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By email to: ukfrs@frc.org.uk

30 April 2014

Dear Ms Pust Shah

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

Deloitte LLP is pleased to respond to FRED 54*: Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland Basic financial instruments* ("FRED 54"). We have set out our detailed responses to the consultation questions in the Appendix to this letter together with some additional comments.

We support the proposal to amend the requirements of Section 11 *Basic Financial Instruments* of FRS 102 in order to allow a wider range of debt instruments to be measured at amortised cost where it adequately captures the risks associated with those instruments.

We would be happy to discuss our letter and the draft proposals with you. If you have any questions, please contact James Rogers on 0207 303 7482 or jrogers@deloitte.co.uk or Helen Shaw on 0207 303 4658 or hshaw@deloitte.co.uk.

Yours sincerely

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Appendix

Responses to detailed questions

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

Yes, we support the proposal to make the requirements of paragraph 11.9 less restrictive. In our view, amortised cost measurement should be available where this adequately captures the risks associated with an instrument (i.e. where the instrument is basic). We agree with the FRC's observation in the introduction to FRED 54 that the original drafting of paragraph 11.9 would, in a number of cases, result in instruments generally regarded as basic being measured at fair value (for example inflation linked debt) and that this would lead to more items measured at fair value than would be the case under IFRS.

We would emphasise that, as the Accounting Council has noted in its advice to the FRC, just because a certain type of financial instrument is common in practice does not necessarily imply that the financial instrument should be measured at amortised cost. Amortised cost should apply when it is the relevant measurement basis for the particular financial asset or liability. We consider that amortised cost measurement is relevant when it reflects a basic lending arrangement. The proposals in FRED 54 are broadly consistent with this view.

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.

We agree that the amended conditions will generally lead to appropriate classification of debt instruments. However, there are some types of instrument where we still have concerns:

1. <u>Debt instruments with a link to inflation</u>

   Paragraph 11.9(b) of FRED 54 allows basic financial instruments to have repayments of principal and/or interest to be linked to a single observable index of general price inflation of the currency in which the instrument is denominated.

   We agree that some, but not all, instruments with a linkage to such an index should be classified as basic. In our view, instruments where the linkage is leveraged should not be classified as basic and so we would recommend amending paragraph 11.9(b) to read:

   > *'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, provided that the link is not leveraged.'*

   Paragraph 11.9(c) of FRED 54 allows for variation of the return to the holder during the life of the instrument provided that, amongst other conditions, the new rate satisfies the conditions in paragraph 11.9(a). This would appear not to allow the new rate to be linked to inflation. Given an inflation-linked instrument can be regarded as basic we believe the references to 'condition (a)' in this paragraph should be amended to refer to 'conditions (a) or (b)'.

2. Investments in preference shares

The amendments proposed in FRED 54 do not address the treatment of investments in preference shares that are also debt instruments. It is our view that FRS 102.11.8(d) and FRS 102.11.14(d) would need to be applied (and not FRS 102.11.9 and FRS 102.11.14(a)-(b)) to all investments in preference shares irrespective of whether the preference shares could also be considered to be debt instruments. This is because 'debt instrument' is not a defined term but 'preference share' has a specific legal meaning and so in the case where either could be considered to be applicable the more specific guidance should be followed. Under this view all investments in preference shares are measured at FVTPL, even where they are basic. This can give rise to different accounting based solely on the legal form of the instrument.

In our view FRS 102.11.8(d) and FRS 102.11.14(d) should only apply to investments in preference shares that are classified as equity by the issuer. If this is the intended reading it would need to be clarified, for example by adding '…preference shares that are classified as equity by the issuer' to the relevant paragraphs.

In the absence of any clarification in relation to the treatment of investments in preference shares which are also debt instruments we can see the potential for diversity in practice to develop. Therefore, we would seek to raise the issue with UK GAAP Technical Advisory Group if not addressed through the amendments to FRS 102 following the consultation on FRED 54.

3. Issuer prepayment options

In some cases an issuer may be required to pay a penalty in excess of the compensation for lost interest allowed by paragraph 11.9(e) of FRED 54 if it elects to early terminate a debt instrument. Under the proposals set out in FRED 54, such a penalty would result in the debt instrument being classified at fair value through profit or loss.

Where early termination is at the option of the issuer and the amount payable by the issuer on early termination is defined to be greater than the fair value of the debt, the option's fair value will be nil (i.e. the option will always be out of the money). Hence requiring the instrument to be measured at fair value solely due to this option whose fair value is nil is counter intuitive. We understand this is the case with some UK mortgages where the borrower can prepay a limited amount of the mortgage per annum without penalty but would suffer excessive penalties if in a given year the borrower chose to pay an amount in excess of that limit. Such a feature serves as a disincentive for the borrower to prepay the mortgage in full (as the option will be out of the money) and provides the lender with a more predictable prepayment profile. The limited prepayment profile is reflected in the interest rate payable by the borrower and earned by the lender. As the lender cannot force the borrower to prepay and incur the penalty and the borrower is never compelled to exercise its right to prepay we struggle to see why such prepayments features should result in the lender being required to measure the loans at fair value through profit or loss.

We therefore recommend that where the prepayment option is at the borrower's discretion the amount of the prepayment should not matter as long as the lender is at least being reimbursed the principal and any unpaid interest in full.

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?

Yes, we believe that the proposed examples are helpful.

We believe the presentation of the examples could be improved by separating them into two subsections, one headed 'Examples of basic debt instruments' and the other 'Examples of non-basic debt instruments'.

We would also recommend that the existing examples of instruments that would 'normally' be basic or non-basic, as set out in paragraphs 11.5, 11.6, 11.10 and 11.11, should be removed and replaced with a single set of examples in the proposed Appendix to Section 11. The inclusion of examples in a number of different places in the standard is, in our view, unhelpful. Additionally some of the existing examples are rather broad and may give users of the standard a misleading expectation and hence should be removed, for example the characterisation of 'bonds and similar debt instruments' as financial instruments that would normally be basic (paragraph 11.5(e)).

It would also be helpful if the proposed changes to paragraph 11.8(b) were amended further to highlight the existence of these examples, as follows:

> *'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). Illustrative examples of such instruments are included in the Appendix to Section 11;'*

Finally, we would also recommend the inclusion of an additional example, demonstrating the sort of inflation-link that is common in practice and which would meet the requirements of paragraph 11.9(b). We feel this is necessary to illustrate that:

- in many cases inflation-linked bonds do not have a coupon that is contractually linked to inflation, rather the coupon is fixed and the principal (upon which the coupon payment is calculated) is linked to inflation; and
- the linkage is generally to the change in, rather than the absolute level of, the inflation index.

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

We agree that the proposed effective date of 1 January 2015 is appropriate, subject to the requirements being finalised in good time to allow companies to prepare for adoption.

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?

We assume that the amendments are intended to be applied fully retrospectively. However, this is not explicit and would recommend making this clear. If this is not the intention it should be noted that those entities which have adopted FRS 102 prior to the mandatory effective date would need transitional provisions.

FRS 102 allows financial instruments to be designated at fair value through profit or loss on initial recognition if the criteria in paragraph 11.14(b) are met. In addition financial instruments can, subject to the same conditions, be designated at fair value through profit or loss on transition to FRS 102 under paragraph 35.10(s). As the revised requirements will not be finalised prior to the date of transition for many entities it is clearly not practical to require entities to have made their designations by the date of transition. However, retrospective designation at fair value could give rise to manipulation or abuse due to the use of hindsight.

We believe additional requirements are necessary if retrospective designation is to be allowed on transition. In particular:

- the wording in paragraph 35.9(s) should be redrafted to make it clear that retrospective designation is allowed as a specific transitional provision only. In the absence of clear requirements the precedent of retrospective designation on transition may be used to argue that this treatment is also appropriate in other circumstances; and

- an explicit limit should be set for retrospectively designating financial instruments at fair value through profit or loss. We would suggest that an entity should be required to have made a designation by the later of 6 months after the publication of the amendment and its date of transition.

Furthermore the transition requirements should set out the time at which the conditions for the fair value option should be assessed which we believe should be aligned with the time at which the election is made. For example, if the fair value option is elected within 6 months of the standard being issued but after the date of transition, the fair value option should be based on a measurement mismatch that exists at the time of the designation.

This issue is common for both retrospective designation at fair value through profit or loss and the retrospective designation of hedge relationships. Therefore, the approach taken for each should be consistent with the other.

Additional comments

<u>The use of ‘variable rate’ as a defined term</u>

Although we agree with the proposed definition of a ‘variable rate’ in the context of determining whether a debt instrument is basic, we recommend that a different term is used for such a rate. The term ‘variable rate’ is commonly used to mean any variable rate and so there is a danger that users will misunderstand the use of it as a defined term in the context of paragraph 11.9 and fail to realise that only certain types of variable rate are allowed. We would recommend that a different term is used, such as ‘basic variable rate’, in order to highlight the restrictive nature of this definition to users of the standard.

<u>Use of the term derivative</u>

Given that the term ‘derivative’ is defined in the glossary of FRS 102, we would recommend that paragraph 11.8(b) of the standard be amended to read:

> *‘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 derivative.’*

In our view this would increase the clarity of this paragraph.