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Our ref: NATS/DLW
Your ref: FRED 54

Financial Reporting Council
Aldwych House
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Dear Sir or Madam

FRED 54 – Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* Basic financial instruments

We welcome the opportunity to comment on the FRC's Exposure Draft, FRED 54 – Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* Basic financial instruments, ("FRED 54").

We support the objectives of FRED 54 to apply amortised cost to a wider range of debt instruments where this is the relevant measurement basis, to align more closely with the measurement requirements in IFRS 9 and to reduce the cost of compliance.

However, we are concerned that the proposals result in complex rules that may be difficult to apply in practice and may still result in some instruments being measured using an inappropriate basis.

In our view, an amendment to FRS 102 adopting an approach based on the principles in IFRS 9 would be preferable and, may be easier to apply than the proposed amendments to FRS 102. However, we note the Accounting Council's advice that such an approach was not considered appropriate while the principles in IFRS 9 remain untested and have therefore restricted our comments to the proposals as they are drafted.

We support the inclusion of examples to aid the application of Section 11, but consider that the examples in paragraphs 11.10 and 11.11 should also be included in the Appendix to Section 11. More examples, to illustrate the application of each of the conditions in paragraph 11.9 would assist in ensuring consistency in classifying financial instruments as 'basic' or 'complex'.

We support the proposed effective date but would welcome further transition guidance for early-adopters of FRS 102.

Our responses to the consultation questions are given in Appendix 1.

Please do not hesitate to contact me if you wish to discuss any aspect of our response.

Yours faithfully

D Wilcox

Donna Wilcox
Technical Senior Manager
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Question 1
Do you support the proposal to amend the conditions of paragraph 11.9 and make the requirements less restrictive?

We support the proposal to make the requirements less restrictive, but consider that the number of proposed conditions and terminology used will add complexity to the application of paragraph 11.9.

It is difficult to assess whether the rules-based proposals meet the objective in FRED 54 of aligning with principles-based measurement requirements in IFRS 9.

Question 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.

Our fundamental concern is that the conditions for a debt instrument to be classified as 'basic' are now so specific and detailed that they will be complex to apply in practice, and could result in instruments being measured at fair value when amortised cost would be more appropriate.

It is also unclear which are "and" conditions and which are "or" conditions.

We note the following in respect of the specific conditions in paragraph 11.9:

11.9(a) Examples of positive and negative rates

It would be clearer if the examples of positive and negative rates were given within, rather than at the end, of paragraph 11.9(a), as follows:

> "a combination of such a positive fixed rate and a positive variable rate (eg such as LIBOR plus 200 basis points) or a negative fixed rate and a positive variable rates (eg such as LIBOR less 50 basis points) but not a positive fixed rate and a negative variable rate (eg such as 500 basis points less LIBOR) ~~(eg such as LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR)"~~

11.9(b) 'general price inflation'

11.9(b) refers to 'a single observable index of general price inflation' which requires further explanation or guidance. In addition, 'general price inflation' may not exist for all currencies and may be difficult to apply to some currencies (such as the Euro) that are used by more than one country with different 'general price inflation'.

11.9(c)(ii) 'market rate'

A definition of 'market rate', used in 11.9(c)(ii), would aid application of the requirements. We note that the term 'market rate' is used in paragraphs 11.13 and 12.7 of FRS 102 in consideration of financing transactions.

In defining 'market rate', we would ask the FRC to consider including a market rate that satisfies condition 11.9(b) (i.e. a return linked to general price inflation) as well as a market rate that satisfies condition 11.9(a), as currently permitted in 11.9(c)(ii).

In our view 11.9(c)(ii) should be clarified to specify that the new rate must be a market rate at the date of the variation to the return and not at inception of the contract.

11.9(c) Application to premiums on redemption

The conditions in relation to variations of the returns to the holder only cover 'rates' so would not appear to apply to a debt instrument with contractual provisions where the premium on redemption depends on the term of the debt instrument. In our view, such instruments should be 'basic', but application of the conditions in 11.9(c) as currently drafted would appear to result in such instruments being 'complex'.

11.8(b) Debt instruments that cannot be 'basic'

Rather than 11.8(b) referring to a list of instruments, it would be clearer if the exclusion referred to 'stand-alone derivatives' with a definition of 'derivative' given in the glossary.

11.9(e) Prepayment options

We agree with the condition in 11.9(e) that debt instruments with *permitted* prepayment options subject to the conditions set out in 11.9(e) should be 'basic'. However, we also consider that debt instruments with *mandatory* prepayment options subject to the conditions set out in 11.9(e) should be 'basic'.

It would be useful to clarify that terms which require the issuer to compensate the holder for loss of interest apply to future interest.

In our view, contractual redemption premiums, other than compensation for loss of interest, should also be permitted within the conditions for 'basic' instruments where prepayment is at the option of the issuer.

Question 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 should be included instead?

We consider the use of illustrative examples to be helpful.

In our view further examples, to illustrate the application of each of the conditions in paragraph 11.9 would assist in ensuring consistency in classifying financial instruments as 'basic' or 'complex', such as an example to demonstrate the requirement of 11.9(c)(i) that the "variation of a return" cannot be contingent on future events. For instance, a loan where the interest rate changes on a fixed date, but the holder or the borrower can select from one of two alternative rates that both meet the conditions in 11.9, i.e. the "return" is contingent upon the choice of rate, but the "variation of the return" is not contingent (i.e. it occurs at a fixed date).

We would also suggest that the examples in paragraphs 11.10 and 11.11 should also be included in the Appendix to Section 11.

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

As noted in our response to FRED 51, we would favour a more stable platform and do not consider changes to the requirements of FRS 102 after the transition date for some entities to be helpful. Additionally, whereas FRED 51 proposes changes to the requirements when an entity chooses to apply hedge accounting, FRED 54 has broader consequences as it changes the mandatory requirements of FRS 102.

However, we recognise the need to amend the 'basic' conditions, so support an effective date of 1 January 2015 rather than a later date that results in entities having to reclassify instruments in their second set of FRS 102 financial statements, which would not be desirable.

Question 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?

We agree that transitional requirements are not generally necessary. However, we would ask the FRC to consider an optional exemption from full retrospective application for early adopters with debt instruments that have been measured at fair value, but that fall to be measured at amortised cost under the revised conditions for 'basic' instruments.

Whilst we appreciate that it was not the intention of FRED 54, it is unclear whether the FRC foresees any instruments moving from amortised cost to fair value measurement as a result of the proposed changes to the 'basic' conditions in FRS 102. If such occurrences are identified, we would recommend transitional guidance to address this scenario.