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For the attention of Jenny Carter
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Ref: AC/FRC

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Dear Sirs

Consultation Document – Triennial review of UK and Ireland accounting standards: Approach to changes in IFRS

Introduction

Ernst & Young LLP welcomes the opportunity to comment on the Consultation Document issued by the Financial Reporting Council ('the FRC').

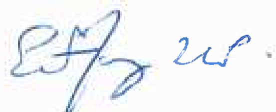
Overall comments on the Consultation Document

In principle, we agree that any changes made to FRS 102 – *the Financial Reporting Standard applicable in the UK and Republic of Ireland* – for accounting periods beginning on or after 1 January 2019 should be limited. We do not believe the needs of users are catered for by making material changes so soon after FRS 102's original effective date. Moreover, we disagree with the proposals to amend the control model in Section 9 of FRS 102 and to provide additional guidance on the allocation of revenue to the component parts of a single transaction, for the reasons explained in our responses to Q2 and Q6.

We note that the FRC intends to issue its detailed proposals for more significant amendments to FRS 102, which will be effective for accounting periods beginning on or after 1 January 2022, in a second FRED to be issued towards the end of the third quarter of 2017. We disagree with this proposal, except for the idea set out in 3.13 (c), i.e. requiring a sub-set of financial institutions to apply the impairment requirements of IFRS 9. Beyond that, in our view, whilst there is merit in testing the appetite to bring new IFRSs into FRS 102 via a consultation paper, there will be insufficient evidence on which to make concrete proposals at this stage, given that IFRSs 9 and 15 will only be applied from 2018 and IFRS 16 from 2019 and so experience of application will have been limited. In our view, the second triennial review exposure draft should not be issued until there has been experience of the new IFRSs. There will also by then be less uncertainty surrounding the implications of Brexit and so it would be possible to use the ED to set out a post-Brexit vision of the future of UK corporate reporting. We agree that entities will need to be given enough time to apply these new requirements, so that implementation (except to require a sub-set of financial institutions to apply the impairment requirements of IFRS 9) will need to be delayed beyond 2022.

If you have any matters arising concerning the content of our response, please contact Tony Clifford on 0207 951 2250.

Yours faithfully



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Responses to FRC questions

FRED 64 Draft amendments to FRS 102 Fair value hierarchy disclosures

Question 1

The FRC has reviewed its principles for developing succinct financial reporting standards for the UK and Republic of Ireland. As a result, limited changes have been made to the principles, to emphasise the need to balance improvement with stability and the need for proportionate solutions (see paragraph 1.11). Do you agree with the principles? If not, why not?

We agree with the proposed changes to the principles that put greater emphasis on the need for balance, stability and proportionate solutions.

Question 2

Significant changes to IFRS have been considered against the FRC's principles for developing succinct financial reporting standards for the UK and Republic of Ireland; see Section 3 *Changes in IFRS – Detailed Analysis*. Do you agree with the proposals for updating FRS 102 as a result of changes in IFRS as part of this triennial review? If not, please provide alternative suggestions.

IFRS 3 *Business Combinations (2008)*

We agree with the proposal not to change FRS 102 to increase consistency with IFRS 3 (2008) for the reasons given in Section 3.

IFRS 9 *Financial Instruments*

See response to Q3 below. We believe that Approach (c) is the most appropriate approach.

IFRS 10 *Consolidated financial statements* and IFRS 11 *Joint Arrangements*

We do not agree with the proposal to amend the control model in Section 9 of FRS 102 as we believe that tinkering with the control wording whilst retaining the rest of the requirements, which are not based on IFRS 10, is likely to have unintended consequences. The proposed change is not expected to affect many entities (as acknowledged by the FRC) and therefore we do not consider the change is justified. Also we believe that the proposed change does not promote stability and that it is not proportionate.

IFRS 12 *Disclosure of Interests in Other Entities*

We agree with the proposal not to amend FRS 102 to include the extra disclosures required by IFRS 12.

IFRS 13 *Fair Value Measurement*

We agree that FRS 102 should be reviewed to achieve greater consistency with IFRS 13. We believe that it would be helpful for users if the definition of the fair value hierarchy in Section 11 of FRS 102 was consistent with the definition in IFRS (and FRS 101). However, any changes should be carefully considered to ensure that there are no unintended consequences.

IFRS 15 *Revenue from Contracts with Customers*

We do not agree with the proposal to introduce elements of IFRS 15 into FRS 102 in the Phase 1 ED. We are not convinced that the proposed changes to provide additional guidance on the allocation of revenue to the component parts of a single transaction are necessary given that Section 10 of FRS 102 permits preparers to look to IFRS in the absence of specific guidance within FRS 102. Also, most entities who use FRS 102 do not have the complex arrangements for which IFRS 15 was designed. Further, we do not believe that elements of IFRS 15 should be introduced piecemeal into FRS 102.We believe that the FRC should wait until experience has been gained of the application of IFRS 15 before considering whether to change the FRS 102 revenue model.

IFRS 16 *Leases*

We agree that no changes to FRS 102 for the IFRS 16 leasing model should be made before 2022. However, we disagree with the proposal to add additional disclosures in lieu of the adoption of IFRS 16 within FRS 102. This is not required by IFRS adopters in advance of the application of the standard and the disclosures required by paragraph 20.30 of FRS 102 already alert users of financial statements to the quantum of operating lease commitments that are off balance sheet.

Question 3

In relation to the impairment of financial assets, the FRC proposes to amend FRS 102 in order to incorporate an expected loss model. Paragraph 3.13 sets out three options for how this might be achieved, with the FRC favouring option (b). Which option would you prefer and why?

Do you have any suggestions for how the simplified approach to impairment losses for trade receivables and lease receivables in IFRS 9 might be developed into a suitable model for entities applying FRS 102 (other than financial institutions, or a sub-set such as banks and building societies).

We believe that Approach (c), i.e. requiring a sub-set of financial institutions to apply the impairment requirements of IFRS 9 in full and make no other amendments to FRS 102 unless there is evidence that the current impairment requirements of FRS 102 are not operating effectively, is the most appropriate approach. In this respect, we consider that the appropriate sub-set of financial institutions that should apply IFRS 9 should be banks, building societies and entities that undertake the business of effecting or carrying out insurance contracts.

The impairment model in IFRS 9 was designed primarily for banks and similar financial institutions and, in our view, it is inconsistent with the revised principles of FRS 102 to introduce this to other entities at this stage unless there is evidence that the current impairment requirements of FRS 102 are not working effectively.

Alternatively, if the FRC does not consider that different entities should apply different impairment models within Sections 11 and 12 of FRS 102, we believe that financial institutions should be required to apply the recognition and measurement requirements of IFRS 9 rather than the recognition and measurement requirements of Sections 11 and 12 with effect from 2022. This has the advantage of removing the need to make other than minimal drafting changes to FRS 102.

We do not agree with Approach (b) since we think adding 'new requirements based on the simplified approach in IFRS 9' adds unnecessary complexity, since this will be different in various respects from the IFRS 9 model and potentially have unintended consequences. For the most part, it will either (as with trade receivables) not make enough of a difference to be worthwhile, or else (as with long term financial assets such as investments in securities) give rise to excessive levels of allowances, that would not give a true and fair view. We also have concerns as to the application of an expected credit loss model to intercompany receivables. Hence use of the simplified approach would not be proportionate.

Question 4

Presently, in paragraph 11.2 (and paragraph 12.2), FRS 102 permits an accounting policy choice in relation to financial instruments, allowing an entity to choose the recognition and measurements of FRS 102, IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments (and elements of IAS 39 as amended by IFRS 9). The FRC proposes to retain the option to choose IAS 39 until the requirements for the impairment of financial assets have been amended in FRS 102 (i.e. for all accounting periods beginning before 1 January 2022). From 1 January 2022 the FRC proposes that the available options will be the requirements of FRS 102 or IFRS 9. Do you agree? If not, why not?

We agree that the option to choose IAS 39 for recognition and measurement of financial instruments should remain available for accounting periods beginning before 1 January 2022.

We also observe that, if the FRC wishes to retain the option to use IAS 39 for the recognition and measurement for financial instruments for accounting periods beginning on or after 1 January 2018, an amendment to FRS 102 should be issued with an effective date prior to accounting periods beginning on or after 1 January 2019. This is because Sections 11 and 12 refer to IAS 39 as adopted for use in the EU and, for accounting periods beginning on or after 1 January 2018, the version of IAS 39 adopted for use in the EU does not, for most entities, contain any recognition and measurement requirements other than for hedging instruments.

Question 5

Do you have any suggestions for how the requirements of IFRS 16 Leases might be developed into a suitable model for entities applying FRS 102? In particular, do you have any suggestions relating to the application of the short-term lease exemption or the exemption for leases when the value of the underlying asset is low?

We believe that it is premature for the FRC to consider how to amend IFRS 16 for entities applying FRS 102 when the standard is not yet effective and there is no experience of application. This is likely to result in drafting errors and unintended consequences. As noted in our covering letter, we do not believe that the FRC should issue an exposure draft in 2017.

Question 6

The FRC proposes to make changes to FRS 102 to incorporate the control model of IFRS 10 *Consolidated Financial Statements*. Company law specifies when consolidated financial statements are prepared, and any changes would supplement these existing requirements by providing further guidance on what is meant by 'control'. Are you aware of any legal barriers to incorporating the control model of IFRS 10 alongside existing legal requirements?

In most situations, any changes to the definition of control in FRS 102 will have no significant impact in practice. However, in other cases entities may be consolidated for the first time or cease to be consolidated. Do you have any information about how significant the practical impact may be and the circumstances in which it might occur?

As explained in our response to Q2 above, we do not agree with the proposal to amend the control model in Section 9 of FRS 102 as we believe that tinkering with the control wording whilst retaining the rest of the requirements of Section 9, which are not based on IFRS 10, is likely to have unintended consequences. The proposed change is not expected to affect many entities (as acknowledged by the FRC) and therefore we do not consider that the change is justified. We therefore do not believe that it promotes stability and neither do we believe it is proportionate.

In our experience, the practical impact of the introduction of IFRS 10 has been most acutely felt by financial institutions with special purpose (or structured) entities.

Question 7

Do you have any comments on the cost-effectiveness of the requirements for share-based payments, currently set out in Section 26 *Share-based Payment* of FRS 102? If you consider that alternative requirements would be more cost-effective, please provide details of how you would adapt the current requirements whilst still providing useful information to users.

We are not aware of any particular comments from users on the requirements of Section 26 which are very similar to those previously used in FRS 20. However, we note that the simplification provided by Section 26, compared to IFRS, that an entity need not use an option pricing model, is rarely used, since an unlisted entity often has no alternative source that it can use to value its share options. We are also aware that valuation of options on unlisted shares can be very challenging. Further, we observe that small entities that are now using the small entities regime within Section 1A of FRS 102 (following the withdrawal of the FRSSE for accounting periods beginning on or after 1 January 2016) are required to account for share-based payment transactions for the first time. Taking these points together, we recommend that the FRC should consider permitting all entities that do not have equity shares traded in a public market an option not to apply the recognition and measurement provisions of Section 26, on the basis that the cost of compliance is not proportionate to users' information needs, Disclosure of the arrangements may be more cost effective.

Question 8

Do you agree with the proposed effective dates for the amendments arising from the triennial review, with incremental improvements and clarifications effective from 1 January 2019 and more fundamental changes effective from 1 January 2022?

Whilst we agree with the effective date of 1 January 2019, as explained in our covering letter, we do not think it is appropriate for the FRC to issue a FRED of proposed major changes as early as 2017. We believe that any FRED for the second triennial should be delayed until possibly as late as 2020 which will give more time for users and preparers to have experience of, and to assess, the new IFRSs' which are only mandated to be applied in 2018 and 2019.This will improve the quality of any proposed changes to FRS 102. In addition, the political situation regarding Brexit will be clearer. We appreciate that entities would require enough time to implement the new requirements, which suggests that any introduction into FRS 102 of the principles of IFRS 9, 15 or 16 should be delayed until 2024 or 2025.

Question 9

Do you have any comments on the approach to keeping FRS 102 up-to-date as part of the triennial review?

Please note that there is no need to repeat comments about potential areas for improvements to FRS 102 that have already been submitted to ukfrsreview@frc.org as these comments have already been noted and will be considered. Detailed comments about potential improvements should continue to be submitted to ukfsreview@frc.org.uk. Those comments received by 31 October 2016 will be taken into account in developing formal proposals for changes. Comments received after this date will be taken into account in the later stages of the review, if they cannot be considered sooner.

In our view, the financial instruments sections of FRS 102 have been the most problematic relative to the other sections of FRS 102. Observations of the six large accounting firms in the UK on financial instruments accounting have been submitted already to the FRC as feedback in response to the invitation for comments from stakeholders on their experiences implementing the new UK and Ireland accounting standards in order to inform the first triennial review. We would draw your attention to those observations.

We note the following other matters where there have been recent developments in IFRSs that have caused recognition and measurement differences with FRS 102:

Equity accounting for investments in subsidiaries, jointly controlled entities and associates in separate and individual financial statements

As equity accounting for investments in subsidiaries, jointly controlled entities and associates in individual and separate financial statements is permitted by Schedule 1 to the Regulations (following changes made by SI 2015/980) and is also permitted by IFRS and FRS 101, we consider that this should also be an option in FRS 102. We do not believe that the rationale for not introducing this option into FRS 102 as explained in paragraph 32 of the Accounting Council's Advice to the FRC to issue Amendments to FRS 102 – Small entities and other amendments (i.e. that FRS 102 already has a number of options for accounting for such investments) is justified. We believe that the option to use equity accounting for investments in subsidiaries, jointly controlled entities and associates should be introduced in the first triennial review.

Bearer plants

IAS 41 *Agriculture* was amended in June 2014 to scope out bearer plants and, instead, account for these under IAS 16 *Property Plant and Equipment*. This has created a difference between IAS 41 and Section 34 *Specialised Activities* of FRS 102 since bearer plants remain included as biological assets in Section 34 rather than property, plant and equipment. The FRC should consider whether to include a similar scope change for bearer plants within FRS 102 in order to align the accounting with IFRS, as it is unhelpful that the requirements of FRS 102 are more onerous than those of IFRS.

Question 10

The FRC will be preparing consultation stage impact assessments to accompany the FREDs arising from the triennial review. At this stage do you have any comments on the costs and benefits likely to arise from the outline proposals in this Consultation Document that will help inform those impact assessments? Please provide evidence to support your views of any quantifiable costs or benefits.

We believe that the FRCs proposals for the second triennial review are likely to result in considerable costs for some entities. However, at this stage, we are unable to quantify these costs.