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Dear Jenny

BDO LLP response to '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)'

We are pleased to have the opportunity to comment on '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)' (FRED 74 / the Exposure Draft).

We broadly agree with the proposed amendments set out in FRED 74. We consider that these changes are required in order to minimise discontinuities in the accounting for financial instruments and leases and avoid unnecessary discontinuation of hedge accounting which would otherwise arise as result of modifications to contractual agreements and hedge documentation. Our responses to the specific questions asked are set out in an appendix to this letter.

We note that the proposed amendments are based on ED/2020/1 Interest Rate Benchmark Reform Phase 2 – Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 (the IASB Exposure Draft), which was published by the IASB in April 2020. In this regard, we have the following comments:

> We agree that this is an appropriate approach in order to ensure that the proposed relief is available to all entities applying FRS 102, regardless of their accounting policy choice in relation to financial instruments. Consequently, we also agree that in addition to considering respondents' feedback on FRED 74, the FRC should take into account the changes made by the IASB in the final version of their amendments published in August 2020 (the IASB's Amendments) when finalising the proposed amendments to FRS 102. As such, as part of our response, we have highlighted a number of specific changes made by the IASB that we consider should be reflected in the final FRS 102 amendments.
>
> The proposed amendments set out by the IASB are far more detailed than those set out in FRED 74. As a result, there may inevitably be scope for divergence in practice between IFRS and FRS 102 reporters and indeed between FRS 102 reporters that may interpret the amendments differently.
>
> While the effective date of FRED 74 aligns to the effective date of the IASB amendments, we note that for EU IFRS reporters, the actual effective date will depend upon EU endorsement. As such, it is possible that for a period of time, FRS 102 reporters would be in a position to avail of reliefs which would be unavailable to EU IFRS reporters.

If you wish to discuss any of the points further, please do not hesitate in contacting me directly.

Yours sincerely,

Anthony Appleton
Partner
For and on behalf of BDO LLP

Appendix: Responses to the questions asked in the Exposure Draft

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

Yes, we broadly agree with the proposed amendments to FRS 102. We provide our specific comments on each section below.

Section 1 – Scope

We agree with the proposed effective date of accounting periods beginning on or after January 2021 with early application permitted, which is consistent with the IASB Amendments.

However, in our view, the proposed wording of paragraph 1.26 that is set out in paragraph 2 of the Exposure Draft could be enhanced. This paragraph requires the reinstatement of a previously discontinued hedging relationship in cases where the discontinuation arose as a result of changes required by interest rate benchmark reform and would not have been required if the amendments had been applied at that time. This would appear to require such a reinstatement even if the hedging relationship in question no longer met the conditions for hedge accounting (for other reasons) at the date of initial application of the amendments. This could mean that entities may look to reinstate hedging relationships that did not meet all other qualifying criteria, which in our view, does not adhere to the requirements of FRS 102. We therefore suggest that paragraph 1.26 should be amended as follows:

> In applying the amendments in paragraph 1.24 retrospectively, an entity shall reinstate a discontinued hedging relationship if, and only if,~~:~~
>
> (a) the discontinuation arose solely due to changes required by interest rate benchmark reform and would not have been required if the amendments had been applied at that time~~.~~;
> (b) at the date of initial application of the amendments, that discontinued relationship still met all other conditions for hedge accounting set out in paragraph 12.18; and
> (c) the entity had not chosen to discontinue hedge accounting in accordance with paragraph 12.25.

We note that adding part (b) would be consistent with paragraphs 7.2.44 and 108I of the IASB's Amendments. We have added in part (c) in order to cater for the fact that FRS 102 reporters are permitted to voluntarily discontinue hedge accounting under paragraph 12.25.

Section 11 – Basic Financial Instrument Issues

We agree with the proposed amendments set out in paragraph 4 of the Exposure Draft which are necessary in order to ensure that the proposed relief is available to all entities applying FRS 102, regardless of their accounting policy choice in relation to financial instruments.

We also agree with the proposals set out in paragraph 5 of the Exposure Draft. Applying paragraph 11.19 of FRS 102 to account for modifications of financial assets and liabilities that are required by interest rate benchmark reform will provide more useful information to users of financial statements and provide practical relief for preparers.

However, we have the following suggestion in respect of paragraph 11.20B:

> Paragraph 11.20B explains that paragraph 11.19 should only be applied to modifications that are required as a direct consequence of interest rate benchmark reform and where the new basis for determining contractual cash flows is economically equivalent to the previous basis. The FRC may wish to consider providing examples of typical modifications that would fall into this category. For example, the replacement of an existing interest rate benchmark with an alternative benchmark rate with the addition of a fixed spread or changes to the reset period/ dates. We note that including some examples would be consistent with paragraph 5.4.8 of the IASB's Amendments.

We also agree with the proposed additional disclosure requirements set out in paragraph 6 of the Exposure Draft.

Section 12 – Other Financial Instrument Issues

Paragraph 12.25F - end date

We note that the first phase of IBOR reform amendments published by the FRC in 2019 (Amendments to FRS 102 - Interest rate benchmark reform) did not include a specific end date in respect of the relief provided for risk components (see paragraph 12.25F). Given that new reliefs pertaining to risk components (i.e. paragraphs 12.25Q to 12.25S) are being proposed as part of this Exposure Draft, it would seem necessary to clarify when the reliefs in paragraph 12.25F cease and when those in paragraphs 12.25Q to 12.25S commence. We suggest that a new paragraph is inserted after paragraph 12.25H which explains that the relief in paragraph 12.25F should cease at the earlier of when changes required by the reform are made as set out in paragraph 12.25I or when the hedge relationship is discontinued. We note that this would be consistent with paragraphs 6.8.13 and 102O of the IASB Amendments.

Proposed amendments

We broadly agree with the proposed amendments to specific hedge accounting requirements set out in paragraphs 8 to 10 of the Exposure Draft but we include below some specific suggestions for your consideration.

> Paragraph 9 proposes amendments to paragraph 12.25B of FRS 102. Paragraph 12.25B sets out the circumstances in which an entity should apply the amendments relating to interest rate benchmark reform. These amendments include Amendments to FRS 102 - Interest rate benchmark reform which addressed accounting issues during the period of uncertainly prior to the reforms taking place as well as these current proposals which address accounting issues once that uncertainty is no longer present. However, the current wording of paragraph 12.25B implies that the amendments in paragraphs 12.25C to 12.25S only apply during the period of uncertainty which would appear to exclude their application once that uncertainty is no longer present i.e. when the reform takes place. This is clearly not the aim as paragraphs 12.25I to 12.25S set out amendments that apply once the uncertainty is removed. We therefore suggest that the wording of paragraph 12.25B is clarified as follows:

> Paragraphs 12.25C to 12.25S only apply to hedging relationships of interest rate risk that are (or have been) affected by interest rate benchmark reform. A hedging relationship is affected by interest rate benchmark reform if the reform gives rise to uncertainties about the timing and/or the amount of the interest rate benchmark-based cash flows of the hedged item and/or the hedging instrument.

Paragraphs 12.25I to 12.25L explain that as and when the uncertainty arising from interest rate benchmark reform is no longer present, certain amendments to hedge documentation will be required. In our view, the proposed amendments would benefit from the following enhancements:

- As regards amendments to the description of the hedging instrument as contemplated in paragraph 12.25I(c), we note that changes required by interest rate benchmark reform may be made in different ways than those contemplated in paragraphs 11.20B and 11.20C. For example, instead of modifying the contractual terms of a derivative, the instrument could be closed out and replaced with a new derivative with the same counterparty on the same terms. Alternatively, the instrument could be closed out and replaced with a different counterparty and/ or on substantially different terms. The former would seem consistent with changes required by the reform whereas the latter would not. In our view, the FRC should clarify that alternative approaches may be consistent with changes required by the reform as long as they were economically equivalent to changing the basis of determine the contractual cash flows of the original instrument and did not result in derecognition.

- From a practical perspective, it may not be feasible for an entity to make the amendments required by 12.25I immediately as and when uncertainty is removed for each hedge relationship. In our view, entities should be allowed some additional time to make such amendments for example, by the end of the reporting period during which the change is made. This could perhaps be clarified at the end of paragraph 12.25L by adding the following text:

  > An entity shall make the amendments required by 12.25I by the end of the reporting period during which a change required by interest rate benchmark reform is made to the hedged risk, hedged item or hedging instrument.

We note that making the above amendments would be consistent with paragraphs 6.9.2, 6.9.4, 102Q and 102S of the IASB's Amendments.

Paragraphs 12.25M to 12.25O specify the accounting requirements for fair value and cash flow hedges. We have the following comments:

- We question whether paragraphs 12.25M and 12.25N are in fact necessary. This is because, absent these amendments, an entity would apply the existing requirements of FRS 102 i.e. paragraph 12.20 for fair value hedges and paragraph 12.23 for cash flow hedges, which would appear to give rise to the same accounting result. An alternative approach would be to cross refer to the existing requirements of paragraph 12.20 and 12.23. However, in respect of cash flow hedges, we suggest that the FRC may wish to clarify that the amount accumulated in the cash flow hedge reserve in accordance with paragraph 12.23 should be deemed to be based on the new alternative benchmark rate. This would ensure that these amounts would be reclassified to profit or loss in the same period (or periods) during which the hedged cash flows based on the alternative benchmark rate affect profit or loss.

- Paragraph 12.25O explains the effect on amounts accumulated in the cash flow hedge reserve for a discontinued cash flow hedge relationship. We do not agree that the amount accumulated in the cash flow hedge reserve should be re-measured using the alternative benchmark rate which is what paragraph 12.25O seems to suggest. Such an adjustment would not seem appropriate given that the hedge relationship has been discontinued and, in accordance with paragraph 12.25A, the amount accumulated in the cash flow hedge reserve should remain until such time as it is appropriate to reclassify. However, in our view, the FRC should clarify that the amount accumulated in the cash flow hedge reserve should be deemed to be based on the new benchmark rate.

We note making the amendments above would be more consistent with paragraphs 6.9.3, 6.9.7 to 6.9.8, 102R and 102W to 102X of the IASB Amendments.

Paragraphs 12.25Q to 12.25S relate to the designation of risk components. We broadly agree with these proposals but have the following comments:

- Based on the current wording of 12.25Q, it is not clear whether the 24 month period applies on a hedge by hedge basis (i.e. to each hedge relationship individually) or on a rate by rate (i.e. to each benchmark rate separately). The former could result in the same benchmark rate having different 24 month periods during which an entity considers whether the separately identifiable criterion will be met. For example, if an entity had two hedge relationships (with the same alternative rate designated as a risk component) then the 24 month period of assessment could be different depending upon the timing of amendments to each hedge relationship. We therefore think that the 24 month period should apply on a rate by rate basis - i.e. from the date an entity designates the alternative benchmark rate as a risk component for the first time.

- In our view, the FRC should also provide further clarity after paragraph 1.26 with regards to the reinstatement of hedge relationships that had been discontinued in the absence of the relief provided in paragraph 12.25Q. More specifically, whether the date from which the 24 month period begins in such cases should be the date an entity designates the alternative benchmark rate as a risk component for the first time or the date of initial application of the amendments. The latter would seem to better reflect the intention of the reliefs provided under the proposed amendments.

We note that making the amendments above would be more consistent with paragraphs 6.9.11, 7.2.45, 102Z1 and 108J of the IASB Amendments.

Section 20 – Leases

We agree with the proposed amendments set out in paragraph 13 of the Exposure Draft

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 have no comments on the costs and benefits identified in the consultation stage impact assessment. However, we note that the second sentence of paragraph 3 is missing a reference to IAS 39 and should therefore be amended as follows:

> The recognition and measurement requirements of IFRS 9 and IAS 39 are available as an accounting policy choice to entities applying FRS 102.