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FRC issue FRED 67 *Draft amendments to FRS 102 – Triennial review – Incremental improvements and clarifications*

Contents

In a nutshell

- As part of its first triennial review, the Financial Reporting Council ('FRC') has issued Financial Reporting Exposure Draft 67 ('FRED 67') that proposes amendments to FRS 102. When finalised, these amendments will be effective for accounting periods beginning on or after 1 January 2019, with early adoption permitted.

- The proposed amendments aim to balance improvements in the quality of financial reporting with maintaining stability and should make compliance with FRS 102 easier and more cost-effective, with no loss of significant information.

- The principal amendments include:

  – Removing the undue cost or effort exemptions and, where applicable, replacing them with accounting policy options.
  – Introducing an overriding principle to the definition of a 'basic' debt instrument in Section 11 of FRS 102.
  – Changes to the list of entities qualifying as a financial institution.
  – Removing the requirement for small entities to estimate a market rate of interest when measuring loans from a director who is also a shareholder.
  – Changes to the requirement to identify intangible assets acquired in business combinations separately from goodwill.

- The proposed amendments do not include the introduction of major changes arising from recent changes to IFRSs, i.e. the introduction of IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*. Any such changes will be the subject of separate FRC consultation and will not be effective before 1 January 2022.

- The deadline for commenting on the proposals is 30 June 2017.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

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Background

When FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* was issued in March 2013 the FRC indicated that it would be reviewed every three years. The intention of this triennial review process was to provide an opportunity to make improvements to FRS 102. The process involved considering a wide range of potential sources of improvements and clarifications including feedback from stakeholders on implementation issues, areas identified by the FRC for review, developments in financial reporting and changes to IFRSs and IFRICs. Feedback from stakeholders was gathered through an invitation to comment directly to the FRC and through responses to a Consultation Document issued in September 2016 ('FRC Consultation Document') that discussed the direction of travel of FRS 102 in light of major changes to IFRSs.

Following this stakeholder feedback, the FRC decided that the initial phase of this first triennial review would focus on incremental improvements and clarifications. This is to allow entities to become more familiar with applying FRS 102 before more fundamental changes to the standard emanating from changes to IFRSs are considered.

The main amendments proposed by FRED 67 are discussed below. There are also other minor amendments proposed that are intended to improve the readability of FRS 102 and to clarify various parts of the standard. These proposed minor amendments do not change the standard significantly but are intended to aid entities in interpreting and applying its requirements.

Removal of undue cost or effort exemptions

Currently in FRS 102, there is a limited number of undue cost or effort exemptions. There were concerns that such exemptions are being applied inconsistently by entities in similar circumstances. FRED 67 therefore proposes removing these and, where relevant, introduces accounting policy options. The key areas affected are outline below.

Investment properties rented to another group entity

FRED 67 proposes introducing an accounting policy choice for entities that rent investment property to another group entity, by which they would be able to choose to measure the investment property either at cost (less depreciation and impairment) or at fair value.

This is to address stakeholder concerns that the cost to obtain a fair value for an investment property that is rented to another group entity far outweighs the benefit, given that the investment property would be treated as property, plant and equipment in the consolidated financial statements.

All other investment property will need to be measured at fair value and no 'undue cost or effort' exemption will be available.

Investments in associates and joint ventures

Currently, an investor using the fair value model in its individual financial statements can use the cost model for any investment in an associate or joint venture for which it is impracticable to measure fair value reliably without undue cost or effort. Given that the cost option is already available to investors in these situations, the exemption served no purpose so it is proposed it is removed.

Statement of cash flows – net debt reconciliation

In January 2016, the IASB issued *Disclosure Initiative (Amendments to IAS 7)*. These amendments introduced requirements to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities. This will include changes arising from both cash flows and non-cash changes.

The FRC has proposed introducing requirements for a net debt reconciliation into FRS 102. This is intended to give financial statement users the information included in the IASB Amendments but in a way that is more familiar to entities preparing their financial statements under UK GAAP, given the fact it is based on the former FRS 1 *Cash Flow Statements*.

Consolidated financial statements

Respondents to the FRC Consultation Document disagreed with initial proposals to make limited amendments to FRS 102 to update it for the control model in IFRS 10 *Consolidated Financial Statements.* It was felt that introducing such amendments would result in increased costs for the vast majority of entities with no resulting benefit to them.

FRED 67 does however propose the introduction of additional disclosures in FRS 102 regarding unconsolidated structured entities (such as special purpose entities). These disclosures originate from IFRS 12 *Disclosure of Interests in Other Entities* and require an entity to disclosure in its consolidated financial statements the nature and extent of its interests in unconsolidated special purpose entities, and the risks associated with those interests.

Financial instruments

Principle and conditions for the classification of debt instruments

Debt instruments are currently classified as 'basic' or 'non-basic' under FRS 102 with this classification being based on a list of prescriptive conditions in Section 11 *Basic Financial Instruments*. In general, those debt instruments classified as basic are measured at amortised cost and those classified as non-basic at fair value through profit or loss. Stakeholders have highlighted to the FRC that applying such a list of conditions has caused a number of problems to entities applying the standard given the nature of the approach which does not leave much room for judgement.

To help address this, the FRED proposes introducing an overriding principle for classification of financial instruments as basic in addition to the list of conditions. In a small number of cases this will allow for debt instruments that breach the conditions to be classified as basic if they are in line with the proposed principle. However, any debt instrument that meets the prescribed conditions will always be classified as basic.

The proposed principle is that a basic debt instrument is one that gives rise to cash flows on specified dates that constitute repayment of the principal advanced, together with reasonable compensation for the time value of money, credit risk and other basic lending risks and costs (e.g. liquidity risk and administrative costs associated with holding the instrument).

To help illustrate the above principle and how it is intended for the rules and principle to work together, a number of additional examples have been included in the 'Examples – Debt instruments' section that follows paragraph 11.9. Amendments to the pre-existing examples in this section are also proposed.

Observation

Entities will only need to consider the principle in cases where an instrument breaches the conditions. This means entities can continue to perform a simple rules based assessment for most basic debt instruments. Due to the minor nature of the amendments to the conditions, it is expected that the vast majority of basic debt instruments will maintain their existing classification under the proposed amendments. The addition of the principle is expected to lead to more debt instruments classifying as basic.

Accounting policy choice

Currently, Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* of FRS 102 allow entities to apply the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* as adopted for use in the EU. The proposed amendments retain this accounting policy choice following the mandatory effective date of IFRS 9 *Financial Instruments* (1 January 2018) following feedback from respondents to the Consultation Document. If such an amendment was not made the choice to apply IAS 39 would no longer be available following the implementation of IFRS 9 given that as of that date IAS 39 is to be withdrawn as part of EU endorsed IFRSs.

The FRC proposes to retain this option until the FRS 102 requirements for the impairment of financial assets have been amended to reflect IFRS 9, or until the decision is made not to amend FRS 102 further in relation to IFRS 9.

Directors' loans to small entities

For those entities qualifying as small, an exemption has been proposed to allow a loan from a director who is an individual and a shareholder in the small entity to be measured initially at transaction price. The exemption will also apply to loans made by close members of family of such individuals. It is not applicable in the reverse scenario, i.e. where a small entity makes a loan to one of its directors, nor does it apply to intercompany loans. FRS 102 previously required such loans to be measured initially at the present value of future payments discounted at a market rate of interest for a similar debt instrument. This frequently proved problematic for small entities where commercial funding was not available and it was difficult to determine an appropriate market rate for a similar debt instrument. This exemption is therefore intended to present a more practical and proportionate accounting solution for small entities.

Debt for equity swaps

A debt for equity swap is a transaction in which an entity issues equity instruments to extinguish a financial liability (in part or in full). Currently, FRS 102 does not contain any specific requirements for the accounting for such transactions; it does however require that an entity initially measure equity instruments at the fair value of the cash or other resources received or receivable. FRED 67 proposes amending Section 22 *Liabilities and Equity* to make it clear that this requirement should not be applied where the issue of equity instruments is in accordance with the original contractual terms of the liability extinguished (e.g. conversion of convertible debt). Under these proposals, an entity is also not required to apply this requirement to transactions with shareholders acting in their capacity as such or when transacting with another party that is under common control.

Definition of a financial institution

Entities that meet the definition of a financial institution under FRS 102 (and FRS 101) are unable to take any of the disclosure exemptions for financial instruments that are available to qualifying entities under those respective standards. Entities applying FRS 102 that meet the definition of a financial institution are also required to comply with additional disclosure requirements relating to any financial instruments they hold as set out in Section 34 *Specialised Activities* of FRS 102. A financial institution is defined in the Glossary to FRS 102 by reference to a list of types of entities e.g. certain banks and building societies. The final type of entity included in the list is one "whose principal activity is to generate wealth or manage risk through financial instruments". This was intended as a 'catch-all' for "entities that have business activities similar to those listed above but are not specifically mentioned in the list."

Following feedback from stakeholders, FRED 67 proposes amending the above definition to remove the references to "generate wealth" and "manage risk". This is intended to address practical issues in interpreting these concepts and should reduce the number of entities that meet the definition of a financial institution and that consequently have to provide additional disclosures. However, a proposed amendment to Section 11 highlights that the additional disclosures for financial institutions (included in paragraphs 34.19 to 34.33) may be appropriate when risks arising from financial instruments are particularly relevant to an entity's business (irrespective of whether that entity meets the financial institution definition).

FRED 67 also proposes removing retirement benefit plans from the list of entities qualifying as financial institutions given the fact that they are not similar to the other types of entities specifically included in that list. In addition, retirement benefit plans are already subject to separate disclosure requirements under Section 34 of FRS 102.

Observation

This proposed amendment will be welcomed by many entities who previously struggled to reconcile their activities with this definition.

Intangible assets acquired in a business combination
Section 18 of FRS 102 requires various intangible assets acquired in a business combination to be recognised separately from goodwill. The FRC received feedback from stakeholders that the current wording in paragraph 18.8 of the Standard has presented practical issues upon application, particularly the reference to the estimating of fair value based on 'immeasurable variables' and how this wording should be interpreted.

Following this feedback, FRED 67 proposes changes to paragraph 18.8 that will require entities to recognise intangible assets separately from goodwill if they:

a. meet the recognition criteria; and
b. are separable and arise from contractual or other legal rights.

The FRC are also proposing to introduce an accounting policy choice for entities to recognise additional intangible assets.

Observation
This is intended to be a proportionate solution that will result in fewer intangible assets being required to be identified separately from goodwill and valued. This is considered appropriate given the consistent accounting treatment for goodwill and intangible assets under FRS 102, i.e. to amortise both over a useful economic life, as opposed to the accounting under IFRS, where goodwill is not amortised.

Revenue
The requirements for recognising revenue in Section 23 are proposed to be amended to include greater clarity in situations in which separately identifiable goods or services are provided under a single transaction. In such transactions, total revenue would be allocated on the basis of the relative stand-alone selling prices of each separately identifiable good or service unless another basis better reflects the substance of the transaction. The proposed amendments to this section specifically mention an example where a product and related services are sold together and where it is then necessary to defer revenue allocated to the services and recognise this over the period during which the services are performed.

Observation
The introduction of guidance on allocating a transaction price to separately identifiable goods or services provided under a single contract is intended as an interim step to the possible future introduction of requirements under IFRS 15 *Revenue from Contracts with Customers*, which are more prescriptive in this area than was the case previously under IAS 18 *Revenue*.

Section 23 *Revenue* is also proposed to be amended to include further guidance on how to determine whether an entity is acting as an agent or a principal. This is based on the guidance in IAS 18 *Revenue*.

Invitation to comment
Comments on the Consultation Document have been requested by 30 June 2017.

The Press release and Consultation Document are available on the FRC website.

Further information
All our past newsletters can be found here.

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