Chartered Accountants Ireland

Chartered Accountants House
47–49 Pearse Street
Dublin 2

Tel +353 1 637 7200
Fax +353 1 668 0842
Email ca@charteredaccountants.ie

www.charteredaccountants.ie

Susanne Pust Shah
Financial Reporting Council
Aldwych House
71-79 Aldwych
London
WC2B 4HN
United Kingdom

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Dear Susanne

RESPONSE OF THE ACCOUNTING COMMITTEE OF CHARTERED ACCOUNTANTS IRELAND

FRED 54: Draft Amendments to FRS 102 – Basic financial instruments

The Accounting Committee (AC) of Chartered Accountants Ireland welcomes the opportunity to comment on the Financial Reporting Exposure Draft (FRED) containing the proposed amendments to the FRS 102 in relation to basic financial instruments.

The responses to the individual questions posed in the ED are included in the appendix to this letter.

Common financial instruments

AC welcomes FRC's proposals intended to reduce the need for businesses to measure debt instruments at fair value, by making the conditions for basic debt instruments less restrictive and aligning the measurement requirements of FRS 102 more closely with IFRS 9. AC notes that, as stated in paragraph 17 of the Accounting Council's advice to the FRC, under the FRED 54 proposal, "common financial instruments will be permitted to be measure at amortised cost, where measurement at amortised cost is appropriate". AC recommends that the FRC and the Accounting Council should actively monitor whether this outcome is achieved, particularly in the event that the typical terms and conditions, of what should be regarded as **common** debt instruments, change to reflect market and banking practice.

Definition of 'fair value'

The definition of 'fair value' as set out the FRS 102's Appendix I: Glossary is the definition that was included in IFRS's IAS 39 *Financial Instruments: Measurement* prior to the issuance of IFRS 13. IFRS 13 (effective from 1 January 2013) introduced an updated definition which is (with limited exceptions) used when fair value measurements are required by other IFRS standards. AC would welcome the alignment of FRS 102 to the new IFRS 13 in relation to the definition of fair value to thereby avoid inconsistencies arising.

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AC would welcome clarification as to which definition of fair value is applicable where an entity applying FRS 102, has, in accordance with Section 11.2(b) opted to make a policy election to apply 'the recognition and measurement provisions' of IAS 39 to its financial instruments (rather than apply the provisions of Section 11 and 12). In that instance, it is unclear whether that entity should apply FRS 102's fair value definition or the IFRS 13 definition. If it is the former, it would appear to create a potential inconsistency between the measurements that an entity uses, compared to the measurements that would arise if it were to instead *directly* apply EU IFRS, which encompasses IAS 39 and IFRS 13.

Ideally, AC would prefer to see the definition of fair value within FRS 102 updated to the wording set out in IFRS 13 so that entities applying (i) FRS 102 (regardless of policy choice taken in section 11 of that standard), (ii) FRS 101 and (iii) IFRS would then all be using the same fair value definition. At a minimum, as explained above, AC would welcome clarification on the appropriate fair value definition to apply when taking the IAS 39 accounting policy choice within FRS 102.

Should you wish to discuss any of the views expressed, please feel free to contact me.

Yours sincerely

Mark Kenny
Secretary to the Accounting Committee

<u>**Appendix**</u>

Question 1

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

AC supports the approach proposed in the above paragraph.

AC would note, however:

(i) *All conditions to be met/not breached*

It would be helpful if the first line of the paragraph was clear that in order for an instrument to meet the test of basic debt instruments, ALL the conditions (a) to (e) need to be satisfied/not breached. The reference to 'satisfies all' has been deleted in the Exposure Draft (ED).

(ii) Maturity date necessary?

It is not necessarily clear that an instrument must have a maturity date. It appears implicit as it is referred to in condition (c), but it might be helpful to revisit this to ensure it is clear.

However, this raises a question as to whether perpetual instruments qualify as basic debt instruments. AC notes that the IFRS Foundation's 'Training Material for the IFRS for SMEs' (version 2013-1) included guidance on applying Section 11, with example 28 illustrating the application of the basic debt definition to a perpetual instrument. It concluded that the basic debt definition could potentially be met for both the holder and the issuer; in particular it noted that 'the fact that there is no right to receive a return of principal does not in itself result in the instrument being within the scope of Section 12.' While AC appreciates that the IFRS for SME's definition of a basic definition is not aligned to that even in the current FRS 102, they both contain the same provision in section 11.9(b) which requires that: 'There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods.....' AC is unclear if this criterion is met in the context of a perpetual instrument and would welcome clarification on this point, perhaps by the inclusion of an example in the Appendix to Section 11.

(iii) Acceptable variable rates

Paragraph 11.9's condition (a) allows tor the return to be a variable rate defined as:

'a rate equal to a single referenced quoted or observable interest rate (eg LIBOR).'

Example 2 in paragraph 11A.2 deals with a fixed interest rate loan for an initial tie-in period, with the rate reverting to 'the bank's standard variable interest rate' after that

point. This example goes on to comment that 'since the new rate (ie the bank's standard variable rate) meets the condition of paragraph 11.9(a), paragraph 11.9(c)(i) (relating to allowing return variations during the life) is met'. The example is therefore concluding that a bank's standard variable rate is 'a rate equal to a single referenced quoted or observable interest rate (eg LIBOR)'.

There is clear market evidence over the past few years that banks with higher arrears rates can have higher variable mortgage rates, with certain lenders charging higher variable rates to compensate for the losses they are making on products such as tracker loans. From the point of view of a borrower, its interest rate may therefore vary dependent on the changing credit risk of its own lending bank. While AC supports such a borrower being in a position to treat its bank loan liability as a basic debt instrument, it would appear to raise a question as to whether this approach (of accepting adjustments for the lender's credit risk) might have a wider application.

For example, corporate groups may have a treasury company subsidiary which lends money to group subsidiaries. The interest rates charged may be adjusted at the discretion of the lender, in accordance with the contractual terms, if, for example, the group's overall borrowing rate (arising from either bank loans or in the listed debt market) changes. Would those intercompany loans be considered basic?

In addition, some loan agreements have a term which allows the lender to increase the rate on a loan if there is an increase in the lender's cost of funding. If it is considered acceptable to permit a variation based on movements in the lender's credit risk (provided that it was an increase in the bank's standard variable rate), would it also be permissible to permit such increases based on a bank's funding costs (provided it was an increase applied in general to existing/new borrowings)?

There is significant scope for abuse if this extension is not clearly circumscribed. AC has sympathy with permitting a financial institution's standard variable rate to be considered basic but believes that it must be clear that it must be a rate that is observable in the market and offered to various borrowers.

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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?

AC is of the view that overall, but subject to the points noted in response to Question 1 and one additional point below, the proposals will more appropriately delineate what is basic in nature from what is not.

Non-convertible preference shares

However, there is one additional area (preference shares) to which AC would like to suggest a revision that, in its view, would further improve the position. Paragraph 11.8(d) includes in its definition of a basic instrument 'an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares.' AC notes that these shares are not eligible for consideration as a basic 'debt' instrument under paragraph 11.9. Therefore, despite being considered 'basic', paragraph 11.14(d) requires these instruments to be measured fair value through profit or loss, if the shares are publicly traded or their fair value can otherwise be measured reliably. All other such investments shall be measured at cost less impairment. AC also notes that paragraph 11.14(d) refers to paragraphs 11.27 to 11.32 for guidance on how to determine fair value with those paragraphs providing measurement guidance on using quoted prices, recent transactions and valuation techniques.

This definition (in paragraph 11.8(d) and its linkage through to paragraph 11.14(d)) would appear to include within its scope standard redeemable preference shares with a fixed maturity and fixed coupon. AC is unclear why non-convertible preference shares which, for example, have a fixed rate of return and fixed maturity date, could not instead be included as part of the 'basic *debt*' category under paragraph 11.9 and thus carried at amortised cost. In particular:

(i) AC is of the view that the terms of a standard redeemable preference share are relatively simple and regularly arise in group situations. In most cases, therefore, it would seem feasible to determine a reliable measure of their fair value, thus requiring many private companies to fair value these financial assets. The 'basic debt' category includes many instruments that are publicly traded and easily measured at fair value. For example, government treasury bills and debt securities issued by another company are often traded in an active market. However, their liquidity factor does not result in these instruments being put into the fair value measurement category under FRS 102. Therefore it is unclear why preference shares might not also be included at amortised cost if they met the qualifying criteria of a basic 'debt' in accordance with paragraph 11.9

(ii) The fact that the legal form of the instrument is shares (and not a 'debt') does not, in AC's view, seem an appropriate basis on which to determine that these require

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fair value measurement. Furthermore, but subject to the clarification requested below, it would be helpful in group scenarios if it was feasible for both the holder and the issuer of such an instrument to be able to apply consistent (amortised cost) accounting.

Similarly, AC is unclear if the issuer of these preference shares (fixed coupon, fixed maturity) can qualify for amortised cost accounting. It would seem clear under Section 22 of FRS 102 that the shares qualify as financial liabilities. However, the paragraph 11.9 criteria that are to be applied to achieve amortised cost accounting are said to apply to *debt* instruments. As noted above, redeemable preference shares are not, in legal form, debt instruments. AC would therefore suggest that the wording in paragraph 11.9 (and related paragraphs) be revised to instead be clear that any instrument that was (i) a liability in accordance with Section 22 and (ii) falls within the general scope of Section 11 generally would at least be eligible for testing under the paragraph 11.9 criteria to see if amortised cost accounting is feasible.

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?

AC finds the inclusion of examples helpful to illustrate the application of the various 'basic debt' criteria of Section 11. It would be helpful to consider including a basic debt instrument that includes a prepayment option to illustrate what is a reasonable compensation for 'loss of interest' as now referred to in paragraph 11.9(e).

In particular it would be helpful if that example was clear that the compensation paid to the lender for 'lost interest' is calculated as being a product of the principal amount prepaid, multiplied by the interest rate differential. That differential is usually the excess of the effective interest rate on the original loan over the effective interest rate that the lender would receive at the prepayment date if it re-invested the principal amount prepaid in a similar contract for the remaining term of the original loan. This would be helpful in demonstrating that the prepayment penalty is compensating the lender for loss of interest by reducing the economic loss from re-investment risk.

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Question 4

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

For first time adopters of FRS 102 in 2015

AC is supportive of setting the above effective date. AC notes that for entities moving to FRS 102 at the overall standard's mandatory application date (annual periods beginning 1 January 2015), it will be helpful to have the ED's less restrictive provisions available at that time.

Early adopters of FRS 102 – in 2014 or prior

It would, however, also be helpful to clarify the position for an entity that has opted to early adopt FRS 102 from 1 January 2014 (or prior periods). In that situation, an option to early adopt the ED's provisions may be helpful. It is worth noting that as the ED will not be finalised for a number of months, AC is of the view that an entity may have already prepared its 2014 half yearly report under the current version of FRS 102 and therefore it would not be appropriate to *require* the implementation of the ED in 2014, i.e. the general effective date of 1 January 2015 should be the mandatory 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?

First time adopters of FRS 102

AC is of the view that for first time adopters of FRS 102 no specific transitional provisions are needed.

Current FRS 102 users

Where an entity has already applied FRS 102 (in 2014 or prior) and is, say in 2015, applying the ED's requirements for the first time, the finalised ED will need to include provisions in its updated Section 11/12 of FRS 102 on how transition to the updated requirements is to apply. Retrospective restatement would appear to be a reasonable approach in accordance with Section 10, '*Accounting Policies, Estimates and Errors*', paragraph 12. This could perhaps be included in Section 35 in order to keep all transition issues together.