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1 April 2014

For the attention of Susanne Pust Shah
Financial Reporting Council
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Dear Sirs

Comment letter: FRED 54 Draft amendments to FRS 102: Basic Financial Instruments

We are pleased to comment on the FRC's recently issued exposure draft proposing amendments to FRS 102, specifically section 11, Basic Financial Instruments. We have commented on the questions posed in the consultation paper in turn below, but also have some overall observations.

We welcome the decision by the FRC to amend the Standard to permit more financial instruments, particularly bank loans, to be measured at amortised cost rather than fair value. Given that FRS 102 does not encompass the concept of embedded derivatives, the Standard as currently drafted will require a number of bank loans with features that are 'complex' as currently defined by the Standard but in practice are relatively common, to be measured at fair value in their entirety. This imposes more onerous measurement requirements on entities adopting FRS 102 than those adopting full IFRS, which in our view is entirely inappropriate.

Intercompany loan balances

Although it is not the subject of this consultation, we would also urge the FRC to reconsider the treatment of intercompany loan balances with a zero or below market rate of interest. As drafted, many companies will now have to impute an interest rate charge on long term intercompany loan balances which have previously been shown as interest free. It will often be quite difficult both to estimate the term of the loan (which in reality may continue to be rolled forward year on year with no formal repayment date agreed) and a market rate of interest for a similar loan.

Whilst we can see the rationale for this treatment where, for example, '0% finance' deals are provided by a motor dealership, in our opinion applying this treatment to intercompany balances is not meaningful. Moreover, it will be onerous to apply and many groups of companies will need to make significant adjustments at the date of transition to account for this. It is also possible to envisage a scenario where a parent company might take a different view as to the likely date of repayment from the subsidiary receiving the loan which would lead not only to differences on consolidation but also to difficulties for the auditors in determining which estimate was more reasonable. Whilst such differences would ultimately net out on consolidation in the group accounts there would clearly be issues for the parent and the subsidiary's own financial statements.

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Furthermore, the accounting for the balancing entry at the inception of the loan (or at the date of transition) is not clear. Per Staff Education Note 2 published on the FRC website, lending companies will recognise either a debit to profit or loss or a debit to cost of investment (which itself may then need to be written down). The recipient will recognise a credit to profit or loss or a capital contribution.

We would urge the FRC to consider including a specific exemption for long term intercompany balances to permit these balances to be measured at nominal value. If the FRC is not minded to consider this, then we believe more guidance is needed on the treatment of the difference between the initial amortised cost of the intercompany loan and its face value – i.e. when it should be recorded in profit or loss and when as an increase in cost of investment/ capital contribution – and also on how the term of the loan should be estimated when there is no formal agreed term and how a market interest rate could be determined. Including examples in the Appendix to section 11 would be useful.

1. **Do you support the proposal to amend the conditions of paragraph 11.9 and make the requirements less restrictive?**

As noted in our introductory comments, we agree with the proposal to amend paragraph 11.9 and therefore increase the range of financial instruments which will be accounted for at amortised cost. As originally drafted, the criteria for qualification as basic were far too restrictive and would have resulted in too many instruments that were in substance 'basic' being accounted for at fair value.

2. **In your view, under the amended conditions will debt instruments be classified appropriately, i.e. will the proposal have the effect that debt instruments that are basic in nature are measured at amortised cost and debt instruments that are non-basic in nature are measured at fair value? If you have reservations, please specify the financial instruments that you believe would not be measured appropriately under the proposed requirements.**

Because it will increase the range of instruments accounted for at amortised cost, and in particular the range of bank loans measured in this fashion, we believe that most debt instruments which are essentially 'basic' will be accounted for as such under the proposed amendments.

The main issue with the requirements as previously drafted was that some relatively common features of loan arrangements, such as caps and floors or contingent settlement provisions, meant that the whole instrument needed to be measured at fair value – the criteria were therefore too restrictive. Given that it is not usually possible for smaller entities to vary the terms of their loan finance as lenders will often not agree (or will impose charges for doing so) the changes to the requirements are a welcome practical step that reduces the burden on such entities.

We do believe it would be helpful for paragraph 11.11 to contain more examples of financial instruments that do not satisfy the conditions in paragraph 11.9 although this could be dealt with by the inclusion of additional examples in the appendix. In addition we believe there is a need for greater clarity as to what constitutes an 'observable index of general price inflation' for instance whether RPI would qualify as such. We would take the view that it does, but as currently drafted it would be possible for others to take a more restrictive view.

3. It is proposed that the appendix to section 11 *Basic Financial Instruments* will contain some illustrative examples. In your view, are the proposed examples helpful? If not, what other examples would you suggest are included instead?

Yes, the illustrative examples are helpful although we believe that adding further examples would be beneficial, given that the approach taken by the exposure draft is rules based rather than principles based. Example 3 as drafted is potentially confusing and could usefully be broken down into several different examples.

Whilst this does not specifically relate to the difference between basic and non-basic financial instruments, we would suggest that an illustrative example of how to account for a zero interest intercompany loan could also helpfully be included, with guidance on how the term of the loan and a market rate of interest can be estimated. Please see our further comments on this issue above.

4. The proposed amendments would be effective from 1 January 2015. Do you have reservations concerning the proposed effective date?

No, we believe that aligning the effective date of the amendments with that of the Standard is appropriate. However we do believe that once the amendment is finalised early adoption of the amendment should be permitted in order to allow any early adopters of FRS 102 to apply the amendments straight away.

We also believe that there need to be transitional provisions for early adopters, some of whom may have financial instruments classified as non-basic under the current version of FRS 102 and therefore measured at fair value that will be measured at amortised cost under the proposed amendments. We also believe that it should be permissible for instruments that would be measured at fair value under the previous version of section 11 but at amortised cost under the revised version to be retrospectively designated as at fair value through profit or loss although a time limit would need to be put on this retrospective designation.

5. The exposure draft does not contain specific transitional requirements and the requirements of Section 35 *Transition to this FRS* of FRS 102 will therefore apply. In your view, are any specific transitional provisions in relation to the proposed amendments necessary? If so, please tell us what transitional provisions you would suggest and why?

No, in our view there is no need for any specific transitional provisions other than as noted above.

We hope that our comments are useful to you. If you have any questions on the contents of this letter, then please contact Tessa Park.

Yours faithfully

KINGSTON SMITH LLP