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BDO

BDO Stoy Hayward
Chartered Accountants

8 Baker Street London W1U 3LL
Telephone +44 (0)20 7486 5888
Facsimile +44 (0)20 7487 3686
DX 9025 West End W1
Web Site: www.bdo.co.uk

Paul Ebbling
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
London
WC1X 8AL

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Direct line: 020 7893 2110
E-mail: peter.chidgey@bdo.co.uk

Dear Sir

FRED 30 Financial Instruments: Disclosure and Presentation, Recognition and Measurement

We welcome the publication of an Exposure Draft addressing the measurement of financial instruments, an area where guidance will be required once UK legislation is changed to permit fair value accounting.

We agree that the process of reviewing and amending UK standards as part of the convergence process should be gradual over the period to 2005 but are not convinced of the need to make them mandatory on a similar basis, as opposed to a "big bang" change from 2005. If the revised UK standards are not identical to IAS then listed groups (and potentially other companies that adopt IAS if UK law permits) will be doubling up on the number of new standards they adopt over a 2 or 3 year period as they will need to adopt a UK version and then, subsequently in 2005/2006, the actual IFRS.

We support an approach that requires those entities that ***choose*** adopt fair value accounting of financial instruments to apply the measurement requirements of FRED 30 but does not mandate the remainder of FRED 30 before 2005.

It appears that FRED 30 will supersede FRS 4 and associated UITF abstracts. It is unclear what requirements regarding disclosure of the maturity of creditors, treatment of issue costs or treatment of finance costs will apply to those entities not:

- subject to the disclosure requirements of FRED 30; or
- choosing to adopt fair value accounting and therefore not subject to the measurement requirements of FRED 30.

Our comments on the specific ASB questions raised in FRED 30 follow.

1. *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?

   As noted elsewhere we do not favour mandatory application prior to 2005. However certain aspects of this standard will need to be made compulsory prior to that date for companies that choose to adopt the fair value accounting rules in financial statements prior to that date.

2. *ASB (ii)* **Implementation in 2004 (Appendix III paragraphs 17-20 -** Notwithstanding the general approach referred to in (z) 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 UITF 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?

   See our response to 1 above as regards the timing of implementation.

   We agree that the FRS 5 recognition and derecognition criteria should be retained until the IASB approach has been finalised.

   FRS 4 applies to all companies. By contrast the FRED 30 requirements relating:

   - to disclosure apply only to listed companies and to banks; and
   - to measurement apply only to those adopting fair value accounting.

   The withdrawal of FRS 4 will considerably reduce the basic disclosures (e.g. maturity) required of unlisted companies and remove guidance on the measurement of financial instruments for those entities not adopting fair value accounting. It is not clear that this was the intention of the ASB.

3. 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.

4. *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?
   (b) 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 III, paragraphs 50-52)

   (a) Yes. We do not believe that any of the requirements should be mandatory prior to 2005 other than those aspects applicable if companies choose to adopt the fair value accounting rules that will be set out in companies legislation.

   (b) We agree that the recycling requirements of IAS 39 should not be implemented in the UK prior to 2005 and the adoption by listed groups of IFRS. However, if the issue has not been agreed by then we are not convinced that it is appropriate to require listed groups to recycle while prohibiting other entities from using the same approach.

5. ***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?
   (b) Do you agree that the approach being proposed in place of recycling? (Appendix III paragraphs 64-68)

   (a) Ideally we would like to see hedge accounting dealt with in a single standard rather than, as present, separating companies not adopting the fair value accounting rules (FRED 23) from those that do (FRED 30). While we have not carried out a detailed comparison of FRED 23 and 30 it would seem illogical for an arrangement to be considered a hedge under one standard and not the other. We set out below two instances where this appears to be the case.

      - FRED 30 Measurement, paragraph 122 prohibits non-derivative financial instruments from being treated as hedging instruments other than in the case of foreign currency risk. It is unclear whether FRED 23 contains a similar prohibition.

      - FRED 30 Measurement, paragraph 153 specifies the accounting for non-derivative instruments used in a fair value hedge. Where such instruments would normally be carried at cost or amortised cost under FRED 30 we would expect the hedge accounting to be consistent between FRED 23 and 30. It is not clear that this is the case.

(b) Yes, but see our response at 4(b) above.

6. 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?

(b) FRS 13 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 1 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?

(c) FRS 13 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?

(a) Yes. We do not believe that any of the requirements should be mandatory prior to 2005 other than those aspects applicable if companies choose to adopt the fair value accounting rules that will be set out in companies legislation.

(b) We agree that unlisted entities should be excluded from the scope of the disclosure requirements of FRED 30. As noted elsewhere we do not favour mandatory application prior to 2005.

(c) We agree that the disclosures should not need to be applied to the individual financial statements of parent entities that are preparing FRED 30 disclosures for their consolidated financial statements.

We comment below on the questions asked by the IASB in their discussion draft.

7. ***IAS 32 (i) Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)***
   (a) 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.
   (b) 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).

(a) We believe that the probability of the means of settlement should be considered, as is the case under UITF 33.
(b) If there is real uncertainty then we agree with a default presentation as a liability. However we are concerned that there may be scope for manipulation. Is the paragraph meant to apply if there is any uncertainty no matter the extent of the uncertainty? Consider the situation where the uncertainty related to the going concern status of the entity and the instrument was only settled in cash/financial assets if the entity ceased to be a going concern. It would be inconsistent to classify the instrument as a liability in accounts prepared on a going concern basis.
(c) Is paragraph 22C only meant to treat as a liability any situation where the number of shares to be issued to settle an obligation is not fixed (i.e. as in the last sentence of 29D)? Currently 22C does not explicitly state that. A contractual obligation of a fixed amount that is to be settled by the issue of a fixed number of shares could be caught by 22C as the number of shares, although fixed, depends on the amount of the obligation.

8. ***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?*

We agree with the proposed approach and the removal of the existing alternative.

9. ***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 & own shares?*

   We are unclear whether this is consistent with the approach for contractual obligation that may be settled in shares. We refer to our points in 7 above.

10. ***IAS32 (iv) Consolidation of the text in IAS32 and IAS39 into one comprehensive Standard***—*Do you believe it would be useful to integrate the text in IAS32 and IAS39 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, but only if this is done intelligently so as to remove duplication and to highlight the connections between the various requirements of the standards.

11. ***IAS39 (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 IAS39?*

    Yes, on pragmatic grounds. At present there is no definition of the term 'loan commitment'. We suggest such a definition is included along the lines of C10 of appendix C to the FRED.

12. ***IAS39 (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 IAS39? If not, what approach would you propose?*

    We support the ASBs approach of retaining the FRS 5 criteria and omitting the IASB provisions from FRED 30 until the operation of the latter in practice can be accessed.

13. ***IAS 39 (iii) Derecognition: pass-through arrangements (Appendix 1, 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?*

    See 12 above.

14. ***IAS39 (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.

15. ***IAS39(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 have no further suggestions to make at present.

16 ***IAS39 (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. The portfolio approach is analogous to warranties where provision is made on a population basis even though the specific warranty claims may not be identifiable. As a pragmatic approach, we agree with the exclusion of assets that have been individually identified as impaired from the portfolio assessment of impairment.

17. ***IAS39 (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?*

No. Such an approach appears to be inconsistent with guidance elsewhere on impairment (e.g. IAS 36: 102 to 106). Paragraph C93 of appendix C identifies difficulties in objectively determining when impairment losses have been reversed as the reason for the prohibition. If that is the case disclosures should be made of the reason for the original impairment and for its reversal similar to those in IAS 37:117.

18. ***IAS39 (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*?

No. The proposals result in firm commitments being accounted for as fair value hedges and forecast transactions as cash flow hedges. It is difficult to see why an unrecognised contractual commitment to purchase an asset should result in different accounting from a forecast purchase of the same asset in the same time-span. The net impact on the accounts would appear to be the same in both cases and it is unclear how the additional costs associated with tracking and accounting would be of benefit.

For fair value hedges the gain or loss on revaluing the 'unrecognised' firm commitment (the hedged item) is taken to profit and loss and recognised as an asset or liability in the balance sheet. The gain or loss on the hedging instrument is also taken to profit and loss account. Thus only the ineffective portion of the hedge affects the profit and loss account and net assets.

For cash flow hedges the loss or gain on the effective portion of the hedging instrument is deferred either via equity in IAS39 or amongst assets and liabilities under FRED 30. Again, under FRED 30, only the ineffective portion of the hedge affects the profit and loss account and net assets. Under IAS 39 net assets are affected by the full change in value of the hedging instrument.

It is unclear how the gain or loss in the balance sheet is to be accounted once the firm commitment is recognised under the revised approach. The FRS should clarify whether it is added to the cost of the asset, written off immediately or recognised in profit and loss consistently with the reporting of gains or losses on the hedged asset or liability?

19 ***IAS39 (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 had 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?*

We agree with the matching of the gain or loss on the hedging instrument with the corresponding loss or gain on the asset or liability arising from the forecast transaction. The approach suggested appears to be more complicated than the previous approach of simply rolling the gain or loss into the initial measurement of the asset or liability. The net impact on profit and loss is unchanged but requires two balances rather than one balance to be tracked. However we note the comment in paragraph C 103 that the change is required to bring IAS39 into line with FASB 133.

20. ***IAS39 (x) Prior derecognition transactions (paragraph 1 71B)—****Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS39 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 (ie 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 had the new requirements been applied?*

As a general principle we agree that changes in accounting policy should be made retrospectively. That said there should be grandfathering requirements where the transactions have occurred many periods previously and information may not be available or the cost of restating is out of proportion to the benefit.

IAS39 became mandatory for periods beginning on or after 1 January 2001 and recognition and derecognition polices for prior periods could not be reversed. We presume that the requirement for restatement in the revised IAS39 would not extend to financial instruments that were derecognised in periods beginning before 1 January 2001. Hence the problems noted above are more likely to arise due to high volumes of trades in financial instruments rather than passage of time.

It is not clear that the suggested grandfathering option of disclosing the balances that would need restating would be any less onerous than actually restating as the same information would appear to be required in each case.

Other FRED 30 comments
Financial instruments: Disclosure and Presentation

21. Paragraph 4 makes reference to FRS 17. Is it intended that in the sponsoring employer's financials statements the requirements of the FRED should apply to the pension plan assets? The revised text for IAS32 refers to IAS29 NOT IAS 19 and we presume that the ASB equivalent should refer to the Pension Scheme SORP not FRS 17.

22. An entity's normal business may be making trades in a non-financial item for physical delivery (e.g. corn) with a view to making a profit from short-term fluctuations in price. Paragraphs 4A and 4B together appear to require that any such contracts, for example to buy or sell corn, are always treated as financial instruments notwithstanding that the contract is within the entity's physical purchase and sale requirements. Is it intended that the existence of such short-term trades should always override the exemption for normal levels of purchases and sales?

23. We note the additional ASB definition at *5A*. Does this indicate that an equivalent paragraph is required in IAS32?

24. In considering the nature of a contractual obligation in paragraph 6 the "clear economic consequences that the parties have little, if any, discretion to avoid" would presumably ignore the absence of commercial discretion due to

    - a lack of access to the foreign currency,
    - lack of regulatory approval or

- a contractually accelerating dividend that the issuer had no commercial option but to redeem?

This should be clarified. If this is not the case paragraph 6 would be inconsistent with the revised approach in 19,22 and 22A.

25. Paragraph 19 requires the classification of an instrument to be made "without regard to probabilities of the manner of settlement". UITF 33 requires a capital instrument to be treated as a liability if it can be settled in shares or by transferring economic benefits at the issuers option and "there is no genuine commercial probability that the option to issue shares will be exercised". This apparent change of policy is not discussed in appendix III to the FRED and should be highlighted.

26. Paragraph 22 discusses the mandatory redemption of a preference share meeting the definition of a liability. It would be helpful to clarify that a mandatory dividend also meets the definition, assuming that is the case.

27. Equity should be defined for the purpose of paragraph 29A. The term is defined in the IASB Framework at paragraph 49. However the same definition is termed "Ownership interest" rather than equity in 4.37 of the ASB SoP.

28. It is unclear whether the phrase "an equity transaction that is not completed" in paragraph 31 A only refers to an aborted transaction. Costs incurred before a year-end in relation to a successful share issue post year-end should not have to be recognised as an expense.

29. The application of paragraph 3lB to a simultaneous listing and offering should be clarified. In practice the listing will not be solely related to other shares, as suggested, but to a whole class of shares including those being issued.

30. We prefer the UK approach to offset. It is unclear why "intent" as to the means of settlement is relevant in paragraph 33 and it is ignored for the purpose of classification in paragraph 19.

Financial instruments: Measurement

31. Paragraph 103A refers to paragraph 73, but that has been deleted.

32. Paragraph 158 requires a gain or loss on a cash flow hedging instrument to be reported on the balance sheet and described as "Gains and losses arising on effective cash flow hedges not yet recognised in the profit and loss account". We have two concerns.

- The heading appears to be unduly cumbersome to be used on the face of the balance sheet and the wording of paragraph 158 does not appear to permit a shorter alternative.
- It is unclear whether a net figure is required or separate gross figures for deferred gains and deferred losses. If the latter it should refer to "Gains arising..." and "Losses arising"

We hope that the above comments are of assistance. If you wish to discuss any of the points raised in our submission please contact Peter Chidgey on 020 7893 2110.

Yours faithfully

BDO Stoy Hayward

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