Smith & Williamson

25 Moorgate • London • EC2R 6AY
Phone: 020 7131 4000 • Fax: 020 7131 4001 • DX: 119507 Finsbury Square EC2
www.smith.williamson.co.uk

Susanne Pust Shah
Financial Reporting Council
Aldwych House
71-91 Aldwych
London
WC2B 4HN

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Dear Susanne

FRED 54 – Basic Financial Instruments

In the appendix to this letter we set out the response of Smith & Williamson to the Financial Reporting Council ("FRC")'s exposure draft of proposed amendments to section 11 of FRS 102 ("the standard") in respect of basic financial instruments.

We also take this opportunity to make the following observations about the requirements of section 11 for measuring basic financial instruments.

Financing transactions

We interpret the term "financing transaction" in the context of paragraph 11.13 as meaning both the broad range of debt instruments, from formal loan agreements to less formal arrangements such as intragroup borrowings, which include the right of the issuer to defer payment, and those circumstances arising from trading and similar situations in which credit is extended beyond a normal settlement period. However we believe that the express inclusion in paragraph 11.13 of the example of the sale of goods or services on extended credit beyond normal business terms or at a non-market interest rate, without any further clarification of the range of more normal loan arrangements which nevertheless fall within the term "financing transaction", may cause a narrower definition to be inferred.

We would ask the FRC to consider clarifying the wording of this paragraph to avoid confusion. This may be achieved by the inclusion of the examples in Staff Education Note 2 *Debt instruments – amortised cost* ("SEN 2") in the examples in the proposed appendix to section 11.

Intragroup loans at zero or below market interest rate

We accept that if fixed or planned intragroup loan repayment terms exist, the arrangement would be considered a "financing transaction" and the amortised cost can be calculated using an estimated market rate. However in many cases repayment terms between group entities can be informal or open-ended, and this may lead to confusion about how such arrangements should be treated. Whilst it is generally accepted that these be considered as repayable on demand, the circumstances of the borrower may suggest that, in substance, there is no possibility of repayment for the foreseeable future and that a long term loan exists.

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In such cases the estimate of the life of the loan may be highly subjective, may differ between lender and borrower and could, potentially, be problematic for auditors to confirm as reasonable.

We would therefore ask the FRC to provide more comprehensive guidance as to the types of intragroup financing transactions to which paragraph 11.13 would apply.

Rates of interest above a market rate

It is conceivable that a rate of interest in a financing transaction may be above a market rate. The guidance in SEN 2 suggests that the FRC only intends paragraph 11.13 to apply to situations where the rate is below a market rate, whereas paragraph 11.13 uses the expression "not a market rate". We believe that this should be clarified in the standard with perhaps an example of how the differences between amortised cost and the actual cash transferred should be accounted for in such situations.

If you require any clarification of our response please contact James Lole.

Yours sincerely

Smith & Williamson LLP

Smith & Williamson

Appendix

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 amend the conditions of paragraph 11.9 and make the requirements less restrictive.

Question 2

In your view, under the amended conditions will debt instruments be classified appropriately, ie 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.

We believe that the amended conditions will result in more debt instruments being correctly classified as basic, particularly with regard to typical situations such as embedded caps and collars and those with commonplace early settlement provisions.

However, we believe that there will still be financial instruments where the treatment will be problematic under the amended conditions. An example, which is common amongst our registered providers of social housing ("RP") client base, is where a long-term loan with a floating interest rate is hedged with a "callable" swap (either embedded or standalone) giving the holder the ability to break the swap at set points in its life with no conditions attached. The holder then has the ability to reset the interest rate.

Our understanding is that, where such swaps are embedded into the loan, the loan will not comply with the amended conditions, because:

- the variation in the return to the holder is contingent on a future event (ie whether or not the holder chooses to exercise its option);
- the contingency is not linked to a change of a contractual variable rate;
- the contingency is not there solely to protect against credit deterioration of the issuer; and
- the new rate post the exercise of the option would not necessarily be market rate at that point.

Consequently paragraph 11.9(c) is breached and the whole instrument is classified as "other".

In practice, there has been much debate on this paragraph within our client group. The debate centres on whether or not an option in the hands of the holder to vary the return would by itself indicate that the variation in return was contingent. This would imply that where the option provides choice over the rate at some point in the future, unless that new rate has to be market rate as at the date the choice is exercised and the current rate is not influenced by that choice, it would fail the test in paragraph 11.9(c). It would be helpful if the FRC clarified this point, and if paragraph 11.9(c)(ii) was amended to clarify that the new rate should be a market rate as at the date of the change.

We also think it would be helpful if the FRC clarified whether they intend that the decision as to whether an instrument is "basic" or "other" is necessarily symmetric. For example, if the instrument is "basic" as far as the issuer is concerned, should it necessarily be "basic" from the perspective of the holder? In our view, it might be sensible for the treatment to be different where options are present: where the choice lies with one party it might be "basic" in their books, if it otherwise meets the necessary conditions, but could at the same time be "other" in the other party's books because the variation in return is not at their discretion. This potential interpretation is not presently consistent with the phrasing in FRED 54. Instead, in our view, most if not all optionality will result in the instrument being treated as "other", because it results in a conditional return. Only if that return is necessarily market rate would it still be classified as "basic", which is unlikely given that the cost of the instrument will have been varied initially precisely because the option has been granted.

We also believe that the references to "condition (a)" used in paragraph 11.9(c) should be changed to "condition (a) or (b)", as there may be instances where long-term loan arrangements allow the parties to switch between fixed, variable or inflation-linked interest rates.

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?

The proposed examples are helpful, although we doubt that examples 4 to 6 are common. Instead there is a range of more complex instruments which are more frequently encountered where the accounting treatment could usefully be indicated in an example.

We would recommend that the example of an intragroup loan at zero interest contained in SEN 2 is also included (including the suggested accounting entries).

It may also be helpful to explain the accounting entries where such a loan is between two fellow subsidiaries, or from subsidiary to parent, such that capital contribution and cost of investment are not appropriate accounting entries.

Question 4

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

We have no reservations concerning the proposed effective date.

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?

Early adopters

We would suggest the inclusion of transitional provisions for entities which have early-adopted FRS 102. Such entities should have the ability to retrospectively designate a financial instrument at fair value through profit or loss where it has already classified an instrument as "other" on early adoption of FRS 102, and the instrument would be classified as "basic" under the amended requirements.

Transition provisions for hedge accounting

Many preparers may be looking to apply hedge accounting; however the delay in finalising the classification of "basic" and "other" financial instruments arising from this exposure draft will mean that these entities may not have the necessary documentation in place at the date of transition, which may have already passed. In such cases we believe that retrospective hedging documentation within a reasonable period should be permitted.