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30 April 2015

Our ref: 01/JCC/FRED 59: Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland (February 2015)

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Dear Jenny,

FRED 59: Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland (February 2015)

We are pleased to have the opportunity to comment on the exposure draft "FRED 59: Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland (February 2015)" (the Exposure Draft).

We appreciate that the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (the Small Companies' Regulations) have introduced some significant complexities into UK reporting. We do not underestimate the challenge of incorporating these legislative changes into a single accounting standard that will be used by most companies that do not meet the conditions to be considered a micro-entity: a policy we continue to support. However, we have some significant reservations regarding the approach taken in the Exposure Draft which, in our view, has not resulted in a clear description of the requirements that apply to entities reporting under the small companies' regime. Our principal concerns are as follows:

- The location and structure of small companies' requirements and the extensive use of cross-referencing, which has made the guidance unnecessarily complex and unwieldy.
- A lack of principles-based guidance on how to determine what additional voluntary disclosures might be necessary for a small company's financial statements to give a true and fair view and whether and how to differentiate between that information and information in respect of a material transaction or balance that might be a subject to a disclosure *requirement* for a non-small entity.
- A lack of adequate cross-referencing to the Act and Small Companies' Regulations, which makes it difficult to locate and understand the source of the requirements.

We also believe that there is a strong argument for allowing companies that apply the small companies' regime to adopt a simplified method for measuring some 'other' financial instruments.

BDO

Jenny Carter
Financial Reporting Council
30 April 2015

Our detailed responses to the questions raised in the Exposure Draft are set out in the attached appendix. If you wish to discuss any of the points further, please do not hesitate in contacting me.

Yours sincerely,

Nicole Kissun

BDO LLP
Nicole Kissun
Partner
For and on behalf of BDO LLP

Appendix: Responses to the questions raised in *FRED 59: Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* (the Exposure Draft or FRED 59)

Question 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?

Do you agree that the proposed disclosure requirements for small entities are clear?

We are concerned that the approach taken in the Exposure Draft has not resulted in a clear description of the disclosure requirements for small entities, particularly when compared with the "one stop" approach which preparers have been used to under the Financial Reporting Standard for Smaller Entities (FRSSE), which provided both accounting and statutory recognition, measurement and disclosure requirements in one place. Our principal concerns about the proposed changes are as follows:

a) *Location and structure of small companies' requirements*

Paragraph 13 of the Accounting Council's Advice to the FRC to issue FRED 59 indicates that it was intended section 1A would set out the presentation and disclosure requirements applicable to small entities. We consider that this would be an appropriate approach if section 1A were the *only* source of disclosure requirements for small companies, however, this is not the case. There are many examples where a paragraph in section 1A cross-refers to a paragraph in another section of the standard. In some cases, a single paragraph in section 1A cross-refers to a substantial number of paragraphs within the wider standard.

In addition, as considered further in part (c) of our response to this question, section 1A does not take a direct approach in addressing the issue of which additional voluntary disclosures a company adopting the small companies' regime might need to include in order for its financial statements to present a true and fair view. Instead, companies are either encouraged to consider the inclusion of specific disclosures (eg in the proposed wording for paragraphs 1A.4 and 1A.15) or given a more general encouragement to consider the disclosure requirements in the other sections of FRS 102 (eg in the proposed wording for paragraph 1A.13). In both cases, these encouragements take the form of cross-references to other parts of the standard.

In both these cases, the approach adopted in FRED 59 means that a user of this guidance will have to flick back and forth extensively within the standard in order to ascertain the exact disclosure requirements and recommendations that apply to a company adopting the small companies' regime; this will be both time-consuming and confusing.

Given that a user of the small companies' provisions of FRS 102 must already refer to each section of the standard to access its recognition and measurement requirements, we think that the related small companies' disclosure requirements should also be included within those sections. Similarly, given that adopters of the small companies' provision of FRS 102 are being encouraged to use the disclosures required of other non-small entities as their principal guide to the type of information that may be necessary in order for the financial statements to give a true and fair view, we believe that a stratified approach to listing disclosures may also be helpful in providing a general indication of the relative importance of the disclosure requirements that apply to entities not applying the small companies' regime.

In order to effectively differentiate between those disclosure requirements that apply to small entities and those that apply to larger businesses, we believe that it would be beneficial to stratify disclosure requirements in each section of FRS 102 in the following way: (a) those disclosure requirements that apply to all entities applying FRS 102 (ie those that are required under the small companies' regime); (b) those additional disclosure requirements that would apply to a non-small company applying the qualifying entity reduced disclosure options; and (c) other disclosure requirements that apply to non-small, non-qualifying entities.

We accept that our suggestion would require a substantial restructuring of FRS 102. Consequently, in order to allow the speedy finalisation of the small companies' requirements, the FRC might wish to address this more pervasive structural concern as part of its first three year review in 2016/17.

b) *Arrangement of disclosure requirements in paragraph 1A.14*

We do not understand the reasoning for the order adopted for the disclosure requirements set out in paragraph 1A.14. They do not appear to be organised in such a way that all disclosures that relate to one particular subject are adjacent to each other (eg disclosures relevant to property, plant and equipment are included in paragraph 1A.12(h), (i) and (q)), nor do they appear to be organised according to where they appear in the Companies Act 2006 (the Act) and Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (the Small Companies' Regulations).

To the extent that the disclosures relevant to companies applying the small companies' regime do remain in a single section of FRS 102, we believe that they should be arranged into groups that relate to similar transactions or balances and more clearly identified (eg through the use of subheadings).

c) *Guidance on additional disclosures necessary for a true and fair view*

As noted in (a) above, section 1A takes the approach of encouraging companies to consider the inclusion of additional disclosures through either specific or general cross-references to other parts of FRS 102. These additional disclosures may be necessary in order for the financial statements to present a "true and fair view of the assets, liabilities, financial position and profit or loss", as required by section 393(1) of the Act and to meet the requirements of paragraph 3.2 of FRS 102.

Whilst, subject to our comments in (a) above, we consider it helpful to encourage small companies to consider the disclosure requirements applicable to other entities, we do not think that the proposals provide sufficient guidance to help them to determine whether and which additional disclosures might be necessary. In particular, we think users of FRS 102 would find useful some general principles that could be used to differentiate between a disclosure that an entity applying the non-small companies' requirements of FRS 102 would have to provide in a particular circumstance (ie a material disclosure requirement) but that an entity applying the small companies' requirements would not in respect of an identical circumstance (ie a material disclosure that is not necessary for a true and fair view).

We understand that the FRC must be careful that any guidance they might draft on this matter is not interpreted as requiring specific disclosures in addition the minimum requirements set out in the Small Companies' Regulations. In order to avoid such a misinterpretation, it may be appropriate to publish this guidance separately rather than including it in FRS 102.

d) *Cross-references to the Companies Act and Small Companies' Regulations*

Other than those explicitly identified as being "encouraged", the disclosures set out in section 1A are intended to reflect only the disclosure requirements imposed on small companies by the Act and the Small Companies' Regulations. However, with the exception of the primary statement formats, the proposals include no indication of which sections of the Act or Small Companies' Regulations are driving these requirements.

As the requirements set out in section 1A, particularly those included in paragraph 1A.14, do not use the precise wording used in the Act or Small Companies' Regulations, it is very difficult to locate the underlying legal requirement. In our view, the ability to easily locate the underlying legal requirement driving a specified disclosure will often be important in order to (a) understand its context and (b) enable users of FRS 102 to refer to the exact legal disclosure requirement on occasions when there are application questions arising from the simplified language used in the standard. One example where this may be particularly useful relevant is the disclosure requirement in paragraph 1A.14(c), which appears to be driven by a combination of section 844 of the Act and section 21(2)(b) of the Small Companies' Regulations.

In our view it would be very useful for the standard to include cross-references to the appropriate parts of the Act and Small Companies' Regulations in order to facilitate this deeper analysis. This could be achieved either through the inclusion of footnotes or adjacent references in the margins to section 1A (an approach previously used in FRS 2) or the inclusion of a more detailed legal appendix.

e) *Language used in section 1A*

As noted above, the requirements set out in section 1A, particularly those included in paragraph 1A.14, do not use the precise wording from the Act or Small Companies' Regulations. Whilst we accept that this is necessary in order to make the guidance clear and understandable, we do not think that this end has been achieved; the language used is still complex and unclear in several places. Good examples of this are in paragraphs 1A.14(m) and (t), which we believe a user of this guidance might find particularly difficult to interpret.

In our view, where the FRC has found it necessary to depart from the precise wording of the Act or Small Companies' Regulations, more accessible language should be used where possible.

f) Section 1B of schedule 1 to the Small Companies' Regulations

We understand section 1B of schedule 1 to the Small Companies' Regulations allows a company to adopt the presentation requirements of IAS 1 when preparing their income statement and statement of financial position. This approach is allowed subject to the following two conditions: (a) the information given is at least equivalent to that which would have been required had the approach not been adopted; and (b) the presentation of the primary statement is "in accordance with generally accepted accounting principles or practice". We take paragraphs 1A.8 to address the first of these conditions and paragraph 1A.7 and 1A.11 to address the second.

In our view, the proposed wording of section 1A provides insufficient guidance on the application of this part of the Small Companies' Regulations. Our principal concerns are as follows:

- It is not clear whether paragraph 1A.7 is intended to be the only guidance necessary to meet condition (b) above in respect of the statement of financial position or whether further reference to IAS 1 is required. In the latter case, it is not clear whether reference is necessary only to paragraphs 54 to 76 of IAS 1 or whether paragraphs 77 to 80A should also be considered.
- A similar question to that noted above arises in respect of paragraph 1A.11 regarding the income statement. In particular, it is not clear why, if it must prepare an income statement "in accordance with generally accepted accounting principles or practice" a small company should not also be required to disclose the information on discontinued operations required by IAS 1.82(ea).
- It is not clear how the requirements in paragraph 1A.8 have been derived and whether they are intended to be an exhaustive list of disclosures necessary to meet condition (a) above or whether reference to the formats in the Small Companies' Regulations is also required. For example, paragraph 1A.8(a) appears to be driven by the Arabic numbers under item BII of Formats 1 and 2 but no similar breakdown appears to have been required in respect of other items in the formats. Similarly, paragraph 1A.8(b) and (c) require an analysis of trade receivables and payables between amounts due from related parties (in general) and those due from others, whereas the formats:
  i. require separate analysis of only certain specific related party balances (eg they do require separate analysis of amounts due to or from group undertakings and those in which there is a participating interest but do not require separate analysis of amounts due to or from directors);
  ii. require this analysis for more than just trade and other payables and receivables (eg they require analysis of loans); and
  iii. require differentiation between loan and share investments.
- We are not clear exactly what disclosure paragraph 1A.8(d) is requiring.
- Paragraph 1A.14(m) includes reference to "commitments" whereas section 413(2)(b) of the Act does not include this term.
- Paragraph 1A.14(t) includes the phrase "...in so far as the disclosure of such risks and benefits is necessary for the purposes of assessing..." whereas section 410A refers to the disclosure of the "nature and business purpose of the arrangements to the extent necessary for enabling the financial position of the company to be assessed".

Do you agree that the proposed Section 1A Small Entities adequately reflects the new small companies' regime set out in company law?

For the reason set out above, we have found it very difficult to assess the completeness and accuracy of the disclosure requirements set out in paragraph 1A.14. We do, however, have the following specific comments on the content of that section:

- Paragraph 1A.14(b) - We believe that this disclosure requirement is driven by the revised requirements of sections 21 and 22 of schedule 1 to the Small Companies' Regulations. However, whereas paragraph 14(b) appears to require an explanation of the period over which *all* intangible assets are written off, it is our understanding of the Small Companies' Regulations that this disclosure is only *required* when either the intangible relates to development costs (section 21(2)(a)) or it has not been possible to reliably estimate its useful economic life (section 22(4)).
- Paragraph 1A.14(g) - We have been unable to ascertain what part of the Act or Small Companies' Regulations drives this requirement.
- The disclosures required by part 2 of schedule 6 to the Small Companies' Regulations (Information about related undertakings where company preparing group accounts) have not been included. These would be required in the event that a parent company applying the small companies' regime chooses to prepare group accounts.
- Paragraphs 1A.2 and 3.1A do not exempt a company applying the small companies' regime from the requirements of paragraph 3.5. However, if it is applicable to a company applying the small companies' regime, and if the intention is to have all disclosures applicable to small companies in section 1A, is not It is not clear why a disclosure equivalent to that specified in paragraph 3.5 is not included in section 1A.

In addition, in our response to the consultation document *'Accounting standards for small entities: Implementation of the EU Accounting Directive'* we indicated that we saw no need to change the current approach of not including all disclosures specified in company law in FRS 102. However, we consider that the approach taken has now resulted in a mismatch. The inclusion of the disclosure requirements in paragraphs 1A.14(c) and (q) has created an inconsistency of approach between FRS 102 as it applies to small companies and FRS 102 as it applies to other companies as the disclosures required by those paragraphs are company law requirements that are applicable to all sizes of company. Whilst we understand and accept the FRC's decision not to change its current approach to company law disclosures, we do think that, if a universally applicable company law disclosure requirement is included in the small companies' requirements, then it should also be included in the requirements for other companies in the most relevant section of FRS 102. This would be a consequential effect of the approach to the placement of disclosure requirements that we suggest in part (a) of our response to this question.

Question 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 the principle would you propose?

In our response to the consultation document *'Accounting standards for small entities: Implementation of the EU Accounting Directive'* we indicated that we saw no need to change the recognition and measurement requirements that apply to companies applying the small companies' regime compared to those that apply to other entities. However, whist we continue to hold this view in respect of most aspects of FRS 102, we have become more concerned about the onerousness of the requirements in respect of the classification of financial instruments as 'basic' or 'other'.

When an entity is determining the appropriate accounting treatment for a financial instrument, it must first determine whether it is a 'basic' or 'other' financial instrument. When a financial instrument falls to be treated as an 'other' financial instrument, section 12 requires it to be measured at fair value through profit or loss unless that measurement is "not permitted by the Regulations". This caveat requires the user of FRS 102 to refer directly to the accounting regulations which, in turn, state that (broadly) a financial instrument may be measured at fair value, if that treatment is also allowed under IFRSs. Under IFRSs, the circumstances under which a financial liability may be subsequently measured at fair value (as opposed to amortised cost) are limited and the requirements that must be applied in that determination are complex.

The suggestion that, in most circumstances, fair value measurement would be available for such instruments under IFRSs does not mean that an entity need not complete this analysis; it would still need to be completed for each 'other' financial instrument identified to ensure that the measurement approach adopted is not contrary to company law. In our view, this cross-reference to the accounting regulations and, indirectly, to full IFRSs, is unnecessarily complex and onerous in general but this is particularly the case for companies adopting the small companies regime. In order to remove the need to undertake this analysis required under the accounting regulations, we recommend that companies applying the small companies' regime should be required to measure 'other' financial instruments (with the possible exception of derivatives and listed equity investments) at amortised cost instead of fair value.

Question 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.

Yes, we agree that the transitional provisions in FRS 102 are sufficient for small entities.

Question 4

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

The comments made in response to question 1 above in respect of section 1B of the Small Companies' Regulations apply equally to the proposed changes set out in paragraphs 12 and 16 of the Exposure Draft, which are driven by the equivalent changes to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

In addition, we have the following comments about the other amendments proposed to FRS 102:

- There is a discrepancy in the proposed wording for section 1A.2 and section 3.1A regarding the paragraphs in section 3 of FRS 102 that do not apply to companies adopting the small companies' regime (reference to paragraphs 3.18 and 3.19 only appear in paragraph 1A.2).
- In paragraph 27 of the Exposure Draft, the proposed amendment to paragraph 9.3 refers to a "90% owned subsidiary" but sections 400 and 401 of the Act refer to holdings of "90% or more" and there is no indication of whether majority or unanimous consent is required.
- In paragraph 27 of the Exposure Draft, the proposed amendment to paragraph 9.3(e) should read "...parent, and group headed...". In addition, we found the use of double negatives in this sub-paragraph confusing and suggest the following alternative: "...and the group and parent are considered eligible as determined by reference to sections 384 and 399(2A) of the Act."
- We have been unable to identify the change in law that has caused the amendment proposed in paragraph 51 of the Exposure Draft (Deleting the "seriously prejudicial" exemption from the requirement to disclose certain provision disclosures), which also existed in FRS 12.97. This seriously prejudicial exemption also exists in IAS 37.92 but we note that FRED 60 does not propose a similar amendment to FRS 101.
- Given that companies applying the small companies' regime need now only disclose related party transactions which are "not conducted under normal market conditions", we think that section 33 of FRS 102 (which does not apply to small companies) should include clarification that related party transactions must be disclosed whether or not they are conducted under normal market conditions.
- We note that paragraph 72 of the Exposure Draft (proposed changes to Appendix IV of FRS 102) indicates that the changes to section 10 of schedule 6 of the Small Companies' Regulations (which are also mirrored in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008) have not affected the group reconstruction requirements of FRS 102. We assume that this conclusion has been reached because the term "...undertaking whose shares are acquired is ultimately controlled by the same party both before and after the acquisition..." has been interpreted to include situations where there is also no ultimate control before and after the transaction rather than to restrict the use of merger accounting to situations where control by the same party before and after the acquisition exists. Without this interpretation, the examples used in the definition of a group reconstruction in Appendix 1 of FRS 102 would only meet the legal constraints in limited circumstances (ie only when there is a common controlling shareholder). We think that this interpretation should be made clear in paragraph A4.30 of FRS 102. If the interpretation of legal requirement is not as we have assumed, we think the examples in Appendix 1 to FRS 102 should be clarified.

Question 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?

Other than our response to question 2 in the Exposure Draft, we have no comments on the Consultation Stage Impact Assessment that relate to FRED 59.