

A closer look 'Basic/non-basic' classification of debt instruments under FRS 102

The accounting for financial instruments will be one of the biggest challenges for entities adopting FRS 102 *'The Financial Reporting Standard applicable in the UK and Republic of Ireland'* for the first time. Not only are there substantial changes, particularly for those entities transitioning from old UK GAAP excluding FRS 26: *Financial instruments: Recognition and measurement*, but the requirements of FRS 102 in this area are complex.

In particular, the approach to classification and measurement of financial instruments under FRS 102 is very different from that of both old UK GAAP and IFRSs. Under FRS 102, financial instruments are classified as either 'basic' or 'non-basic', which can determine whether an instrument is measured at cost or fair value. This has also been an area of uncertainty and FRS 102 was amended in July 2014 to address concerns raised about the restrictive nature of the criteria for classifying debt instruments as basic.

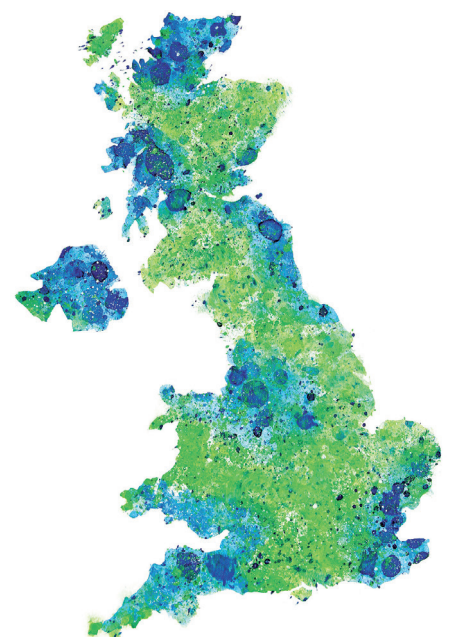
The revised criteria continue to place restrictions on the terms a debt instrument may have if it is to be classified as basic. The criteria place limit on the type of returns on an instrument, how those returns change over the life of the debt instrument and the prepayment and extension features that may be present. In addition, the criteria prevent derivatives and instruments whose contractual terms may result in loss of principal or accrued interest from being classified as basic. In this publication we take a detailed look at these criteria and provide examples to illustrate their application. We also provide an overview of the background and the approach to classification.

1. Background

Basic financial instruments are those within the scope of *Section 11: Basic Financial Instruments* and are limited to the following:

- cash;
- debt instruments meeting certain conditions (see below). Examples of debt instruments are trade debtors and creditors, bank and intercompany loans, bonds and mortgages;
- commitments to receive or make a loan to another entity that:
 - (i) cannot be settled net in cash; and
 - (ii) when the commitment is executed, are expected to meet the conditions for classification as basic;
- investments in non-convertible and non-puttable preference shares; and
- investments in non-puttable ordinary shares.

Basic/non-basic classification is based on specific criteria rather than an overarching principle. Some features of debt instruments that may be regarded as simple and/or common may not be considered 'basic' under Section 11 as they do not comply with the conditions.



Financial instruments that would otherwise be within the scope of Section 11 but do not meet the above conditions are within the scope of *Section 12: Other financial instrument issues*.

Classification of investments in equity instruments as basic or non-basic has little impact as recognition and measurement is the same irrespective of their classification. Such instruments are measured as at fair value through profit or loss (FVTPL), unless the fair value cannot be determined reliably, in which case they are measured at cost less impairment.

Basic debt instruments are accounted for at amortised cost under Section 11, unless they are designated (subject to conditions) as FVTPL. Section 12 generally requires non-basic debt instruments to be measured as at FVTPL.

Basic/non-basic classification is based on specific criteria (reproduced below) rather than an overarching principle. Some features of debt instruments that may be regarded as simple and/or common may not be considered 'basic' under Section 11 as they do not comply with the conditions. Therefore, the terms of instruments should be carefully identified and assessed to determine if the conditions are met.

2. Investments in preference shares

FRS 102 includes investments in non-convertible and non-puttable preference shares in the definition of basic financial instruments and requires a specific treatment for such investments. This applies irrespective of whether those investments also meet the definition of a basic debt instrument. As a result, the accounting treatment may depend on the legal form of the instrument.

A debt instrument is not a defined term and judgement will be required to interpret it. One possible reading of the term in this context could be any financial instrument that would not be classified as an equity instrument of the issuer. However, since preference shares have a specific legal meaning, the more specific requirements for preference shares should be followed in cases where preference shares are not classified as equity by the issuer rather than the requirements that apply to debt instruments. This means that the legal form of a financial instrument can impact the accounting outcome.

An investment in non-convertible and non-puttable preference shares falls within the definition of a basic financial instrument. However, section 11 requires such instruments to be measured at FVTPL (or cost if its fair value cannot be measured reliably). An investment in a bond with similar terms would be accounted for at amortised cost if it met the criteria for a basic financial instrument. This anomaly has been drawn to the attention of the Accounting Council but the requirements of the Standard are clear and it seems that no action will be taken to address the issue ahead of the three-year review.

3. Derivative financial instruments

The recognition and measurement provisions of Sections 11 and 12 do not explicitly refer to derivative financial instruments although they are referred to in the disclosure requirements of those sections and defined in the glossary. However, in practice, standalone derivatives will generally be either in the scope of Section 12 and measured at fair value or outside the scope of Section 12 and measured at cost (which may be nil).

FRS 102.11.8(b) explicitly prohibits classifying the types of instruments listed in FRS 102.11.6(b) as "basic". The types of instruments listed are all derivatives: options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging financial instruments. However, even where a derivative financial instrument is not of a type listed it is unlikely to meet the criteria for being basic. For example, a cross-currency swap would be non-basic for a number of reasons, such as because it is a dual currency instrument (see below). Also, an interest rate cap would be non-basic because the link to interest rates would be considered leveraged (see below).

The requirements for debt instruments do not apply to loan commitments, which may fall within the scope of Section 11 if they cannot be settled net in cash; and when the commitment is executed, the debt instrument is expected to meet the conditions to be basic.

Some derivative financial instruments are explicitly scoped out of both Sections 11 and 12, for example financial guarantee contracts.

4. Overview of the criteria for classification of debt instruments as basic

To be basic, a debt instrument must comply with all of the conditions of FRS 102.11.9. These conditions have been reproduced in full [in the box below].

The conditions for basic debt instruments in FRS 102.11.9

The conditions a debt instrument shall satisfy in accordance with paragraph 11.8(b) are:

- (a) The contractual return to the holder (the lender), assessed in the currency in which the debt instrument is denominated, is:
 - (i) a fixed amount;
 - (ii) a positive fixed rate or a positive variable rate*; or
 - (iii) [not used]
 - (iv) a combination of a positive or a negative fixed rate and a positive variable rate (e.g. LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR).

- (aA) The contract may provide for repayments of the principal or the return to the holder (but not both) to be linked to a single relevant observable index of general price inflation of the currency in which the debt instrument is denominated, provided such links are not leveraged.

- (aB) The contract may provide for a determinable variation of the return to the holder during the life of the instrument, provided that:
 - (i) the new rate satisfies condition (a) and the variation is not contingent on future events other than:
 - (1) a change of a contractual variable rate;
 - (2) to protect the holder against credit deterioration of the issuer;
 - (3) changes in levies applied by a central bank or arising from changes in relevant taxation or law; or
 - (ii) the new rate is a market rate of interest and satisfies condition (a).

Contractual terms that give the lender the unilateral option to change the terms of the contract are not determinable for this purpose.

- (b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.
- (c) Contractual provisions that permit the issuer (the borrower) to prepay a debt instrument or permit the holder (the lender) to put it back to the issuer before maturity are not contingent on future events other than to protect:
 - (i) the holder against the credit deterioration of the issuer (e.g. defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or
 - (ii) the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law.

The inclusion of contractual terms that, as a result of the early termination, require the issuer to compensate the holder for the early termination does not, in itself, constitute a breach of this condition.

- (d) [not used]

- (e) Contractual provisions may permit the extension of the term of the debt instrument, provided that the return to the holder and any other contractual provisions applicable during the extended term satisfy the conditions of paragraphs (a) to (c).

* A variable rate for this purpose is a rate which varies over time and is linked to a single observable interest rate or to a single relevant observable index of general price inflation of the currency in which the instrument is denominated, provided such links are not leveraged.

In the remaining sections of this article, we analyse the conditions for classification as basic in detail, and provide examples illustrating the application of the conditions (some of which are taken from the standard: examples B,C,D,I,J,K and N). All terms of a debt instrument must be considered before concluding on its classification as basic or non-basic. This is because single non-basic feature will cause the instrument as a whole to be classified as non-basic. A single contractual term may also impact more than one of the conditions. Therefore, all contractual features should be assessed against all the conditions.

In order to be classified as basic, the returns of a debt instrument must meet the conditions in FRS 102.11.9(a) (the 'Condition for Returns'). The following three sections explain the restrictions on each type of basic return: fixed returns are discussed in section 5, variable returns in section 6 and combined returns in section 7. The restrictions on variable rates of return are the most complex; a variable rate of return can only be basic if it is linked to an inflation index or interest rate. However, not all such linkages will be basic. In addition to the Condition for Returns FRS 102.11.9(aA) (the 'Condition for Inflation Linked Instruments') further restricts the returns on inflation linked instruments. This is discussed in section 6.2 below.

The returns of an instrument may be different in different periods of an instrument's life (e.g. a loan with an initial fixed period), or in different scenarios (e.g. a loan with a capped variable rate). FRS 102.11.9(aB) (the 'Condition for Variations') places restrictions on such changes in returns, which are discussed in section 8 below.

FRS 102.11.9(b) (the 'Restriction on Losses') prevents an instrument from being classified as basic if, through its contractual terms, the holder could lose the principal or accrued interest outstanding. The Restriction on Losses is discussed in section 9 below.

FRS 102.11.9(c) (the 'Condition for Prepayment Options') and FRS 102.11.9(e) (the 'Condition for Extension Options') restrict the prepayment and extension features that may be present in a basic financial instrument. These conditions are discussed in sections 10 and 11 respectively. These sections also consider the impact of prepayment and extension features on the Condition for Returns, the Condition on Variations and the Restriction on Losses. This is because a prepayment option that meets the Conditions for Prepayment Options, could still cause the instrument to be non-basic if it could result in the holder losing part of the principal amount, and so breach the Restriction on Losses.

5. Fixed returns to the holder

If returns to the holder are either a fixed amount or at a positive fixed rate the Condition for Returns is met.

Example A: Fixed rate loan

Entity Q lends £10 million to Entity P. The terms of the loan require repayment of £10 million by Entity P in three years. The interest rate on the loan is 7% per annum on £10 million payable in arrears at the anniversary date of the lending. There are no other features in the contractual terms that result in any variability in the contractual cash flows.

For Entity Q, the loan gives rise to a fixed rate of return over the life of the instrument and so meets the Condition for Returns.

Example B: A zero-coupon loan

[FRS 102.11.9 Example 1]

For a zero-coupon loan, the holder's return is the difference between the nominal value of the loan and the issue price. The holder (lender) receives a fixed amount when the loan matures and the issuer (borrower) repays the loan. The return to the holder meets the condition of paragraph 11.9(a)(i).

If an instrument includes any additional returns, such as a premium payable on early redemption, these must also be considered before concluding the Condition for Returns is met. An entity must ensure the other conditions are met before concluding the instrument is basic.

6. Variable returns to the holder

If the return to the holder is at a positive variable rate the Condition for Returns is met. A variable rate in this context has a very specific meaning that is narrower than the common usage of the term. For this purpose a variable rate is a rate which varies over time and is linked to:

- a single observable interest rate; or
- a single relevant observable index of general price inflation of the currency in which the instrument is denominated, provided such links are not leveraged.

If an instrument has a variable rate of return that is not based on an observable interest rate or inflation index, it is not considered basic.

In some cases judgement may be required to determine whether a variable rate is positive. It is necessary to consider more than the level of the rate on initial recognition of the debt instrument but scenarios that are possible but remote need not be taken into account. For example, it may be theoretically possible for an observable interest rate to become negative.

If an instrument includes any additional returns, such as a premium payable on early redemption these must be also considered before concluding the Condition for Returns is met. An entity must also confirm the other conditions are met before concluding the instrument is basic.

6.1 Returns linked to interest rates

A positive variable rate with an unleveraged link to a single observable interest rate will meet the Condition for Returns. FRS 102 uses LIBOR and a bank's standard variable rate as examples of observable interest rates. In other cases judgement may be required in determining whether an interest rate is observable.

FRS 102 does not define leverage, but does contain the following example:

Example C: Interest on a loan is referenced to two times the bank's standard variable rate

[FRS 102.11.9 Example 5]

In accordance with the definition of a variable rate, the contractual interest rate payable can be linked to a single observable interest rate. A bank's standard variable rate is an observable rate and meets the definition of a variable rate, but the rate in this example is two times the bank's standard variable rate and the link to the observable interest rate is leveraged. Therefore, the rate in this example is not a variable rate as described in paragraph 11.9(a). The instrument is measured at fair value in accordance with Section 12.

From this we can conclude that any debt instrument linked to a multiple of two or more times an observable interest rate would not be basic. A threshold of two or more times is consistent with the treatment of interest rate features in debt instruments under IAS 39. However, in the absence of any further guidance it could also be argued that any multiple greater than one increases the variability of returns on the instrument, and so constitutes leverage.

6.2 Returns linked to inflation

A positive variable rate with an unleveraged link to a single relevant observable index of general price inflation of the currency in which the instrument is denominated will meet the Condition for Returns. It is a requirement that the index is one of **general** price inflation and so some measures of inflation will not meet the test. An index of general price inflation is one that measures general price inflation of goods and services (e.g. both the Retail Price Index ('RPI') and Consumer Price Index ('CPI') in the UK).

Example D: Interest on a GBP denominated mortgage is linked to the UK Land Registry House Price Index (HPI) plus 3%

[FRS 102.11.9 Example 7]

In accordance with paragraph 11.9(aA) the holder's return may be linked to an index of general price inflation of the currency of the debt instrument. The mortgage is denominated in GBP and a permitted inflation index would be an index that measures general price inflation of goods and services denominated in GBP.

The HPI measures inflation for residential properties in the UK and is not a measure of general price inflation. The return to the holder therefore fails to meet the condition in paragraph 11.9(aA). The instrument is measured at fair value in accordance with Section 12.

For an instrument to qualify as basic, the inflation index it is linked to must be of the currency in which the instrument is denominated (which will not necessarily be the functional currency of either the issuer or the holder).

The concept of leverage is more difficult to apply to inflation-linked instruments than to instruments with a return linked to interest rates. Interest payments on inflation-linked instruments are generally calculated as a fixed rate on the initial principal multiplied by the inflation adjustment. This fixed rate is normally the “real interest rate” on date of issue. Therefore payments of the form $P_0 * X\% * I_t / I_0$ (where P_0 is the initial principal, X is a constant, I_t is the level of the index at time t and I_0 is the level of the index on the date of issue) are not leveraged if X is the real interest rate (even where X is greater than 2).

The principal repayment on inflation-linked instruments may also be adjusted for inflation. In this case care needs to be taken not to introduce leverage by applying an inflation adjusted interest rate to an inflation-adjusted principal. The Condition for Inflation-Linked Instruments aims to address this by allowing either the principal repayments or return to the holder to be linked to inflation, but not both. In this context “returns to the holder” needs to be interpreted to mean the interest rate applied to the principal outstanding.

Example E: Inflation linked bond

Entity A issues a £ denominated bond with a stated maturity date. The principal amount outstanding is linked to UK RPI. The principal outstanding at time t is calculated as follows:

$$\text{Principal at time } t = \text{£}100\text{m} * RPI_t / RPI_0$$

Where RPI_t is the level of the RPI at time t and RPI_0 is the level of RPI on the date of issue. Entity A pays interest quarterly in arrears at a rate of 4% on the principal outstanding, therefore the interest payable at time t is calculated as follows:

$$\begin{aligned} \text{Interest at time } t &= \text{Principal at time } t * 4\% \\ &= \text{£}100\text{m} * RPI_t / RPI_0 * 4\% \end{aligned}$$

The bond meets the Conditions for Returns because UK RPI is a relevant observable index of general price inflation of the currency in which the bond is denominated, and the linkage is not leveraged.

The bond meets the conditions of FRS 102.11.9(aA) because, in addition to the above, the principal outstanding is adjusted for inflation but the interest rate applied to the principal outstanding is constant. Although both payments of interest and principal vary with inflation, variation in the interest payment is due solely to changes in the principal outstanding and not to changes in the rate.

6.3 Returns linked to a foreign currency

The assessment as to whether a foreign currency denominated debt instrument is basic, should be carried out in the currency in which the contract is denominated, rather than in the functional currency of the entity holding or issuing the debt instrument. If foreign currency denominated debt is classified as basic, any change in the carrying amount of the debt instrument because of a change in the exchange rate is recognised in profit or loss as required by Section 30 *Foreign Currency Translation* of FRS 102.

Where an instrument has cash flows denominated in more than one currency that instrument will not qualify as basic because, whichever currency the instrument is assessed in, the variability in returns due to the second currency will not meet the Condition for Returns.

Example F: Dual currency bond

Entity D invests in a dual currency bond. The bond’s principal is to be repaid in a fixed amount of Euros and periodic floating interest payments are denominated and paid in US Dollars. The instrument will not qualify as basic. This is because, if the instrument is assessed in Euros, the linkage to the US Dollar gives rise to a return that does not meet the Condition for Returns. If the instrument is assessed in US Dollars, the linkage to the Euro gives rise to a return that does not meet the Condition for Returns. Therefore, regardless of the currency in which the assessment is made, the result will be the same.

6.4 Convertible debt

For convertible debt within the scope of Sections 11 and 12 in its entirety (i.e. any investment in convertible debt from the perspective of the holder and any issued convertible debt with no equity component from the perspective of the issuer), if the conversion feature results in a variable return to the holder it will not be basic.

Example G: Convertible bond (1)

Entity E purchases a bond that is convertible into a fixed number of shares of the issuer.

The bond does not meet the Condition for Returns because the return is variable and linked to the value of the equity of the issuer (and so not equal to referenced, quoted or observable interest rate). Consequently, the bond is not considered to be basic.

Example H: Convertible bond (2)

Entity F issues a bond for £9.5 million that pays no interest before maturity. At maturity, Entity F is required to deliver as many of its own equity instruments as are equivalent in value to £10 million. Although the bond is convertible into equity, it is not a compound instrument because it has no equity component.

Entity F has issued a bond that provides a return that is a fixed amount to the holder. The linkage to the equity of the issuer does not cause the return to vary. The return is the difference between the proceeds from the bond issue and the amount due from Entity F at maturity (£10 million - £9.5 million = £0.5 million). Therefore, the bond meets the Condition Returns.

For compound instruments, from the perspective of the issuer, the liability component of the convertible debt may qualify as basic depending on the terms of the instrument.

6.5 Asset backed securities

When a debt instrument's contractual cash flows are specifically derived from specified assets of the borrower, it is unlikely that the instrument will meet the criteria for classification as basic. An entity would need to consider if the linkage to the underlying assets in such an instrument could result in a variable return that would not qualify as basic. In circumstances where cash flows are contractually repayable by the borrower only when received on an underlying asset or pool of assets, this could also result in a breach of the conditions relating to variation in returns and loss of principal and interest (see below). In addition, prepayment features linked to prepayment of the underlying assets would breach the conditions for prepayment features (see below).

FRS 102 lists asset-backed securities, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables, as examples of instruments that do not normally qualify as basic. The considerations above may be relevant for receivables and payables arising from transfers of assets where the transferred asset is not derecognised.

7. Combinations of different fixed and variable returns to the holder

Returns to the holder that are a combination of a positive variable rate and either a positive or negative fixed rate that would individually meet the Condition for Returns will also meet that condition. So, for example, LIBOR plus 2 per cent and LIBOR less 0.5 per cent would meet the Condition for Returns but 5 per cent less LIBOR would not.

Where there is a combination of a positive variable rate and a negative fixed rate, an entity will need to consider whether the combined rate could breach the Restriction on Losses. This is discussed further in section 9 below.

Example I: A loan with interest payable at the bank's standard variable rate plus 1% throughout the life of the loan

[FRS 102.11.9 Example 3]

As discussed under Example 2 [in FRS 102.11.9 – see below], a bank's standard variable rate is a permitted variable rate in accordance with the definition of variable rate. The combination of a positive fixed rate (ie plus 1%) and a positive variable rate is a permitted return under paragraph 11.9(a)(iv). The combination of a bank's standard variable rate plus a fixed interest rate of 1% therefore meets the condition in paragraph 11.9(a)(iv).

Example J: Interest on a loan is charged at 10% less 6-month LIBOR over the life of the loan.

[FRS 102.11.9 Example 6]

The effect of combining a negative variable rate with a positive fixed rate is that the interest on the loan increases as and when the variable rate decreases and vice versa (so called inverse floating interest).

Under paragraph 11.9(a)(iv) the combination of positive or negative fixed rate and positive variable rate is a permitted return. The variable rate (6-month LIBOR) meets the definition of a variable rate, as the rate is a quoted interest rate. However, since the variable rate is negative (minus 6-month LIBOR), the rate is in breach of paragraph 11.9(a)(iv). The instrument is measured at fair value in accordance with Section 12.

8. Variation in returns during the life of an instrument

Different rates of return may apply in different periods of an instrument's life. In such cases the instrument will qualify as basic only if, as required by the Condition for Variations, the variation is determinable and the new rate of return satisfies the Condition for Returns. In addition, the Condition for Variations also requires that the new rate either:

(i) is not contingent on future events other than:

- 1) a change in a contractual variable rate;
- 2) to protect the holder against credit deterioration of the issuer;
- 3) changes in levies applied by a central bank, or arising from changes in relevant tax or law; or

(ii) a market rate of interest;

The variation is not considered to be determinable if the revised rate of return is not specified on the date of initial recognition. For example, an option that allows the holder to reset the rate to 6M LIBOR plus 1% would be determinable, whereas an option that allows the holder to reset the rate to a rate of their choosing at the date of variation would not be determinable.

Example K: A fixed interest rate loan with an initial tie-in period which reverts to the bank's standard variable interest rate after the tie-in period

[FRS 102.11.9 Example 2]

The initial fixed rate is a return permitted by paragraph 11.9(a)(ii). A bank's standard variable interest rate is an observable interest rate and, in accordance with the definition of a variable rate, is a permissible link. In accordance with paragraph 11.9(a)(ii) the variable rate should be a positive rate.

The variation of the interest rate after the tie-in period is non-contingent, and since the new rate (ie the bank's standard variable rate) meets the condition of paragraph 11.9(a), paragraph 11.9(aB)(i) is met.

Example L: Floating rate loan with a cap

Entity C purchases a bond with a stated maturity date that pays a variable rate equal to a single observable interest rate. The variable rate is capped at 5%.

Even though the interest on the loan is fixed in some periods and variable in others, in any given period the bond gives rise to a return that meets the Condition for Returns. The variation of the interest rate is contingent on a change in the contractual variable rate and so the Condition for Variation is met.

9. Loss of principal or accrued interest

A contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods would breach the Restriction on Losses, and prevent the classification of the debt instrument as basic.

Example M: Borrower's option to prepay at fair value

Entity C lends £10 million to Entity D at a fixed interest rate; the loan is repayable in 3 years. Entity D has the right to prepay the loan at an amount equal to the fair value of the remaining contractual interest and principal payments.

The exercise of the prepayment option is not contingent on future events and so does not breach the specific requirements for prepayment options (see below). However, the repayment amount could be less than the accrued interest and principal amount outstanding, hence the termination payment is not considered to be compensation and the option to prepay at fair value breaches the Restriction on Losses. Consequently the loan is not considered to be basic.

Where there is a combination of a positive variable rate and a negative fixed rate the combined rate would breach the Restriction on Losses if the combined rate was not itself positive. This may seem counter-intuitive as it could be argued that the holder will get back the full principal plus negative accrued interest. However, the conclusion that negative interest breaches the Restriction on Losses follows directly from Example 4 in the standard (reproduced below as example N). Judgement may be required to make the assessment of whether the combined rate is positive. It will be necessary to consider more than the level of the combined rate on initial recognition of the debt instrument, but scenarios that are possible but remote need not be taken in to account. However, where there is a floor at or above zero, this will prevent the rate from becoming negative and so prevent a rate that might otherwise be negative breaching this condition.

Example N: A loan with interest payable at the bank's standard variable rate less 1% throughout the life of the loan, with the condition that the interest rate can never fall below 2%

[FRS 102.11.9 Example 4]

Paragraph 11.9(aB)(i)(a) permits variation of a return to a holder (lender) that is contingent on a change of a contractual variable rate. In this example the contractual variable rate is the bank's standard variable rate. The variation of the return to the holder is between the bank's standard variable rate less 1% and 2%, depending on the bank's standard variable rate. For example, if the bank's standard variable rate is less than 3%, the return to the holder is fixed at 2%; if the bank's standard variable rate is higher than 3%, the return to the holder is the bank's standard variable rate less 1%. The contractual variation meets the condition of paragraph 11.9(aB)(i)(1).

The holder is protected against the risk of losing the principal amount of the loan via the interest rate floor of 2%. The requirement of paragraph 11.9(b) is therefore also met.

An instrument that is subordinated to other instruments may meet the Restriction on Losses if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest even in the event of the debtor's bankruptcy, i.e. the loss suffered on default is not a result of the contractual provisions of the debt instrument.

The right of the lender to access collateral or security of the borrower in the case of non-payment under the contractual terms of the loan is also not necessary to meet the requirement of the Restriction on Losses. The right to collateral should however be considered when assessing the classification of a debt instrument. In particular consideration should be given to any non-recourse provisions (i.e. contractual terms linking the payments on the debt instrument to the performance of specified assets).

10. Prepayment options

For prepayment options, an entity needs to consider both the circumstances in which the option can be exercised and its impact on the returns of the instrument. Demand deposits include a prepayment option exercisable by the holder at any time, hence the requirements for prepayment options apply to such instruments.

10.1 When the option can be exercised

A contract may permit the issuer to prepay, or the holder to put back, a debt instrument before maturity. The Condition for Prepayment Options states that in order for an instrument to be basic, contractual provisions that permit the issuer (the borrower) to prepay a debt instrument or permit the holder (the lender) to put it back to the issuer before maturity are not contingent on future events other than to protect:

- (i) the holder against the credit deterioration of the issuer (e.g. defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or
- (ii) the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law.

Example O: Borrower's option to prepay at par (1)

Entity A lends £10 million to Entity B at a fixed interest rate; the loan is repayable in 3 years. Entity B has the right to prepay the loan after the first anniversary of the loan at £10 million plus any accrued interest.

The prepayment option written by Entity A as part of the loan to Entity B does not breach the Condition for Prepayment Options because the right to prepay is not contingent on future events.

Example P: Lender's option to demand early repayment contingent on covenant breach

Entity E lends £10 million to Entity F at a fixed interest rate; the loan is repayable in 3 years. Entity E has the right to demand early repayment at par plus accrued interest if Entity F's interest cover ratio (ratio of interest cost to profit before interest) falls below a specified level.

Even though the prepayment option is contingent on a future event (i.e. the future interest cover ratio), the prepayment option does not breach the Condition for Prepayment Options because that specifically excludes a condition that protects the holder from credit deterioration.

The Condition for Prepayment Options refers only to circumstances which permit (rather than require) the borrower or lender to prepay. Where the provision for early repayment is automatic (i.e. contractual terms that require the instrument to be repaid prior to maturity) the provision should nevertheless be assessed against the Condition for Prepayment Options as if it was an option. For example, if an automatic prepayment provision is not contingent on future events, other than to protect the holder against the credit deterioration of the issuer then this provision would not violate the Condition for Prepayment Options.

If a prepayment option meets the requirements in Condition for Prepayment Options, an entity must ensure the other conditions are met before concluding the instrument is basic.

10.2 Impact of the option on returns

The amount received by the holder of an instrument on redemption is an important element of the returns to the holder. The Condition for Prepayment Options addresses this when it states that "the inclusion of contractual terms that, as a result of the early termination, require the issuer to compensate the holder for the early termination does not in itself, constitute a breach of this condition". This sentence was introduced in the July 2014 amendments to FRS 102, which sought to address feedback that the criteria for classification as basic were too restrictive. This feedback included specific concerns relating to compensation payments.

The reference to "this condition" can be read as referring to conditions of FRS 102.11.9 more broadly (i.e. not just the Condition for Prepayment Options). In this case, termination payments considered to be compensation could be excluded from the assessment of returns required by other parts of FRS 102.11.9.

Although it is clear that compensation must be a payment from the issuer to the holder, it is not otherwise defined in FRS 102. Determining whether a payment from the issuer to the holder constitutes compensation will be judgmental.

Example Q: Borrower's option to prepay at a variable premium

Entity C lends £10 million to Entity D at a fixed interest rate; the loan is repayable in 3 years. Entity D has the right to prepay the loan at an amount equal to the present value of the remaining contractual interest and principal payments (i.e. payments due up to and including the end of Year 3) discounted by the original effective interest rate adjusted for changes in interest rates since origination if the risk-free market interest rate is lower than the equivalent risk-free market interest rate at origination. The prepayment penalty (otherwise known as a 'make-whole' provision) aims to compensate the lender for decreases in market interest rates since the loan was originated.

The make-whole provision is a term that requires the issuer to compensate the holder for the early termination (i.e. the amount paid is always greater than or equal to the principal plus accrued interest outstanding). The return therefore meets the Condition for Prepayment Options.

Compensation for the holder must be a payment by the issuer to the holder. Therefore, any termination payment that could breach the Restriction on Losses (i.e. one that is less than principal plus accrued interest) is not be considered to be compensation for the holder. This has the effect that all cash flows of the instrument are included in the assessment of whether the Restriction on Losses is met.

Where an amount received by the holder on exercise of a prepayment option is not considered to be compensation for the holder it should be taken into account when assessing whether the returns to the holder of a debt instrument meet the Condition for Returns and the Condition for Variations.

Where exercising a pre-payment option causes a variation in the return on the instrument (once compensation payments have been excluded) an entity must assess if that variation breaches the Condition for Variations. If the return under each possible redemption scenario was known at inception (i.e. the return is determinable) and would meet the Condition for Returns, then the variation in the return on the instrument will meet the Condition for Variations.

Example R: Borrower's option to prepay at par (2)

Entity H acquires a 5% fixed rate bond for £9.7 million on 31 December 20X1. The bond was originally issued by Entity S for £10 million. The terms of the bond require repayment of £10 million by Entity S on 31 December 20X4. Entity S has the right to prepay the loan at £10million plus any accrued interest on the 31 December 20X2 and 20X3.

The potential rates of return to Entity H are as follows:

Scenario 1: If Entity S chooses to exercise on the 31 December 20X2 Entity H earns an 8.25% fixed return.

Scenario 2: If Entity S chooses to exercise on the 31 December 20X3, Entity H earns a 6.65% fixed return.

Scenario 3: If Entity S chooses not to exercise its early repayment option, Entity H earns a 6.13% fixed return.

Because the returns to Entity H are a fixed, known, rate of return meeting the Condition for Returns in each possible scenario, and exercise of the option is not contingent on future events the variation in the return to the holder will also meet the Condition for Variations.

11. Extension options

Contractual provisions may permit the extension of the term of the debt instrument. To be classified as basic the Condition for Extension Options requires that the return to the holder and any other contractual provisions applicable during the extended term must satisfy the conditions of paragraph FRS 102.11.9. In particular, where an extension option causes a variation in the return, that variation must satisfy the Condition for Variation for the instrument to qualify as basic (see above).

12. Closing remarks

The classification of financial instruments under FRS 102 involves the application of detailed rules. The approach is very different to that under both *IAS 39 Financial instruments: Recognition and measurement (and its old UK GAAP equivalent FRS 26)* and *IFRS 9: Financial instruments*. This will make it one of the more difficult areas for entities adopting FRS 102 for the first time. It may also sometimes result in instruments that would be measured at FVTPL under one standard and amortised under another and so could influence the decision as to which recognition and measurement rules the entity choose to apply.

How Deloitte can help

Our integrated team of accounting and taxation specialists can assist you in managing the impact of the changes to UK financial reporting. Information about the services we offer can be found at www.deloitte.co.uk/futureofukgaap.

More information on the new UK financial reporting regime, as well as other UK accounting, reporting and corporate governance news and publications, can be found at www.ukaccountingplus.co.uk.

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