Financial Reporting Council

July 2014

Impact Assessment and Feedback Statement

Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Basic financial instruments and Hedge accounting

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Impact Assessment

Introduction

1 The Financial Reporting Council (FRC) is committed to a proportionate approach to the use of its powers, making effective use of impact assessments and having regard to the impact of regulation. The FRC issued an Impact Assessment with FRS 100 *Application of Financial Reporting Requirements*, FRS 101 *Reduced Disclosure Framework* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* which included 12 example case studies to illustrate the impact of the new accounting standards on a wide range of UK entities.

2 The cost-benefit impact of the adoption of the requirements of FRSs 100 to 102 as issued in March 2013 was estimated in the Impact Assessment issued with those standards. This Impact Assessment only analyses the potential changes to the original assessment and evaluates whether cost increases or cost savings are likely to arise for entities as a result of issuing *Amendments to FRS 102 – Basic financial instruments and Hedge accounting*. The Impact Assessments have been performed and are presented separately for the amendments to the classification requirements of basic financial instruments and hedge accounting.

Basic financial instruments

3 The amendments to FRS 102 in respect of the conditions for classification of financial instruments as basic are intended to increase the number of financial instruments that can be measured at amortised cost. Based on the assumption that an amortised cost valuation of a financial instrument is less costly to determine than a fair value measurement, the FRC believes that the amendments will reduce the reporting costs of entities that hold such financial instruments.

4 These amendments are cost-neutral for entities that only hold financial instruments which continue to be classified as basic following the amendments. Entities that prefer to value their financial instruments at fair value instead of amortised cost retain this option and remain unaffected by this amendment.

5 Given that the effective date of FRS 102 is for accounting periods beginning on or after 1 January 2015, some entities may have already performed an initial assessment of their financial instruments based on the conditions set out in FRS 102 (extant to the amendments). These entities will be required to re-analyse their financial instruments based on the new conditions for basic debt instruments and will incur some extra cost in respect of this new analysis. However, the FRC believes this additional cost is outweighed by the on-going cost savings of allowing entities to measure more financial instruments at amortised cost.

6 The FRC believes that the amendment of FRS 102 in respect of the classification conditions for basic financial instruments will have a positive impact on financial reporting.

Hedge accounting

7 The Impact Assessment has been prepared using some of the case study scenarios presented in the Impact Assessment of FRSs 100 to 102 originally issued in March 2013. The selected case studies include entities that have financial instruments which are classified as non-basic and are measured at fair value through profit or loss, as this captures the type of entities that are most likely to choose to apply hedge accounting.

8 The FRC believes that the amendments to the hedge accounting requirements in FRS 102 will have a positive impact on financial reporting as they are intended to make the

application of hedge accounting more straightforward for entities. Hedge accounting is optional, and entities are expected to perform their own cost-benefit analysis to decide whether or not they wish to apply hedge accounting.

9 The following selected scenarios set out the estimated impact of the amended hedge accounting in FRS 102:

Scenario	
Company C	Medium-sized company with overseas operations
Company D	Large unquoted parent company
Entity F	Building society
Entity H	Registered provider of social housing
Entity J	Pension scheme

Company C – Medium-sized company with overseas operations

Scenario

Company C is a medium-sized company. It is an importer and exporter, conducting many transactions in currencies other than GBP. As a result, Company C enters into forward foreign exchange contracts for a proportion of its cash flows (both inflows and outflows).

Company C has a small finance team but also has an experienced treasurer. It takes advice from its auditors on the presentation of its financial statements.

Company C has not voluntarily adopted FRS 26 (IAS 39) *Financial Instruments: Recognition and Measurement* in the past.

Applicable accounting standards

Company C applies FRS 102.

Company C previously reduced its exposure to volatility in the profit and loss account by accounting for foreign currency transactions at the rates of exchange specified in those forward foreign exchange contracts as set out in SSAP 20 *Foreign currency translation*. To achieve an element of matching gains and losses on foreign currency transactions going forward, Company C would need to apply hedge accounting. It decided, based on the original version of FRS 102, not to adopt hedge accounting because the administrative burden of doing so outweighed the benefits of the accounting treatment permitted.

Costs of implementing the amended hedge accounting requirements

Hedge accounting is a choice. If Company C retains its decision not to adopt hedge accounting, then the proposed amendments will have no effect on it.

Company C may review the new requirements and the cost of applying hedge accounting and may conclude that the additional costs are justified. The costs will mainly arise from administrative tasks, eg hedge documentation, determining valuations, ongoing monitoring of the hedging relationships and making the appropriate accounting entries.

Company D – Large unquoted parent company

Scenario

Company D is a large unquoted parent company. It has a number of subsidiaries and is the ultimate parent company within its group. Company D's business is based in the UK, although it has a small number of transactions in foreign currencies for which it takes out forward foreign exchange contracts. It has financing arrangements (bank loans and leases) which are considered to be basic financial instruments.

Applicable accounting standards

This case study looks only at the situation where Company D applies FRS 102 to its separate and group financial statements (rather than choosing to use EU-adopted IFRS).

Company D reduced its exposure to volatility in the profit and loss account by accounting for foreign currency transactions at the rates of exchange specified in those forward foreign exchange contracts as set out in SSAP 20. To achieve an element of matching gains and losses on foreign currency transactions going forward, Company D had decided, based on the original version of FRS 102, to adopt hedge accounting. It believed that the administrative burden was outweighed by the benefits of the accounting treatment permitted.

Costs of implementing the amended hedge accounting requirements

It is likely, given that the hedge accounting requirements have been simplified, that Company D will be able to apply hedge accounting to the identified hedging relationships under the amended hedge accounting requirements. The ongoing costs should be no higher than those already planned, although the company may incur additional cost to reassess its hedging relationship under the amended hedge accounting requirements.

Entity F – Building Society

Scenario

Entity F is a building society. It has been preparing its financial statements in accordance with the Building Societies Act 1986 and current FRSs. It has not adopted FRS 26 but it has provided certain disclosures about financial instruments in accordance with FRS 13 *Derivatives and other Financial Instruments: Disclosures.*

Applicable accounting standards

Entity F will apply FRS 102 and as a financial institution it must provide additional disclosures as set out in Section 34 *Specialised Activities* of FRS 102.

Entity F is likely to seek to apply hedge accounting where possible.

Costs of implementing the amended hedge accounting requirements

It is likely that under the amended hedge accounting requirements Entity F will be able to apply hedge accounting to a wider range of hedging relationships, since the amended accounting requirements allow entities more flexibility. The costs of applying hedge accounting should not exceed those previously estimated.

Entity H – Registered provider of social housing

Scenario

Entity H is a registered provider of social housing. It has been preparing its financial statements in accordance with the Industrial and Provident Societies Acts and UK accounting standards. It has not adopted FRS 26.

Entity H has a significant amount of borrowings from financial institutions. Some of these loans may have terms that mean that they are non-basic financial instruments. In addition, Entity H has taken out interest rate swaps which are also non-basic financial instruments. Entity H has dedicated treasury staff.

Applicable accounting standards

Entity H will apply FRS 102 including any relevant requirements for public benefit entities.

Costs of implementing the amended hedge accounting requirements

Entity H may choose to apply the amended hedge accounting requirements. The additional costs arising from applying hedge accounting should be reasonably low since the entity can utilise its existing treasury staff. The cost should not increase as a result of the amendments.

If Entity H determines that the cost, in terms of staff time, of applying hedge accounting, outweighs the benefits for its financial reporting, it chooses not to apply hedge accounting. No additional costs are imposed by the amendments.

Entity J – Pension Scheme

Scenario

Entity J is a pension scheme. It prepares its financial statements in accordance with current FRSs and the SORP for pension schemes.

Applicable accounting standards

Entity J will apply FRS 102, specifically Section 34 *Specialised Activities – Retirement Benefit Plans: Financial Statements*.

Costs of implementing the amended hedge accounting requirements

It is considered unlikely that Entity J would choose to apply hedge accounting, since its primary purpose is to report the value of its assets, and the returns thereon.

Feedback Statement

1 The FRC issued FRED 51 *Draft Amendments to FRS 102 – Hedge Accounting* (FRED 51) in November 2013 and FRED 54 *Draft Amendments to FRS 102 – Basic financial instruments* (FRED 54) in February 2014. The comment period on FRED 51 closed on 14 February 2014 and on FRED 54 on 30 April 2014.

2 The purpose of this feedback statement is to summarise the comments received to both consultations. The Accounting Council's Advice to the FRC[1] sets out how the key comments have been taken into account in finalising the amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

3 The FRC received 21 and 29 comment letters to FRED 51 and FRED 54, respectively. The table below analyses the respondents by category.

Table 1: Respondents by category

	No. of respondents	
	FRED 51	**FRED 54**
Accountancy firms	9	11
Accounting bodies	4	5
Representative bodies of preparers	5	6
Preparers	1	5
Users	1	2
Government body	1	0
Total	21	29

FRED 51 – Hedge Accounting

4 FRED 51 posed eight questions, and the feedback and FRC response to them are summarised below.

5 In summary, a majority of respondents was supportive of the proposal that the amended hedge accounting requirements should be based on those in IFRS 9 *Financial Instruments.* They agreed that the proposed amendments are an improvement to the existing hedge accounting requirements in FRS 102. A few respondents were critical about a change to FRS 102 fairly shortly before the standards effective date.

FRC response

6 At the time of publication of FRS 102, the FRC signposted that it will consult on changes to the hedge accounting requirements once the IASB had finalised its revised hedge accounting model. The FRC also informed constituents of its intention to make these changes (subject to consultation) prior to the effective date of FRS 102. We note that respondents were generally in favour of making the changes before FRS 102 becomes effective.

[1] References to the Accounting Council's Advice to the FRC in this Feedback Statement are to the Accounting Council's Advice to the FRC to issue *Amendments to FRS 102 – Basic financial instruments and Hedge accounting* which is included in *Amendments to FRS 102 – Basic financial instruments and Hedge accounting* issued in July 2014.

Question 1

Do you support the adoption in FRS 102 of the three hedge accounting models as set out in this FRED? If not, why not?

Table 2: Respondents' view on Question 1

	No. of respondents
Agreed	18
Disagreed	1
No comment	2
Total respondents	21

7 The majority of respondents supported the proposed hedge accounting models, predominantly because they were in favour of a consistent accounting basis with IFRS. Some respondents confirmed that they believe the amended models are easier to apply in practice than the extant requirements.

8 A number of respondents qualified their affirmative response and requested a number of technical amendments to the proposal, mainly with the aim of aligning the hedge accounting requirements in FRS 102 more closely with those in IFRS 9.

9 The respondent who disagreed with the proposed hedge accounting models rejected the proposal because the respondent fundamentally disagreed with the requirement to measure certain financial instruments at fair value through profit or loss.

FRC response

10 Prior to the issue of FRS 102, constituents' concerns regarding the recognition and measurement of derivatives at fair value were carefully considered. It was concluded that in order to provide high-quality information the recognition of derivatives is preferable to a disclosure only accounting regime. The proposed hedge accounting requirements in FRED 51 were not seeking to revisit these original decisions.

11 Based on suggestions by respondents we have made certain technical amendments where the benefits of greater flexibility outweigh the disadvantages of greater complexity. For example, we have broadened the scope of eligible hedged items in line with IFRS 9.

Question 2

Do you agree with the overarching principle of setting the requirements for hedge accounting in a way that can be straightforwardly applied by entities undertaking relatively simple economic steps to manage risk? If not, why not?

Table 3: Respondents' views on Question 2

	No. of respondents
Agreed	19
Disagreed	0
No comment	2
Total respondents	21

12 There was general agreement that the hedge accounting requirements should be as straightforward to apply as possible. Some respondents suggested that the clarity of the requirements could be improved by providing enhanced examples (see also Question 7).

13 A number of respondents felt that some of the requirements are too simplistic and as a result too restrictive. It was particularly urged to review the restrictions on eligible hedged items and hedging instruments.

FRC response

14 The proposed requirements have been reviewed and drafting amendments have been made to remove unnecessary technical jargon and clarify the requirements.

15 We have taken into account the responses and have broadened the scope of items that are eligible hedged items.

16 We considered requests from respondents to permit a narrowly defined departure from the requirement that only an entire or a proportion of an entire item can be a hedging instrument. An equivalent exemption is provided for in IFRS 9, for example in respect of the time value of an option. We have not seen compelling evidence that would suggest that many entities applying the hedge accounting in FRS 102 would need these exemptions, and in the interest of keeping the requirements relevant, FRS 102 is more restrictive in this regard than IFRS. We note that in any case, entities with more complex hedging arrangements than provided for in FRS 102 have the option to apply IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 to recognise and measure their financial instruments.

Question 3

The draft amendments to FRS 102 require an economic relationship between the hedging instrument and hedged item. Do you agree with this approach to establishing whether a hedging relationship exists? If not, why not?

Table 4: Respondents' views on Question 3

	No. of respondents
Agreed	18
Disagreed	0
No comment	3
Total respondents	21

17 Most respondents agreed with the proposed requirement for an economic relationship between hedged item and hedging instrument and favoured this approach to an effectiveness test at the start of the hedging relationship (see also Question 4). Although most of the respondents agreed with the proposal, they also suggested that the final amendments should include an explanation of when an economic relationship exists, so to avoid diversity when this requirement is applied in practice. Many respondents suggested using the same or similar descriptions as contained in IFRS 9.

FRC response

18 An explanation of when an economic relationship exists has been included in the final amendments, see paragraph 29 of the Accounting Council's Advice to the FRC for more detail.

Question 4

> The draft amendments have the effect of removing the requirement to make a binary assessment at the beginning of a hedging relationship that defines that hedge as effective or ineffective. The effect of this would be to allow hedge accounting to be used for the effective portion of any relationship meeting the qualifying conditions.
>
> Do you agree with this approach? If not, why not? If you envisage practical application difficulties, please provide an illustration of these.

Table 5: Respondents' views on Question 4

	No. of respondents
Agreed	18
Disagreed	0
No comment	3
Total respondents	21

19 The removal of the requirement for an effectiveness test at the beginning of the hedging relationship received overall support. A number of respondents, in particular the accountancy firms, highlighted the importance for entities to appropriately determine the sources of ineffectiveness, so that ineffectiveness is appropriately captured in profit or loss. It was suggested to provide additional guidance and/or requirements in FRS 102 on ineffectiveness.

20 Two respondents noted that the requirements for documentation of a hedging relationship are too onerous and should be simplified.

FRC response

21 Entities are required to determine and document causes of ineffectiveness, in order to commence hedge accounting. We note that the sources of ineffectiveness are varied and depend on the individual hedging arrangements and circumstances. Providing a list of possible sources may be misinterpreted as a prescribed analysis, which may discourage entities from applying their own expertise and judgement. We therefore decided not to follow the suggestions from respondents and have not included detailed requirements or guidance on ineffectiveness. See also the FRC response to Question 7 below.

22 As set out in paragraph 31 of the Accounting Council's Advice to the FRC, the documentation requirements have been simplified compared to the documentation requirements in IFRS 9 and are considered relatively undemanding to meet.

Question 5

> The draft requirements for net investment hedges state that when a hedging relationship is discontinued, amounts deferred in equity may not be reclassified to profit or loss. This is to achieve consistency with paragraphs 9.18A and 30.13 of FRS 102. Do you agree with this proposal, or should recycling of gains or losses on hedging instruments be permitted regardless of the mismatch with the foreign currency movements?

Table 6: Respondents' views on Question 5

	No. of respondents
Agreed	15
Disagreed	2
No comment	4
Total respondents	21

23 A majority of respondents agreed that in order to achieve consistency with other parts of FRS 102, exchange gains or losses deferred in equity should not be recycled through profit or loss. The respondents who disagreed, believed that deferred exchange gains or losses should always be recognised in profit or loss on disposal of the investment. They recommended that paragraph 9.18A of FRS 102 should be amended instead, in order to achieve consistency.

FRC response

24 The requirement in paragraph 9.18A of FRS 102, which prohibits the recycling of exchange gains or losses deferred in equity through profit or loss, is consistent with the IFRS for SMEs. It was not the purpose of FRED 51 to revisit the original decision to align FRS 102 with the IFRS for SMEs in this respect.

25 As set out in the Accounting Council's Advice to the FRC to issue FRED 51 – *Draft Amendments to FRS 102 – Hedge Accounting*, the Accounting Council considered two possible approaches to this issue. Firstly, to treat amounts deferred in equity in relation to net investment and cash flow hedges consistently and to require recycling of amounts deferred in equity and thereby introducing an inconsistency with the requirements in paragraph 9.18A of FRS 102. Alternatively, to align with the requirements in paragraph 9.18A of FRS 102 and thereby being inconsistent within Section 12 *Other Financial Instruments Issues* concerning the treatment of amounts deferred in equity under a net investment hedge and cash flow hedge. The Accounting Council is of the view, and a majority of respondents agreed, that the latter option is preferable, as it allows more meaningful overall reporting related to investments in overseas subsidiaries.

Question 6

The draft amendments propose an alteration to Section 11 of FRS 102 to broaden the range of instruments that may be designated at fair value through profit or loss, with the effect of allowing, in some cases, economic hedging. Do you agree with these changes? If not, why not?

Table 7: Respondents' views on Question 6

	No. of respondents
Agreed	20
Disagreed	0
No comment	1
Total respondents	21

26 Respondents to this question agreed with the proposed amendment to widen the scope of instruments that may be measured at fair value through profit or loss.

Question 7

Included as non-mandatory guidance in the draft amendments are examples of the three proposed hedge accounting models (Appendix to Section 12). In your view, are these examples helpful application guidance of the requirements of paragraphs 12.15 to 12.25? If not, please provide examples of hedges that could be more usefully included.

Table 8: Respondents' views on Question 7

	No. of respondents
Agreed	16
Disagreed	1
No comment	4
Total respondents	21

27 Overall, respondents agreed that the examples are helpful to demonstrate the hedge accounting requirements. Most respondents, however, including those who were of the view that the examples are not helpful, suggested that the examples should include more realistic scenarios. In particular, respondents recommended that the examples should include a demonstration of how ineffectiveness is accounted for.

FRC response

28 We understand that hedge accounting may be a challenge, especially for entities that have not applied hedge accounting before. Nevertheless, the examples are not intended as an educational tool for entities seeking a more detailed understanding of the application of hedge accounting.

29 We acknowledge that some of the assumptions in the examples might not be necessarily borne out in practice. However, these simplifications have been made in order to focus on the basic mechanics of hedge accounting, which are the same for simple and complex hedging relationships.

30 We have responded to requests for scenarios of arrangements that are more widely used in practice and that the example should illustrate the impact of ineffectiveness. Example 2 demonstrates the application of hedge accounting in a situation where an entity is entering into an interest rate swap to fix variable interest rate payments on a loan. All three examples demonstrate the accounting for ineffectiveness.

Question 8

> The draft amendments propose a transitional exemption which will allow certain one-off remeasurements of hedging instruments and hedged items at the transition date. Do you believe that these exemptions facilitate application of hedge accounting to arrangements in place at transition? If you have reservations, please tell us why and provide details of alternative transitional arrangements.

Table 9: Respondents' views on Question 8

	No. of respondents
Agreed	4
Disagreed	15
No comment	2
Total respondents	21

31 A majority of respondents was concerned that the proposed transitional provisions were insufficient. They noted that entities adopting FRS 102 may have applied different types of hedge accounting prior to the adoption of FRS 102 and recommended that the transitional requirements should address those different positions.

32 A number of respondents noted that the hedging requirements will be finalised after the date of transition and that adequate transitional reliefs, especially in respect of the documentation requirement, should be provided.

33 Some respondents were concerned about the transitional provisions for entities that elect to apply IFRS (IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9) to recognise and measure their financial instruments and suggested that transitional reliefs in respect of the documentation requirement should be made available.

FRC response

34 In response to the feedback from respondents, the transitional provisions in the final amendments have been substantially revised. See paragraphs 34 to 36 of the Accounting Council's Advice to the FRC for more detail.

35 The transitional exemptions in respect of documentation have been extended to entities that elect to adopt the recognition and measurement requirements of IFRS 9 and/or IAS 39.

FRED 54 – Basic financial instruments

36 FRED 54 posed five questions and the feedback and FRC response are summarised below.

37 In overview, the majority of respondents was in favour of the amendments and requested that these are finalised as soon as possible to enable adoption by entities. Some respondents went on to identify a number of instruments that they considered to be basic, but which did not appear to be so under the amended requirements in FRED 54. They requested that the FRC consider these further and provide additional information, guidance and examples in the final standard that clarify its views on the classification of those instruments.

38 Respondents requested inclusion of a large number of examples in addition to those already provided in FRED 54. They went on to request transitional provisions for certain entities including those who may have early adopted the requirements of FRS 102.

39 A number of respondents also raised issues that were outside the scope of the amendments proposed in FRED 54. These included requests that the classification of financial instruments be based on principles rather than prescriptive conditions, alignment of the FRS 102 disclosure of fair value hierarchy to that in IFRS and requests for inclusion of intercompany loans as basic financial instruments which are accounted for at cost, rather than amortised cost as required by FRS 102.

FRC response

40 FRED 54 was issued to address constituents' feedback, arising from their initial implementation efforts, that there were unintended accounting consequences in relation to basic debt instruments which had not been identified during the lengthy FRS 102 consultation process. Those amendments were intended to make the conditions for basic debt instruments less restrictive so that a wider range could be measured at amortised cost.

41 The FRC recognises that the FRS 102 requirements for the classification of financial instruments are rules-based. However, this was considered during the extensive FRS 102 consultation. These amendments did not intend to revisit those original decisions.

42 In finalising these amendments, consideration has been given to the responses to FRED 54 and certain changes to the standard, and additional examples and guidance have been included to address the concerns raised. Additional provisions have been included to address the constituents' concerns in relation to the transition to these requirements subsequent to the initial transition date to FRS 102.

43 FRS 102 has always required intercompany loans to be accounted for at amortised cost. The amendments did not propose any changes to this requirement and no subsequent changes have been made in this respect as this was outside the scope of the FRED 54 consultation. Similarly, no amendments to align the FRS 102 disclosure of fair value hierarchy to that in IFRS are included as this was outside the scope of the consultation. The FRC will consult on issues arising on the implementation of FRS 102 during the planned triennial review.

Question 1

Do you support the proposal to amend the conditions of paragraph 11.9 and make the requirements less restrictive?

Table 10: Respondents' views on Question 1

	No. of respondents
Agreed	23
Disagreed	1
No comment	5
Total respondents	29

44 Most respondents agreed with the overall objective of amending the requirements in paragraph 11.9 of FRS 102 so that the requirements for debt instruments to be classified as basic were less restrictive. They noted that the original requirements in FRS 102 would have been disproportionately onerous and would not have provided users with the most relevant information in the financial statements.

45 As the proposals represent a set of prescriptive conditions for determining which financial instruments are basic, a number of respondents went on to note that generally standards should provide principles-based solutions. However, those same respondents often agreed that, on balance, the complexity added by the proposed amendment is manageable and likely to lead to greater consistency in practice. Others recommended that this approach, whilst acceptable in the short term, should be reviewed as part of the first triennial review of FRS 102.

46 One respondent, identifying themselves initially as users of financial statements, stated that they did not support the amendments, as they did not believe the amendments went far enough in producing relevant information for users of financial statements. That respondent went on to state that the FRC needed to identify the information sets users find useful in relation to financial instruments and then set out clear principles regarding valuation and treatment of changes in valuation. They felt that Sections 11 *Basic Financial Instruments* and 12 required significant redrafting to produce the best balance between costs and benefits.

47 A number of preparer representatives, whilst in principle supporting the approach to amend FRS 102 where constituents identified significant unintended consequences, went on to request an amendment to the fair value disclosure hierarchy for which they believe there is a stronger case than that made for the proposals in FRED 54. They noted that this amendment would have similar objectives – mitigate a cost burden, and provide more appropriate information to users – to those for FRED 54.

FRC response

48 The FRC recognises that the FRS 102 requirements for the classification of financial instruments are rules-based. However, this was considered during the extensive FRS 102 consultation. These amendments did not intend to revisit those original decisions. However, the FRC will keep under review the consideration of a principles-based solution for classification of financial instrument and will propose relevant amendments if a solution becomes apparent.

49 No amendments to align the FRS 102 disclosure of fair value hierarchy to that in IFRS are included as this was outside the scope of the consultation. The FRC will consult on issues arising on implementation of FRS 102 during the planned triennial review.

Question 2

In your view, under the amended conditions will debt instruments be classified appropriately, ie will the proposal have the effect that debt instruments that are basic in nature are measured at amortised cost and debt instruments that are non-basic in nature are measured at fair value? If you have reservations, please specify the financial instruments that you believe would not be measured appropriately under the proposed requirements.

Table 11: Respondents' views on Question 2

	No. of respondents
Agreed	8
Disagreed	16
No comment	5
Total respondents	29

50 A majority of respondents raised concerns that the proposals did not clearly address the classification of a number of debt instruments they considered as basic in nature and which they felt should be measured at amortised cost. It was obvious from the responses received that, the absence of a clear principle to drive the classification of an instrument as "basic" or "non-basic" meant that respondents find it difficult to know whether application of the proposals will result in instruments being classified appropriately. Whilst some asked for further clarifications and amendments to the requirements as proposed by FRED 54, others asked for further definitions and guidance to be included in the final standard.

51 A number of preparers in the social housing sector and their representatives and advisers raised concerns with the accounting for various loans common in that sector. These included Lender Option Borrower Option loans (LOBOs), Cancellable Embedded Hedge (CEH) loans, and loans with embedded swaps with varying features. A majority of respondents in this sector expressed the view that such loans should be classified as "basic" under the standard.

52 Other respondents identified other types of instruments, some with specific features, where the treatment was not clear from the proposed amendments and requested a clarification of the intended treatment. Such instruments included: inflation linked debt; non-recourse and limited recourse loans; investments in preference shares; and loans with terms permitting mandatory cost adjustments, early repayment options, changes in interest rates due to taxation and law changes, and negative interest rates.

53 One respondent noted that it is unclear if a reassessment of the "basic" criteria is required if there is a failure to meet the criteria subsequent to origination or whether reassessment is only required if there is a modification of the financial terms. The same respondent went on to note that the exposure draft is silent on this matter and on the accounting for a financial instrument upon its reclassification from held at fair value to a basic financial instrument.

54 Some respondents requested various definitions to be added to the glossary, including definitions for derivatives, leverage and what constituted market rates.

55 One respondent identified as a user disagreed on the basis that "derivatives should be accounted for at historical cost with information about possible future cash flows disclosed in the notes to the accounts. Financial liabilities should typically be accounted for at settlement values, and financial assets should be accounted for at historical cost, with

market values where available disclosed in the notes." This respondent noted that users of financial statements are interested in information about the past and future cash flows of a company and expressed the view that neither amortised cost nor fair value provides this information clearly and without generating clutter. This respondent felt that a focus on closer alignment with the "moving target that is IFRS 9 is not appropriate".

FRC response

56 We considered the requests in relation to loans in the social housing sector, and the Accounting Council's Advice to the FRC provides further commentary in relation to the classification of such loans.

57 We also considered concerns in relation to structured loans and reclassification of financial instruments subsequent to origination. Although no amendments were considered necessary to the standard, further commentary is provided on these topics in the Accounting Council's Advice to the FRC.

58 A number of amendments to the proposals in FRED 54 were made to incorporate changes proposed by constituents. However, we have not included some of the definitions requested by constituents as they are commonly understood terms.

59 Prior to the issue of FRS 102, constituents' concerns regarding the recognition and measurement of derivatives at fair value were carefully considered. It was concluded that in order to provide high-quality information, the recognition of derivatives is preferable to a disclosure only accounting regime. The proposed requirements in FRED 54 were not seeking to revisit these original decisions.

Question 3

> It is proposed that the Appendix to Section 11 *Basic Financial Instruments* will contain some illustrative examples. In your view, are the proposed examples helpful? If not, what other examples would you suggest should be included instead?

Table 12: Respondents' views on Question 3

	No. of respondents
Agreed	5
Agreed but with additional improvements identified	19
Disagreed	0
No comment	5
Total respondents	29

60 All the respondents who answered this question noted that they found the examples useful. However, a majority of those went on to make requests for further examples to be included to the standard. Those instruments identified by respondents included: intercompany loans with a zero rate of interest; social housing sector loans such as LOBOs, and CEH; structured loans (those with a variable rate loan with a separate transferrable interest rate collar, or contractual provisions allowing for contingent changes in interest rate due to credit deterioration of the issuer); loans with early repayment options, or variable premium; leveraged inflation-linked debt instruments; issuer convertible debt; holder convertible debt; profit participation features; and Euro-denominated loans linked to a country-specific inflation rate.

61 Some respondents stated that the Appendix containing the examples would be more user-friendly if each example illustrated the application of one single classification rule and each

separate rule in paragraph 11.9 of FRS 102 was illustrated by an example. These respondents requested that the examples should use common financial instruments and that a mixture of examples that do and do not meet the requirements for classification as basic instruments should be included.

62 Some respondents made suggestions for improvements to the examples included in the proposed amendments. In particular, Examples 2 and 3 included in FRED 54 were seen as confusing and needing further amendments.

63 Other respondents noted that some examples are placed within the text of the standard as issued whilst others were proposed to be included in the Appendix to Section 11. These respondents suggested that it would be less confusing to house all examples in the Appendix which forms an integral part of the standard. They also noted that a number of examples in FRS 102 which were inherited from the IFRS for SMEs are too simplistic and can be confusing in the context of the amended standard. They noted that these should either be deleted or moved to the Appendix with additional explanatory text to explain the conclusions reached.

FRC response

64 We considered the inclusion of further examples as requested by the constituents, however, it was clear that the list was too long for all examples to be included in the standard. Instead, the examples have been streamlined to ensure that they illustrate the application of one single classification rule in paragraph 11.9 of FRS 102.

65 As a result of constituent feedback, a number of other changes were made to the examples proposed in FRED 54. Consistent with other examples in Section 11, the new examples are now included in the body of the section to follow on from the paragraph they are illustrating. Suggestions for improvements of particular examples have been taken up in the final amendments.

Question 4

The proposed amendments would be effective from 1 January 2015. Do you have reservations concerning the proposed effective date?

Table 13: Respondents' views on Question 4

	No. of respondents
Agreed (yes)	10
Disagreed (no)	14
No comment	5
Total respondents	29

66 A majority of respondents who answered this question were supportive of the proposed effective date for the amendments.

67 Those who raised reservations were mainly concerned that clarification was needed for entities which have early adopted FRS 102. They proposed that an option to permit but not require early adoption of the new requirements would be helpful for these entities.

68 Others, whilst being supportive of the proposed amendments, requested that the amended requirements should be available for use in good time to allow companies to prepare for adoption. Some of these respondents went on to note their disappointment

that the FRC is still making amendments to FRS 102 after the date of transition for many entities. They urged the FRC to make no further changes until the first triennial review.

69 One respondent identifying themselves as users of financial statements stated that "the acknowledged lack of adequate consultation regarding FRS 102 needs to be remedied before FRS 102 becomes effective. This should ensure proper consultation with users of accounts including full consideration of accounting treatments that produce clearer information."

FRC response

70 The FRC is issuing these amendments so that they are available in good time to allow companies to prepare for adoption.

71 The FRC and its predecessor body the Accounting Standards Board performed extensive consultation preceding the issuance of FRS 102 in March 2013. That consultation took account of views of preparers, auditors and users of the financial statements of entities that were within the scope of that standard. It should be noted that users of financial statements of unlisted companies, ie those within the scope of FRS 102, tend to be limited to lending banks and venture capital firms, other creditors, employees, management and other governmental and regulatory bodies. During the consultation, the FRC received and considered the views of credit departments of banks that lend to such companies, other governmental bodies and management of some of these companies, although they also represented the preparers' viewpoint. Representatives from such entities are also members of the FRC, its committees and councils and provided their views throughout the development of the standard. As such, further consultation with users will be considered once FRS 102 implementation practice becomes apparent as part of the triennial review.

Question 5

The exposure draft does not contain specific transitional requirements and the requirements of Section 35 *Transition to this FRS* of FRS 102 will therefore apply. In your view, are any specific transitional provisions in relation to the proposed amendments necessary? If so, please tell us what transitional provisions you would suggest and why?

Table 14: Respondents' views on Question 5

	No. of respondents
Agreed	12
Disagreed	9
No comment	8
Total respondents	29

72 A number of respondents identified that transitional provisions were necessary in relation to the proposed amendments in two specific cases. These related to provisions for those who have already early adopted the current FRS 102 requirements as well as for first-time adopters of FRS 102.

73 Some respondents noted that transitional provisions were necessary for those who have already early adopted FRS 102 with financial instruments classified as non-basic under the current version but which would be classified as basic under the amended requirements. They noted that these entities should be permitted to either retrospectively designate these instruments at fair value through profit or loss or to designate them at a date later than upon transition to FRS 102, if these instruments meet the criteria for such designation.

74 Others noted that transitional provisions for first-time adopters of FRS 102 were required in relation to the application of the fair value option. They noted that paragraph 35.10(s) of FRS 102 permits designation only on initial recognition or at the date of transition. This date has already passed and some entities would now find that they need to designate some instruments at fair value through profit or loss but this option would not be available under Section 35 of FRS 102. These respondents requested that retrospective designation should be permitted for first-time adopters affected in this way.

75 Others raised concerns with application of cash flow hedge accounting to instruments which will now be measured at amortised cost under the new rules but were at fair value through profit or loss under the old rules. The hedge accounting documentation would not have been in place at the date of transition to FRS 102 making these instruments ineligible for hedge accounting. These respondents requested that these entities should be permitted to back date hedge accounting documentation for a limited time period.

FRC response

76 In response to feedback from constituents, transitional provisions have been included to enable entities that were impacted by the amendments to the classification requirements – those that have early adopted FRS 102 and those that are required to re-designate their financial instruments in accordance with the amended requirements – to make the requisite changes.

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