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FRC publishes *Triennial review 2017 Incremental improvements and clarifications* (Amendments to FRS 102)

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The Financial Reporting Council (FRC) has published incremental improvements and clarifications to FRS 102 *'The Financial Reporting Standard applicable in the UK and Republic of Ireland'*.

- The amendments have arisen as a result of the first triennial review of FRS 102 and after taking into account stakeholder feedback on the implementation of FRS 102 and recent developments in financial reporting.

- The principal 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:

  – Introducing an overriding principle to the definition of a 'basic' debt instrument.

  – Confirming the simplification of the measurement of directors' loans to small entities, following the interim relief granted in 2017.

  – Requiring fewer intangibles to be separated from goodwill in a business combination.

  – Permitting investment property rented to another group entity to be measured at cost (less depreciation and impairment), rather than fair value.

  – Simplifying the definition of a financial institution to remove references to 'generate wealth' and 'manage risk'.

  – Allowing the tax effects of gift aid payments by subsidiaries to their charitable parent to be taken into account at the reporting date when it is probable that the gift aid payment will be made in the following nine months.

  – Taking into account the new small entities and micro-entities regimes in the Republic of Ireland which differ slightly from those already existing in the UK.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

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- The effective date for most of the amendments to FRS 102 is accounting periods beginning on or after 1 January 2019, with early application generally only permitted if all amendments are applied at the same time.
- The amendments do not include any changes arising from recent major 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 at the earliest.

Background

When FRS 102 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, 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 and through two exposure drafts, Financial Reporting Exposure Draft (FRED) 67 and FRED 68.

Following this stakeholder feedback, the FRC decided that the 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 are discussed below. There are also other minor amendments that are intended to improve the readability of FRS 102 and to clarify various parts of the standard. These minor amendments do not change the standard significantly but are intended to aid entities in interpreting and applying its requirements.

What are the main areas of improvement or clarification?

Removal of undue cost or effort exemptions

Currently in FRS 102, there is a limited number of undue cost or effort exemptions. These have been removed and, where relevant, accounting policy options have been introduced. There were concerns that such exemptions are being applied inconsistently by entities in similar circumstances and the amendments therefore remove these.

Investment properties rented to another group entity

The amendments introduce 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.

Information should be available to apply retrospectively a change in accounting policy for investment property rented to another group entity. However, the transition provisions also enable a revaluation to be treated as the deemed cost going forward.

Observation

This will be a very welcome change to FRS 102 and eliminate the existing divergence of views about whether or not it is appropriate to use the undue cost or effort exemption for such properties. It will, in effect, reinstate the treatment under old UK GAAP.

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 has been removed.

Statement of cash flows – net debt reconciliation
In January 2016, the IASB issued Disclosure Initiative (Amendments to IAS 7 *Statement of Cash Flows*). These amendments introduced requirements to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities. This includes changes arising from both cash flows and non-cash changes. The FRC has introduced requirements for a net debt reconciliation into FRS 102. This is intended to give financial statement users information similar to that required by the IASB Amendments but in a way that is more familiar to entities preparing their financial statements under UK GAAP, given the fact that the FRS 102 reconciliation is based on what had been required by 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*. The amendments however introduce additional disclosures in FRS 102 regarding unconsolidated special purpose entities. These disclosures originate from IFRS 12 *Disclosure of Interests in Other Entities* and require an entity to disclose in its consolidated financial statements the nature and extent of its interests in such entities and the risks associated with those interests.

Observation
The existence of unconsolidated special purpose entities may already be disclosed as a critical accounting judgement, but this amendment is intended to draw attention to the need to disclose more information about such entities more generally.

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 for entities applying the standard given the nature of the approach which does not leave much room for judgement.

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

The 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 and lender's profit margin).

To help illustrate the above principle and how it is intended for the rules and principle to work together, 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 have also been made.

Changes have also been made to the condition contained in paragraph 11.9(c) to allow the instruments that include reasonable compensation payable by the holder to the issuer when a debt instrument is terminated early to be consistent with basic classification.

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 amendments.

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. Following feedback received from respondents the amendments retain this accounting policy choice after the mandatory effective date of IFRS 9 *Financial Instruments* (1 January 2018). If such an amendment had not been 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
Following the interim amendment made in May 2017 to permit early adoption of the directors' loan proposals, permanent amendments have been made to FRS 102 to provide small entities with the option to account for loans from a director or a close family member of that director initially at transaction price, when that group of people contains at least one shareholder in the entity. In the case of small LLPs the reference to shareholder should be read as a member who is a person.

The exemption is not applicable in the reverse scenario, i.e. where a small entity makes a loan to one of its directors or a close family member of a director, 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. Early application of this amendment is permitted without having to apply all the other amendments at the same time.

An entity taking advantage of this exemption that subsequently ceases to be a small entity may, when remeasuring the loan to present value, determine the present value on the basis of the facts and circumstances existing at that time or at the date the financing arrangement was entered into. An entity that subsequently becomes eligible to take advantage of the exemption and chooses to do so must apply the exemption retrospectively.

Observation
This amendment will be very welcome by the large number of small entities affected by it. However, the FRC has resisted calls to extend it to larger entities or to loans to directors.

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 an entity to measure equity instruments initially at the fair value of the cash or other resources received or receivable. Section 22 Liabilities and Equity has been amended 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) or where such transactions are with owners in their capacity as such or are with entities under common control where the substance of the transaction includes an equity distribution or contribution.

Observation
In the case of convertible debt, this confirms that the treatment (i.e. no profit or loss on conversion) is consistent with IFRSs and old UK GAAP. However, it also confirms that a gain or loss should be recognised for conversions that are not in accordance with the original contractual terms unless the exceptions noted above apply.

Changes to disclosure requirements
The requirement in paragraph 11.41 to disclose categories of financial assets and liabilities has been simplified to align with the disclosures that are required by Company Law. The amended paragraph 11.41 now only requires separate disclosure of the carrying amounts of financial assets and financial liabilities measured at fair value through profit or loss. This disclosure may be made separately by category of financial instrument (i.e. no aggregate total for all categories is required). Financial liabilities that are not held as part of a trading portfolio and are not derivatives are however required to be shown separately.

Definition of a financial institution
Entities that meet the definition of a financial institution under FRS 102 (and FRS 101) are unable to take the disclosure exemptions in relation to financial instruments 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, the above definition has been amended 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. The amended definition simply refers to "any other entity whose principal activity is similar to those listed above but is not specifically included in that list".

However, an amendment to Section 11 highlights that the additional disclosures may be required when the risks arising from financial instruments are particularly significant to the business (for example because they are principal risks for the entity), and specifically highlights that paragraphs 34.19 to 34.33 include examples of disclosure requirements for risks arising from financial instruments that may be relevant in such cases.

Stockbrokers have been removed 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 (i.e. they primarily provide a service rather than hold financial instruments). In addition, retirement benefit plans have been removed because they are already subject to separate disclosure requirements under Section 34 of FRS 102.

Observation
This amendment will be welcomed by many entities that previously struggled to reconcile their activities with this definition. It does not completely resolve the uncertainty about the status of group treasury companies but they will not be financial institutions unless their principal activity is similar to a bank or one of the other types of entities listed, which will require the exercise of judgement.

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 in practice.

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

(a) meet the recognition criteria for intangible assets generally;

(b) arise from contractual or other legal rights; and

(c) are separable (i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or liability).

This amendment 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 situation under IFRS, when goodwill is not amortised. Entities may choose separately to recognise additional intangible assets acquired in a business combination that meet the recognition criteria if this provides useful information to the entity and the users of the financial statements. However, when an entity chooses to recognise additional intangible assets, this policy must be applied to all intangible assets in the same class, and must be applied consistently to all business combinations.

The transitional provisions make it clear that changes in the recognition of intangible assets acquired in a business combination must take place prospectively (i.e. there is no restatement for past business combinations).

Observation

This will restore the position to one very similar to that under old UK GAAP in practice, although there are technical differences. Any entity that wants to recognise more intangible assets, for example to be consistent with group reporting under IFRSs, will be able to do so provided that it is applied as a consistent policy.

Revenue

Amendments to Section 23 Revenue were proposed in FRED 67 to provide greater clarity in situations in which separately identifiable goods or services are provided under a single transaction. However, respondents did not support the proposal, and consequently FRS 102 was not amended in this respect. A more detailed review of Section 23 will take place when the incorporation of IFRS 15 is considered.

Section 23 Revenue has been 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*.

Gift aid payments
Amendments have been made to FRS 102 as a result of significant differences in practice in the accounting treatment for gift aid payments made by an entity that is wholly owned by one or more charitable entities. The payments are typically made during the nine months following the relevant reporting date, and are treated as a distribution to owners for accounting purposes but as a donation for tax purposes.

For an entity wholly owned by one or more charitable entities, the amendments clarify that:

- The gift aid payment, as a distribution to owners, is not accrued at the reporting date (unless a deed of covenant is in place) and is recognised in equity; and

- The tax effects of the gift aid payment is recognised in profit or loss at the reporting date, when it is probable that the payment will be made in the nine months following the reporting date.

Early application of this amendment is permitted without having to apply all the other amendments at the same time.

Observation
This amendment, which was the subject of FRED 68, will be very welcome by entities in the charity, social housing and higher education sectors that have "trading" subsidiaries. It will eliminate the diversity of practice which has arisen as a result of confirmation by the ICAEW in 2014 that the gift aid payments are distributions for legal purposes. It will enable such entities to continue to recognise a nil or low effective tax rate which is a consequence of the tax treatment of the gift aid payments. However, it also clarifies that it is not possible to recognise a liability for the gift aid payment itself in advance of payment unless such an obligation is created by a deed of covenant.

Effective date and early application
The effective date for most of the amendments to FRS 102 is for accounting periods beginning on or after 1 January 2019, with early application generally only permitted if all amendments are applied at the same time. As noted above, the only exceptions to this are the amendments relating to directors' loans to small entities and the tax effects of gift aid payments, for which early application is permitted separately.

UK entities
The changes to disclosure requirements in FRS 105 for micro entities in the UK, which update the standard in line with recent amendments to statutory requirements, are applicable for accounting periods beginning on or after 1 January 2017. Consequential amendments to FRS 105 as a result of the triennial review (i.e. for consistency with amendments to FRS 102) are applicable for accounting periods beginning on or after 1 January 2019. Early application is permitted provided that all the amendments to FRS 105 are applied at the same time.

Republic of Ireland entities
With respect to the Republic of Ireland, the amendments to disclosure requirements under Section 1A for small entities and FRS 105 (which are required for consistency with changes in the law) are applicable to accounting periods beginning on or after 1 January 2017. Earlier application is permitted for companies that apply the Companies (Accounting) Act 2017 from the same date. Consequential amendments to FRS 105 as a result of the triennial review (i.e. for consistency with amendments to FRS 102) are applicable for accounting periods beginning on or after 1 January 2019. Early application is permitted provided that all the amendments to FRS 105 are applied at the same time.

Further information
The press release and amendments are available on the FRC website.

All our past newsletters can be found here.

If you have any questions about the amendments, please speak to your usual Deloitte contact.

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