# Our response to FRED 67

## Draft amendments to FRS 102 - triennial review 2017

Restricted
29 June 2017

Building Societies Association

# Introduction

We support any effort to improve, clarify and simplify accounting regulation.  Most of the proposed incremental amendments in this exposure draft do just that.  We therefore welcome the decision not to incorporate recent and forthcoming changes in international financial reporting standards into FRS 102 at this stage.

**Consultation questions**

**Question 1** *Overall do you agree with the approach of FRED 67 being to focus, at this stage, on incremental improvements and clarifications to FRS 102? If not, why not?*

We agree with the exposure draft's approach on incremental improvements and clarifications to FRS 102. We therefore welcome the decision not to incorporate recent and forthcoming changes in international financial reporting standards into FRS 102 at this stage. Now is not the time to introduce elements of IFRS 9, IFRS 15 and IFRS 16 into FRS 102. Far better to wait and learn from the experiences of larger, more complex entities. This is particularly true where IFRS 9 is concerned.

IFRS 9 is much more than an accounting issue. Its effect is felt in regulatory capital. In late 2016, the Basel Committee for Banking Supervision and the EC both proposed transitional arrangements[1] to help IFRS reporters deal with the negative impact on regulatory capital arising from the introduction of expected credit loss ("ECL") accounting. The standard's impact is greater on UK GAAP building societies, which are all on the standardised approach to credit risk, than for those entities, mainly the largest banks and building societies, on the internal ratings-based approach. Under IFRS 9, a rise in impairment depletes the capital adequacy of entities such as building societies that use the standardised approach to credit risk - the 1:1 reduction in capital arising from increased impairments is not offset by reduced risk weighted assets.

[1] Effectively a five-year glide path ending 31 December 2023.

Smaller building societies need an equivalent longer time to rebuild their capital resources following the introduction of ECL accounting that larger entities now will have. This could leave them more exposed to a capital shock.

The Basel and EC proposals mean that the full monitoring period for the capital will not be analysed until end 2023 at the earliest. We therefore urge the FRC to delay further incorporation of the ECL elements of IFRS 9 until 2027. This three year "bedding in" period will give stakeholders time to observe the implementation by IFRS reporters, and to develop a proportionate approach to expected loss provisioning, which may involve an alternative to the loan level PD progression approach.

**Question 2** *FRED 67 proposes to amend the criteria for classifying a financial instrument as 'basic' or 'other'. This will mean that if a financial instrument does not meet the specific criteria in paragraph 11.9, it might still be classified as basic if it is consistent with the description in paragraph 11.9A.*

*Do you agree that this is a proportionate and practical solution to the implementation issues surrounding the classification of financial instruments, which will allow more financial instruments to be measured at amortised cost, whilst maintaining the overall approach that the more relevant information about complex financial instruments is fair value? If not, why not?*

Additional financial instruments will be considered "basic" (and thereby measured on amortised cost rather than fair value basis) beyond those meeting the prescriptive conditions, if they are consistent with a new principle-based description.   The significant majority of societies adopted FRS 102 with IAS 39 as they had certain products that met the definition of a non-basic financial instrument (and needed macro hedging). We therefore support such a simplifying and proportionate measure.  Other stakeholders have pointed out that it would be helpful for the standard to specify that when the principle-based paragraph is adopted, it is explained within the financial statements as a significant area of judgement when the debt instrument is material to the financial statements.

Clearly, there will be additional resource associated with determining which financial instruments will now qualify as "basic" but we do not consider this work will be unduly onerous

**Question 3** *FRED 67 proposes that a basic financial liability of a small entity that is a loan from a director who is a natural person and a shareholder in the small entity (or a close member of the family of that person) can be accounted for at transaction price, rather than present value (see paragraph 11.13A). This practical solution will provide relief to small entities that receive non-interest-bearing loans from directors, by no longer requiring an estimate to be made of a market rate of interest in order to discount the loan to present value. Do you agree with this proposal? If not, why not?*

This issue does not have an impact on building societies although it could conceivably on their members.  This proposal seems to be a welcome, straightforward simplification that should not reduce the usefulness of a small entity's financial statements.

**Question 4** *FRED 67 proposes to amend the definition of a financial institution (see the draft amendments to Appendix I: Glossary), which impacts on the disclosures about financial instruments made by such entities. As a result, fewer entities will be classified as financial institutions. However, all entities, including those no longer classified as financial institutions, are encouraged to consider whether additional disclosure is required when the risks arising from financial instruments are particularly significant to the business (see paragraph 11.42). Do you agree with this proposal? If not, why not?*

The formal removal of retirement benefit plans from the definition of a "financial institution", while not being a major change in substance, is nevertheless a welcome clarification.

**Question 5** *FRED 67 proposes to remove the three instances of the 'undue cost or effort exemption' (see paragraphs 14.10, 15.15 and 16.4) that are currently within FRS 102, but, when relevant, to replace this with an accounting policy choice. The FRC does not intend to introduce any new undue cost or effort exemptions in the future, but will consider introducing either simpler accounting requirements or accounting policy choices if considered necessary to address cost and benefit considerations.  As a result, FRED 67 proposes:*

*(a) an accounting policy choice for investment property rented to another group entity, so that they may be measured at cost (less depreciation and*

*impairment) whilst all other investment property are measured at fair value (see paragraphs 16.4A and 16.4B); and*

*(b) revised requirements for separating intangible assets from the goodwill acquired in a business combination, which will require fewer intangible assets to be recognised separately. However, entities will have the option to separate more intangible assets if it is relevant to reporting the performance of their business (see paragraph 18.8 and disclosure requirements in paragraph 19.25B).*

*Do you agree with these proposals? If not, why not?*

We support the removal of these exemptions when replaced with a clear and proportionate accounting policy choice. Other stakeholders have noted the "undue cost or effort" test is difficult to apply and leads to inconsistencies between entities.

**Question 6** *Please provide details of any other comments on the proposed amendments, including the editorial amendments to FRS 102 and consequential amendments to the other FRSs.*

The lack of progress of the IASB's macro hedging project means that the macro hedging requirements of IAS 39 will be retained for the foreseeable future. This situation is highly relevant to building societies. The significant majority of societies adopted FRS 102 with IAS 39 due to the lack of a macro fair value hedge accounting option within FRS 102. (A smaller number of societies were also driven this way by having certain products that met the definition of a non-basic financial instrument). The macro hedging situation, in effect, drove the policy choice for impairment, an unsatisfactory outcome.

We therefore very much support the Corporate Reporting Council's advice to the FRC to incorporate macro hedging requirements into FRS 102 by cross reference to the IAS 39 requirements, rather than by importing them directly into FRS 102. This will enable building societies to apply macro hedging with the recognition and measurement requirements of sections 11 and 12 of FRS 102.

**Question 7** *FRED 67 includes transitional provisions (see paragraph 1.19). Do you agree with these proposed transitional provisions? If not, why not? Have you identified any additional transitional provisions that you consider would be necessary or beneficial? Please provide details and the reasons why.*

No comment.

**Question 8** *Following a change in legislation the FRC is now required to complete a Business Impact Target assessment. A provisional assessment for these proposals is set out in the Consultation stage impact assessment within this FRED. The overall impact of the proposals is expected to be a reduction in the costs of compliance. In relation to the Consultation stage impact assessment, do you have any comments on the costs or benefits identified? Please provide evidence to support your views of the quantifiable costs or benefits of these proposals.*

We welcome the impact assessment though note it is rather general in nature and based on “informal outreach”, rather than anything more rigorous.  While we agree the proposals will lead to welcome long term savings, and to potentially clearer financial statements, there will be initial costs as indicated under transitional costs section of the impact assessment. These initial costs will be incurred in, for example, reformulating accounting policy, re-stating accounts and communicating policy changes to stakeholders.  They should not be significant, however.

**About us**

The Building Societies Association represents all 44 UK building societies. Building societies have total assets of over £364 billion and together with their subsidiaries, hold residential mortgages of over £282 billion, 21% of the total outstanding in the UK. They hold over £260 billion of retail deposits, accounting for 18% of all such deposits in the UK. They employ approximately 40,000 full and part-time staff and operate through approximately 1,550 branches.

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