



FRED 74 DRAFT AMENDMENTS TO FRS 102: INTEREST RATE BENCHMARK REFORM (PHASE 2)

Issued 30 September 2020

ICAEW welcomes the opportunity to comment on the FRED 74 Draft amendments to FRS 102: Interest-rate benchmark reform (Phase 2) published by Financial Reporting Council in May 2020, a copy of which is available from this [link](#).

We support the Financial Reporting Council's proposed amendments to FRS 102 *The Financial Reporting Standard for the UK and Republic of Ireland* to address accounting issues arising from the effects of interest rate benchmark reform on an entity's financial statements.

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KEY POINTS

SUPPORT FOR PROPOSALS

1. We broadly support the Financial Reporting Council's (FRC) proposed amendments to FRS 102 *The Financial Reporting Standard for the UK and Republic of Ireland* to address accounting issues arising from the effects of interest rate benchmark reform on an entity's financial statements. However, we do have some comments regarding the drafting and the proposals for transition, hedging documentation, designation of risk components, and leases.
2. Our comments on the FRC's proposals are consistent with the feedback we provided to the IASB's ED/2020/1 *Interest Rate Benchmark Reform—Phase 2: Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16* upon which the proposals in FRED 74 are based. We support the FRC's intention to review any changes made by the IASB to the proposals in ED/2020/1 when finalising the amendments to FRS 102.

ANSWERS TO SPECIFIC QUESTIONS

Question 1

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

3. Yes, we broadly agree with the proposed amendments to FRS 102 to address accounting issues arising from the effects of interest rate benchmark reform on an entity's financial statements. However, we have some comments regarding the drafting and the proposals for transition, hedging documentation designation of risk components and leases, as discussed in the following paragraphs.

Drafting

4. Proposed paragraph 11.20B states that 'an entity shall apply paragraph 11.19 to account for a modification that is required by interest rate benchmark reform, as if the modification was a periodic re-estimation of cash flows of a variable rate financial instrument to reflect a change in a market rate of interest.' In our view, this description of the required accounting treatment is not entirely clear and may result in confusion. We would prefer a more direct description of the required accounting and/or an accompanying staff education note which demonstrates how application of this practical expedient would work in practice, for example, for a simple variable rate loan.

Transition

5. Proposed paragraph 1.26 states that in applying the amendments retrospectively, an entity is required to 'reinstate a discontinued hedging relationship if, and only if, 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.'
6. In our view, this could be read as requiring reinstatement even where the hedging instrument has been terminated, managed within a trading mandate or has been designated in a new hedge accounting relationship. There seems little point in reinstating a new hedge relationship having applied the requirements in FRED 74 to, for example, change hedge documentation, if the hedge will immediately be discontinued because the hedging instrument no longer exists.
7. Similarly, if the hedging instrument has been used in a new hedge relationship there seems little point in reinstating an old hedge relationship and causing the new relationship to fail. If the derivative has been moved to the trading book, restating the trading position does not

seem to provide users with appropriate information. We suggest that paragraph 1.26 be updated to clarify when reinstatement could apply and permit but not require reinstatement of hedge accounting relationships in these circumstances. Such an option should be set out as all hedge accounting relationships must be reinstated or none are reinstated.

Documentation

8. Proposed paragraph 12.25I states that 'As and when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows, an entity shall amend the documentation of the hedging relationship previously prepared in accordance with paragraph 12.18(d).'
9. We note that a literal interpretation of the proposal to only change hedge documentation when uncertainty ends might result in severe operational challenges. When uncertainty ends there could be an unusually large volume of changes to prepare for over a relatively short time period, and the application of the proposals would be more practicable if a reasonable period of time was allowed to make operational changes and changes to hedge documentation.
10. Proposed paragraph 12.25I also specifies the changes that can be made to hedging documentation as a result of interest rate benchmark reform. We suggest that the scope of acceptable changes for the hedged item should be wider in order to address all situations where the description of the hedged item needs to be amended as a direct consequence of the reform. Hedged items may be described in different ways in existing hedge documentation so consequential amendments, in addition to changing the reference to the interest rate, may be needed. For example, the drafting for proposed paragraph 12.25I(b) could be as follows: 'amending the description of the hedged item so that it refers to an alternative benchmark together with other amendments to the description of the hedged item that are required by the reform'.

Designation of risk components

11. Proposed paragraph 12.25Q states that 'If an alternative benchmark rate is documented as a non-contractually specified risk component and that rate is not separately identifiable at the date of documentation (for the purposes of meeting the requirements in paragraph 12.16C), it shall be deemed to have met that requirement at that date, if and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within 24 months of that date.'
12. We question whether 24 months is sufficient for markets to develop sufficiently, particularly now in light of the Covid-19 pandemic. It would be an unfortunate and unhelpful outcome if the FRC was required to spend additional time, at a later date, developing and issuing a further amendment just to extend this deadline.

Finance leases - lessees

13. Under the proposals, the effect of interest rate benchmark reform is regarded as a modification to a lease liability in accordance with the practical expedient proposed in paragraph 20.11B. In our view, this creates a tension with the existing guidance on the treatment of contingent rents as per paragraph 20.11. This is because the Glossary to FRS102 refers to changes due to 'future rates of market interest' as an example of a contingent rent (which would then be charged as an expense in the year in accordance with 20.11).

14. When interest rate benchmark reform is the only change to the lease, it may be that a similar outcome is reached as a result of applying the practical expedient in paragraph 20.11B compared to the requirements under paragraph 20.11. This is because there would likely be no change to the lease liability, but the effective interest rate would change prospectively. Nevertheless, we believe it would be helpful if the proposed amendments were to make clear that paragraph 20.11 for contingent rents is not applicable for changes arising from interest-rate benchmark reform.
15. We note that the proposals for Section 20 *Leases* address accounting for finance leases by lessees. It might be helpful if the Basis for Conclusions were to comment on the fact that the amendments do not affect other lease arrangements ie, operating leases for lessees and lessor accounting.
16. We note that there is no guidance to address the situation when there are other modifications to a lease occurring at the same time as changes arising from interest rate benchmark reform. In the absence of direct guidance on this matter, it may be that entities consider a two stage process to be appropriate ie, by applying the practical expedient to changes arising from interest rate benchmark reform and then apply additional requirements within the standard for other changes to the lease. Alternatively, entities might consider a one stage approach similar to that outlined in IFRS (which requires that when there are other modifications to leases at same time as IBOR reform, entities apply the usual IFRS 16 guidance on modifications, including those for IBOR reform). It is worth noting that, in the absence of any guidance in the proposed amendments and the lack of any requirements in FRS 102 for lease modifications, entities will need to develop an appropriate approach and policy in either scenario.
17. We acknowledge that part of the issue raised in paragraph 16 is the absence of requirements in FRS 102 for lease modifications. We understand that this is a matter which may well be addressed when IFRS 16 is incorporated into FRS 102. Therefore, while we do not expect this matter to be addressed as part of these proposals, it might be something to consider as part of forthcoming plans to update FRS 102 for IFRS 16.
18. As a general point, it might also be helpful if the FRC were to clarify whether minimum lease payments are impacted (for disclosure or measurement purposes) once a variable interest rate changes. As above, we do not expect this to be addressed as part of these proposals. Instead, it might be something to consider as part of forthcoming plans to update FRS 102.

Disclosure

19. We also suggest that an exemption is given from the requirement of paragraph 10.13(b). This is because paragraph 10.13(b) requires disclosure, to the extent practicable, of the amount of the adjustment made to each affected line item by a change in an accounting standard. Requiring this information would appear to negate the intended purpose of the practical expedient.

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.

20. We agree that the proposed amendments will minimise the financial reporting costs of accounting for changes to financial instruments and leases arising as a result of interest rate benchmark reform.