24 April 2014

Our ref: 57/14

Your ref: FRED 54

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Dear Susanne

FRED 54 *Basic financial instruments*

ICAEW is pleased to respond to your request for comments on FRED 54 *Basic financial instruments.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

FRED 54 BASIC FINANCIAL INSTRUMENTS

Memorandum of comment submitted in April 2014 by ICAEW, in response to FRC's exposure draft FRED 54 *Basic financial instruments* published in February 2014.

Contents

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft FRED 54 *Basic financial instruments* published by the FRC on 13 February 2014, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

We generally support the proposed amendments

5. We are generally supportive of the proposed amendments and are pleased to note that many relatively straightforward debt instruments – such as loans with embedded interest rate caps or floors or with stepped interest rates or certain prepayment provisions – will now qualify to be measured at amortised cost as we believe that this model adequately reflects the risks associated with such instruments. We are pleased to note that classification as basic under the proposals is not just because the instruments are relatively common in practice.

Some instruments may still be misclassified

6. On the whole, we feel that the proposals draw the line between basic and non-basic debt instruments in a sensible place. However, we are concerned that some instruments – including those with repayments that are linked to inflation, with mandatory cost adjustments or with certain prepayment features – may still be accounted for in an inappropriate manner. See our answer to question 2 below for more details.

More examples would be helpful

7. The addition of the appendix of illustrative examples is helpful and should aid understanding of the requirements of the standard. However, we believe that the examples can be improved further. Moreover, additional examples would also be useful. See our answer to question 3 below for more details.

Transitional provisions are needed for early adopters

8. We agree that generally there is no need for transitional provisions. However, as explained in our answer to question 5 below, we believe that there are some specific instances where such provisions may be necessary.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

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

9. Yes. We support the proposed amendment as the original conditions that debt instruments had to meet before they could be classified at amortised cost were too restrictive and would have resulted in all but the most rudimentary of debt instruments being measured at fair value. Moreover, the original drafting would in many cases have resulted in debt instruments that would be measured at amortised cost under IFRS being fair valued under UK GAAP. Implementing FRS 102's original requirements would not only have been disproportionately onerous for many relatively simple businesses but also would not have necessarily provided users of the financial statements with the most relevant information.

10. We believe that the amortised cost model should be available where it adequately reflects the risks associated with the instrument. We are therefore pleased to note that many relatively straightforward debt instruments – such as loans with embedded interest rate caps or floors or with stepped interest rates or certain prepayment provisions – will qualify to be measured at amortised cost under the proposals.

11. We generally prefer standards that provide principles-based solutions to those that contain a series of detailed rules. It is therefore, in many ways, regrettable that the proposals follow the latter approach. However, we agree that in this instance – on balance – a rules-based approach may be the best option as it should lead to greater consistency in practice.

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.

12. Generally we feel that the proposals draw the line between basic and non-basic debt instruments in a sensible place. However, we are concerned that some instruments may still be accounted for in an inappropriate manner.

a) Inflation linked debt

13. Paragraph 11.9(b) allows repayments of principal and/or interest to be linked to a single observable index of general price inflation of the currency in which the instrument is denominated. While we welcome this proposed amendment, we believe that further clarification is needed on a number of points to ensure that the board's intended outcome is achieved in practice.

14. Referring to an 'observable index of general price inflation' may seem innocuous at first glance but in reality it may be more challenging than it appears. While most people would agree that the consumer price index (CPI) would qualify as an observable index of general price inflation and that something like the UK Land Registry House Price Index (HPI) would not, there is potentially a grey area in between. For example, while we believe that the Retail Price Index (RPI) is an observable index of general price inflation, others may take a contrary view.

15. We also have concerns about the reference in paragraph 11.9(b) to 'the currency in which the instrument is denominated'. While this will not present a problem where the instrument is denominated in sterling, it could – in some instances – be more challenging if the instrument is denominated in other currencies.

16. The position is particularly unclear where the instrument is denominated in euros. The current drafting seems to suggest that it would it be acceptable to classify an instrument as basic if repayments were linked to the inflation rate of any country in the eurozone. But it would make little sense, for example, for repayments on a loan issued by a bank in Germany to a UK business with operations in France to be linked to the inflation rate in Greece and therefore such instruments should naturally be classified as non-basic. In our view, inflation linked euro-denominated instruments should be classified as basic only when they are linked to a suitable measure of the eurozone inflation rate – such as the Harmonised Index of Consumer Prices or HICP – or when there is a good business reason for repayments to be linked to a particular eurozone country's inflation rate. In our view, the reason why such an instrument does or does not qualify as basic should be clearly disclosed.

17. There is also some uncertainty about instruments denominated in other foreign currencies. For example, a UK company may take out a US dollar loan from a UK bank either because it has operations in the US or because one of its businesses operates in an industry where transactions are denominated predominantly in US dollars. We believe that such a loan should be basic if repayments are linked to the US inflation rate but non-basic if they are linked to the UK inflation rate. The current drafting appears to suggest that this would be the case but it is not entirely clear.

18. In our view instruments where the link to inflation is leveraged should not qualify as basic and should therefore be measured at fair value rather than amortised cost. The current drafting does not specifically mention leverage and it would appear that such instruments would be classified as basic. We would suggest amending paragraph 11.9(b) so that it reads 'linked to a single observable index of general price inflation of the currency in which the instrument is denominated provided that link is not leveraged'. If the board were to adopt this suggested amendment, it would also be helpful to add a definition of leveraged to the glossary ie, a multiple of more than one.

19. Finally, it is unclear whether paragraph 11.9(b) permits a positive variable rate such as LIBOR to be linked to an index of general price inflation. The current drafting would appear to allow a variable rate to be leveraged for inflation as the variable rate already compensates for the nominal time value of money. It may be helpful to expressly state that the inflation link can only be applied to the principal and/or a fixed rate of interest.

20. Adding further examples to the appendix that deal with the scenarios described above would be helpful. We would particularly encourage the board to include an example of an instrument with repayments linked to the RPI and one or two examples of instruments denominated in euros.

b) Prepayment options

21. In some instances the contractual terms may require the issuer to pay an amount in excess of both its fair value and its carrying amount if they wish to prepay a debt instrument before maturity. In our opinion, if the holder can require the issuer to make such a prepayment then the instrument should be classified as non-basic as the issuer will be required to do more than simply compensate the holder for loss of interest as a result of early termination. Conversely, where the prepayment is entirely at the option of the issuer, we believe that the instrument should be basic regardless of the size of any penalty payment.

22. We are pleased to note that paragraph 11.9(e) makes it clear that certain prepayment options do not in themselves prevent instruments from being classified as basic. However, we suggest that the final sentence of this paragraph is amended to clarify that contractual prepayment provisions will not prevent an instrument from being classified as basic where the holder can only require prepayment of an amount that compensates them for loss of interest as a result of early termination or where the prepayment is entirely at the option of the issuer.

23. Adding further examples of prepayment options – such as where the holder can require early repayment in the event of credit deterioration of the borrower or where the borrower can choose to prepay voluntarily – to the appendix would be helpful.

c) Mandatory cost adjustments

24. Our understanding is that a significant number of debt instruments contain clauses – sometimes referred to as mandatory cost adjustments – that allow a bank to pass on to the borrower some or all of any additional costs levied against it by the Bank of England. Other instruments contain similar clauses that allow changes in the bank's return if there are changes in relevant tax legislation. Under the proposals it would appear that such instruments would be classified as non-basic whereas we believe that the risks associated with them are more akin to basic financial instruments.

25. We therefore suggest that the board extend paragraph 11.9(c) to add additional sub-clauses allowing a variation in the return of the holder where the variation is not contingent on future events other than 'changes in levies applied by a central bank' or 'changes arising from changes in tax legislation'.

26. A related change to paragraph 11.9(e) – which already mentions changes in tax legislation – would also be needed as a consequence of our suggested amendment to paragraph 11.9(c) as the issuer may wish to repay the debt early due to additional costs being levied.

27. Inclusion of a specific example in the appendix dealing with a variation of the return of the holder due to a change in bank levies would also be helpful.

d) Other common instruments

28. Some respondents will no doubt call for the availability of the amortised cost model to be further extended. However, when considering their petitions, the board should remember that just because an instrument is relatively common in practice does not necessarily mean that it should be classified as basic and measured at amortised cost.

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?

29. Yes. The addition of the appendix of illustrative examples is helpful and should aid understanding of the requirements of the standard. However, we believe that the examples can be improved further. Moreover, additional examples would be useful.

30. Currently examples of what is and isn't a basic financial instrument appear in a number of places within the text of the standard (eg, paragraphs 11.5, 11.6, 11.10, 11.11) as well as in the appendix. This is, perhaps, a little confusing and we feel that it would be better if all of the examples were housed in the appendix. However, if this approach were adopted, we would suggest that the appendix becomes an integral part of the standard rather than something that simply accompanies it.

31. Many of the examples that currently appear in the body of the standard are retained from the IFRS for SMEs but, unfortunately, in a number of instances these are too simplistic. For example, listing 'loans from banks' in paragraph 11.10 as something that would normally be considered basic is not particularly helpful and may be misleading given that in a number of circumstances bank loans will be classified as non-basic. These examples should either be deleted or moved to the appendix where additional explanatory text could be added to properly explain the conclusions that have been reached.

32. Some of the examples currently introduce new principles or definitions eg, example 4 attempts to define leverage. Care should be taken to ensure that principles or definitions are included in the body of the standard rather than within the examples.

33. The examples included in the appendix could, in some cases, be improved:

- Examples 1, 4, 5 and 6 are good as they are clear, simple and address only a single issue.
- Example 2 is less clear as although it states that unless there are indications to the contrary it can be assumed that a bank's standard variable rate would 'under normal economic conditions not fall below 0%', it does not go on to explain what would happen if in abnormal circumstances we expect it to go negative or if it does indeed go negative. In such circumstances would the instrument cease to qualify as basic and have to be reclassified from amortised cost to fair value as there would be a loss of principal which would breach the requirements of paragraph 11.9(d)? And, if so, how would one account for this reclassification? Our view is that loans with potentially negative interest rates should not be precluded from amortised cost treatment.
- Example 3 is also a little confusing as it combines a number of different factors into one scenario. It may be clearer to break this down into more than one example in order to make the logic clearer and easier to understand.

34. We have already highlighted a number of additional examples that we think could usefully be added to the appendix in our response to question 2 above. The board may also wish to add additional examples explaining the appropriate classification of instruments with stepped interest rates or extension options.

35. It may also be helpful to restructure the appendix so that it is divided into two sections – the first containing examples of instruments that qualify as basic and the second containing examples of instruments that do not. This would make it easier for readers to navigate their way through the examples.

Question 4

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

36. We are happy with the proposed effective date of 1 January 2015 provided that early adoption is allowed. It is, however, essential that the final requirements are finalised as soon as possible to enable entities time to prepare for transition.

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?

37. We agree that generally there is no need for transitional provisions. However, as explained below, we believe that there are some specific instances where such provisions may be necessary.

38. We note that some entities will have adopted FRS 102 early and will therefore already be applying the standard. They will therefore already be using the existing requirements of paragraph 11.9 and may find that certain instruments need to be reclassified from fair value to amortised cost when the amendments become effective. While we appreciate that entities will be required to follow the requirements relating to changes in accounting policy in Section 10 of FRS 102, for the avoidance of doubt, transitional provisions for such entities would nonetheless be welcomed. We also suggest that early adopters that do not want to reclassify such instruments are allowed to designate them at fair value through profit or loss retrospectively provided the requirements of paragraph 11.14(b) are met.

39. We also have concerns in relation to the application of the fair value option by entities transitioning to FRS 102 for the first time. Paragraph 35.10(s) states that designation at fair value through profit or loss can be made only on initial recognition or at the date of transition. As in most instances this date has already passed, this may cause a problem as those entities which assumed that they didn't need to apply the fair value option to particular instruments (as they would already have been measured at fair value under the existing requirements) may not only find that these items are now measured at amortised cost under the new rules but also that it is too late to designate them at fair value through profit or loss. We suggest that, in such cases, an entity should be able to designate an instrument at fair value through profit or loss retrospectively provided that this is done by the later of 12 months after its date of transition or three months after the standard has been finalised.

40. Similar issues may arise where an entity decides that it wants to apply cash flow hedge accounting to an instrument that is now measured at amortised cost under the new rules but which would have previously been measured at fair value and hence would have been ineligible for this treatment under the old rules. As the entity would not have had its hedging documentation in place at the date of transition, it would not qualify for hedge accounting. The board needs to make it clear – either in this amendment or the hedging amendment – that documentation can for a limited time effectively be back dated in such situations.

41. While we presume that the amendments are intended to be applied fully retrospectively, this is not explicit. We recommend that the final standard makes this clear.

Additional comments

Definition of a variable rate

42. We believe that the proposed definition of a variable rate – which, confusingly, appears at the end of paragraph 11.9(a) as well being added to the glossary – is not very helpful as it is counter to what most people would understand this term to mean ie, it would be reasonable for someone to assume that a variable rate is any rate which varies over time. It would therefore be helpful if the standard made it clear that it is referring to a more narrowly defined subset of variable rates. This could be done by using a term such as 'basic variable rates' rather than simply referring to 'variable rates'.

43. We also believe that the current definition is drawn too narrowly as it appears that loans with repayments linked to inflation would not currently qualify. Moreover, unless the definition is revised there would be inconsistencies between it and its use in other places in Section 11 eg, paragraph 11.19.

44. We therefore suggest revising the definition so that it reads 'a [basic] variable rate is a rate which varies over time and is linked to a single observable interest rate or a single observable index of general price inflation of the currency in which the instrument is denominated provided that link is not leveraged' and deleting the sentence from the end of 11.9(a).

Use of the term derivative

45. There seems to be a reluctance to use the term 'derivative' within the standard which does not seem to be justified. For example, paragraph 11.8(b) would be far clearer if it ended '…and is not a derivative' rather than with '…and is not a financial instrument described in 11.6(b).' This seems odd as derivative is a defined term within FRS 102.

Paragraph 11(c)

46. We suggest paragraph 11(c)(ii) is changed to ‘the new rate is a market rate of interest at the date of change and satisfies condition (a) or (b)’. In addition, we suggest that paragraph 11.9(c)(i) also refers to ‘condition (a) or (b)’.

47. The ‘date of change’ reference adds clarity and should be included for the avoidance of doubt.

48. The addition of the ‘or (b)’ references could have key consequences for businesses with long-term loan agreements that allow the parties to switch between variable, fixed or inflation linked interest rates. Without the ‘or (b)’ references, businesses with such loans – which we understand include a large number of housing associations – would find that they have to be classified as non-basic and measured at fair value rather than at amortised cost.

Intercompany loans at zero or below market interest rates

49. Although not specifically related to this consultation, we suggest that the board considers issuing further guidance on the treatment of intercompany loans at zero or below market interest rates that do not have a fixed term as there is some confusion about how such arrangements should be treated. Our view is that such loans should be treated as repayable on demand and measured at nominal value unless there are contractual terms that indicate otherwise. In the absence of any such terms, we believe that discounting generally should not be necessary.

50. Adding examples to the appendix to Section 11 showing when discounting would and wouldn’t be necessary may be one way of providing clarity. These examples – which we suggest should illustrate the position from the perspective of both parties to the transaction – could also usefully provide further guidance on what to do with the difference between the amortised cost of the intercompany debt and the actual cash transferred ie, they could illustrate whether it should be taken to profit or loss or treated as a capital contribution (as is the norm for shareholder transactions).

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