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INVESTOR IN PEOPLE

Jenny Carter
Financial Reporting Council
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30 September 2020

Dear Madam

FRED 74, Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Interest rate benchmark reform (Phase 2)

Ernst & Young LLP welcomes the opportunity to comment on FRED 74 issued by the Financial Reporting Council ('the FRC').

We support the FRC's efforts to address the issues affecting financial reporting on the replacement of an existing interest rate benchmark (or an 'IBOR') with an alternative interest rate (referred to as 'Risk Free Rate' or 'RFR'). We agree with the vast majority of FRED 74 but we recommend that some additional points are addressed to align with the amendments to IFRS published by the IASB in August 2020; *Interest Rate Benchmark Reform – Phase 2 - Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16*.

Our responses to the specific questions in the FRED 74 are provided in the Appendix.

Should you wish to discuss the contents of this letter with us, please contact Danny Trotman at the above address or on +44 (0)20 7951 4079.

Yours faithfully

Danny Trotman, for and on behalf of
Ernst & Young LLP
United Kingdom

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Appendix – Responses to Exposure Draft Questions

Question 1
Do you agree with the proposed amendments to FRS 102? If not, why not?

We agree with the proposals, except as set out below. In each case the issue is equivalent to one of those considered by the IASB during the course of finalising their phase 2 amendments to IFRS published in August 2020 and we recommend that the IASB's final wording is used as a basis for the equivalent amendments to FRS 102.

Transition

Paragraph 1.26 of FRED 74 requires reinstatement of discontinued hedging relationships that would not have been discontinued if the amendments had been applied. We suggest that, in order to make application of this requirement more operational and to ensure that it results in reinstatement only when appropriate, it should relate only to those hedges that meet the FRS 102 hedge accounting conditions at the beginning of the period of adoption. In all other instances, reinstatement of hedges that previously failed would not be required.

Documentation

For practical reasons, we suggest that the proposal in paragraph 12.25I of FRED 74, that relates to when hedging documentation is updated, should allow entities a reasonable period of time to update the hedging documentation following a change to the hedging relationship. Considering that, as IBOR reform progresses, entities may have to update a significant volume of hedging documentation, it would be reasonable for entities to have until the end of the reporting period of the first year of adoption to make any necessary updates.

Accounting for fair value and cash flow hedges

Paragraphs 12.25M and 12.25N of FRED 74 provide additional guidance for how to account for the effects that will arise on transition of an IBOR to an RFR. We consider that these paragraphs are not necessary, as entities can refer to the existing requirements in FRS 102 as described in paragraphs 12.20 and 12.23. Following this approach should ensure that any gains and losses arising from IBOR reform are accounted for consistently with other gains and losses arising from hedging relationships.

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Accounting for leases

The current proposals seek to address the accounting by lessees for certain modifications required by IBOR reform to finance leases. We welcome guidance on this area, given the current lack of guidance in FRS 102 for lease modifications.

However, as the proposals only address lessee accounting, we would welcome clarity on the accounting by lessors for similar finance lease modifications, either within Section 20 of FRS 102 or in the Basis for Conclusions. The current definition of 'contingent rent' within the Glossary to FRS 102 includes changes in *"… future market rates of interest"*. This would appear to result in the lessor recognising a change resulting from IBOR reform as contingent rent as the income arises.

Based on the definition of contingent rent referred to in the previous paragraph, it would be helpful if the amendments clarified that the contingent rent accounting as set out in paragraph 20.11 of FRS 102 does not apply in situations where paragraphs 20.11A and 20.11B apply. However, we believe that the effect of the amendments is likely that there would be no change to the finance lease liability but the effective interest rate would change prospectively, resulting in an impact similar to contingent rent accounting.

Question 2
In relation to the Consultation stage impact assessment, do you have any comments on the costs and benefits identified? Please provide evidence to support your views.

We consider the approach being proposed by the FRC will have a positive effect on financial reporting.