Setting the Standard

our Financial Reporting eNewsletter

December 2014 – May 2015

Editor's Note

Welcome to the latest edition of 'Setting the Standard', the FRC's electronic newsletter on financial reporting. Our mission is to promote high quality corporate governance and reporting to foster investment; financial reporting sits at the heart of that work. Over the winter period we have issued several consultations related to UK GAAP, published an interim reporting standard and amendments to FRS 102. Our proposals for a new financial reporting regime for small and micro-entities, in connection with the implementation of the EU Accounting Directive, received positive endorsement and the new regime will soon be finalized (see lead article below). The Financial Reporting Lab also published its William Hill case study. The European Commission published a Green Paper on the Capital Markets Union. The Commission's primary aim is to make the financial system more stable by opening up a wider range of funding sources and unlocking more investment. Much of the focus is on investment for SMEs and infrastructure projects. Of particular interest to the FRC is the suggestion that SMEs would benefit from a "common minimum set of comparable information for credit reporting and assessment". On the subject of the smaller end of the market, we have been gathering evidence to help us understand better the reporting challenges faced by smaller listed and AIM quoted companies and are finalising our report which is due for publication in June.

Anna Colban, Editor

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New Financial Reporting Regimes for Small Entities and Micro Entities

By Jenny Carter

Regulations implementing the new Accounting Directive in the UK came into force on 6 April 2015 (legislation to implement the new Accounting Directive in the Republic of Ireland is expected later in the year).

Around 3 million companies in the UK now meet the thresholds to be small and/or micro companies. Our proposals to withdraw the FRSSE and replace it with separate requirements for small and micro-entities will impact them and other forms of entities, such as LLPs, that are small.

Revisions to accounting standards are necessary to maintain their consistency with the revised legal framework. The FRC has also taken the opportunity to re-consider the most appropriate form of standard for micro companies.

Following the positive response to our high-level consultation in 2014 on the proposed changes to the financial reporting framework, we issued the following suite of FREDs in February 2015:

(a) FRED 58 *Draft FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime*;

(b) FRED 59 *Draft amendments to FRS 102 – Small entities and other minor amendments*; and
(c) FRED 60 *Draft amendments to FRS 100 and FRS 101*.

The micro-entities regime (FRED 58)

Micro-entities are the smallest of companies (with turnover of up to £632,000) and a subset of small entities. FRED 58 proposes a new accounting standard for micro-entities, developed around the legal framework and from the requirements of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. There are limited disclosure requirements and a number of simplifications to recognition and measurement requirements have been proposed. For example:

(a) no assets can be measured on an ongoing basis at fair value or a revalued amount;
(b) there should be no requirement to account for deferred tax; and
(c) no accounting policy choices will be permitted, including the options to capitalise development costs and borrowing costs.

The micro-entities regime is optional for those companies meeting the strict eligibility criteria. Most of the micro-entities choosing this regime will currently be applying the FRSSE, which will be withdrawn. Generally the requirements of FRED 58 will either be simpler or broadly the same as the equivalent requirements of the FRSSE. This new standard will be known as FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

The small entities regime (FRED 59)

The size thresholds for small companies have increased, with the turnover limit now £10.2 million. The new legal framework for the small companies regime limits the disclosures that can be required by accounting standards for these companies but, importantly, the financial statements of small companies must still give a true and fair view.

The proposals for the new small entities regime set out in FRED 59 reflect this new legal framework. FRED 59 proposes amendments to FRS 102 to bring small entities (other than those eligible and choosing to apply the micro-entities regime) within its scope. This will mean that small entities apply the existing recognition and measurement requirements of FRS 102, whilst the presentation and disclosure requirements are based on the legal framework. In addition to the disclosures required by company law, the directors of small entities will need to determine whether additional information should be disclosed in order to meet the requirement for the financial statements to give a true and fair view. FRED 59 encourages directors to consider all the disclosure requirements of FRS 102 that are relevant to the entity in order to determine which additional disclosures should be provided. A small number of specific disclosures are also encouraged.

FRED 59 also proposes a small number of other amendments necessary to maintain consistency between FRS 102 and company law.

Amendments to FRS 100 and FRS 101 (FRED 60)

These amendments update the framework of accounting standards set out in FRS 100 *Application of Financial Reporting Requirements*, and in particular propose withdrawing the FRSSE and introducing FRS 105.

In addition, amendments are required to FRS 101 *Reduced Disclosure Framework* in order to maintain consistency with company law. This includes greater flexibility in relation to the format of the profit and loss account and balance sheet, which will allow entities choosing this option to adopt a presentation that is closer to that applied by entities preparing IAS accounts.

Next steps

The FREDs closed comment on 30 April 2015. We expect to issue the final standards and amendments issued in July 2015.

The proposals will be effective for accounting periods beginning on or after 1 January 2016. For FREDs 59 and 60 early application will be permitted for accounting periods beginning on or after 1 January 2015, which is consistent with the effective date of the change in legislation. For FRED 58 early application will be permitted once the standard is issued because the micro-entities regime is already available in company law.

UK GAAP Update

By Jenny Carter

In recent months there have been other developments in UK GAAP, which are briefly discussed below.

Amendments to FRS 102 – Pension obligations

Amendments to FRS 102 were issued in February 2015, and are effective for accounting periods beginning on or after 1 January 2015. The main issue addressed is that, for entities already recognising assets or liabilities for defined benefit plans in accordance with FRS 102, no additional liabilities need be recognised in respect of a 'schedule of contributions'.

This amendment has not yet been reflected in the full edition of FRS 102 (last revised in August 2014) so do make sure you take account of it if it applies to you.

FRS 104 Interim Financial Reporting

In March 2015 the FRC issued FRS 104 *Interim Financial Reporting* replacing the Statement *Half-yearly financial reports*, which was issued by the ASB in 2007. Some entities applying UK and Irish GAAP are required by law or regulation to prepare a half-yearly report, and if so, FRS 104 is intended to provide one of the frameworks for doing so. FRS 104 does not, in itself, require entities to prepare interim reports or to apply FRS 104 in doing so. However, if an entity chooses to apply FRS 104 it is required to apply all of its provisions.

FRS 104 is based on IAS 34 *Interim Financial Reporting* and has been developed for entities applying FRS 102 *The Financial Reporting Standard applicable in the UK and Ireland* in their annual financial statements. It is effective for interim periods beginning on or after 1 January 2015 with early application permitted. The underlying requirements of FRS 104 are similar to those in the ASB Statement *Half-yearly financial reports*, but have

been modernised for consistency with FRS 102. The combined impact of applying FRS 102 and FRS 104 will promote the publication of useful and understandable interim financial information.

FRED 61 Draft amendments to FRS 102 – Share-based payment transactions with cash alternatives

FRED 61 was issued in April 2015 to address an FRS 102 implementation issue. It proposes a narrow scope amendment for share-based payment transactions with cash alternatives to achieve greater consistency with the equivalent requirements of IFRS 2 *Share-based Payment* and FRS 20 *(IFRS 2) Share-based Payment*, with the aim of improving the quality of financial reporting and reducing the cost of compliance with FRS 102 for these transactions.

FRED 61 is open for comment until 1 June 2015, and proposes that the amendment is effective for accounting periods beginning on or after 1 January 2015.

Influencing IFRS

Close to the finish line for a new leases standard?

By Annette Davis

In March 2015 the IASB finished its technical re-deliberations on the leases project and has given IASB staff approval to start the process of finalising the standard. It is expected to be published before the end of 2015 and will require lessees to recognise all lease assets and liabilities on the balance sheet and recognise amortisation of lease assets and interest on lease liabilities over the lease term.

Although this is a joint project with the FASB the two Boards have decided on two different approaches to lessee accounting. The FASB have decided to require lessees to account for leases that are already recognised on the balance sheet (i.e. existing finance leases) in the same way as for the IASB model. For leases that are not currently recognised on the balance sheet (i.e. existing operating leases) lessees will be required to recognise lease assets and liabilities and to recognise a single lease expense, typically on a straight line basis, over the lease term.

The IASB has recently published a project update. The IASB will not discuss the effective date of the standard until later this year. The IASB's policy is to set a mandatory effective date far enough into the future for jurisdictions to have sufficient time to incorporate the new requirements into their legal systems and preparers to have sufficient time to implement the new requirements. Our current expectation is that the effective date will not be before annual periods beginning 1 January 2019.

More information on the IASB's leases project is available at: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Pages/Leases.aspx

Will a new insurance accounting standard arrive soon?

by Seema Jamil-O'Neill

During 2014 the IASB has been re-deliberating the responses to the Exposure Draft it issued in June 2013. On current estimates a final standard is expected to be published in 2016, and will replace the existing standard IFRS 4 *Insurance Contracts*. The intention is to measure insurance contract liabilities consistently on a current value basis (currently, entities are permitted to grandfather their existing measurement basis).

In recent months, IASB has spent a considerable amount of time debating possible accounting solutions for contracts where provision of investment management and insurance services are interlinked (e.g. with-profits contracts). Often the insurer promises guaranteed bonuses to the policyholder under such contracts. A key characteristic is that the insurer does not charge a fee but instead participates in the returns on the management of financial assets. Such contracts tend to be long-term in nature with variable returns. This means that measuring and reporting the insurer's share of the return cannot be aligned with the general principle in the IASB's proposed standard that the insurer's profit is estimated upfront and recognised over the coverage period in a systematic way reflecting the transfer of service provided under the contract.

The European Insurance CFO Forum met with the IASB during November 2014 to note its concerns with the IASB's proposed accounting requirements in relation to participating contracts and to propose their own model. IASB's re-deliberations during 2015 have focussed on the best way to address the concerns they raised whilst still remaining consistent with the general accounting model for insurance contracts without participating contracts.

We have been closely monitoring the progress of this project and have undertaken a number of outreach activities with UK stakeholders. The results of these activities have been discussed with IASB members and staff, at the EFRAG Technical Expert Group which includes Anthony Appleton (Director of Accounting and Reporting Policy), and at the IASB's Accounting Standards Advisory Forum (ASAF) where Roger Marshall (Chairman of the Accounting Council) represents the UK.

IASB Disclosure Initiative

by Rosalind Szentpéteri

The aim of the IASB's Disclosure Initiative is to ensure that IFRS disclosures are relevant and provide material and useful information. This is closely aligned with the aim of the FRC's Clear & Concise initiative, which encourages improvement in the quality of financial reporting through a focus on clear communication, the application of materiality and the appropriate placement of information.

The IASB launched the Disclosure Initiative in response to feedback that while financial statements have been increasing in size, many users do not feel that all of the information provided is relevant, clearly communicated or easily understandable.

The Disclosure Initiative includes a number of sub-projects:

- The Principles of Disclosure project, which aims to develop a framework for disclosure;
- Following the completion of the Principles of Disclosure project, the IASB intends to perform a standards-level review of IFRS disclosure requirements to identify and assess conflicts, duplication and overlaps;
- A research project on how materiality is applied in practice in the financial statements;
- Proposed amendments to IAS 7 *Statement of Cash Flows*, introducing a new requirement for entities to disclose a debt reconciliation; and
- Implementation of narrow-scope amendments to IAS 1 *Presentation of Financial Statements*, to achieve short-term improvements and ensure that entities are able to use judgement when applying IAS 1. The revised standard has now been issued and is effective for annual periods beginning on or after 1 January 2016 with earlier application permitted.

As part of the FRC's influencing activities, the FRC has responded to the IASB's consultations relating to the Disclosure Initiative. These responses can be accessed here.

Principles of Disclosure

The IASB is drafting a discussion paper for the Principles of Disclosure project, which is expected to be published in Q4 2015. The development of a disclosure framework will be based on a review of the requirements of IAS 1, IAS 7 and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Principles of Disclosure discussion paper will propose objectives for disclosure, and principles for communication, cohesiveness and consistency, formatting and cross-referencing information.

In addition, the IASB will be considering further the concepts of 'presentation' and 'disclosure' in its Conceptual Framework discussion paper, which is expected to be published in Q2 2015. A clear definition of presentation and disclosure would enable the IASB to draw a clear boundary for the disclosure framework.

The FRC believes that the development of a framework for disclosure will result in improvements in the quality of financial reporting. We are encouraging the IASB to develop principles for disclosure that provide the flexibility for companies to communicate clearly and ensure that the information that is most important for investors is easily accessible.

Materiality

The IASB is drafting a practice statement that aims to provide practical guidance on the application of materiality. Appropriate application of materiality is essential for useful and relevant disclosure and ensuring that important information is not obscured. The draft practice statement is expected to be published for consultation in Q2 2015.

Debt reconciliation

The IASB has recently published an exposure draft proposing a new requirement in IAS 7 for entities to disclose a reconciliation of liabilities from financing activities (a debt reconciliation), in response to requests from investors and others for more information on debt and liquidity. This is discussed further in the following article.

Financial Reporting Lab

Following on from the Lab's work on reporting of cash and debt basics

by Sue Harding

One of the first series of topics tackled by the Lab in 2012 was reporting of cash flows, debt terms and maturity tables, and net debt reconciliations. These areas were discussed with the help of five companies and 19 investment organisations taking part in the Lab's work. Investors identified several voluntary reporting practices followed by companies that are helpful in communicating important information on these topics. The Lab shared these in three reports that provide practical illustrations and encourage companies to make improvements where applicable to their own context. These reports can be found <here>.

As noted above, the IASB has recently published an exposure draft proposing that all IFRS reporters disclose a reconciliation of financing liabilities showing changes in the balance sheet amounts over the period (a debt reconciliation), and additional information on the accessibility of reported cash.

Completing the picture

The balances for reconciliation under the IASB's proposal are identified as those 'for which cash flows have been, or would be, classified as financing activities in the statement of cash flows, excluding equity items.' Companies must already show a similar reconciliation of changes in equity items, so showing the same for debt helps complete the financing picture. While overall changes in cash flows are already captured in the cash flow statement, relating these to cash changes in debt and adding commentary about the accessibility of cash, also help to fill in the overall liquidity picture.

The FRC's response to the IASB at https://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRC-responds-to-IASB-Disclosure-Initiative-Pro-(1).aspx, encourages clarification that there is flexibility for companies to include the proposed debt reconciliation within the context of:

- an expanded 'gross' debt reconciliation: for example, companies may want to include in the reconciliation changes in accrued interest that may not be required under the proposal (ie interest paid may not be classified as financing); or
- a 'net' debt reconciliation: companies may elect to include changes in other components of what they manage as their measure of 'net debt', such as liquid investments, or make further adjustments to the reported amounts of debt. One example of this in the Lab's net debt report was BT's adjustment to reflect its hedging of the currency risk relating to foreign currency denominated debt.

Providing basic information on debt and cash flows

A company's debt and cash flows remain key areas that investors want to understand for their analysis of factors such as liquidity, leverage and refinancing risk, and valuation. Showing information clearly can save a company's current and potential investors and analysts critical time in getting to a comfortable level of understanding on the basics, clearing the way for greater focus on the key strategic issues and opportunities for a company.

Investors and analysts participating in the Lab's project indicated a need to satisfy themselves that they understand the cash and non-cash movements in net debt. Providing clarity in this area is particularly important when there is complexity in the changes occurring in the period, such as acquisitions, disposals, fair value accounting, and foreign currency fluctuations, as each of these are driven by different factors and are not usually made visible elsewhere.

The Lab found that investors are generally accepting of a company-defined net debt, but clear descriptions of the items included and showing how each relates to the balance sheet helps to anchor this approach as the starting point for the investors' own analysis. Similarly, information on the availability of cash or investments included in net debt, for example cash required for operational requirements or significant tax consequences of transferring cash within the group, is helpful to investors in considering the overall liquidity position from a holistic, or economic vantage point.

While many UK companies already produce a net debt reconciliation, investors in the Lab project encouraged more to do so, and all to ensure that in complex situations, different changes over the period and separate components of net debt are shown. The example below illustrates several of the potential elements, with the extent of detail being dependent on a company's own circumstances.

Example net debt disclosure

	Cash and cash equivalents	**Financial investments**	**Borrowings**	**Derivatives related to debt**	**Lease obligations**	**Net debt**
Balance at beginning of period	**XXX**	**XXX**	**XXX**	**XXX**	**XXX**	**XXX**
Cash flows	Xxx	xxx	xxx	xxx	xxx	xxx
Acquisition	Xxx	xxx	xxx	xxx	xxx	xxx
Disposal	Xxx	xxx	xxx	xxx	xxx	xxx
Fair value changes		xxx	xxx	xxx		xxx
Fair value hedge adjustments			xxx	xxx		xxx
Currency movements		xxx	xxx		xxx	xxx
Leases entered into					xxx	
Interest accruals		xxx	xxx		xxx	
Balance at end of period	**XXX**	**XXX**	**XXX**	**XXX**	**XXX**	**XXX**

Within the reconciliation above, the columns on borrowings, derivatives and leases (what could be considered gross debt) would likely become mandatory on the basis that cash flows that relate to them are (or will be) classified as financing, but the requirement to provide this debt reconciliation could be met through disclosure of the net debt reconciliation, providing the broader context of what the company manages using its own definition of net debt. Companies that currently provide a net debt reconciliation may already be supplying the elements of disclosure proposed by the IASB.

The Lab also found that relating net debt information to the corresponding IFRS amounts is a key concern for investors, and this would be inherent in the proposed reconciliation as it starts with the balance sheet amounts and relates them to cash and non-cash changes during the period. If approved, this would represent a significant step in requiring several aspects of the net debt reconciliation and related disclosure that the Lab's reports highlight as being important to investors, and that some companies already provide.

Current Lab Projects

The Lab is completing its first project on Digital Reporting, focusing on the Digital Present and how companies and investors are currently using digital means of communicating corporate reporting information. We expect to publish the report in May, and then turn to the Digital Future and what companies and investors may have as a vision for the future of digital reporting. The Lab also continues to develop its project on Disclosure of Dividend Policy and Capacity, and a series of Case Studies to support the FRC's initiative on Clear & Concise Reporting. To keep up to date on the Lab's current projects see

https://www.frc.org.uk/Lab/Current-projects

Corporate Reporting Review

by Carol Page

CRR is often asked how companies should respond when they first receive a letter from us. There are a number of good practices we have experienced which, if followed, tend to result in earlier closure of the matters under review:

- responses that address all of the questions raised;
- not just answering the question asked in our first letter, which is based on the accounts, but raising our understanding of the issue to that of the company;
- anticipating the next step and volunteering information and documentation likely to be helpful to our enquiry without being asked;
- responses that explain fully the board's judgements and how they comply with the requirements of IFRS;
- board and, where applicable, audit committee involvement;
- full and early engagement with auditors who can help facilitate discussion. Many of our enquiries result in agreed changes to the company's future reporting. The auditor's support for that resolution is important as any subsequent disagreement would be problematic;
- correspondence that clarifies that these parties have been involved; and
- a willingness to consider alternative viewpoints expressed by the FRC.

A comprehensive and thoughtful approach to a response to our first letter is an indication that the board is taking our enquiry seriously.

We expect boards to work cooperatively with the FRC in successive rounds of correspondence and any meetings that may be necessary, to ensure that users of the company's next accounts can rely on cases having been closed with issues satisfactorily addressed.

Spotlight on our Accounting Council

The FRC's Accounting Council has ten Members, including a mix of investor, company and auditor representatives and an academic. Starting with the November 2014 edition of this newsletter we are introducing the 10 members of the Accounting Council. They include:

Chris Buckley
Member

Chris Buckley has been Director, External Reporting at GlaxoSmithKline since 2001 and is responsible for the Group's annual and quarterly financial reporting to shareholders and for advising on technical accounting issues within the Group. Prior to 2001, Chris held a number of internal and external financial reporting roles within GSK and its predecessor companies. He is a member of the 100 Group Financial Reporting Committee and the Corporate Governance and Reporting Forum at the CBI. Chris is a member of the ICAEW, qualifying with KPMG in London.

Pauline Wallace
Member

Pauline Wallace is a chartered accountant who last year retired as a partner with PwC. She spent a number of years leading the global IFRS financial instruments expert team in the firm's Global Accounting Consulting Services (Global ACS) group and was a member of the Global ACS leadership team, with responsibility for developing the network's policy on financial instrument accounting issues. Subsequently she became the UK firm's head of public policy and regulatory affairs, leading their responses to government and other regulatory initiatives and representing the firm in matters of public policy. Prior to joining PwC, Pauline held various roles, including technical director of the Hong Kong Society of Accountants and senior IFRS technical partner at Arthur Andersen.

Open for Comment

UK GAAP

FRED 61: Draft amendments to FRS 102 – Share-based payment transactions with cash alternatives	comment period ends **1 June 2015**

IFRS

Classification of Liabilities (proposed amendments to IAS 1)	comment period ends **10 June 2015**

Recently Issued

UK GAAP

FRS 104: Interim Financial Reporting

Foreword to Accounting Standards

FRS 102 – Editorial amendments clarification statements

FRS 102 - Pension Obligations

IFRS

Investment Entities: applying the consolidation exception (amendments to IFRS 10, IFRS 12 and IAS 28)

Disclosure Initiative (amendments to IAS 1)

Project update: Leases: definition of a lease

Project update: Leases: practical implications of the new leases standard

Project update: Insurance contracts without participation features

Financial Reporting Lab

Case study report – William Hill accounting policies

Corporate Reporting Review

CRR AQR Priority Sectors