University of Worcester

ifa | Institute of Financial Accountants

Corporate

Consultation FRED 67

Response to Consultation

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Introduction

1. The Institute of Financial Accountants (IFA) and the University of Worcester (UW) welcome the opportunity to comment on The Financial Reporting Council's (FRC) consultation on FRED 67, which was published in March 2017.

2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. Information about the IFA and the UW is provided below.

Who we are

4. Established in 1916, the Institute of Financial Accountants (IFA) is an internationally recognised professional accountancy membership body. Our members work within micro and small- to medium-sized enterprises (SME) or in micro and small- to medium-sized accounting practices (SMP) advising micro and SME clients.

5. The IFA is part of the Institute of Public Accountants (IPA) of Australia Group, the world's largest SME-focused accountancy group, with 35,000 members and students in 80 countries.

6. We are proud of our unique relationship with our members, who predominantly come from a SME/SMP background. As a professional accountancy body, we aim to provide the very best support and guidance to our members who operate within this arena, frequently tailoring policies and recommendations to meet the unique challenges and trading relationships associated with smaller business.

7. We offer a programme of professional qualifications and education as well as resources, events, training and seminars. As well as resources, events, training and seminars. IFA members uphold high standards of conduct, confidentiality and ethics and undertake annual continuing professional development (CPD) activities.

8. The IFA is a full member of the International Federation of Accountants (IFAC), the global body for the accountancy profession and is formally recognised as an awarding organisation by Ofqual, the public body responsible for monitoring standards, exams and qualifications (other than degrees) in England, underlining the quality of the IFA's work and the integrity of its qualifications. It is also authorised by HM Treasury and the Financial Services Authority in the Isle of Man as a supervisor to monitor its members for compliance with the Anti-Money Laundering regulations in the UK and the Isle of Man.

10. The UW has strong professional and practice-based strengths at several of its academic institutes. The University has a strong focus on applied research designed to shape and influence the practice of business, teachers, health professionals, coaches and managers. There is an emphasis of how our research can ultimately have a real-world impact.

11. The University of Worcester's Business School (WBS) has a small but growing research base. Having made its first submission to the REF (Unit of Assessment 19: Business & Management Studies) and launched its DBA program in 2013 it is now firmly committed to substantially growing its research, applied research and knowledge transfer activity. WBS research is rooted in local, regional, national and international contexts and benefits our students through our focus on research-informed teaching and our innovative research degree program. WBS has always been conscious to avoid 'ivory tower' research for its own sake and ensure their links to public and private sector organisations keep them in touch with constant change.

12. WBS is recognised for its client-focused and bespoke-solution approach. We work with key decision makers in a wide range of private, public and third sector organisations to deliver measurable impact. From executive development in leadership and management via our accredited Leading to Excellence™ framework, to networking, recruitment, consultancy and applied research.

13. Over the last 12 months the IFA and UW have been working on a joint project to investigate how the accounting profession, particularly micro- entity, micro- practice, SMEs and SMPs, have been affected by the transition to FRS 102 and FRS 105. As part of this project, the IFA and UW have surveyed the IFA members and to gather their

thoughts and comments on the incremental improvements and clarifications proposed by FRED 67. This response to the consultation on the proposals in FRED 67 incorporates the views of the IFA and its members, via the survey which consisted of 41 participants, together with views from the UW.

General Comments

14. We are pleased to have an opportunity to comment on the proposals put forward in FRED 67 in respect of amendments to FRS 102 for periods commencing on or after 1 January 2019. This consultation response has been structured to firstly outline any general comments or observations arising from our review of FRED 67 and the survey of our members. We then provide some background statistics from our survey which we believe add substance to the response in terms of type of organisations that have contributed and the UK accounting standards they are adopting to prepare their financial statements. Finally, we respond to each of the specific questions proposed by the FRC in the consultation document.

15. Other comments provided by participants included:

    a. It is pleasing to see that the FRC is doing its best to provide clarity and remove anomalies.

    b. There were some frustrations that the standard is being changed quite soon after introduction, when the profession has not had chance to get to grips with it in practice.

    c. The FRC should be encouraging businesses to disclose more information in their financial statements to protect the interests of minority shareholders, who otherwise would have very little information from management.

    d. We are aware that this consultation's focus is FRS 102. However, we thought it would be beneficial to draw to the FRC's attention the concerns raised by our members in respect of FRS 105. We received comments that "FRS 105 is too simple and consequently devalues accounts to the extent that they are meaningless to micro entity owners/directors and their creditors e.g. banks. In many cases, separate disclosures/confirmations are being required so the quest for simplicity has resulted in more cost". We believe this is the reason for only 29% of the survey participants intending to adopt FRS 105 for their micro- entity financial statements (refer to point 18 below).

    e. For planning purposes, it would be helpful to have an indicative timetable from the FRC for making changes to FRS 102 relating to IFRS 9 Financial Instruments, IFRS 15 Revenue from Contracts with Customers and IFRS 16 Leases.

Background to the Survey

16. As the membership of the IFA is predominantly SME/SMP it was not surprising that the profile of participants to the survey was as follows:

	Size of Business	Size of Clients *(accounting practices only)*
Micro	69%	66%
Small	22%	29%
Medium	9%	5%
Large	0%	0%

We are extremely grateful to our members for their responses to the survey, which has enabled us to communicate the views of the professionals working in the smaller part of the sector whose opinions may not usually be shared with the FRC.

17. The majority of our members previously prepared their financial statements in accordance with the requirements of the FRSSE. We therefore asked participants whether they will be adopting FRS 102 Section 1A or full FRS 102 for **small company** financial statements, which had previously been prepared under the FRSSE. The response was as follows:

    a. 71% will be adopting FRS 102 Section 1A.

    b. 29% will be adopting full FRS 102.

18. We asked also participants whether they will be adopting FRS 102 Section 1A or full FRS 102 for **micro company** financial statements, which had previously been prepared under the FRSSE. The response was as follows:

    a. 49% will be adopting FRS 102 Section 1A.

    b. 22% will be adopting full FRS 102.

    c. 29% will be adopting FRS 105.

19. Only 24% of the survey participants prepare or audit financial statements for groups of companies and of this 58% are small private groups and 42% are medium private groups.

20. The survey asked members to indicate whether they would consider early adoption of FRS 102 (revised from 1 January 2019), the response was as follows:

    a. 29% intend to early adopt.

    b. 25% will wait until 1 January 2019.

    c. 46% thought it was too early to tell.

Specific questions

21. In addition to our general comments, our comments on specific questions set out in the consultation document are set out below.

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?

22. Yes, the IFA, UW and 87% of the survey participants agree with this approach. We believe it is important to allow the profession time to become familiar with the implementation of FRS 102 and making any significant changes to the standard from 1 January 2019 would cause complication and concern throughout the profession. This is particularly important for micro- entities, SMEs and SMPs who may not have the in-house technical knowledge and support to adapt to frequently changing financial reporting.

23. We also agree it was sensible to exclude changes from FRS 102 in respect of updates to full IFRS in relation to *IFRS 9 Financial Instruments, IFRS 15 Revenue from Contracts with Customers* and *IFRS 16 Leases*. We believe the FRC should allow full IFRS adopters to become familiar with financial reporting under these new standards before considering any amendment to FRS 102.

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?

24. We support these proposals, as they will simplify financial reporting in respect of financial instruments. A significant proportion of the survey participants (98%) agree with this proportionate and practical solution. Although, interestingly only 10% of the survey participants prepare or audit accounts which include non-basic financial instruments therefore the impact of this change on micro- entities and SMEs may be minimal.

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?

25. We agree with the proposal to allow loans from directors who are also shareholders to be recorded at transaction price, rather than present value. This impacts a significant number of micro- entities and SMEs, as indicated by 82% of the survey participants preparing or auditing financial statements which include loans from directors who are also shareholders. The response to this proposal from our members was overwhelmingly positive, with 96% being in agreement.

26. We were also pleased to see the amendment to FRS 102 to provide optional interim relief for small companies in respect of accounting for directors' loans at transaction price, which was issued in May 2017.

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?

27. Yes, we support the proposal to amend 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?

28. 69% of the survey participants agreed with the proposal to remove the ‘undue cost or effort exemptions’ and not to use any such exemptions in the future. However, we feel it is extreme to rule against never using ‘undue cost or effort’ in the future, particularly with the potential incorporation of IFRS 16 Leases into FRS 102 in the future. Therefore, it might be helpful to keep the ‘undue cost or effort exemption’ as an option to future proof the standard.

    We agree with the proposal to incorporate an accounting choice of cost (less depreciation and impairment) or fair value for investment properties rented to other group companies, as we believe this will simplify financial reporting for SMEs and 76% of the survey participants were also in favour of this proposal. In addition, 73% of the survey participants were in favour of the proposal to reduce the number of intangible assets which are recognised separately from goodwill following a business combination. However, we believe that requiring companies to separate their intangible assets encourages them to consider the reasons they are paying more than the book value for a company. One participant felt that “differentiating intangibles is just as important as tangible assets for readers of the financial statements”. We also believe this proposal will incorporate too much choice into FRS 102, which will lead to inconsistencies across companies in the reporting of goodwill and intangible assets following a business combination.

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.

29. The proposal to allow loans from directors who are also shareholders to be recorded at transaction price, rather than fair value, should also apply to inter-company loans. Many intercompany loans are informal agreements with either non-market rates of interest or zero interest rates and no formal repayment terms. In addition, some companies may not be able to afford external finance and as such intercompany finance is their only option. By recording a ‘market rate of interest’ it is detracting away from the substance of the transaction, which is a loan at favourable terms issued as financial assistance to support another group company. Under the current requirements of FRS 102, such loans are initially recorded at the present value of future payments discounted at a market rate of interest. However, determining the market rate of interest can be complex for some businesses as it will depend upon the maturity of the debt, credit risk, gearing and security offered. If the requirement to record intercompany loans at fair value remains after this consultation period, we would like to see further guidance over how to determine market rates of interest.

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.

30. Overall we agree with the transitional provisions and 88% of survey participants were in favour of these provisions. However, one member commented that they believe this “adds more complexity and makes it even harder to create transparent meaningful reporting”.

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.

31. Overall, we believe that the proposed changes will beneficial to our members since there will be no need to spend time and resources fair value directors’ loans and financial instruments which will not be categorised as basic. Furthermore, it is helpful to include a choice regarding the treatment of business combinations. The proposed changes are moves towards ‘substance over form’, which are therefore beneficial to members, investors and other key stakeholders.

Contact Details

32. Should you wish to discuss our responses further, please contact either Anne Davis by email at anned@ifa.org.uk or Stephanie Tiller by email at stephanie.tiller@worc.ac.uk