CL 137K

14 October 2002

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Dear Paul

Exposure Draft 30— Financial Instruments: Disclosure and presentation; Recognition and measurement

The Federation is pleased to have the opportunity to comment on the proposed FRED 30— Financial Instruments: Disclosure and presentation; Recognition and measurement.

The Federation represents nearly 1400 independent, not for profit housing providers. Our members include registered social landlords, housing associations, co-ops trusts and transfer organisations. They manage more than 1.8 million homes provided for affordable rent, supported housing and low cost home ownership as well as delivering a wide range of community and regeneration services.

Banks continued to increase their position as the leading providers of funds to housing associations At March 2001 they had 60% of the market, while building societies had 20%. Total capital markets issues represented *15%* of all existing private finance facilities at March 2001 with other sources providing *5%*. In certain circumstances, housing associations are permitted to use financial derivative instruments for the management of financial risk.[1]

The Federation believes that FRED 30 imputes a trading mentality into management decisions, introduces additional volatility in the accounts and ultimately confuses users of the accounts. Adopting fair value, based on a snap-shot measurement, may send distorted signals about financial performance. Furthermore, we are concerned that, in some cases, estimating fair value will be complex and time-consuming. A more detailed explanation of these issues is provided in the enclosed paper.[2]

[1] Housing Corporation Circular R2-05/99 *Financial derivative instruments – regulatory policy.*

[2] National Housing Federation's Response to consultation paper *Financial instruments and similar items*. June 2001 (http://www.iasb.org.uk/docs/fiiwg/uk14.pdf).

Many commentators responding to the JWG draft standard supported a limited application to the draft's requirements and we are happy to note the proposal that unlisted entities would not be required to adopt the IAS 39 measurement model from 2005 (Appendix III, paragraph 54). However, it is our understanding that this would not exempt housing associations that have issued bonds or use derivatives etc. In this case, the rationale behind the proposal is diluted, exposing certain unlisted entities to unintended and onerous reporting requirements that is likely to impair the understandability of the accounts produced.

We recommend that the ASB should re-consider the exposure draft, explicitly excluding from its scope organisations like registered social landlords, which are not taking out loans or dealing in financial instruments as their primary business activity and whose main stakeholders are funders, local authorities and tenants.

Yours sincerely

Janine Relph
Policy Officer

NATIONAL HOUSING FEDERATION

Dear Allan

The Federation is pleased to have the opportunity to comment on the discussion paper *Financial instruments and similar items.*

We welcome the stated purpose of enhancing clarity and usefulness of published financial statements, but we believe that fair values should only be computed for tradeable financial assets and liabilities, and the resulting risk considerations should be reported in the notes to the accounts only, without interfering with balance sheet or income statement figures.

The Federation believes that the Draft Standard in its present format imputes a trading mentality into management decisions, introduces additional volatility in the accounts and ultimately further confuses users of the accounts.

We recommend that the ASB should re-consider the Draft Standard thoroughly, excluding from its scope organisations like Registered Social Landlords which are not permitted to trade in financial instruments, which are non-profit distributing organisations and whose main stakeholders are funders, local authorities and tenants. Our concerns, together with our proposals for change, are further detailed in the enclosed paper.

I would be glad to discuss them with you if that would be helpful.

Response to consultation paper *Financial instruments and similar items* National Housing Federation, June 2001

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CONSULTATION RESPONSE

DISCUSSION PAPER
FINANCIAL INSTRUMENTS AND *SIMILAR ITEMS*
The National Housing Federation welcomes the opportunity to comment on the consultation paper *Financial instruments and similar items* incorporating the Joint Working Group's Draft Standard,

The Federation represents over 1,400 independent, not for profit housing providers. Our members include registered social landlords (RSLs), housing associations, co-ops, trusts and transfer organisations. They manage more than 1.7 million homes provided for affordable rent, supported housing and low cost home ownership as well as delivering a range of community and regeneration services.

The Federation, together with its Scottish and Welsh counterparts, is the recognised SORP-making body for RSLs in the United Kingdom.

MAIN RESPONSE

Impact of fair value measurement principle

The Federation disagrees with the Draft Standard's premise that cost-based measurement should be abandoned in favour of fair value measurement for the wide range of items defined as "financial instruments". This premise portrays all companies as active traders in their financial assets and liabilities, thus disregarding management intentions and confusing users of the accounts.

The Federation believes that, in order to enhance clarity and usefulness of published financial statements, changes in the fair value of financial instruments should not be recognised in the accounts themselves as suggested in the Draft Standard, but instead should be disclosed in the notes to the accounts.

The idea that the most relevant measure for any financial item is its market-based value, rather than its contractual amount, is hardly contentious in conceptual terms. Translating this idea into practical reporting requirements raises some fundamental questions about the purpose of financial statements, though. The Draft Standard recommends that market-based values be reported in financial statements for all financial assets and liabilities, whatever their function.

This requirement disregards management intentions. For instance, revaluing bank loans at market value each year provides useful management information to make such decisions as early redemption or renegotiation. However, for a company not engaged in active loan trading, this market value bears no relationship to the amounts actually due to the lender which alone matter to managers when appraising the financing of the business (e.g. for cash-flow forecasts). The Draft Standard thus imputes a trading mentality into management decisions. In our example, financing activities are treated as speculative, whereas they should be considered as a means of funding operations at a specific cost. RSLs are certainly not trading in financial assets and liabilities, and indeed are not allowed to freely trade in derivatives. Housing Corporation Circular *R2-05/99 Financial derivative instruments —regulatory policy* allows RSLs to use derivatives in a defensive hedging strategy only, and explicitly forbids RSLs to sell derivatives'.

Fair value measurement doesn't meet the need of accounts users for greater transparency and clarity either. It introduces into financial statements an additional element of volatility which does not reflect any actual business decision. In the case of RSLs, published accounts are used by lenders, regulators and of course tenants. Going back to our bank loan example, implementing the Draft Standard would mean that the interest charge reported does not match the interest charge actually due.! RSL stakeholders rely on the latter figure for assessing performance, which would no longer be part of published accounts. Many similar discrepancies would be introduced by the Draft Standard, to the point that published financial statements would not make sense to users. RSLs would eventually need to produce two sets of accounts, one to comply with accounting standards, the other to produce a meaningful report to stakeholders.

This inappropriate situation could be avoided if greater consideration were given to the main purposes of external financial reporting. Under the fundamental changes proposed in the Draft Standard, financial statements incorporate some elements of risk assessment and some elements of immediate valuation of a company's worth (for financial instruments), while retaining traditional recognition and measurement principles for non-financial assets and liabilities. On the contrary, the Federation believes that financial statements should have the single purpose of recording and summarising realised income and expenditure, total assets and liabilities actually held.

Annual market valuations are indeed useful and should be complemented by information on financial and operational risks incurred and risk management strategies developed. However, fair values should only be computed for tradeable financial instruments, and the resulting risk considerations should be reported in the notes to the accounts without interfering with balance sheet or income statement figures.

1 Except to unwind an existing hedging position, or if the sale is part of a collar.

SPECIFIC COMMENTS ON JWG QUESTIONS

Questions reproduced below are only those on which we are commenting.

Scope and definitions

1 The Draft Standard would apply to all enterprises ***[...].*** *Do you agree?*
2 [.j Do you agree with the definition [of a financial instrument] in the Draft Standard?
3 The Draft Standard would apply to all financial instruments except for those referred to in paragraph 1. Do you agree with the proposed scope exclusions [.j?

The Federation fully subscribes to the view held in the Basis for Conclusions that “smaller, non-public or non-listed enterprises should be exempt from the Draft Standard because many may lack the capabilities and resources to implement the proposed recognition and measurement principles. ***[...]*** For these enterprises, the cost of implementing this Draft Standard might outweigh the benefits”2.

We do not agree that the Draft Standard should apply to all enterprises. In particular, it should not apply to organisations like RSLs which do not trade in financial instruments and whose primary business is the acquisition and long term management of non-financial assets. These non-profit distributing bodies have a quite different approach to risk assessment than listed companies, and rarely undertake projects on financial grounds alone. Moreover, the Standard understates the extra work and staff training required to compute fair values of each separate financial instrument.

The Federation does not endorse the definition of financial instruments proposed in para. 7 of the Draft Standard. As interpreted by the ASB, this definition covers, in addition to derivatives and marketable equity and debt

2 Page *165*, para. 2.10.

products, “debtors, creditors, deposit accounts”3. For debtors, the current method of specific and general provisions for bad debts is quite satisfactory for RSLs. As for creditors, FRS 4 *Capital instruments* adequately covers the range of financial situations faced by most RSLs. The Federation believes that, not-tradeable items (in particular non-tradeable debtors and creditors) should be excluded from the definition of financial instruments.

Recognition and derecognition

7 The basic recognition principle is that an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it has contractual rights or contractual obligations under a financial instrument that result in asset or liability. Do you agree?

The Federation agrees with this recognition principle provided that the new rule applies equally to financial and non-financial instruments. Therefore, either non-financial instruments should be brought into the scope of this recognition principle, or relevant standards applying to non-financial instruments should be updated accordingly. The new recognition principle should not be introduced until consistency has been achieved.

Measurement

14 The Draft Standard would require an enterprise to measure all financial instruments at fair value when recognised initially and to re-measure them at fair value at each subsequent measurement date [...J. Do you agree?
19 The Draft Standard would require an enterprise that cannot estimate fair value using observable market exit prices of identical or similar instruments to estimate the value by using a valuation technique. ***[...]*** *Is the material [in the Application Supplement J clear and operational? Is this material sufficient?*
21 The Draft Standard would require the reported value of an enterprise 's financial liabilities to reflect the enterprise 's own creditworthiness and changes in it. ***[...]*** *Do you agree?*

We agree in principle with the need for an annual mark-to-market exercise but believe that its impact should only be disclosed in the notes to the accounts, not reported in the accounts themselves.

3 ASB Press Notice 179.

A major problem with the Draft Standard is its lack of practical guidance on the implications of fair value measurement. The 70-page Application Supplement doesn't provide a single worked example of how to compute fair values for non-tradeable instruments. The only computational example4 relates to a corporate bond, a product for which market valuation techniques are straightforward. Consistency in fair value methodologies and assumptions is essential to allow meaningful comparisons between companies. Yet the lack of guidance in the consultation paper can only lead to disparity between accounting practices. So many questions are left unanswered that the Standard appears inapplicable in its present format.

A specific problem arises from the proposal that the reported value of financial liabilities reflects a company's own creditworthiness. This proposal would ultimately lead to the inclusion of unrealised and "illogical" revaluation gains! losses: poorly performing companies with a deteriorating credit rating will record a revaluation gain if the Standard is implemented5. No doubt this situation will be very hard to explain to lenders and other users of the accounts!

Income statement presentation

24 The Draft Standard would require an enterprise to recognise all changes in the fair value of financial instruments [...] in the income statement in the reporting periods in which they arise. Do you agree?
25 The Draft Standard would require an enterprise to separately disclose the income statement effects of certain changes in fair value [...] Do you agree with the proposed disaggregation?
26 The Draft Standard would require that interest revenue and interest expense be determined on the fair value basis, using the current yield to maturity basis [...]. Do you agree with the proposed method of determination?

The Standard doesn't explain which companies might qualify for the exception to the fair value rule when reporting interest revenue and expense mentioned in para. 139. It completely overlooks the consequences of this exception: will two standards coexist in practice for interest revenue and expense, with some companies having to report revalued amounts while others would be allowed to report actual amounts? This would further increase confusion of accounts users.
4 Basis for Conclusions, page 246.

5 The inevitability of this strange result is explicitly acknowledged in the Basis for Conclusions (page 226, para. *4.55)*.

The Federation does not agree with recognition principles that unnecessarily introduce additional volatility in the income and expenditure account. Immediate recognition of changes in fair value does not make sense for organisations such as RSLs whose financial instruments are subsumed to their not-for-profit corporate objective.

Overall, the Draft Standard favours a disconnection between economic performance and reported results, which is detrimental to the understanding of a company's business6. The Federation believes on the contrary that surpluses or losses computed in compliance with accounting standards should reflect a company's underlying profitability.

In the absence of practical guidance, the disaggregation of fair value changes remains a totally impractical requirement. Isolating the impact on fair value of changes in credit risk premiums alone is well beyond the capabilities of most companies, even the largest

Hedge accounting

27 The Draft Standard would not permit any special accounting for financial instruments entered into as part of risk management activities. Do you agree?

While the Federation accepts that there should be no special accounting for financial instruments entered into as part of risk management activities, it doesn't seem appropriate to apply the Draft Standard's recognition and measurement rules' to financial liabilities alone when the purchase of non financial assets forms part of that risk management activity. RSLs routinely fund the acquisition of housing properties with private loans, which amounts to an internal hedge (with the hope that the net effect of variations in property prices and debt prices will be neutral). Consequently, revaluing liabilities alone at market prices is meaningless.

For this reason, the draft standard should not apply until the accounting requirements for non-financial assets are amended for consistency, taking account of current assets and liabilities management (ALM) techniques. It is otherwise likely that organisational risk management will be driven by accounting treatment rather than risk prevention and containment.

6 In the case of bank loans alone, we have already pointed at meaningless reported revaluation gains/losses and interest charges.

Disclosure

28 The Draft Standard would require disclosure of an enterprise 's significant financial risks and of the enterprise 's financial risk management objectives and policies. Do you agree that this information is necessary [...].

The Federation welcomes these additional disclosure requirements, but again finds it hard to assess their practicality due to the lack of appropriate guidance. We recommend that example notes be added to The Standard, in appendix. In addition, the Standard should weigh the benefits of additional disclosure in the light of the increased workload placed upon organisations. The Federation recommends a two-tiered approach whereby detailed disclosure would only apply to organisations trading in financial instruments, and aggregate disclosure would apply to all other organisations.