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28 April 2023

Sent by email to ukfrsperiodicreview@frc.org.uk

Dear Madams/Sirs

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

We welcome the opportunity to respond to the consultation on this important update to FRS 102.

You will see from our detailed responses to the consultation questions set out on the following pages that we are broadly supportive of the key changes proposed including the 5-step revenue model and on balance sheet lease accounting.

We have challenged some of the proposals and the impact assessment, for example:

- We recommend that for the revenue and lease changes in particular the FRC gives entities another year for transition, ie an effective date of 1 January 2026.

- We are concerned that the new definition of fair value could cause issues for the measurement of and presentation of changes in the fair value of financial liabilities in respect of own credit risk, both conceptually and by comparison with IFRS 9. Our detailed response includes alternative suggestions to deal with this.

- We do not see a strong case for changing the definitions of asset and liability in the pervasive principles section.

- For FRS 105 we can see a better case for changing lease accounting than revenue recognition, the other way round from FRED 82.

- We do not think that decisions on the introduction of an expected credit loss model should be based on decisions of the IASB in its review of the IFRS for SMEs. Such a decision should focus on entities such as banks, building societies and other providers of finance, entities most likely excluded from the scope of the IFRS for SMEs.

- We consider the estimated costs of the changes to be optimistic.

If you have any questions on the points raised, please do not hesitate to contact me.

Yours faithfully

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Question 1: Disclosures

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

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?

We respond by section below, covering those areas where we have comments.

Leases

We generally agree with the level of disclosure required in the proposed revised section 20.

In our view, the requirement in paragraph 20.87 to provide maturity analysis for short-term and low value leases is excessive, going beyond the similar IFRS 16 requirement. Although there is a Companies Act requirement to disclose (undefined) particulars and the total amount of off-balance sheet commitments, there is no specific requirement to break this down by maturity. We cannot see how this disclosure would be relevant for short term leases in any case.

We suggest that a disclosure requirement could usefully be added to require entities to disclose which discount rate type they have adopted given there are several (ie rate implicit in lease, incremental borrowing rate, obtainable borrowing rate or gilt rate). We comment further on discount rates in our response to question 6.

Revenue

We welcome the increased disclosure requirements around revenue. In our view, the disclosure requirements of the extant standard would warrant improvement even without changes to the recognition model.

We have some specific comments on revenue disclosures as follows:

- In our view, the requirements on disclosure of revenue disaggregation in paragraphs 23.121 and 23.121A are insufficient as proposed, the disclosure requirements will lead to only limited improvements to information provided compared to the current standard. At the very least, a disclosure objective for disaggregation should be set, similar to that in IFRS 15.

- We suggest that a specific disclosure requirement is introduced to explain and quantify the effect of any significant variable consideration arrangements. We do not believe that reliance on the general disclosures on estimates and judgements in section 8 will result in sufficient relevant information.

- We suggest that an explicit requirement to disclose the entity's accounting policy on the capitalisation of costs to obtain a contract is introduced to ensure comparability.

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Expected credit losses

We welcome the introduction of paragraphs 11.48ZA and 11.48ZB providing further disclosures in respect of expected credit losses for entities choosing the IFRS 9 recognition and measurement model.

However, we suggest that 11.48ZB is modified to provide examples of the reconciling items that would be typically expected; for instance, expected credit losses on financial assets newly recognised in the period. This would give an indication of how detailed the reconciliation is expected to be to enhance consistency.

In our view, more, if not all, of the IFRS 7 credit risk disclosures should be required by FRS 102 preparers choosing the IFRS 9 option. While this would create an additional burden for some preparers, the entities choosing this option are likely to be in a position to do so readily. We are not aware of any instances of entities other than financial institutions applying this option.

Business combinations

We welcome the limited changes to these disclosures with one caveat.

With regards to paragraph 19.26B (the requirement to disclose reasons supporting the goodwill amortisation period when it did not arise from a reliable estimate), in our experience most entities in this position would have fallen back on the 10 year limit given in the standard (paragraph 19.23(a)). Even if that is not the case, by definition the period chosen would not have been the result of a reliable estimate, so we see little value in requiring a disclosure of the supporting reasons for the period chosen.

Moreover this proposed requirement appears to be required throughout the goodwill amortisation period, which renders it even more disproportionate as the business combination itself could have been many years ago.

Uncertain tax treatments

Although proposed guidance has now been included in this area, we note that there are no proposed new disclosure requirements.

We suggest that there be a requirement to disclose a brief explanation and quantification of material (individually or collectively) uncertain tax treatments. In our view and experience it is not reasonable to assume that the general disclosures around judgements and estimates set out in section 8 of FRS 102 will cover this adequately. We also think it would be useful to state explicitly that such disclosures cannot be excluded on the ground that they may be prejudicial, not least because the accounting assumes in any case that the taxation authority has full knowledge of the circumstances.

Small entities

In principle we welcome the requirements on small entities being required to provide certain important disclosures that could previously only be encouraged.

As a more general point, the proposals maintain a curious situation where small entity preparers are required to apply more judgement in determining which disclosures are required than main FRS 102 preparers. Previously this situation was a direct effect of the law, but this is no longer the case.

In the medium term, the FRC may want to rethink the way this two-tier approach operates, although we acknowledge this is a complex question requiring engagement with lawmakers and stakeholders and could not be addressed in this periodic review.

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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?

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?

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

FRS 102

We agree with the overall proposal to align FRS 102 with the 2018 Conceptual Framework. FRS 102 is a principles-based framework and is intended to be broadly consistent with IFRS, so it is sensible that they share the same conceptual underpinnings. We support the process of simplification of the discussion when compared to the IASB's framework given the nature and format of FRS 102. We consider the length and level of complexity of the proposed section to be proportionate to the rest of the standard.

We compared FRED 82 and IASB/ED/2022/1. In most instances where there are differences we prefer the FRED 82 wording.

However, we consider that further improvements could be made:

- The section no longer contains a statement requiring the accruals basis of accounting (paragraph 2.36 in current FRS 102), although the revised section 2 of FRS 105 does. It is not clear why this is and we do not consider it helpful given this is such a fundamental concept.

- We note that the term "economic phenomenon" has been replaced by 'event'. Whilst recognising that this an easier to understand term, we believe its meaning in common usage (ie something that has happened) is too narrow. The IASB's term also encompasses the rights and obligations that exist following an event and changes to those rights and

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obligations over time. In simplistic terms, the conceptual framework applies to the statement of financial position at the period end and not only the events that have applied during the period. If the term event is retained, then it should be explained that the term is intended to also cover the rights and obligations that are created by those events and their subsequent measurement and presentation.

- We do not understand why IASB/ED/2022/1 paragraph 2.40 on the boundary of the reporting entity has been excluded. In our view, this is highly relevant in some situations, such as accounting for special purpose entities, employee benefit trusts, unincorporated entities and common investment structures.

- We think that the section could be condensed by removing some of the material on the measurement basis, especially the detailed descriptions of the historical cost and current value bases. In our view, these concepts are sufficiently well understood not to require this material, and FRS 102 is generally prescriptive on the measurement bases that can be applied.

- We do not understand why paragraph 2.104 uses the term 'the statement of profit or loss' rather than 'the income statement'. Also, the wording of paragraph 2.103 assumes that the two-statement approach has been adopted (FRS 102 5.2(b)) so there is an argument for amending this wording to cover the case where a single statement of comprehensive income is presented.

We do not support the changes to the definitions of asset and liability in the standard as they will have no effect in practice. In our view, the revised definitions would only have an impact on sections 18 and 21, but this impact is specifically excluded as the extant definitions will be retained for these sections. We suggest that the FRC clarify any areas where it expects that the new definitions will have any impact in this version of FRS 102 or defer any changes to the definition to a periodic review where they will have an effect in practice.

FRS 105

In our view, the nature of FRS 105 means that section 2 could be shortened further, or even removed altogether with certain items moved to other sections.

Micro-entities are unlikely to have transactions or balances that are not covered by the detailed rules of the standard. In addition, compliance with FRS 105 is presumed in law to give a true and fair view. Therefore it seems unnecessary to include explanatory material that is unlikely to be referenced by preparers, in part because there are no accounting options in FRS 105 other than on transition.

Much of the material in section 2 is also covered in the other sections of the standard or in the glossary.

In our view, the only items in the proposed section 2 of FRS 105 that are required to be retained somewhere in the standard are:

- The requirement to use the accrual basis.

- The stipulation that all assets and liabilities are measured initially at cost (paragraph 2.38).

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- The guidance on offsetting (paragraph 2.37); and
- The guidance on fair value (paragraph 2.39)

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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?

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?

In principle we welcome the alignment of the definition with IFRS 13. While we would expect the effect of the new definition on the measurement of assets to be limited in practice, the application of principles consistent with IFRS should be sought where possible. We believe the changed definition may create some difficulties when applied to liabilities with respect to own credit risk and have expanded on this point below.

We have some specific observations where we believe the guidance could be improved further:

- We would question whether it is necessary to include the guidance on highest and best use, principal market and most advantageous market, as this is how preparers would naturally interpret the definition of fair value anyway. In our experience, it is rare that these concepts need to be explicitly considered by IFRS preparers and they are even less likely to be relevant for most FRS 102 preparers.

- When financial liabilities are measured at fair value, IFRS 9 (paragraph 5.7.7) generally requires the part of the fair value movement that relates to changes in own credit risk to be presented in other comprehensive income rather than profit or loss. The IASB amended IFRS 9 to remove (in most cases) the impact of own credit risk from profit or loss in response to stakeholders' concerns that it would create inappropriate volatility and that, in general, the effects of own credit risk are not realised as they are not reflected in any settlement amount. The proposed changes to FRS 102 will create a GAAP difference with IFRS and it is not clear if this divergence was intended. This contrasts with FRS 101 in which there is an encouragement to apply a true and fair override of the Companies Act in order to present the own credit risk impact in OCI. Our view is that this situation is undesirable. Our preference would be that the definition of fair value for liabilities remain unchanged, thus avoiding the counter-intuitive situation where an entity recognises a gain on its own liabilities when its ability to pay those liabilities is threatened. Alternatively, the accounting could be fully aligned with IFRS 9 by reflecting the movement in own credit risk through other comprehensive income.

  In considering this matter further, we urge the FRC to also consider the practical implications for preparers in valuing out-of-the-money derivatives such as interest rate swaps and forward exchange contracts, the most commonly held financial liabilities measured at FVTPL. Many preparers use valuations provided by the counter-party bank – the move away from a settlement-based valuation approach to fair value may create additional complexity and burden for preparers. Research into these processes will better inform the cost-benefit assessment of this change.
  If the FRC does adopt the new definition of financial liability, we suggest that the change is only required prospectively so an entity is relieved from calculating the effects of own credit risk in previous periods. This would match the approach taken in IFRS 13.

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- The IFRS for SMEs exposure draft paragraph 12.18(b) has the wording "the inputs to the valuation technique reasonably represent market expectations and measures of the risk return factors inherent in the asset". By contrast the equivalent wording in FRED 82 2A.16(b) is simply "the inputs to the valuation technique are reasonable." We find this much less clear and does not necessarily have the same meaning.

- Paragraph 2A.5 in the extant FRS 102 states that *"There are many situations in which the variability in the range of reasonable fair value estimates of assets that do not have a quoted market price is likely not to be significant. Normally it is possible to estimate the fair value of an asset that an entity has acquired from an outside party."*
  There is no statement as strong as this in the revised guidance and in practice we have found this paragraph useful when challenging entities that have claimed not to be able to fair value an item (for example equity holdings in other unquoted entities). We therefore suggest that it should be retained.

- IFRS 13 includes considerations relating to units of account, for example how to consider control premiums, non-controlling discounts and holdings which exceed the trading volume for an asset. These considerations are not included in FRED 82 and are not self-evident. We therefore suggest that they are incorporated into the guidance to ensure clarity and consistency.

We do not object to retaining the extant definition of fair value for the purposes of section 26 Share-based Payment.

However, if the rationale for this is to avoid the own credit risk issue explained above, then that raises the question of why the issue is permitted to arise in the context of financial instruments.

We note that the extant definition of fair value is also retained in section 20 Leases for lessor accounting purposes. As this concerns the fair value of assets, we do not envisage any difference between the extant and new definitions in this case.

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Question 4: Expected credit loss model

(a) 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?

(b) 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?

(c) 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?

(a) We do not agree with the FRC's approach to defer its conclusion as to whether to align FRS 102 with the expected credit loss model of IFRS 9 pending the issuance of IASB's third edition of the IFRS for SMEs Accounting Standard.

There is already significant and justifiable divergence between FRS 102 and IFRS for SMEs (which is already proposed to increase in respect of leases.)

More importantly, the significantly different scope of FRS 102 compared with IFRS for SMEs are particularly relevant when considering impairment models for financial instruments. ECL is of most relevance to entities providing debt and lease capital to third parties as part of their core business – entities that will be predominantly excluded from the scope of the IFRS for SMEs but within the scope of FRS 102.

Therefore, we do not believe that the conclusions reached in third edition of the IFRS for SMEs is important in concluding as to whether to align FRS 102, to some extent, with the expected credit loss model of financial asset impairment from IFRS 9 Financial Instruments.

(b) We agree it is appropriate for certain entities to apply an expected credit loss model to their financial assets measured at amortised cost whilst other entities retain the incurred loss model. We believe it is reasonable for FRS 102 preparers for whom the assessment,

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management and pricing of credit risk is incidental to their core business (eg most corporates as compared to lenders and other finance providers) should continue to retain the incurred loss model.

For such preparers, we believe that the ECL model is unlikely to result in systemic material changes to the impairments recognised on their key financial assets, being trade receivables. The cost and disruption of implementing an expected loss model would not be justified.

Therefore, we concur that it is preferable to keep the current incurred loss model in place for all financial assets for certain entities.

We agree with the two-tier approach to financial asset impairment because the expected credit loss model would improve financial reporting by banks, building societies and other providers of debt/lease capital as a core business activity. However, if such an approach is applied then:

- the scope of entities required to apply the expected credit loss model must be clearly defined; and
- all such entities should be required to apply the expected credit loss model rather than being permitted to. If an expected credit loss model was introduced as a policy choice, we are concerned that the financial statements of entities within the same sector for which, by definition, the management of credit risk is a key consideration would not be comparable.

(c) In general, we agree with the FRC’s view that it is appropriate to define the scope of entities who should apply ECL model based on an entity’s activities rather than instrument type. We agree that entities entering into regulated or unregulated credit agreements as lender, or finance leases as lessor should apply the ECL model, however further guidance should be provided to determine when an entity’s activities meet these requirements.

However, we note that the expected credit loss model is particularly difficult to apply to intra-group receivables. The nature of such balances is often quasi-equity in nature with no defined payment terms, no interest charged etc making information on credit risk unreliable and of little value to users in many cases. We urge the FRC to consider the nature of such balances within any population of entities proposed to apply an expected loss model and whether the information value of applying such a model to those balances exceeds the costs and complexities of implementation.

If the FRC do proceed with a two-tier approach, then consideration must be given to how it will be reflected in the standard. Our initial view is this would be best achieved by requiring such entities to apply IFRS 9, or specified paragraphs of it, rather than introducing greater complexity to FRS 102 for a limited number of entities.

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Question 5: Other financial instruments issues

(a) 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?

(b) 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?

(a) We agree with the FRC's proposal to prevent an entity from newly adopting IAS 39 when the FRC has reached its conclusion as to whether to align FRS 102 with the expected credit loss model.

We believe this represents a balanced approach to phasing out the use of IAS 39 and mirrors, to some extent, the continuing availability of only the IAS 39 macro-hedging rules within IFRS 9. Given the macro hedging requirements are already incorporated into FRS 102 by cross-reference to the IAS 39 requirements, preventing entities from newly adopting IAS 39 is justified.

(b) We support the deletion of these amendments to maintain the simplicity and conciseness of the revised FRS 102 standards. However, we believe these amendments should only be removed when it is clear that the reform of all benchmark rates that might be relevant to the UK has occurred. We understand there has been some delays in the reform of the benchmark rates in the US. The FRC should consider whether the reform has been completed globally before taking the decision to remove the amendments from FRS 102.

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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?

Have you identified any further simplifications or additional guidance that you consider would be necessary or beneficial?

FRS 102

It is commonly accepted that on-balance sheet lease accounting results in a more meaningful presentation of an entity's financial position, providing support for the proposed changes to FRS 102. However, the potential complexities of applying different models for accounting and tax calculation purposes should be considered as part of the cost/benefit analysis.

We comment on specific aspects below, including the simplifications.

Scoping

We query whether and why the scope exclusion in paragraph 20.1(f) is appropriate. At the very least, further guidance is required (specifically on what is meant by 'non-typical contractual terms') given its importance to determining the scope of section 20. We note that extant FRS 102 includes paragraphs B20.1 and B20.2 which suggest that the exclusion was expected to be rare.

On the face of it, we think this term is intended to convey a similar meaning to embedded derivatives in IFRS. Under IFRS 16, embedded derivatives that are not closely related would be separated and accounted for under IFRS 9 leaving the host to be accounted for under IFRS 16.

However, FRS 102 does not include guidance on embedded derivatives. The exclusion therefore removes such an arrangement from the scope of section 20 in its entirety and into the scope of section 12. The question then arises whether the lessee accounts for a right of use asset at all, either initially or subsequently. The answer seems to be no. It is not clear whether that was intended or is appropriate.

Discount rate

We agree with the simplification allowing a lessee to use an obtainable borrowing rate if the incremental borrowing rate cannot be readily obtained. We expect that this simplification will be important for some entities.

However, we question whether the usage of a gilt rate where neither the incremental nor the obtainable borrowing rates can be readily determined is reasonable. Such a rate is entirely independent of the asset or entity's financial position and it's not clear whether it would ever be necessary given the obtainable borrowing rate simplification. Whilst it is

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proposed that this should only be used 'in exceptional cases', we fear that it will be overused given the information is widely available. As such rates will understate an entity's credit risk, the initial right of use assets and lease liabilities will be systematically overstated, and interest expense systematically understated for such entities. If entities were required to estimate a credit spread, even using methods such as an implied spread from previous borrowing or available industry data, then that would almost certainly result in a more meaningful and accurate result.

We also challenge paragraph PBE20.53 which allows public benefit entities to replace their obtainable borrowing rate with the rate of interest obtainable on their deposits held with financial institutions. It is not clear to us whether this provision can be used on a lease by lease basis or must be consistent for all of an entity's leases. It is also unclear whether there is any restriction on the meaning of 'deposit' in this context in terms of size, duration or nature in relation to the lease.

Furthermore, this does not seem logical as the rate on an entity's deposits relates to an entity's status as lender rather than borrower so there is no link between that and leases where they are lessee.

Lease modifications and reassessments

We think that the circumstances where an entity is permitted to use an unchanged discount rate for a lease modification are sensible. This may greatly help entities reduce the number of discount rate decisions they are required to make without introducing a necessary GAAP difference given that the simplifications are optional.

As a minor point, we think that the use of the term 'incidental to' in paragraph 20.78(a) is unusual in the context. This could be reworded to 'insignificant compared to' for example.

However, we find the wording in paragraph 20.72 concerning lease reassessments confusing, specifically 'if the value of each lease payment for the remainder of the lease term is unaffected by the change in the lease term'.

Does the first mention of 'lease term' in this phrase refer to the original term or the new term? If the original term, then this would appear to exclude automatically any shortening of the term. If the new term, then this would appear to exclude any lengthening of the term.

It is not clear which, if any, of these interpretations was intended.

Multiple components

We disagree with the practical expedient in paragraph 20.34.

To illustrate this, suppose a contract contains a lease for one asset over five years with lease payments of £10,000 a year and another asset for ten years with lease payments of £10,000 a year. We assume that the expedient means that this could be treated as a single lease of the ten-year asset for £20,000 a year for the first five years and £10,000 a year for the second five years, with the five year lease and associated asset essentially disregarded.

We consider this would be misleading as the asset would then be depreciated over ten years which would fail to consider the fact that one of the two assets is no longer leased after five years. It would also follow that impairments of the disregarded asset would be ignored, whereas impairments of the ten-year asset could be overstated; in fact, there

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could even be argued to be a day 1 impairment. There could be further implications if some of the assets have extension options or undergo lease modifications, and distorted disclosures. We cannot see how this would be appropriate unless all such disregarded assets across the entity were immaterial in aggregate. We may have misunderstood the expedient, but if so, we think its implications should be better explained. In any case, the condition that 'at least half' of the consideration is allocated to one lease component is too low for such a significant expedient.

Sale and leaseback accounting

It is not clear whether the policy choice in paragraph 20.128(a) is intended to apply on an entity wide or a lease-by-lease basis. We would prefer an entity wide basis for consistency.

Incidentally, the reference to paragraph 20.48 in paragraph 20.128(a)(ii) should probably be to paragraphs 20.49 to 20.51 instead.

Variations arising from change in index

One of the key simplifications proposed is to give preparers the option as to whether they remeasure the liability or rather take the changes in an index or rate to profit or loss.

There are two key paragraphs:

20.67 After the commencement date, a lessee shall measure the lease liability by:

(a) increasing the carrying amount to reflect interest on the lease liability;

(b) reducing the carrying amount to reflect the lease payments made; and

(c) remeasuring the carrying amount to reflect any reassessment (as set out in paragraphs 20.70 to 20.75) or lease modifications (as set out in paragraphs 20.76 to 20.79), or to reflect revised in-substance fixed lease payments.

20.74 A lessee may remeasure the lease liability by discounting the revised lease payments, if there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments. Such a change could include, for example, a change to reflect changes in market rents following a market rent review. A lessee may make this election on a lease-by-lease basis. When a lessee remeasures the lease liability to reflect those revised lease payments, it shall do so only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments. If a lessee chooses not to remeasure the lease liability in such circumstances, the difference between the lease payments included in the lease liability at the commencement date and the revised lease payments is recognised in profit or loss in the period to which each payment relates, as described in paragraph 20.58.

In our view, there is a conflict between the REQUIREMENT to remeasure the liability to reflect revised in-substance fixed lease payments and the OPTION to re-measure for changes related to an index or rate.

In the UK, most commercial property leases have lease payments that have either an upwards only RPI link or have upwards only market rent reviews. So, to take a very simple example, a 5 year lease with £100 payable each year which will be indexed by RPI each year. Ignoring discounting, one initially recognise a liability and an asset of £500 each. If

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RPI is 10% in year 2, the annual payments for the rest of the lease term would rise to at least £110.

The central interpretive question is whether this represents, in substance, a fixed lease payment. If it is, then 20.67 applies and the change must be reflected in the lease liability, resulting in a remeasurement to £440 with a corresponding increase in the right of use asset.

When applying IFRS 16, there is a consensus view that, once the variability is resolved (ie the amount of any annual increase, which cannot be reversed, has been determined in accordance with contractual terms) then higher amount is an in-substance fixed lease payment. This view is partly supported by reference to the analysis in paragraph B42 of IFRS 16.

We believe a similar interpretation would be drawn from paragraph 20.55 of FRED 82 as, once the change is determined, there is no genuine variability if the lease only permits upward changes in the annual payment:

20.55 In-substance fixed lease payments are payments that may, in form, contain variability, but that, in substance, are unavoidable. Such payments exist, for example, if:

(a) there is no genuine variability, for example payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring;

In our view, the practical expedient should be removed or clarified that it does not apply if changes cannot be reversed in the future because such changes are, in-substance, fixed and the GAAP difference is not justifiable.

Low value exemption

Paragraphs 20.11 – 20.12 could be seen as helpful in setting out a long list of assets that would qualify or not qualify for this exemption.

However, 20.13 states that judgement is required in some cases.

Given that the test is explicitly based on the value of the asset at the start of the lease and is an absolute test (paragraph 20.9) we think it would be helpful if the standard could state a threshold, consistent with the guidance in IFRS 16.

This would improve comparability and understandability.

Onerous contracts

We note that paragraph 20.84 prohibits the recognition of an onerous provision in respect of a lease on the basis that it would be included in the impairment of right of use assets.

However, we consider that there would be cases where this is inappropriate. For example, if a leased property is no longer being used but has associated costs that are not included in the lease liability as they are considered non-lease components (and the entity has not applied the practical expedient in paragraph 20.33), we read this paragraph as meaning that only the lease liability can be recognised and not the additional effect of the associated costs. An onerous contract provision is thus avoided purely because the costs are embedded in a lease and not set out in a separate contract.

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It may be that the intention was to read 20.84 at a component rather than a contract level which would avoid the issue above, but the wording is unclear.

FRS 105

We challenge whether it is appropriate to not bring in the on-balance sheet model for leases to FRS 105 for several reasons:

- The impact assessment in FRED 82 suggests that the cost per micro-entity for this would be very modest.
- Where micro-entities have leases, it is generally unlikely that they would have many (except perhaps property companies, see below). However, the impact of bringing for example even a single property lease on balance sheet could be proportionately very high for such an entity. The cost is thus low in proportion to the effect.
- Some property companies may meet the definition of micro-entities and the effect of on balance sheet accounting for leases would be highly significant for them.
- Many micro-entities apply FRS 102 rather than FRS 105 so this would introduce a significant new source of divergence between similar entities. It may even result in some micro-entities choosing to move to FRS 105 which would probably be regarded as an unwanted side effect.
- As the micro-entity thresholds are partly based on balance sheet totals, i.e. total fixed and current assets, the application of the test is therefore affected by whether on or off-balance sheet accounting is adopted for leases. This therefore appears circular.
- Micro-entities would be required to move to the on-balance sheet model once they grow out of the micro thresholds. They would have to do this in conjunction with all other transitional changes for existing FRS 105 vs FRS 102 differences which may not be resource efficient.
- By contrast, if FRS 105 adopted on balance sheet accounting, it would bring the whole of UK accounting onto this model, ensuring that the entire profession would become accustomed to it as soon as possible. Simplified transition requirements could be tailored for FRS 105 should this be deemed necessary.

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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?

Have you identified any further simplifications or additional guidance that you consider would be necessary or beneficial?

FRS 102

We are supportive of the overall principle of implementing the five-step model into FRS 102, along with the bulk of the application guidance contained in IFRS 15 and enhanced disclosures.

We consider that the structure of the section is more logical and clearer to follow than IFRS 15. Some of the language is more understandable, for example 'promise' rather than 'performance obligation'.

We have specific comments on the proposed section 23 following the order of the standard as set out below:

- Paragraph 23.1(d): In our view, the exclusion of non-monetary exchanges should be consistent with paragraph 23.6 in the extant FRS 102, which is marginally broader in scope, excluding further situations where recognising revenue would seem inappropriate.

- Paragraph 23.14(a)(ii) could be better worded as "The increase or decrease in consideration resulting from the modification" as the amount could be negative.

- Paragraph 23.35 only considers the significance of a material right to an individual contract but for certain loyalty schemes a material right might become significant at an entity wide level. We believe material rights should only be disregarded if they are insignificant at both levels.

- The guidance on principal vs agent in paragraph 23.38 differs from the equivalent in IFRS 15. The three factors in 23.38 are each determinative in that if any of them is true then the entity is considered to be a principal. However, two of these factors (primary responsibility and inventory risk) are only indicators in IFRS 15. Price setting is an indicator in IFRS 15 and is not mentioned in FRED 82 at all. While we do not think the guidance in FRED 82 needs to be identical, we do not see a good reason for creating potential GAAP differences by changing the relevant importance of aspects of the fact pattern.

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- Paragraph 23.45: the second sentence does not substantively add to the requirement and will not always be relevant so could be deleted.

- Paragraph 23.49 appears inconsistent with paragraphs 23.53 (a) and 23.54 – the former limits revenue recognition if a return is "expected" while the latter limits only if a return is highly probable. It is not clear why the analysis of similar economic relationships should be based on different probability thresholds. A similar principle applies to paragraph 23.120 because this is also applied by reference to expectations rather than being consistent with the highly probable criterion for variable consideration in general.

- Paragraphs 23.58 and 23.59 requires revenue to be adjusted for the time value of money when payments are deferred but not when paid in advance. It is not clear to us why this principle should not be applied symmetrically, ie for finance received from, as well as offered to, customers.

- We disagree that the threshold for separating the time value of money should be set at six months when the equivalent period in IFRS 15 is twelve months. This will create an unnecessary GAAP difference. We are not aware of any indication that typical credit terms in the UK are shorter than the rest of the world. It appears contrary to the general approach to aligning with IFRS 15, subject to reasonable simplifications, as this difference would make FRS 102 more onerous to apply than IFRS 15.

- The wording in paragraph 23.60 does not contain any guidance for how changes in fair value are accounted for, unlike IFRS 15. We think that the wording in IFRS 15:68 could be incorporated with explicit guidance for fair value changes arising due to the form of the consideration and where it changes for other reasons. This is important in certain industries and for start-up entities where the form of consideration paid for services may be the entity's shares.

- We regard the wording in paragraphs 23.70, 23.71 and 23.71A as less clear than the equivalent wording in IFRS 15 paragraphs 84 to 86. In particular, paragraph 23.71A appears to be more permissive, suggesting that there are accounting alternatives. In such a scenario we regard allocating variable consideration to a specific part of the contract to be both conceptually preferable and less onerous than the alternative, and therefore we suggest that the wording in paragraph 23.71A is amended to state that this treatment shall be adopted.

- Occasionally the word 'distinct' has been omitted when compared to the wording in IFRS 15 and this omission can change the meaning significantly. For example, in paragraph 23.75, the wording would currently suggest that revenue is recognised whenever a good or service is transferred to the customer but this might not be the case if the item is bundled with another item that the entity has not yet transferred.

- There appears to be a difference between paragraph 23.78(d) and IFRS 15.35(c) in that the former requires an asset to exist for the test to be met and the latter does not. The way elements of paragraphs 35 and 36 of IFRS 15 have been combined in arriving at the FRED 82 wording has missed the situation where the entity's performance does not create an asset at all. This is probably unintentional, but we suggest the wording is amended to be consistent.

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- We disagree that the guidance on put options is a simplification from IFRS 15 in practice, as the basis for conclusions suggests. The standard requires an entity to determine whether it is probable that such an option would be exercised by reference to the economics of the contract whereas IFRS 15 uses the term 'significant economic incentive'. Arguably assessing whether an option's exercise is probable involves more judgement than assessing significant economic incentives as the latter term sets a higher threshold and it will generally be clearer when one exists.

- The wording in paragraphs 23.92(e) could usefully include the word 'only', i.e., "…when the method **only** includes costs that reflect an entity's performance…"

- The wording in paragraph 23.91(b) should allow for the fact that there could have been significant work carried out on items not yet delivered to the customer, a principle set out in IFRS 15 paragraph B15.

- It is unclear why guidance on bill and hold arrangements has not been included. This is the only aspect of Appendix B of IFRS 15 that has not been reflected in FRED 82. While it could be argued that the principle is implicit in the overall guidance on transfer of control, the same could be said of other areas such as consignment arrangements where there is further guidance.

- The reference to credit risk in paragraph 23.113 is unhelpful in the context of FRS 102 as without further explanation it could be read as bringing in a need to consider expected credit losses when this principle does not exist in the rest of the standard.

- Paragraph 23.122(b): it is unclear whether the requirement is to disclose impairments on receivables and impairments on contract assets separately from each other, or to bundle them but show them separately from other impairments.

FRS 105

We question whether the benefit of bringing the five-step model into FRS 105 outweighs the costs. The benefits are likely to be limited because:

- In our view, it would be rare for the guidance to result in a significantly different outcome from extant FRS 105 given the nature of revenues that micro-entities are likely to have.

- Entities applying FRS 105 cannot be included in a consolidation so there is less benefit from convergence with IFRS or revised FRS 102.

- Convergence would be limited in any case given the high level of simplifications in the proposed guidance. As micro-entities grow out of their thresholds, the entity would still face a considerable exercise in assessing the different requirements under FRS 102 as proposed.

- Given the standard has very limited disclosure requirements, any changes to the accounting are likely to be opaque.

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- The revised model may require accountants to expend significant effort in assessing its implications for very limited benefit as, in most cases, there will be little if any change to the amounts recognised in the financial statements.

  We therefore suggest that the extant wording is retained.

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Question 8: Effective date and transitional provisions

(a) 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?

(b) 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?

(c) 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?

(d) 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?

(e) Do you have any other comments on the transitional provisions proposed in FRED 82?

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

(a) We do **not** agree with the proposed effective date of 1 January 2025 for **all** amendments set out in FRED 82, specifically not for the new revenue and lease recognition requirements.

Subject to the complexity of their income streams and the extent of their leasing arrangements, we believe that some entities would not have sufficient time to prepare for the adoption of the new revenue and leasing requirements which requires entities to make more judgements and estimates and have implications for entities' business processes and internal controls over financial reporting. We believe entities would require more time to analyse multiple customer contract terms, identify new information needs, and implement changes to systems and processes to apply the amended standards.

IFRS 15 was first issued in May 2014 but only became effective for periods beginning on or after 1 January 2018, following the IASB's decision to defer the effective date for a further 12 months. Whilst the deferral was partly due to late changes to IFRS 15, it did result in IFRS entities having 43 months to prepare for the adoption of IFRS 15. FRS 102 entities would have less than 24 months to prepare for the new revenue requirements.

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We are particularly concerned for the charity sector in adopting the new leasing requirements. Charities often operate through numerous retail establishments which will make the process for implementing these changes extensive and onerous. Retailers applying FRS 102 may face similar difficulties.

Charities and some other industries have SORPs which will need to be considered by their respective bodies adding further time to the consideration of leasing and revenue changes.

We suggest that the FRC defers the effective date of the new revenue and leasing requirements until January 2026.

We agree with the effective date of 1 January 2025 for the other incremental improvements and clarifications.

(b) We agree with the proposal to permit an entity to use, as its opening balances, carrying amounts previously determined in accordance with IFRS 16. We believe that this would provide simplification for entities that have previously reported amounts in accordance with IFRS 16 for consolidation purposes.

(c) We do not agree with the proposal to require entities to use the modified retrospective basis to calculate the lease liabilities and right-of-use asset at the date of initial application.

Whilst, a full retrospective method requires more data and analysis compared to the modified retrospective method, we believe that the FRC should also provide the option of full retrospective approach to entities who wish to adopt this method. Full retrospective approach provides users of the financial statements with better information and comparability between reporting periods so should not be mandatorily excluded.

(d) We support the proposal 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 applications. We believe that the simplification of the transition to the new revenue accounting requirement would be beneficial to the FRS 102 entities.

We refer you to our answer to question 7 where we recommend that the proposal to change the revenue section of FRS 105 is not enacted.

(e) We challenge whether the requirement to disclose the amount of the adjustment to profit or loss for the **current period** as a result of the lease accounting changes (paragraph 1.37(a)) is helpful for users. This requires comparing current year reported profit or loss with a hypothetical figure that is not otherwise reported and is not required for any other accounting transition that we are aware of.

In our view it would be more appropriate to require the disclosure of a reconciliation from previously reported lease commitments to the opening lease liability figure. This would be consistent with IFRS 16.

(f) No other comments.

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Question 9: Other comments

Do you have any other comments on the proposed amendments set out in FRED 82?

(a) Section 24: Government grant: We noted that the FRC proposed amendments to change the definition of performance related conditions to include conditions that require the performance of a specified activity, for example a condition to purchase a specified asset.

We believe this could have a significant impact for entities applying the performance model for government grant accounting, including the charity sector as a whole. While the Charity SORP does recognise that there can be conditions beyond performance-related conditions that can inhibit the recognition of income, we are concerned that the changes made to the definition of a performance-related condition could lead to significant and inappropriate changes to income recognition. It may be difficult to distinguish a specific activity on which entitlement is conditional from a specific activity for which the grant or donation has been provided – the latter is commonly presented as income on receipt, though restrictions on use might affect the presentation in the statement of funds.

We disagree with the sentence added to paragraph 24.5A as a new obligation to repay a grant (or changes to such obligations) should not necessarily result in a reduction in profit or loss. Such an approach would be appropriate if the grant had previously been recognised as income, but when it had been deferred (under the accruals model) then the adjustment would be a balance sheet reclassification from deferred income to a financial liability. Paragraph 24.5A is not limited to the performance model.

(b) Section 4- Statement of financial position: We urge the FRC to work with government to address unhelpful anomalies in the Companies Act formats like the need for debtors due in more than one year to be within current assets.

(c) Section 19- Business combination and Goodwill: The FRC should consider removing any barriers to the use of merger accounting principles over and above those required by company law.

The FRC should consider removing the requirement that the rights of each equity holder relative to others are unchanged as required by section 19.27(b) and remove the requirement that non-controlling interest in the net asset of the group is not altered by the transaction as required by Section 19:27(c). This would help preparers in bringing more transactions into the scope of a choice to apply merger accounting and would make the criteria more consistent with transactions under common control outside the scope of IFRS 3.

We recommend that such revisions take into account the diversity in practice that can be observed in the market in respect of the various forms of group restructuring.

(d) Section 27: Impairment: - Despite the explicit requirement to exclude tax cash flows and apply a pre-tax rate in value in use calculations, the reality is impairment calculations are, in practice, often based on post-tax rates given the inherent difficulty in determining

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market pre-tax rates. The IASB are currently considering amendments which, in part, reflect these practical realities. We encourage the FRC to consider similar amendments.

(e) Section 7: Statement of cashflows:

We understand that the FRC is awaiting the IASB's final amendments from their proposal to amend the disclosure requirements of IAS 7 in respect of supplier financing. However, given the significance, stakeholder interest and widespread usage of such financing arrangements, and the focus the FRC has placed on this matter in the past, we believe that the FRC should proceed independently. A requirement for additional disclosure would be beneficial to financial statement users and would not be onerous for preparers.

(f) Basis for Conclusions B17: Property, plant and equipment

We note the FRC's comment in the basis for conclusions paragraph B17 that despite stakeholders seeking additional guidance on the capitalisation of asset enhancements intended to provide climate or other ESG benefits, the FRC has decided not to add guidance to section 17 for this specific issue.

However, we note that in certain sectors such as social housing such enhancements will be required to a substantial extent in the next few years and hence this issue is pressing.

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Question 10: Consultation stage impact assessment

Do you have any comments on the consultation stage impact assessment, including those relating to assumptions, sources of relevant data, and the costs and benefits that have been identified and assessed? Please provide evidence to support your views.

In particular, feedback is invited on the assumptions used for quantifying costs under each of the proposed options (Section 3 of the consultation stage impact assessment); any evidence which might help the FRC quantify the benefits identified or any benefit which might arise from the options proposed which the FRC has not identified (Section 4 of the consultation stage impact assessment); and appropriate data sources to use to refine the assumption of the prevalence of leases by entity size (Table 23 of the consultation stage impact assessment).

We consider that the estimated costs of implementing the revenue and lease changes have been significantly underestimated.

The 2 hours of familiarisation time assumed for revenue seems very low. Anecdotal evidence suggests that individuals spent much longer than this understanding IFRS 15. Even for accountants that are already conversant with IFRS 15, they would need to invest time in understanding the simplifications in FRED 82. Understanding such a set of changes is inevitably an iterative process whereas 2 hours suggests a single reading session.

The impact assessment suggests that up to 20 hours may be taken by entity to amend systems and processes depending on size, whereas audit firms would take 40 hours (smaller firm) and 20 hours (larger firm) to do the same. This suggests that the latter figures are optimistic, because an audit firm will need to devise systems and processes that cover all the fact patterns and industries across their audit portfolio. As a larger firm, we have found that it can easily take 20 hours of total time to devise even best practice guidance for audit teams on IFRS 15 for example, let alone compliant work programmes.

Moreover we reached out to our base of audited entities via a survey. Of 30 responses, 21 thought that at least 10 hours of staff time would be spent in the first year on the revenue recognition changes, 13 of those thought it would be at least 20 hours with 7 thinking it would be at least 30 hours. The FRC has assumed that 22 hours (including familiarisation) would be spent by a small minority of large entities, 12 hours for medium sized entities and 7 hours or fewer for the large majority. We believe that despite its small sample size our survey does cast doubt on how realistic the FRC’s assumptions are.

We also disagree that it can be assumed that there will be no ongoing costs for monitoring and accounting for new contract types and modifications compared with the extant standard. The revised guidance is far more explicit on the effect of contract modifications and for many different types of contract and contract terms. We would suggest that except for a very simple entity, an accountant should expect to spend several hours in each annual reporting cycle reconsidering whether the entity’s revenue approach remains appropriate and complete. The level of attrition in the industry, and hence the cost of new employees getting up to speed should not be ignored either. Indeed, 13 of 30 respondents to our survey estimated at least 10 hours per year of ongoing additional work on the revenue recognition changes.

Similar comments to the above can be made for leases in terms of familiarisation time and auditor time. From our survey, the same number of entities thought that the initial time cost would be 20 hours or more as for the revenue changes, with more (10) estimating it at 30 hours or more. 10 respondents also thought that at least 10 hours per year of ongoing additional work would result, with the FRC estimating this to be at most 4 hours for all but a small number of large entities. In this area also we therefore consider the FRC estimates to be optimistic.

It should also be noted that some entities that do not currently breach the small company thresholds may do so once their leases are brought on balance sheet given the effect on gross assets. This does not seem to have been taken into account in the FRC's estimates.