IRISH FUNDS
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ASSOCIATION

Susanne Pust Shah,
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30 April 2014

Dear Susanne,

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

Further to your invitation to comment on FRED 54 "Draft Amendments to Financial Reporting Standard 102: Basic financial instruments" we welcome the opportunity to comment on FRS102. We strongly support an approach whereby the FRC brings forward proposals to amend FRS 102 where constituents identify significant adverse unintended consequences. We are writing to you to highlight our members' continuing concern that the FRC has rejected an amendment to the fair value disclosure hierarchy for which we believe there is a stronger case than that made for the proposal in FRED54.

We strongly agree with the IMA's response which is attached to this letter, which details the issues created by a fair value hierarchy in FRS102 which diverges from the fair value hierarchy used by other accounting frameworks including IFRS and US generally accepted accounting principles. Not only does this introduce an additional cost burden on preparers of financial statements but more importantly it is likely to confuse and be a cause of concern for investors in investment funds. Given that FRS 102 is to a large extent based on IFRS it appears somewhat illogical that the fair value hierarchy included in FRS102 differs from IFRS. Significant divergences from both current UK GAAP and current IFRS are likely to act as a disincentive to stakeholders to adopt FRS102, when they are considering adopting FRS 102 or IFRS when this choice has to be made.

Unlike many investment entities in the United Kingdom, most investment entities in the Republic of Ireland do not report under a SORP but will consider applying FRS 102 or IFRS going forward. For many of these entities the divergence of the proposed fair value hierarchy from current practice is a major cause of concern.

We would ask you to reconsider previous requests made to amend the fair value hierarchy to be consistent with other accounting frameworks. We believe that amendment would be consistent with your approach whereby the FRC brings forward proposals to amend FRS 102 as evidenced in FRED 54.

We are grateful for the opportunity to provide our comments and would welcome the opportunity to discuss this further with you.

Yours faithfully,

Patrick J Lardner

Pat Lardner
Chief Executive

We, the IMA[1], support the FRC's approach of proposing amendments FRS 102 in response to significant issues raised by constituents. However, the FRC should be consistent in applying this approach and we do not believe it has been. Our response makes the case for an amendment to the FRS 102 fair value hierarchy disclosures for financial institutions which we believe to be stronger than the case made for the amendment proposed in FRED 54. We urge the FRC to consider our suggested amendment as a matter of priority.

Question 1

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

In principle we support an approach whereby the FRC brings forward proposals to amend FRS 102 where constituents identify significant adverse unintended consequences, especially where the FRC has extended the scope of FRS 102 beyond that of the IFRS for SMEs. However, we are concerned that the FRC has rejected an amendment to the fair value disclosure hierarchy for which we believe there is a stronger case than that made for the proposal.

It appears inconsistent that the FRC regards the proposed amendment as having sufficient priority but has rejected an amendment in respect of the fair value disclosure hierarchy. The proposed amendment is designed to mitigate the <u>cost burden</u> of measuring certain financial instruments at fair value, when amortised cost is <u>an appropriate</u> measurement basis, even though the amortised cost basis is available via the <u>option to apply IAS 39</u>. The fair value disclosure hierarchy amendment would be designed to mitigate a <u>cost burden</u>, provide <u>more appropriate</u> information to users and for which there is <u>no alternative solution</u> available.

The proposals set out in FRED 54

The proposals are intended to address the issue that some simple financial instruments will not qualify as basic financial instruments and as a consequence entities would incur unnecessary costs in measuring these financial instruments at fair value (The Accounting Council's Advice to the FRC to issue FRED 54, paragraph 8). The Advice acknowledges that amortised cost is <u>an</u> appropriate measurement basis but does not assert that it is <u>more</u> appropriate.

The requirements of FRS 102 are based on the IASB's IFRS for SMEs. In developing the IFRS for SMEs the IASB simplified significantly the recognition and measurement principles in full IFRSs and in doing so recognised that their approach would cause some items measured at cost or amortised cost under IAS 39 to be measured at fair value under the IFRS for SMEs. The burden this added fair valuation might place some SMEs was one of the reasons the IASB gave for providing a choice of following Sections 11 and 12 or IAS 39 in

[1] The Investment Management Association (IMA) represents the UK investment management industry. Our members manage over £4.5 trillion of assets on behalf of UK and overseas clients. This includes £0.8 trillion in about 2,500 Authorised Funds (i.e. unit trusts and open-ended investment companies). The IMA is the SORP-making body responsible for the SORP for Authorised Funds.

accounting for financial instruments (IFRS for SMEs Basis for Conclusions, paragraph BC106(b)). The FRC retained the choice provided by the IASB and added further flexibility by introducing a third option whereby entities can follow the recognition and measurement principles in IFRS 9.

There is an argument that a solution already exists whereby an entity can choose to follow the recognition and measurement principles in IAS 39 or IFRS 9 and therefore the amendment proposed in FRED 54 is unnecessary. The existence of alternative solutions weakens the case for amending FRS 102.

The FRS 102 fair value hierarchy problem

The FRC extended the scope of FRS 102 beyond that of the IFRS for SMEs and in doing so recognised that entities performing "specialised activities" were drawn into scope. Section 34 was added to FRS 102 in order to supplement the requirements for such entities. The FRC modified the measurement requirements in paragraph 11.14 to replicate the fair value option available in IAS 39 and, in respect of financial institutions, added disclosure requirements based on IFRS 7. These requirements include fair value disclosures in accordance with paragraphs 34.22 and 34.42 but, instead of replicating the IFRS 7 fair value disclosure hierarchy, these disclosures are based on the measurement hierarchy in paragraph 11.27.

A problem arises from the use of paragraph 11.27 as the basis for making fair value disclosures in accordance with paragraphs 34.22 and 34.42. This forces entities applying FRS 102 to diverge from full IFRS in a way that reduces the quality of information provided to users and increases the cost of providing that divergent information. Unlike the proposals set out in FRED 54, where an alternative solution to the problem already exists via IAS 39 or IFRS 9, entities required to apply paragraphs 34.22 and 34.42 have no recourse to an alternative solution.

The consequences of the problem are two-fold.

- Firstly, under FRS 102 many entities will be forced to report a significant proportion, and in some cases a substantial majority, of their financial instruments in the lowest of the three levels. Under IFRS the vast majority of these same financial instruments would be reported in level 2 with only a small proportion, if any, in the lowest level. The IFRS three-level hierarchy is now well established and is in use for its fourth year. Therefore, it is likely to be well understood by users of financial statements. There is a risk of users misinterpreting the lowest level of the FRS 102 hierarchy as being comparable to the IFRS hierarchy and misunderstanding the respective quality of the valuations of otherwise comparable entities. This could lead to misinformed decision making.

- Secondly, FRS 102 introduces a second tier that does not exist, and has never existed, in UK or international accounting standards. It is the business of investment entities to deliver benefits to their investors through changes in fair value. It is core to their operations that they are able measure fair value accurately and reliably. They have sophisticated systems and processes for measuring fair value, very often on a daily basis, and very often in order to directly determine the share price at which investors subscribe. Therefore, a valuation method that is intended to be proportionate in the context of entities other than financial institutions is an oversimplification and a dis-proportionate burden on the established and robust processes of many financial institutions. In short, it will require costly workarounds in order to deviate from the established norm of IFRS.

Evolution of the fair value hierarchy

Paragraph 11.27 of FRS 102 replicates the three-level fair value measurement hierarchy in the IFRS for SMEs, which can be summarised as follows:

(a) a quoted price in an active market;

(b) the price of a recent transaction;

(c) a valuation technique.

However, this hierarchy is an anomaly arising from the significant simplifications made to the measurement requirements of IAS 39 by the IASB in finalising the IFRS for SMEs. These simplifications appear to be predicated on the facts that, where the hierarchy is inappropriate, there is recourse to the recognition and measurement principles in IAS 39 and that financial institutions are ineligible to use the IFRS for SMEs (IFRS for SMEs Basis for Conclusions, paragraphs BC106(a), final sentence, and BC107)). This seems to be an acknowledgement by the IASB that the IFRS for SMEs fair value disclosure hierarchy is not fit for use by financial institutions, but this does not matter because financial institutions cannot apply the IFRS for SMEs.

It is interesting to note that, in developing the March 2004 amendments to IAS 39, the IASB proposed substantially the same three-tier fair value measurement hierarchy but simplified these proposals when the amendments were finalised and made it clear that recent transactions do not take precedence over a valuation technique (Basis for Conclusions on IAS 39, paragraphs BC102, BC103 and BC222(m)).

In March 2009 the IASB issued amendments to IFRS 7 requiring disclosures based on a three-level hierarchy, which can be summarised as follows:

(a) quoted prices in active markets;

(b) observable inputs to valuation techniques;

(c) unobservable inputs to valuation techniques.

The IASB concluded that this hierarchy would improve comparability between entities about the effects of fair value measurements and determined that it was more important for the disclosure hierarchy above to be the same as US GAAP than for it to be the same as the measurement hierarchy implicit in IAS 39 (Basis for Conclusions on IFRS 7, paragraphs BC39A and BC39B).

In May 2011 the IASB issued IFRS 13 which amended the measurement hierarchy to align it with the disclosure hierarchy. IFRS 13 was adopted by the European Commission in December 2012 and EU-adopted IAS 39 was amended to require fair value to be measured in accordance with IFRS 13. Therefore, the three-tier fair value hierarchy for both measurement and disclosure is now aligned for entities applying EU-adopted IAS 39, IFRS 9 and US GAAP.

In December 2004 the ASB issued FRS 26 (IAS 39) as part of a package of convergence standards and in December 2005 added FRS 29 (IFRS 7) to the package. In May 2009 the ASB issued amendments to FRS 29 in order to maintain alignment with IFRS 7. This had the effect of implementing the IFRS 7 fair value disclosure hierarchy in the UK. The fair value measurement and disclosure requirements of these UK standards remain converged with the respective IAS/IFRS as they were prior to the issue by the IASB of IFRS 13 in May 2011.

The FRS 102 fair value hierarchy solution

We believe there is a straight forward, limited scope solution to the problem. The disclosure requirements are specific to financial institutions and retirement benefit plans and an amendment can be made solely in this context. Paragraphs 34.22 and 34.42 could be amended to refer to the fair value hierarchy in IFRS 13 or to define the fair value hierarchy for disclosures rather than referring to paragraph 11.27. Such amendments would have little risk of unintended consequences for other entities, and are consistent with the FRC's principles for succinct financial reporting. In particular, such amendments would:

- improve consistency with global accounting standards through the application of an IFRS-based solution;
- reflect up-to-date thinking in the way businesses operate (it is the core business of investment entities to be able to determine the fair value of financial instruments);
- balance consistent principles for accounting with practical solutions based on users' information needs (providing better information about the use of unobservable inputs to determine fair value); and
- be cost-effective to apply (most entities already have the ability to disclose in accordance with IFRS 7 but the second level under FRS 102 will require developments and workarounds. The amendment would be broadly cost-neutral for entities that currently cannot disclose in accordance with IFRS 7).

Partial solution provided by SORPs

In response to the publication of FRS 102 we have revised the SORP: Financial Statements of UK Authorised Funds. This SORP attempts to mitigate some of the adverse consequences by extending the FRS 102 fair value hierarchy disclosures by requiring the valuation techniques category to be subdivided between valuation techniques using observable inputs and those using unobservable inputs. This approach improves the quality of reporting but it cannot mitigate the cost burden of the recent transactions category required by FRS 102. The result is that, in order to provide the best quality fair value disclosures, entities reporting under the SORP will have a higher burden of reporting than entities reporting under either full IFRS or FRS 102.

We understand other SORP-making bodies have proposed a similar approach in the Exposure Draft of the SORP: Financial Statements of Investment Trust Companies and Venture Capital Trusts issued in December 2013 and the Exposure Draft of the SORP: Financial Reports of Pension Schemes issued in April 2014.

However, there remain many investment entities in the UK and the Republic of Ireland that do not report under a SORP but will apply FRS 102. Many of these already apply FRS 29 and therefore their investors are familiar with the IFRS 7 fair value hierarchy. It makes little sense for these entities to move away from the global standard for fair value disclosures that has been established. For these entities the only solution that will ensure the quality of information provided to users is to amend FRS 102. It is not sufficient for the FRC to rely on SORPs to mitigate this problem.

Question 4

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

No. It would seem appropriate for the amendments to be available from the same effective date as FRS 102.

If the FRC decides to consider our suggested amendment in respect of the fair value hierarchy, the effective date should be the same as FRS 102. We realise there may be concerns about the short timeframe available but it should be recognised that most entities already have the ability to disclose in accordance with IFRS 7 but the second level under FRS 102 will require developments and workarounds. The suggested amendment would reduce the implementation burden. It is worth noting that when the IASB introduced the fair value disclosure hierarchy in March 2009, it applied for accounting periods beginning on or after 1 January 2009 i.e. for periods that had already started (IFRS 7 paragraph 44G).