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Our reference: 85/350

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Dear Mrs Shah

FRED 54 – Draft Amendments to FRS 102, The Financial Reporting Standard applicable in the UK and Republic of Ireland – Basic financial instruments

Moore Stephens LLP is pleased to respond to the FRC on the proposed amendments to FRS 102 on basic financial instruments.

We are generally supportive of the proposed amendments subject to some drafting changes, as the current standard would make the application of FRS 102 more onerous than IFRS for certain financial instruments, which would not have been the intention of the FRC.

We are now in the transitional period for first time adopters with a December year end, we urge the FRC to make no further changes to the standard to help preparers with transition.

Attached to this letter you will find Appendix 1 with our comments to the specific questions raised in the exposure draft.

If you wish to discuss any matters raised in this letter then please contact David Chopping, Partner (+44 (0) 207 651 1050) or Tina Patel, Senior Technical Manager (+ 44 (0) 207 651 1674).

Yours faithfully

Moore Stephens LLP

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Appendix 1

Response to FRED 54 – Draft Amendments to FRS 102, The Financial Reporting Standard applicable in the UK and Republic of Ireland – Basic financial instruments

Questions 1 *Do you support the proposal to amend the conditions of paragraph 11.9 and make the requirements less restrictive?*

We support the proposals to amend the conditions of paragraph 11.9 to make the requirements less restrictive, subject to the following drafting amendments:

a) 11.8 (b) the additional wording should read:

   " … *and are not derivatives such as, options, rights, warrants, future contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument*'.

   Currently as drafted reference is made to paragraph 11.6 (b), however that paragraph makes reference to financial instruments that **normally** [emphasis added] would not satisfy the conditions in paragraph 11.8 and therefore, fall to be non-basic. We believe it is clear that such instruments would be non-basic and therefore reference to 11.6 (b) should be deleted and the wording we have proposed above be inserted.

b) 11.9 (b) clarify the use of "and/or", that the return to the holder refers only to the interest on the loan that could be linked to inflation.

c) 11.9 (b) clarification is required on the use of *"linked to a single observable index of general price inflation of the currency in which the debt instrument is denominated".*

   For example, if a Greek subsidiary (issuer) of a UK parent has a euro denominated loan that pays returns linked to inflation in euros. What would be the single observable index of general price inflation of the currency in which the debt instrument is denominated?

   Would this be the Greek general price inflation or a Europe wide general price inflation? This issue should be clarified before the amendment is finalised. We believe in our example the inflation rate should be the country's general price inflation.

   The reference to a single observable index of general price inflation in the proposed amendments should be linked to the currency and country in which the debt instrument is denominated, unless there is support for another rate to be used

d) 11.19 should also make reference to general price inflation, as re-estimating the future payments has no significant effect on the carrying amount of the asset or liability, given general price inflation is a variable rate.

e) 11.9 (c) (i) and (ii) make reference to (a) in both sub-paragraphs, reference should also be made to 11.9 (b), and the proposed amendment should therefore read "…(a) and (b)…".

f) 11.9 (c) (ii) should make clear the new market rate is at the time of the contract variation.

g) The interaction between 11.9 (d) and example 3 needs to be clarified.

   11.9 requires that there are no contractual provisions that could result in the holder losing principal. Considering example 3 as currently drafted, if there was no floor there is a possibility that the holder could lose principal if the banks variable rate were below 1%. Should this be non-basic, if so example 3 should be clarified to state that.

h) 11.9 (e) states that contractual repayment provisions may include terms that require the issuer to compensate the holder for loss of interest as a result of early termination. Our view is that the compensation should be no more than fair value of the loan therefore the wording should be changed to:

"...require the issuer to compensate the holder for loss of interest at no more than the fair value of the debt instrument as a result of the early termination."

Question 2 *In your view, under the amended conditions will debt instruments be classified appropriately, i.e. 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.*

Subject to the amendments noted in our response to question 1, our view is that the amendment will lead to most financial instruments being classified appropriately.

In some situations condition (e) may not be met when the holder has the ability to increase rates due to a levy imposed on the bank by regulators that they pass onto customers. The issuer may wish to repay the debt as there is in effect a potential credit deterioration in the holder.

To ensure such a term does not fail the basic test an adjustment to condition (c) would also be required as the contract may provide for a variation by the holder during the life of the instrument for the levy. If the debt instrument has a fixed rate of interest and the return is adjusted for the levy neither (i) or (ii) is met and therefore the loan would be non-basic. 11.9 (c) (i) should be amended to add a third option that allows a change in rate due to a levy to be basic.

Currently as drafted if a rate can be changed due to a change in tax regulations or law, the loan would be non-basic unless an additional option is added within 11.9 (c).

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?*

We view the examples as helpful, subject to the following amendments:

a) The examples in paragraph 11.10, 11.11, 11.13, 11.20 and 11.35 should be inserted into the appendix, it will make the section flow better rather than have examples scattered all over.

b) 11A.2, inclusion of the following sentence needs clarifying:

"...Unless there are indications to the contrary, it can be assumed that a bank's standard variable rate would under normal economic conditions not fall below 0%..."

The reason for this being included needs to be clarified. Is the text included to illustrate that if the rate were to fall below 0% this would result in the holder losing principal; paragraph 11.9 (d) is not met and therefore the instrument is non-basic, if so it would be useful to include text to that effect in the example.

Consideration should be given to what happens if the return becomes negative during the life of the loan under normal economic conditions; is the loan reclassified to non-basic if so how is this done, guidance would be useful, or does the issuer need to consider at initial recognition the fact the rate "could" (as mentioned in paragraph 11.9 (d)) become negative, even though the likelihood of it occurring is remote under normal economic conditions, which would cause the instrument to be non-basic.

c) 11A.6 appears to define general price inflation. If this is the intention of the FRC, then this should be added to the glossary.

Other examples that may be of use are:

- A unit linked loan. This is unlikely to meet the basic test as it is not a rate equal to a single reference quoted or observable interest rate (eg LIBOR).

- Clarification on why the liability component of a convertible debt would meet the basic criteria and how to deal with the conversion as a following on to section 22's appendix example.

- Split example 3 into a number of smaller examples to help users understand the application of the requirements.

Question 4 *The proposed amendments would be effective from 1 January 2015. Do you have reservations concerning the proposed effective date?*

We agree with the proposed effective date, however given we are now in the transitional period for first time adopters with a December year end, we urge the FRC to make no further changes to the standard to help preparers with transition.

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?*

Given the timing of the amendment we believe transitional provisions are required.

Consider the following, an entity having applied the current requirements of paragraph 11.9 concluded that a debt instrument was non-basic and therefore the instrument is held at fair value through profit or loss, which is the treatment the entity wanted.

On application of the amendment the debt instrument falls to be basic, however given the date of transition has passed ie 1 January 2014, the exemption in paragraph 35.10(s) cannot be applied. For this reason, the FRC should allow designation of previously recognised financial instruments after the date of transition that existed at that date. The election should be available for a specific time period from when the amendment is issued.

The transitional requirements should also consider the interaction with FRED 51 on hedge accounting when finalised, and there should be some overlap from when the amendments can be applied ie designation and hedge accounting. As mentioned in the previous paragraph an instrument may now meet the basic financial instrument requirement and therefore an entity could apply cash flow hedge accounting whereas before the entity may not have been able to apply hedge accounting as both instruments were held at fair value through profit or loss.

Finally, transitional guidance should be provided for a company that has early adopted FRS 102. For example, a debt instrument currently falls to be non-basic as it does not meet the basic requirements, but on adoption of the proposed amendments the debt instrument would fall to be basic and recognised at amortised cost. However, if the company wishes to continue with the fair value through profit or loss measurement basis, the company would not be able to apply the requirements of paragraph 11.14(b) as initial recognition has passed or could the company argue that initial recognition is when the amendment is adopted and therefore paragraph 11.14(b) can be applied. Guidance should be provided to clarify the accounting.