Tel: +44 (0)20 7486 5888
Fax: +44 (0)20 7487 3686
DX 9025 West End W1
www.bdo.co.uk

55 Baker Street
London W1U 7EU

Mei Ashelford
Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

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Direct line: 020 7893 2980
Email: nicole.kissun@bdo.co.uk

Dear Mei

BDO LLP response to 'Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland - Triennial review 2017 Incremental improvements and clarifications'

We are pleased to have the opportunity to comment on the proposed amendments to FRS 102 set out in 'Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland - Triennial review 2017 Incremental improvements and clarifications' (the 'Exposure Draft').

We are generally supportive of the amendments proposed in, and the approach taken by, the Exposure Draft. In particular we welcome the decision not to introduce in to FRS 102 new concepts and requirements drawn from IFRSs which, in many cases, have not yet been implemented by even the largest of companies in the UK. We also support the attempts the FRC is making to ensure the standard is proportionate, such as the relaxation of the requirement to measurement intra-group investment properties at fair value and to recognise a potentially large number of intangible assets on a business combination and those intended to promote easier and more consistent application.

In our view, however, the FRC could have gone further in some areas, most notably in terms of the still potentially very complex distinction between 'basic' debt instruments and 'other' debt instruments which qualify for fair value measurement under the Companies Act and in the scope of the director/shareholder loan exemption proposed for small companies.

Our responses to the specific questions asked in the Exposure Draft are set out in an appendix to this letter.

If you wish to discuss any of the points further, please do not hesitate in contacting me directly.

Yours sincerely,

Nicole Kissun

Nicole Kissun
Partner
For and on behalf of BDO LLP

Appendix: Responses to the questions asked in the Exposure Draft

Question 1

Overall do you agree with the approach of FRED 67 being to focus, at this stage, on incremental improvements and clarifications to FRS 102? If not, why not?

Yes, we agree with the FRC's approach of focussing on incremental improvements and clarifications. As we noted in our response to the September 2016 Consultation Document 'Triennial review of UK and Ireland accounting standards - Approach to changes in IFRS' (the 'September 2016 Consultation Document'), now is not the right time to be seeking to introduce new concepts and requirements drawn from IFRSs which, in many cases, have not yet been implemented by even the largest of companies in the UK.

Question 2

FRED 67 proposes to amend the criteria for classifying a financial instrument as 'basic' or 'other'. This will mean that if a financial instrument does not meet the specific criteria in paragraph 11.9, it might still be classified as basic if it is consistent with the description in paragraph 11.9A.

Do you agree that this is a proportionate and practical solution to the implementation issues surrounding the classification of financial instruments, which will allow more financial instruments to be measured at amortised cost, whilst maintaining the overall approach that the more relevant information about complex financial instruments is fair value? If not, why not?

Yes, we agree that the introduction of a principle that will allow more financial instruments to be measured at amortised cost is a proportionate and practical solution to the implementation issues surrounding the classification of financial instruments based on the assumption that the more relevant information about complex financial instruments is provided through measurement at fair value.

We note that the proposed wording for the principle added in paragraph 11.9A uses language that is similar to that used in IFRS 9. We are concerned that some users of the standard might infer from this that IFRS 9's much more extensive "SPPI" guidance might be of relevance when interpreting its practical meaning. In our view, this leads to a risk of divergence in practice between preparers and auditors who have an IFRS background and those who do not. An implicit requirement to seek further guidance from IFRSs would clearly mark a significant increase in complexity to an already potentially difficult part of the standard. The FRC could reduce this risk by either reconsidering the language used or by issuing a Staff Education Note containing interpretive guidance and further examples.

The above views notwithstanding, as noted in our response to the September 2016 Consultation Document, we have wider concerns about the approach taken for debt instruments in sections 11 and 12 of FRS 102. We continue to question whether the whether the cost of applying the distinction between a 'basic' and 'other' debt instrument outweighs the benefits of doing so. In particular, we consider the requirement to analyse the terms of a debt instrument both under FRS 102 to determine that it is classified as an 'other' financial instrument and, if it is, then under IFRSs to ascertain whether fair value measurement is allowable under the Companies Act is unnecessarily complex and at risk of being overlooked. For this reason, it is our view that a more fundamental review of the requirements for financial instruments is warranted with a view to introducing amortised cost as the default measurement base for all debt liabilities.

We set out our other comments on the proposed amendments to sections 11 and 12 in our response to question 6 below.

Question 3

FRED 67 proposes that a basic financial liability of a small entity that is a loan from a director who is a natural person and a shareholder in the small entity (or a close member of the family of that person) can be accounted for at transaction price, rather than present value (see paragraph 11.13A). This practical solution will provide relief to small entities that receive non-interest-bearing loans from directors, by no longer requiring an estimate to be made of a market rate of interest in order to discount the loan to present value. Do you agree with this proposal? If not, why not?

Yes, we agree with the proposed relaxation of the requirements that apply to a loan to a small entity from a director who is a natural person and a shareholder in the small entity. We note, however, that the wording proposed for paragraph 11.13A might also preclude the application of this relaxation to:

- Loans made directly to a subsidiary of a small group from a director/shareholder of a parent; and
- Loans made to small entities other than companies which do not have "shareholders" or "directors" (eg small LLPs).

In addition, in our view, there are other circumstances in which the same or similar challenges and cost/benefit analysis might apply and justify an extension to the proposed amendment. For example, a director/shareholder may provide a loan to a parent of a small group which in turn loans the funds on under the same terms to a subsidiary entity. This arrangement may well have arisen because commercial funding is not available to the subsidiary and it would, therefore, be equally challenging for the subsidiary to determine an appropriate market rate for the parent-subsidiary loan as it would be for the director-parent loan. The challenges inherent in determining an appropriate market rate of interest in these circumstances means that it is likely that there will be a wide range of possible rates that might be applied which would cast doubt over the relevance and reliability of the resulting financial information.

We recognise that one reason why the FRC is hesitant to widen the scope of this proposed relaxation is because it is unable to mandate disclosure in respect of the terms of intra-group loans in the same way as is possible for loans with owners under FRS 102.1AC.35. In our view, this concern could be allayed through the use of the overriding requirement for small entity financial statements to provide a true and fair view set out in FRS 102.1A.5 and the inclusion of recommended disclosures in FRS 102.1A.Appendix D. We would also highlight that the relaxation being proposed in paragraph 11.13A is an optional rather than mandatory treatment meaning that disclosure of off-market terms could be avoided through the application of the extant (present value) financing transaction requirements set out in FRS 102.

Finally, we would highlight that there is no guidance included in the Exposure Draft that would apply when a small entity that applies the proposed relaxation ceases to qualify as a small company (or, indeed, vice versa). Our understanding is that the FRC would not expect a small entity to revisit initial recognition if it became medium in a later period when the instrument was still outstanding. However, some practitioners may take a view that a change in entity size leads to a change in accounting policy that should be applied retrospectively. In our view the FRC should clarify the requirements in this respect.

We set out our other comments on the proposed amendments to sections 11 and 12 in our response to question 6 below.

Question 4

FRED 67 proposes to amend the definition of a financial institution (see the draft amendments to Appendix I: Glossary), which impacts on the disclosures about financial instruments made by such entities. As a result, fewer entities will be classified as financial institutions. However, all entities, including those no longer classified as financial institutions, are encouraged to consider whether additional disclosure is required when the risks arising from financial instruments are particularly significant to the business (see paragraph 11.42). Do you agree with this proposal? If not, why not?

Yes, we agree with the proposal to amend the definition of a financial institution. Whilst the revised definition will still require judgement to be applied, this is unavoidable given the wide range of activities that might be fall in the "grey area" between definitely a financial institution and definitely not. This problem is particularly illustrated by the practical difficulties and divergence in practice arising from the application of the current definition to group treasury companies and, in consequence, we recommend the current Accounting Council's Advice section of FRS 102 which says that 'a subsidiary entity engaged solely in treasury activities for the group as a whole is likely to meet the definition of a financial institution' is revised so as not to risk conflict with the new definition and its intended application.

Acknowledging that some entities may be exposed to risk as a result of its use of financial instruments, we support the proposed encouragement of entities that do not meet the definition of a financial institution to consider the need for additional disclosures. We do, however, have two comments in respect of the drafting of the proposed revised wording in paragraph 11.42:

- 'Particularly significant' is not a defined term nor is it a term which is used elsewhere in financial reporting. In consequence, we are concerned that its practical interpretation may be inconsistent. In our view, a more commonly understood term should be used (eg material risks or principal risks) and guidance, perhaps in the form of a Staff Education Note, is issued to clarify to what extent this revised requirement is expected to lead to additional disclosures in non-financial institutions.
- Following on from our previous observation, on the assumption that 'particularly significant' and 'material' do have the same meaning, we question whether the disclosures in paragraphs 34.19 to 34.33 ought to be included in section 11 as it would seem unlikely that a disclosure related to a material risk should be omitted from a set of financial statements purely by virtue of the entity not meeting the definition of a financial institution.

Question 5

FRED 67 proposes to remove the three instances of the 'undue cost or effort exemption' (see paragraphs 14.10, 15.15 and 16.4) that are currently within FRS 102, but, when relevant, to replace this with an accounting policy choice. The FRC does not intend to introduce any new undue cost or effort exemptions in the future, but will consider introducing either simpler accounting requirements or accounting policy choices if considered necessary to address cost and benefit considerations.

As a result, FRED 67 proposes:

a) an accounting policy choice for investment property rented to another group entity, so that they may be measured at cost (less depreciation and impairment) whilst all other investment property are measured at fair value (see paragraphs 16.4A and 16.4B); and
b) revised requirements for separating intangible assets from the goodwill acquired in a business combination, which will require fewer intangible assets to be recognised separately. However, entities will have the option to separate more intangible assets if it is relevant to reporting the performance of their business (see paragraph 18.8 and disclosure requirements in paragraph 19.25B).

Do you agree with these proposals? If not, why not?

Yes, we agree with the proposal to remove the three 'undue cost or effort' exemptions that are currently within FRS 102 and, where relevant, to replace them with an accounting policy choice. In our view it is very difficult to ensure appropriate and consistent application of these exemptions across the market. However, whilst we agree in principal that the FRC should, wherever possible, seek alternatives to the introduction of new 'undue cost or effort' exemptions, we would consider it unwise to make a firm statement that such a route will not be taken in the future. In addition, we would advise the FRC against the introduction of too many accounting policy choices as, by their nature, they reduce direct comparability between entities.

Investment properties

We agree with the proposal that an investment property rented to another group entity can be measured at cost rather than fair value and anticipate that the simplified treatment will be by far the most popular option.

We question whether there may still be circumstances in which a reliable fair value cannot be made for an investment property. For example, as highlighted in paragraph 31 of the Corporate Reporting Council's Advice section of the Exposure Draft, '...in the UK all entities should be able to obtain a fair value for an investment property, without undue cost and effort...', the valuation of an overseas investment property may be more complex. In consequence, we would encourage the FRC to consider whether a provision similar to that included in FRS 102.11.30 which introduces cost (rather than fair value) measurement for financial instruments that feature a wide range of reasonable fair value estimates. This test is more objective than the 'undue cost or effort' exemption that it would replace.

In terms of the proposed wording of paragraph 16.4A, we question whether this exemption should be extended to intermediate parent companies that prepare group accounts.

Separate intangibles in a business combination

We agree in principal with the introduction of an accounting policy choice in respect of the separate recognition of intangible assets on a business combination. Whilst we acknowledge that some respondents to this consultation might assert that the information provided by the extant requirements is decision-useful and promotes a more rigorous examination of the purchase price, it does so at a sometimes significant price. In our view, this proposal will be very popular with preparers.

We question, however, whether the approach proposed for the introduction of this accounting policy choice might lead to a significant reduction in comparability between different entities. This is because the proposed wording does not just offer a choice between the recognition of "FRS 102-level" intangibles and "IFRS-level" intangibles in a business combination; it also provides substantial choice within the "FRS 102" option, particularly if you consider the amount of flexibility there might be in the interpretation of the meaning of a "class of intangible assets" in this context. This choice may lead to a greater degree of "cherry picking" and structuring than might be anticipated.

In terms of the proposed wording for the revised paragraph 18.8, we do not consider it to be sufficiently clear whether the "FRS 102-level" intangibles and "IFRS-level" intangibles choice is one made once following the first business combination under the revised requirements or on a business combination-by-business combination basis. In addition, in the final section of paragraph 18.8, we would recommend the following words are inserted for clarity: "...any or all intangible assets acquired in a business combination separately from goodwill...".

We would also observe that the "minimum" conditions set out in the proposed wording for FRS 102.18.8 would appear to be more restrictive than was the case under "old" UK GAAP, which did not require contractual or other legal rights in addition to whether they were separable. Whilst we do not disagree with these proposals, we would recommend that the FRC makes this difference clear as we are aware of some people holding the view that the new option would be identical to "old" UK GAAP. Finally, we would recommend that some examples of the sorts of intangibles that would and wouldn't be recognised under this alternative treatment should be provided given that it is different to previous requirements, albeit only subtly from "old" UK GAAP.

Question 6

Please provide details of any other comments on the proposed amendments, including the editorial amendments to FRS 102 and consequential amendments to the other FRSs.

We have the following additional comments on the proposed amendments in the Exposure Draft:

Section 1A Small entities

- The proposed wording for paragraph 1A.4A requires a "statement that the financial statements are prepared in accordance with the small entities' regime". In our view, this requirement should be clarified to emphasise that the statement should refer to the small companies' regime as set out in the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409), rather than section 1A of FRS 102. It is also not clear why this requirement is included in the body of section 1A and not in Appendix C to section 1A, along with the other disclosure requirements imposed on small entities.

Section 3 Financial Statements Presentation

- The new footnote referenced from paragraph 3.16B refers to "the listing of subsidiary undertakings". Given that this is a direct reference to a requirement in company law, in our view the terminology used in the footnote should be consistent with that used in the legislation (ie "information on subsidiary undertakings" and include a specific reference (eg Section 1 of Schedule 4, of SI 2008/410).

Section 7 Cash Flow Statements

- The amendment to paragraph 7.7 allows an entity to start the reconciliation of operating cash flows from 'any measure of profit or loss disclosed in the income statement'. This would appear to allow the cash flow statement to start from any non-GAAP measure so long as it is presented on the face of the income statement. This would be a more relaxed approach than taken in IAS 7, which requires the reconciliation to start from profit or loss (IAS 7.18(b)) or profit before tax (as illustrated in IAS 7's illustrative examples). It is unclear whether this is an unintended consequence of this revised requirement.
- Net debt definition in Appendix I to FRS 102 uses the term "borrowings" but borrowings is not itself a defined term and may be interpreted differently and lead to divergence in practice.

Section 9 Consolidated and Separate Financial Statements

- Proposed new paragraph 9.23(f) requires the disclosure of "the nature and extent of [an entity's] interest in unconsolidated special purpose entities" but gives no indication of what those disclosures might comprise. We note that IFRS 12 contains a great deal of detailed guidance on this overarching disclosure requirement and are concerned that a lack of guidance in FRS 102 on the nature and extent of expected disclosures might lead to a wide divergence in practice if some preparers refer to IFRS 12 whilst others take a much more limited approach.
- The purpose of the proposed new paragraph 9.33A is unclear.

Section 11 Basic Financial Instruments

- A proposed new footnote to paragraph 11.2(b) suggests that the FRC will be cross-referring to a version of IAS 39 on the IASB's website. In our view, the version of IAS 39 that the FRC intends to incorporate into FRS 102 should be located on the FRC's own website so continuing availability can be ensured. This comment is equally applicable to the footnote that is being added to paragraph 12.2(b).
- Paragraph 11.6A should make clear whether re-assessment if and only if the circumstances set out in that paragraph exist or whether it is permitted in other circumstances.
- In our view, it remains unclear how the definition of a basic financial instrument in paragraphs 11.9(a)(ii), 11.9A and Example 3 under paragraph 11.9A apply to variable interest rates which may become negative and what might happen if and when that index does drop below zero. This is an illustration of the complexities inherent in the general approach to the classification of financial instruments currently adopted in FRS 102 and highlighted in our response to question 2 above.
- Example 9 under paragraph 11.9A uses the term "IFRS as adopted in the EU" whereas this terminology has been eliminated elsewhere (eg in paragraphs 1.4, 1.5 and 10.6.
- The amendments to Example 3 under paragraph 11.13 has deleted "prevailing market rate(s)" which was marked bold as a defined term but the introduced text does not have that term in bold type.
- The amendments to paragraph 11.14 cater for situations where fair value can no longer be reliably measured (eg cost or the last available fair value measurement)?
- The opening sentence of paragraph 11.27(c) should also be amended to introduce the word "another".

Section 16 Investment Property

- Paragraph 16.1A should cross-refer to paragraph 16.4A(b), not 16.4.
- The text proposed for paragraph A4.40B & 40C notes that, when an entity elects to use the deemed cost transitional exemption in relation to PP&E, intangible assets or investment property rented to another group entity, a revaluation reserve should be established and certain disclosures provided. In our view, this guidance should be included in the body of the standard, rather than in an appendix where there is a significant risk that it will be overlooked.

Section 15 Investments in Joint Ventures

- In our view, the subheading above paragraph 15.14 should be the "revaluation model" or similar to be consistent with the paragraphs in section 17 to which this section refers. The model adopted is not a fair value through profit or loss model.
- Paragraph 15.15 appears to require fair value changes to be recognised only in other comprehensive income but that paragraph refers to paragraphs 17.15E and 17.15F that require recognition in profit or loss in certain circumstances. This appears inconsistent.

Section 19 Business Combinations and Goodwill

- The revised wording for paragraphs 19.12-13B does not make clear how one would account for the time value of money in the event of a change in estimate for contingent consideration; should the cumulative interest charge be corrected at the date of the reassessment (ie interest should be calculated from the date of acquisition) or should discounting only take effect from the date of recognition of the contingent consideration and not be reversed should it subsequently be derecognised?

Section 22 Liabilities and Equity

- Paragraph 22.8 should include guidance on how shares subject to merger or group reconstruction relief are measured. This may be achieved, in part, through a cross-reference to paragraph A4.24 in which the matter is discussed in greater detail.
- We assume the new example added at the end of section 22 is intended to illustrate the GAAP difference between IFRS and FRS 102, namely that IAS 32.23 would require the recognition of a gross liability for the cash obligation in these circumstances, irrespective of whether the contract is settled with a fixed or variable number of shares or cash. In our view, the example should be introduced with more explicit reference to this GAAP difference and should also make reference to the accounting (or lack thereof until settlement) for a contract that meets the definition of an equity instrument.
- We note that the proposed wording for paragraphs 23.33 and 23.34 included in the Exposure Draft is different from that included in the staff mark-up on the FRC's website; the wording in the staff mark-up is a correct reflection of the IAS 11.43 and 44 wording but the FRED's wording is not.

Section 23 Revenue

- We do not consider that any of the extant requirements in section 23 would prevent an FRS 102 preparer from adopting an IFRS 15-compliant revenue policy. In consequence, we do not consider the proposed amendment in paragraph 23.3A to be necessary.
- The proposed new Example 27 in section 23 includes reference to credit risk as a factor in the agent vs principal determination. We note, however, that the reference to credit risk was removed in the April 2016 amendments to IFRS 15.

Section 24 Government Grants

- It is unclear, following the proposed amendment to paragraph 24.7, whether loans at nil or low interest rates that constitute government assistance should be accounted for under section 24 or section 11/12.

Section 26 Share-based Payment

- It is unclear whether the proposed new paragraph 26.1B relates only to equity settled share-based payments or also to cash-settled arrangements; it cross-refers to paragraph 26.17 that relates only to the former.

Section 29 Income Tax

- In our view, the proposed requirement set out in paragraph 29.11A is applicable more generally; it does not apply only to the calculation of deferred tax in a business combination as implied by its proposed location.

Section 30 Foreign Exchange Translation

- In our view, the phrase "unrealised gain" should be more clearly linked to the concept of realised profits as some might understand the term realised simply to mean that the associated asset or lability has been disposed of.
- Whilst we do not disagree with the proposed change to paragraph 30.13, we note that there are other similar examples of this circumstance that have not been addressed in FRS 102. For example, paragraph 34.15 where the consideration for a service concession arrangement is an intangible asset and section 23 (Revenue) if the consideration does not take the form of qualifying consideration.

Section 33 Related Party Disclosure

- It is unclear how the proposed introduction of paragraph 33.7A will interact with paragraph 33.9. For example, might share-based payments require disclosures under paragraph 33.9 as they do not feature in the Companies Act disclosures?
- We would also highlight, where Key Management Personnel comprise more than just the directors, the basis of the disclosures will be different given that the KMP disclosures would include share-based payments and employers NICs. This inconsistency may be confusing to the reader.

Amendments to Appendix IV

- Paragraphs A4.37B and 37C are not relevant only to charitable companies; they are relevant to all companies.
- We would recommend that the wording proposed for paragraph A4.37D better explains the issue and alternative interpretation.
- Paragraph A4.43 should be cross-referenced from section 33.

Question 7

FRED 67 includes transitional provisions (see paragraph 1.19). Do you agree with these proposed transitional provisions? If not, why not?

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

In addition to the clarification of the treatment of shareholder/director's loans to small entities when those entities cease to be small (and vice versa) set out in our response to question 3 above, we have the following observations in respect of the transitional provision set out in the Exposure Draft:

- We question whether the proposed wording in paragraph 1.19 should refer to the 'date of initial application' (1 January 2019, assuming no early adoption) rather than, or as well as, the 'date of transition' (1 January 2018, assuming no early adoption). Without making this allowance, entities may be forced to seek professional valuations for intra-group investment properties and/or intangible assets arising on a business combination for the preparation of their financial statements for the period immediately preceding the period in which the amendments are first applied, only to eliminate those valuations in the comparative period on the adoption of the amendments.
- Following on from the point made above, for intangible assets arising in a business combination, an entity would be forced to restate a comparative period business combination in the absence of a 'date of initial application' transitional exception in order to set its policy in respect of the classes of intangible assets it intends to recognise going forward under the new requirements.

- We acknowledge and support the FRC's decision to make the shareholder/director's loans to small entities relaxation available for immediate adoption. In our view a similarly helpful action could be taken in respect of intra-group investment properties through the release of a statement asserting that the proposed amendments to FRS 102 allows the extant "undue cost or effort" exemption in FRS 102.16.4 to be applied.

Question 8

Following a change in legislation the FRC is now required to complete a Business Impact Target assessment. A provisional assessment for these proposals is set out in the Consultation stage impact assessment within this FRED.

The overall impact of the proposals is expected to be a reduction in the costs of compliance. In relation to the Consultation stage impact assessment, do you have any comments on the costs or benefits identified? Please provide evidence to support your views of the quantifiable costs or benefits of these proposals.

We have no further comments on the costs and benefits likely to arise from the proposals in the Exposure Draft that will help inform the impact assessments.