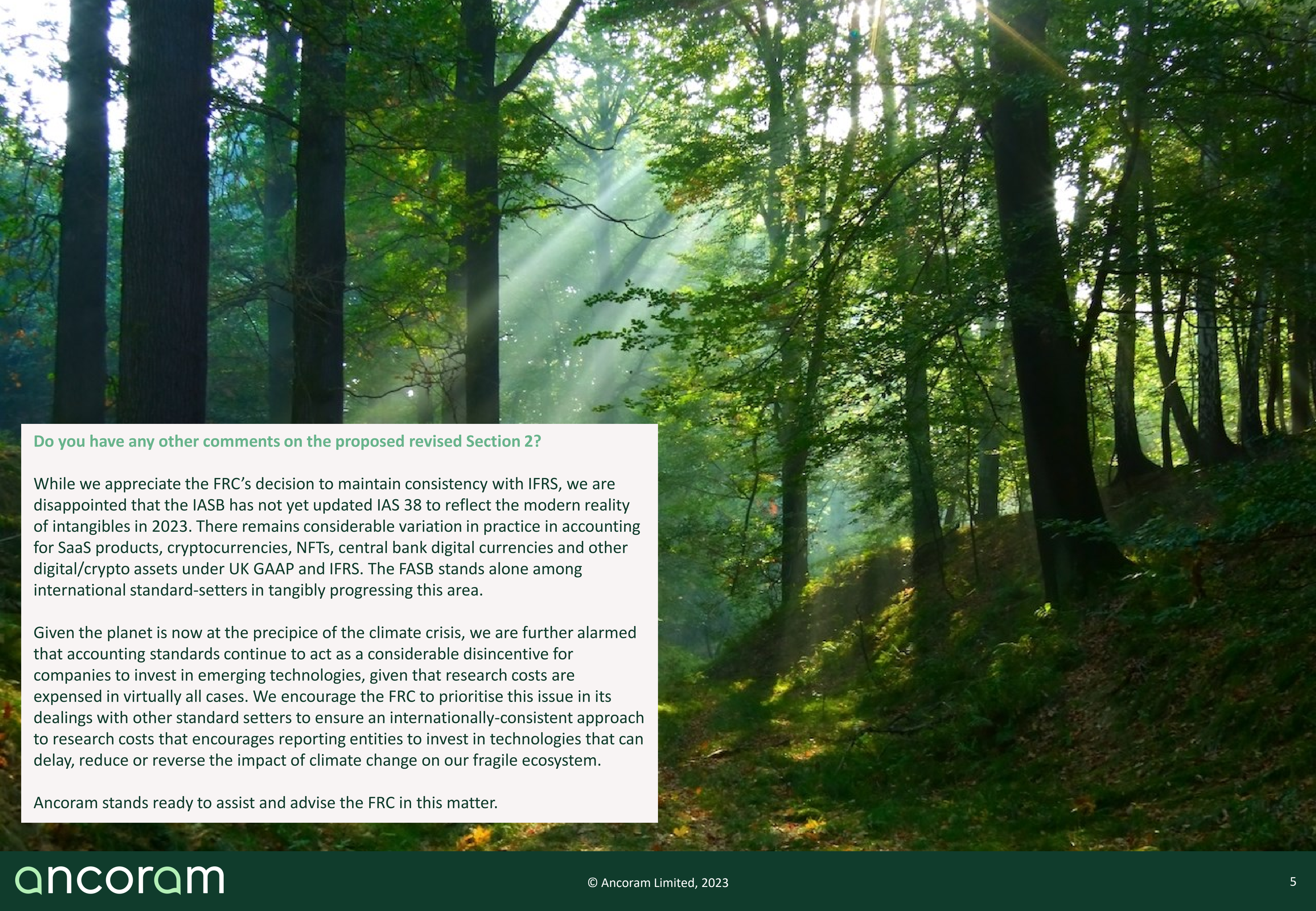

Do you have any other comments on the proposed revised Section 2?

While we appreciate the FRC's decision to maintain consistency with IFRS, we are disappointed that the IASB has not yet updated IAS 38 to reflect the modern reality of intangibles in 2023. There remains considerable variation in practice in accounting for SaaS products, cryptocurrencies, NFTs, central bank digital currencies and other digital/crypto assets under UK GAAP and IFRS. The FASB stands alone among international standard-setters in tangibly progressing this area.

Given the planet is now at the precipice of the climate crisis, we are further alarmed that accounting standards continue to act as a considerable disincentive for companies to invest in emerging technologies, given that research costs are expensed in virtually all cases. We encourage the FRC to prioritise this issue in its dealings with other standard setters to ensure an internationally-consistent approach to research costs that encourages reporting entities to invest in technologies that can delay, reduce or reverse the impact of climate change on our fragile ecosystem.

Ancoram stands ready to assist and advise the FRC in this matter.

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Question 3: Fair value

The proposed Section 2A *Fair Value Measurement* of FRS 102 would align the definition of fair value, and the guidance on fair value measurement, with that in IFRS 13 *Fair Value Measurement*. Do you agree with this proposal? If not, why not?

Yes, we agree that the fair value definition and measurement guidance should be aligned with IFRS 13 *Fair Value Measurement*. It is vital that 'fair value' holds an internationally-consistent definition and measurement basis that transcends territorial borders.

We recognise that some financial leaders in the UK public sector have criticised fair value accounting and hierarchy disclosures as a leading cause of delays in publishing audited financial statements. We do not believe that this criticism is fair, given the increasingly-dynamic investment portfolios in this space. We encourage the FRC to work with CIPFA LASAAC and CCAB member bodies to develop robust fair value guidance appropriate to the public sector.

Do you agree with the proposed consequential amendment to Section 26 *Share-based Payment* of FRS 102 to retain the extant definition of fair value for the purposes of that section? If not, why not?

Share-based payments are no longer as rare in private companies as they were when FRS 102 was first issued in March 2013. It is particularly important that prospective and current investors can readily understand how fair value is determined; we believe this is best ensured by aligning Section 26 of FRS 102 to the requirements of IFRS 2.

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Question 4: Expected credit loss model

The FRC intends to defer its conclusion as to whether to align FRS 102 with the expected credit loss model of financial asset impairment from IFRS 9 *Financial Instruments* pending the issue of the IASB's third edition of the *IFRS for SMEs* Accounting Standard. Any proposals to align with the expected credit loss model will therefore be presented in a later FRED. Do you agree with this approach? If not, why not?

We agree with the FRC's approach in principle, but believe UK and Irish subsidiaries of groups preparing consolidated financial statements under IFRS should be permitted to apply the expected credit loss (ECL) model in their UK/Irish GAAP financial statements, if it will reduce the reporting burden. In these limited circumstances, the users of the financial statements are often primarily the ultimate and/or intermediate parent entities, who are versed in ECL impairment methods and welcome consistency of financial reporting.

In IASB/ED/2022/1 the IASB proposes to retain the incurred loss model for trade receivables and contract assets, and introduce an expected credit loss model for other financial assets measured at amortised cost. The FRC's preliminary view is that, in the context of FRS 102, it may be appropriate to require certain entities to apply an expected credit loss model to their financial assets measured at amortised cost, but allow other entities to retain the incurred loss model. Do you agree with this view? If not, why not?

The incurred loss model is well-established in UK/Irish financial reporting, and to many non-financial services entities the ECL approach may appear a step back to the days of 'general' and 'specific' bad debt provisions. We believe that the best determinants of which impairment model should be applied are (a) the reporting entity's business model for managing the financial asset, similar to the classification criteria of IFRS 9, and (b) the information needs of the users of the financial statements.

To illustrate our position, consider the following examples:

- Public interest entities, debt factorers, commercial lessors, lenders, commercial and trade finance providers, insurers and financial institutions will often apply risk management processes similar to the ECL model in managing their credit risk exposures and so could reasonably be expected to adopt the ECL model in their financial reporting;
- Where an operating entity intends to sell its trade receivables to a third party on 'without recourse' terms, or to a debt factorer at a discount, there is little benefit, if any, in applying the ECL model to that reporting entity's financials;
- Where a reporting entity holds financial assets at amortised cost that are neither trade receivables nor contract assets, we believe it is appropriate to expect these to be impaired under the ECL model;
- In the majority of UK/Irish entities holding 'vanilla' trade receivables and contract assets, the business intends to hold and collect the contractual cash flows (i.e. invoice payments). We agree with the FRC that an incurred loss model is more appropriate and more practicable in these circumstances than the ECL basis.

Based on stakeholder feedback received to date, the FRC does not intend to use the existing definition of a financial institution to define the scope of which entities should apply an expected credit loss model. The FRC's preliminary view is that it may be appropriate to define the scope based on an entity's activities (such as entering into regulated or unregulated credit agreements as lender, or finance leases as lessor), or on whether the entity meets the definition of a public interest entity. Do you have any comments on which entities should be required to apply an expected credit loss model?

As noted in our examples above, we believe a principles-based approach is more appropriate to determine the impairment model. For the majority of unlisted SMEs, the information needs of the financial statement users are vastly less complex compared to those of quoted companies and public interest entities. We do not believe the benefits of improved comparability in SME financial statements sufficiently justify the significant costs of implementation for many businesses.

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Question 5: Other financial instruments issues

When it has reached its conclusion as to whether to align FRS 102 with the expected credit loss model, the FRC intends to remove the option in paragraphs 11.2(b) and 12.2(b) of FRS 102 to follow the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. This intention was communicated in paragraph B11.5 of the Basis of Conclusions to FRS 102 following the Triennial Review 2017. In preparation for the eventual removal of the IAS 39 option, the FRC proposes to prevent an entity from newly adopting this accounting policy. Do you agree with this proposal? If not, why not?

We support the FRC's proposal in this regard.

Temporary amendments were made to FRS 102 in December 2019 and December 2020 in relation to interest rate benchmark reform (IBOR reform). The FRC intends to consider, alongside the future consideration of the expected credit loss model, whether these temporary amendments have now served their purpose and could be removed. Do you support the deletion of these temporary amendments? If so, when do you think they should be deleted? If not, why not?

Given international events such as the war in Ukraine and current inflationary pressures, we suggest that the FRC maintains a watching brief on this matter and reconsiders these temporary amendments if and when the UK and Irish economies are more stable than at present.

Question 6: Leases

FRED 82 proposes to revise the lease accounting requirements in FRS 102 to reflect the on-balance sheet model from IFRS 16 *Leases*, with largely-optional simplifications aimed at ensuring the lease accounting requirements in FRS 102 remain cost-effective to apply. An entity electing not to take these proposed simplifications will follow requirements closely aligned to those of IFRS 16, which is expected to promote efficiency within groups.

Do you agree with the proposals to revise Section 20 of FRS 102 to reflect the on-balance sheet lease accounting model from IFRS 16, with simplifications? If not, why not?

In the case of commercial lessors and other reporting entities that lease out assets as a material component of their business model, we believe the IFRS 16 model provides a true and fair basis of reporting the financial performance, and associated risk, of such transactions. We therefore support the FRC's adoption of a simplified IFRS 16 model into FRS 102.

In the case of lessees, we expect the majority of lease arrangements to meet the short-term, portfolio or low value criteria and so in many cases the simplified IFRS 16 model will not be relevant.

Our concern is primarily for lessees who enter into a material lease agreement, and who may need to explain to their lenders, investors and other financial statement users the impact of the proposed simplified method on their EBITDA, gearing and liquidity. We would question whether such entities could be ready to adopt the simplified method as early as 1 January 2025, given the considerable costs of adoption where the contractual terms are more complex. We encourage the FRC to delay the implementation of these amendments to 2026 or 2027.

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Question 7: Revenue

FRED 82 proposes to revise the revenue recognition requirements in FRS 102 and FRS 105 to reflect the revenue recognition model from IFRS 15 *Revenue from Contracts with Customers*. The revised requirements are based on the five-step model for revenue recognition in IFRS 15, with simplifications aimed at ensuring the requirements for revenue in FRS 102 and FRS 105 remain cost-effective to apply. Consequential amendments are also proposed to FRS 103 and its accompanying Implementation Guidance for alignment with the principles of the proposed revised Section 23 of FRS 102.

Do you agree with the proposals to revise Section 23 of FRS 102 and Section 18 of FRS 105 to reflect the revenue recognition model from IFRS 15, with simplifications? If not, why not?

Yes, we agree that it is appropriate to revise FRS 102 and FRS 105 to align more closely with IFRS 15. Our concern however remains for reporting entities engaged in rate-regulated activities, whose revenue models, funding mechanisms and investment allowances are determined by Ofgem, Ofwat and similar regulators. We encourage the FRC to align the UK GAAP financial reporting requirements of such entities with the regulatory mechanisms imposed, to reflect the substance of their revenue model.

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Question 8: Effective date and transitional provisions

The proposed effective date for the amendments set out in FRED 82 is accounting periods beginning on or after 1 January 2025, with early application permitted provided all amendments are applied at the same time. Do you agree with this proposal? If not, why not?

FRED 82 is a weighty upgrade to UK GAAP and, even with the FRC's proposed simplifications to revenue recognition and lease accounting models, many reporting entities may struggle to meet the implementation deadline. We believe accounting periods beginning on or after 1 January 2026 or 2027 would be a more appropriate effective date, given the costs involved. We concur that all amendments should be applied concurrently.

FRED 82 proposes transitional provisions (see paragraphs 1.35 to 1.60 of FRS 102 and paragraph 1.11 of FRS 105). In respect of leases, FRED 82 proposes to permit an entity to use, as its opening balances, carrying amounts previously determined in accordance with IFRS 16. This is expected to provide a simplification for entities that have previously reported amounts in accordance with IFRS 16 for consolidation purposes, promoting efficiency within groups. Do you agree with this proposal? If not, why not?

We agree with this proposal, which is pragmatic for the preparers and reflects the decision-useful information needs of the financial statement users.

Otherwise, FRED 82 proposes to require the calculation of lease liabilities and right-of-use assets on a modified retrospective basis at the date of initial application. Do you agree with this proposal? If not, why not?

We concur with the FRC's approach; the modified retrospective basis is most likely to be least burdensome for preparers applying the simplified IFRS 16 model for the first time.

In respect of revenue, FRED 82 proposes to permit an entity to apply the revised Section 23 of FRS 102 on a modified retrospective basis with the cumulative effect of initially applying the revised section recognised in the year of initial application. This is expected to ease the burden of applying the new revenue recognition requirements retrospectively by removing the need to restate comparative period information. Unlike IASB/ED/2022/1, to ensure comparability between current and future reporting periods, FRED 82 does not propose to permit the revised Section 23 of FRS 102 to be applied on a prospective basis. However, FRED 82 proposes to require micro-entities to apply the revised Section 18 of FRS 105 on a prospective basis. Do you agree with these proposals? If not, why not?

The revised Section 18 of FRS 105 in FRED 82 provides a proportionate approach for micro-entities.

We support the FRC's proposals with regard to Section 23 of FRS 102 to prioritise year-on-year comparability; the extensive re-working of revenue recognition and lease accounting in some entities will make this a fundamental necessity.

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