FRED 30 Financial Instruments: Disclosure and Presentation

Recognition and Measurement

Response to ASB Questions

ASB (i) Treating IASs 32 and 39 as a package (Appendix III, paragraph 15)—The ASB has concluded that it is best to view the requirements in IASs 32 and 39 as a single package of requirements that should, as far as is practicable, be implemented in the UK at a single point in time. Do you share this view?

Yes.

ASB (ii) Implementation in 2004 (Appendix III, paragraphs 17-20)—Notwithstanding the general approach referred to in (i) above, the ASB is proposing to implement, at a single point in time, some parts of the standards in mandatory form, some in non-mandatory form and some not at all for the time being. At the same time, it is proposing to withdraw FRSs 4 and 13 (and related UIITF Abstracts) and keep in place most parts of FRS 5. Do you believe that, in the circumstances, this represents the best possible approach of implementing in the UK the international requirements in this area?

No, we do not support this approach. We believe that this piecemeal approach to the introduction of standards is cumbersome to apply and will impair the comparability of financial statements between different financial periods and also between different entities. We believe that implementation should be in 2005 and do not support the option to apply early.

ASB (iii) Recognition and derecognition (Appendix III, paragraphs 23-29 - The FRED proposes that the proposed new IAS 39 approach to recognition and derecognition should not be implemented in the UK at the present time. Instead, when the direction of international convergence on this subject becomes clearer, a further consultation document will be issued. Do you agree with this approach?

Yes, we agree with this approach. Please note additional comments below.

ASB (iv) Measurement (Appendix III, paragraphs 30-49 - The ASB is proposing that, prior to 2005, companies should be required to adopt IAS 39's measurement requirements only if they choose to adopt the fair value accounting rules that will be set out in companies legislation. Entities that do not choose to adopt those rules will not initially be required by UK standards to adopt the measurement requirements at all.

(a) Do you agree with this approach?

No, we do not believe that companies should be given a choice of adopting the measurement requirements in FRED 30. For the reasons previously outlined in our response to ASB (ii), we believe that a mandatory implementation of all aspects of the standard should apply from January 2005.

Do you agree that the recycling requirements of IAS 39 should not be implemented in the UK pending completion of the project on reporting financial performance and do you agree with the alternative treatment proposed in the FRED? (Appendix LIT, paragraphs 50-52)

Yes.

ASB (v) Hedge accounting—The ASB is proposing a similar approach to IAS 39's hedge accounting requirements as to its measurement requirements. (Appendix III, paragraphs 57-63, 69 and 70)

(a) Do you agree with this approach?

Yes, we support the approach in the context of overall convergence.

However, we believe that there are industry specific issues which merit further consideration in relation to hedge accounting requirements. The hedging model proposed in FRED 30/IAS 39 proposes a method of accounting which for certain businesses is not consistent with the way in which the business in managed. On the basis that the financial statements should reflect an entity's risk management activities, our concern is that application of the hedging model in these circumstances will result in financial statements which are not consistent with the management of the entity. This is particularly relevant to the "banking book" activities of a bank. Banks generally manage their banking book activities on a cost basis, applying gap analysis and other activities to manage their financial risk exposures. Banks generally hedge the risk in these books on a net basis. The prohibition of net hedging in FRED 30 is not consistent with the way these businesses are managed. We suggest that the detailed criteria required in order to use hedge accounting, and in particular the prohibition on net hedging be reconsidered for banks.

(b) **Do you agree that the approach being proposed in place of recycling? *(Appendix III, paragraphs 64-68)***

Yes.

ASB (vi) Unlisted entities and individual financial statements

(a) The FRED proposes that, prior to 2005, entities should be required to comply with IAS 39's measurement and hedge accounting provisions in certain circumstances only. That will change in 2005 for the consolidated financial statements of listed entities but, the FRED suggests, not for other entities or other types of financial statement. Thus, from 2005 listed entities that do not prepare consolidated financial statements and unlisted entities will not be required to adopt IAS 39's measurement and hedge accounting provisions unless they choose to adopt the fair value accounting rules set out in the Companies Act 1985. Similarly, listed entities that prepare consolidated financial statements will not be required to adopt IAS 39's measurement and hedge accounting provisions in their individual financial statements unless they adopt the fair value accounting rules in those financial statements. Do you agree with this approach?

We do not agree with this approach. We believe that the rules applying to listed entities post 2005 should also be applied to unlisted entities.

(b) FRS 13's disclosure requirements apply only to entities, other than insurance entities, that are listed or have publicly-traded securities and all banks. The ASB is proposing to revise the disclosure requirements on I January 2004 and to apply those new requirements to all listed entities, all other entities that have publicly-traded securities and all banks (in other words, the exemption for listed insurance entities will be removed, but otherwise the scope will be unchanged). Do you agree with this approach or do you believe that, from 2004, the requirements should apply to some other entities (for example, unlisted insurance companies) or, alternatively, to a narrower range of entities?

We agree with this approach.

(c) **FRS 13's disclosure requirements apply both to consolidated financial statements and to individual financial statements, except that they do not need to be applied in the individual financial statements of entities that are preparing FRS 13-compliant consolidated financial statements. The FRED proposes to retain a similar exemption. Do you agree with this approach?**

Yes

Response to IASB Questions on IAS 32

IAS 32 (i) Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)—Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

We do not believe that the classification of a liability should be made without regard to the probabilities of the different manners of settlement if it leads to the consequences mentioned in this question. The important principle is that the substance of the instrument rather than its legal form governs the classification.

IAS 32 (ii)Separation of liability and equity elements (paragraphs 28 and 29>-Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

Yes we agree with the proposed approach which is consistent with the definition of equity as a residual interest in net assets.

IAS 32 (iii) Classification of derivatives that relate to an entity's own shares (paragraphs 29C - 29G)—Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

Yes.

IAS 32 (iv) Consolidation of the text in IAS 32 and LAS 39 into one comprehensive Standard—Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the IASB Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

Yes, integration of the texts would be useful as they are read in conjunction with one another. We note that IAS 39's Application Guidance forms an integral part of the standard whereas the equivalent guidance for IAS 32 is for illustrative purposes. This inconsistency would require to be eliminated in a consolidated standard.

Response to IASB Questions on IAS 39

IAS 39 (i)Scope: loan commitments (paragraph 1(i))- Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of LAS 39?

Yes.

IAS 39 (ii))Derecognition: continuing involvement approach (Appendix I, paragraphs 35-57>- Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

We consider the continuing involvement approach taken in the exposure draft of IAS 39 to be inherently flawed and unlikely to work in practice. We believe that the UK standard FRS 5 "Reporting the substance of transactions" has worked well and that any approach to this area should apply substance over form (or economic risks and rewards) as its basic principle.

IAS 39 (iii)Derecognition: pass-through arrangements (Appendix I, paragraph 41)—Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from, one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

Yes.

IAS 39 (iv)Measurement: fair value designation (paragraph 10-Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

Yes, we support the proposed amendment, however we do not agree that the designation should be irrevocable. We believe that entities should be permitted to re-designate financial instruments initially designated as held for trading as instruments measured at cost.

IAS 39 (v)Fair value measurement considerations (paragraphs 95 - 100D)—Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95 - 100D of the Exposure Draft? Additional guidance is included in paragraphs A32 - A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

We believe the final three sentences in paragraph 98 should be retained as drafted in the current version of IAS 39. The phrase 'normally' should also be retained in paragraph 99. This recognises that, in some cases, the current quoted market price may not be indicative of the amount of cash that could be realised by selling the asset.

In the case of large holdings, these may only be disposable at a significant discount to quoted market price. Although such an adjustment would necessarily be subjective, we believe it would be imprudent and misleading to investors to record the asset at the higher quoted price where such an amount could not be realised. In addition, where a large holding is initially acquired, marking the holding to quoted market price may result in a large gain being recognised immediately following acquisition.

IAS 39 (vi) Collective evaluation of impairment (paragraph 112 and 113(a)-113(d))- Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

We agree with the principle of including individual loan assets/financial assets found not to be individually impaired in a group of assets with similar credit risk characteristics. This is consistent with the knowledge entities have that a certain proportion of their loan book will not be repaid even though individual loans may not have been deemed to be impaired.
The methodology for measuring collective impairment appears reasonable.

IAS 39 (vii)Impairment of investments in available-for-sale financial assets (paragraphs 117-119)—Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?'

We disagree with this proposal. Where an impairment has been recorded in the profit and loss it should be reversed through profit and loss account!

IAS 39 (viii) Hedges of firm commitments (paragraphs 137 and 140-Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

Yes we agree with this treatment.

IAS 39 (ix)'Basis adjustments' (paragraph 160)— Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that bad previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?[2]

We disagree with the proposal to recycle gains and losses on cash flow hedging instruments as stated in paragraph 160.

IAS 39 (x) Prior derecognition transactions (paragraph 171B)—Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised bad the new requirements been applied?

If IAS 39 were to be implemented in its current format we would support the approach whereby prior derecognition transactions would be grandfathered.

Other Comments

- **Hedge Accounting**

We believe that there are industry specific issues which merit further consideration in relation to hedge accounting requirements. The hedging model proposed in FRED 30/lAS 39 proposes a method of accounting which for certain businesses is not consistent with the way in which the business in managed. On the basis that the financial statements should reflect an entity's risk management activities, our concern is that application of the hedging model in these circumstances will result in financial statements which are not consistent with the management of the entity. This is particularly relevant to the "banking book" activities of a bank. Banks generally manage their banking book activities on a cost basis, applying gap analysis and other activities to manage their financial risk exposures. Banks generally hedge the risk in these books on a net basis. The prohibition of net hedging in FRED 30 is not consistent with the way these businesses are managed. We suggest that the detailed criteria required in order to use hedge accounting, and in particular the prohibition on net hedging be reconsidered for banks.

- **Loan Loss provisions**

Paragraphs 111-114 require specific provisions for loan losses to be determined as "the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instruments effective interest rate". Under current IR/UK Gaap financial institutions create specific provisions for loan losses based on the BBA SORP on Advances. This SORP does not require financial institutions to determine specific provisions solely on the basis of discounted cash flows.

The proposals in FRED 30 / IAS 39 are far more stringent than those in place in JR/UK Gaap and those proposed by the Basle Capital Accord. As the implications of the proposals in FRED 30 would be a major change for financial institutions and others, with considerable practical difficulties, this issue needs to be considered and debated further with specific industry representatives prior to being established as an accounting principle.

- **Definition of recognition**

We agree with the ASB's decision to omit detailed guidance on recognition pending the outcome of deliberations on an international approach to the topic.
However, recognition is referred to several times through other parts of the proposed standard and it is left to the reader to interpret it as they like. For example, it is clear that "initial recognition" (paragraphs 66,6 8) has a specific meaning - but one which is undefined in the standard. To aid the comprehension of the standard we believe that it is necessary to define recognition (in line with FRS 5) explicitly in the standard.

- **Forecasted transaction**

We require clarification on use of the term 'forecast transaction', defined in paragraph 127 as 'an uncommitted but highly probable anticipated future transaction'. Particularly with reference to paragraphs 162— 163, we require clarification whether reference is being made to 'forecast transactions' or to cashflows in general.

- **Effective interest rate method**

We require further clarification with regard to effective interest rate / method.

- **Status of SORPs**

Please clarify what the status of the BBA SORPS will be on implementation of FRED 30 as a standard, in particular the position where conflict arises between a SORP and the FRED.

- **Reporting Financial Performance**

The project dealing with reporting financial performance needs to address the classification of different types of gains and losses in the profit & loss account. This mailer should be dealt with in tandem with the FRED 30 proposals.

- **Other**

1. Paragraph 16 on page 137 re: regular way contracts, refers to paragraphs 30— 33 which have been deleted.
2. Paragraph 103A on page 153 refers to paragraph 73 which has been deleted (should reference be made to paragraph 69 instead?).
3. The cover of the FRED retains the word recognition in the title - presumably a typographical error.