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Need to know
FRC proposes amendments to classification of financial instruments under FRS 102

In a nutshell

- The Financial Reporting Council (FRC) has issued FRED 54 'Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland – Basic Financial Instruments'*.
- The proposed amendments to FRS 102 will make amortised cost measurement available for a broader range of debt instruments.
- In addition to amending and clarifying the rules on 'basic' or 'non-basic' classification the FRED includes examples illustrating the application of the revised requirements.

Classification as 'basic' or 'non-basic' under FRS 102 is based on a set of rules rather than on an overarching principle.

Why are the amendments proposed?

Under FRS 102 '*The Financial Reporting Standard applicable in the UK and Republic of Ireland'*, to measure a financial instrument at amortised cost (as opposed to fair value), it must qualify as a 'basic' financial instrument.

Following the publication of FRS 102 in March 2013, concerns were expressed about the restrictive nature of the criteria for classifying financial instruments as 'basic'.

Classification as 'basic' or 'non-basic' under FRS 102 is based on a set of rules rather than on an overarching principle. The FRC received feedback that these rules overly restrict the instruments that qualify as 'basic'. As a consequence some common instruments that would be accounted for at amortised cost under IAS 39 *Financial instruments: recognition and measurement* or IFRS 9 *Financial instruments* would be classified as 'non-basic' and so accounted for at fair value through profit or loss ('FVTPL') under FRS 102.

Measuring fair values is more onerous than measuring amortised cost because it requires a valuation to be obtained at each reporting date and also introduces volatility in profit or loss. The amendments set out in FRED 54 are intended to reduce the cost of compliance with FRS 102 by allowing amortised cost measurement where it adequately captures the risks associated with those financial instruments.

Although the effect of the amendments proposed in FRED 54 is that amortised cost measurement will be allowed in more cases, it still should not be assumed that just because a particular type of instrument is common that it will be measured at amortised cost. Each instrument will need to be assessed in relation to the revised criteria. For example, it is common for entities to hold investments in convertible debt. Such an investment would be classified as 'non-basic' under both FRS 102 and the revised proposals set out in FRED 54.

When is classification as 'basic' or 'non-basic' important?

FRS 102 has two sections that deal with the recognition and measurement of financial assets and liabilities; Section 11 'Basic Financial Instruments' and Section 12 'Other Financial Instruments'. Only financial instruments classified as 'basic' are within the scope of Section 11.

Classification of investment in equity instruments as 'basic' or 'non-basic' has no impact on their accounting treatment as recognition and measurement is the same under both Section 11 and 12 (FVTPL or cost if fair value cannot be measured reliably). However, for debt instruments only 'basic' financial instruments can be measured at amortised cost. All 'non-basic' debt instruments would fall within the scope of Section 12 and would be measured at FVTPL.

How are these proposals different from what is currently in FRS 102?

The amendments proposed in FRED 54 do not alter the fundamental approach of FRS 102 in respect of 'basic' or 'non-basic' classification. The assessment continues to be rules based and to qualify as 'basic', a debt instrument must comply with all the criteria set out in FRED 54. Some of the key changes and clarifications made in FRED 54 are set out below.

Inflation linked debt instruments

The strict criteria of FRS 102 limits variable returns on 'basic' debt instruments to those equal to a single referenced or observable interest rate over the life of the instrument. As a result any debt instrument linked to an inflation index (rather than an interest rate) would have been 'non-basic' and so measured at FVTPL under Section 12.

Under the proposals in FRED 54, a financial instrument linked to a single observable inflation index could be 'basic' if that index is an index of general price inflation of the currency in which the debt instrument is denominated. For example, a GBP denominated debt instrument linked to UK RPI or a USD denominated debt instrument linked to US CPI could be 'basic', but a GBP denominated debt instrument linked to US CPI would be 'non-basic'.

What is considered to be an index of general price inflation under FRED 54 is narrow. A sterling denominated mortgage, with interest linked to the UK Land Registry House Price Index (HPI) is given as an example in FRED 54 of a 'non-basic' instrument because HPI is not a measure of general price inflation.

Compensation for lost interest on early termination

Where a fixed rate debt instrument includes an option to repay the debt before maturity, the issuer will often be required to pay compensation for lost interest to the holder in addition to the repayment of principal and accrued interest. Such amounts, referred to as 'make whole' payments, are often calculated by reference to the present value of the unpaid future interest payments. Although often based on a single observable interest rate, the 'make whole' payment results in a return that is variable but not equal to such a rate. Therefore, there was some doubt under FRS 102 as to whether an instrument with such a feature could be considered 'basic'.

The amendments proposed in FRED 54 make it clear that a 'basic' financial instrument may contain a prepayment provision that requires the issuer to compensate the holder for loss of interest as a result of early termination. However, the interaction of such terms with the other criteria will need to be considered. For example, an option to prepay at fair value would still be considered 'non-basic' under FRED 54 because it could result in the loss of principal or accrued interest which violates one of the conditions to qualify as 'basic'.

Debt instruments with different rates in different periods

FRS 102 allows some financial instruments with combinations of fixed and variable rates to be basic, such as debt paying interest at LIBOR plus 200 basis points. However, it is not clear whether debt instruments which have some periods where the rate of interest is fixed and others where it is variable are considered basic too. For example, a debt instrument may have an initial fixed interest rate period, after which it will revert to paying a variable rate of interest plus a margin. In other cases a loan may pay a variable rate of interest capped at a certain rate, so if LIBOR is below the cap the interest rate is LIBOR but if LIBOR is at or above the cap the interest rate is fixed. FRED 54 proposes amendments to clarify that such instruments can be 'basic' when the other conditions are also met.

FRED 54 also explicitly allows debt instruments with extension options to be classified as 'basic' as long as the other criteria for 'basic' classification are met throughout the extended period.

The criteria for basic/non-basic classification are found in paragraphs 8 and 9 of Section 11 of FRS 102. If modified as set out in FRED 54 they will read as follows:

The criteria

11.8 An entity shall account for the following financial instruments as basic financial instruments in accordance with Section 11:

(a) cash;

(b) a debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9 and is not a financial instrument described in paragraph 11.6(b)*;

(c) 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 in paragraph 11.9; and

(d) an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares.

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) a combination of a positive or a negative fixed rate and a positive variable rate (eg LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR).

A variable rate is a rate equal to a single referenced quoted or observable interest rate (eg LIBOR).

(b) The contract may provide for repayments of the principal and/or the return to the holder to be linked to a single observable index of general price inflation of the currency in which the debt instrument is denominated.

(c) The contract may provide for a 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; or
(ii) the new rate is a market rate of interest and satisfies condition (a).

(d) 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.

(e) Contractual provisions that permit the issuer (the borrower) to prepay a debt instrument or permit the holder 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 (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or
(ii) the holder or issuer against changes in relevant taxation or law.

Such contractual prepayment provisions may include terms that require the issuer to compensate the holder for loss of interest as a result of the early termination.

(f) 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 (e).

* financial instrument described in paragraph 11.6(b) are options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument.

Foreign currency denominated debt instruments

FRS 102 was silent in relation to variability of foreign currency denominated debt instruments due to changes in foreign exchange rates. It is an explicit requirement of FRED 54 that the assessment of returns should be in the currency in which the debt instrument is denominated. As a result it is clear that a financial instrument that would otherwise qualify as 'basic' would not be classified as 'non-basic' because it is denominated in a currency other than the functional currency of the entity, i.e. a debt instrument that would be considered 'basic' when held by a USD functional currency entity would also be considered 'basic' when held by a GBP functional currency entity.

However, some foreign currency features would still cause an instrument to be classified as 'non-basic'.
For example, a bond with GBP denominated principal paying fixed EUR amounts in interest each period would be 'non-basic'.

Investments in preference shares

FRS 102 requires investments in preference shares (including those that may also be considered to be debt instruments) to be classified and measured on a different basis from debt instruments. Such investments are measured at FVTPL or cost if fair value cannot be measured reliably.

This means that the legal form of a financial instrument can impact the accounting outcome. For example, an investment in preference shares could be measured at FVTPL while a loan with substantially the same terms could be accounted for at amortised cost. The proposed amendments to FRED 54 do not address this issue.

Is FRED 54 the same as IFRS 9?

The approach to classification and measurement of financial instruments under FRED 54 is very different from that under IFRS 9 (and IAS 39).

The requirements for financial instruments in FRS 102 were based on those in the IFRS for SMEs, a simplified version of IFRSs. The IFRS for SMEs was published in 2009 and based on IFRSs at the time. The development of IFRS 9 was in its early stages, with only an exposure draft for the classification and measurement requirements published.
As a result of this, and simplifications made at that time, there are some significant differences to the current IFRS 9 classification model. As discussed above, the proposals in FRED 54 do not fundamentally alter the approach taken to the classification of financial instruments, and so these differences remain.

However, although the approach to classification and measurement is very different, the application of the rules set out in FRED 54 should ultimately result in accounting outcomes closer to those under IFRS 9 than the application of the current FRS 102 requirements.

When will the final amendment be issued?

FRED 54 is currently available for comment and it is hoped that the final amendments will be published before the end of 2014. To facilitate this FRED 54 has been issued with a reduced comment period ending on 30th April 2014. It is proposed that the amendments will have the same mandatory effective date as FRS 102 with early adoption permitted.

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**.

Contacts

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