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For the attention of Susanne Pust Shah

29 April 2014

Dear Susanne

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

We welcome the opportunity to comment on the draft amendments to FRS 102 set out in Financial Reporting Exposure Draft 54 (FRED 54) in respect of basic financial instruments.

We broadly support the changes set out in FRED 54 and lay out our responses to the specific questions raised in the FRED in Appendix 1 to this letter. In order to seek to make the final standard as clear as possible and to reduce diversity in practice, we have a number of detailed observations on the proposals. We set out our detailed comments within Appendix 2.

If you wish to discuss any of the points raised, please contact Terry Harding on 0207 694 8105, Steve Hubbard on 0207 694 8033 or Muriel Buchanan on 0207 694 8712.

Yours sincerely

KPMG LLP

KPMG LLP

Enclosures:
Appendix 1: Responses to specific questions raised in FRED 54
Appendix 2: Detailed comments in relation to FRED 54

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Appendix 1: ***Responses to specific questions raised in FRED 54***

Q1 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 amend the conditions of paragraph 11.9 and make the requirements less restrictive.

Q2 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.

We agree with the overall direction of the FRED and believe that under the amended conditions debt instruments will broadly be classified appropriately. In Appendix 2, we have included more detailed observations, including some minor amendments to the proposed wording of paragraphs 11.8 and 11.9.

Q3 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 support the idea of providing illustrative examples in an Appendix to Section 11 and we think that the examples provided in the FRED are generally helpful in illustrating the application of the proposed requirements. However, we believe that the Appendix would be more user-friendly if (i) each example illustrated the application of one single classification rule only and (ii) each separate rule in paragraph 11.9 were illustrated by an example. It would be helpful if the illustrative examples used financial instruments that are common in practice and provided a mixture of examples that do and don't meet the requirements for classification as basic financial instruments.

Q4 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.

Q5 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 believe that transitional provisions should be added to address the following situations

- Early adopters of FRS 102 would already have classified their financial instruments in line with the current requirements in Section 11. We suggest that the FRC clarify that on adoption of the revised Section 11 these entities follow the normal rules relating to changes in accounting policies under Section 10 *Accounting Policies, Estimates and Errors*, i.e. the new classification requirements are applied retrospectively.

- Paragraph 35.10(s) of Section 35 *Transition to this FRS* allows an entity to designate, at the date of transition to FRS 102, any financial asset or financial liability at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 11.14(b) at that date. Any entity with a date of transition to FRS 102 prior to the publication date of the Section 11 amendments might have had the opportunity to use the paragraph 35.10(s) designation for an instrument now classified as basic if the provisions of the FRED had been effective at the time. We therefore think that these entities should be granted an additional window for 'fair value designation' on adoption of the Section 11 amendments.

Appendix 2: *Detailed comments in relation to FRED 54*

- *Definition of variable rate* – The FRED proposes to add a definition of 'variable rate' to both paragraph 11.9(a) and the overall FRS 102 Glossary. We have a number of observations in this respect, as follows:
  - Firstly, the proposed definition ('a rate equal to a single referenced quoted or observable interest rate') is narrower than used elsewhere in FRS 102 (e.g. in paragraph 11.19 on amortised cost accounting) or than would be commonly understood in practice. Thus, the proposed definition would not appear to include inflation linked rates or LIBOR plus / minus x basis points. So as to avoid any confusion with other sections of FRS 102, we suggest that the definition be omitted altogether from the Glossary and the relevant words at the end of paragraph 11.9(a) be amended to 'a variable rate <u>for this purpose</u> is a rate equal to …'
  - The last sentence of paragraph 11.9(a) defines a 'variable rate' as a 'rate equal to a <u>single</u> referenced quoted or observable interest rate'. Looking at Example 4 in the Appendix, it appears that the word 'single' in that definition is intended to mean 'unleveraged', although this was not immediately obvious to us when reading the definition. Perhaps the word 'unleveraged' could be used in the definition for clarity.
  - Given that 'quoted' rates are also 'observable', should the former term be omitted from the definition?

- *11.8(b)* – The suggested amendments make the definition of basic financial instruments appear circular. Indeed, the revised paragraph 11.8(b) now states that a debt instrument cannot be a basic financial instrument if it is financial instrument described in paragraph 11.6(b). The latter lists 'options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument' as examples of financial instruments that do not *normally* satisfy the conditions in paragraph 11.8.

  Presumably the FRC's intention was simply to exclude all derivatives from classification as basic financial instruments and hence amortised cost accounting. Perhaps this could be done more easily by changing the words in 11.8(b) to '*a non-derivative debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9*'. In the same context, we note that the term 'derivative' is already defined in the Glossary, so that there will be no need to add further definitions.

- *11.9(a)* – It is unclear why the requirement for the contractual return to be 'assessed in the currency in which the debt instrument is denominated' has been included. Was the intention here to exclude dual-currency loans? If so, should it read 'assessed in the currency in which the principal amount is denominated'? In either case, the practical application of this rule could be usefully illustrated as part of the examples in the Appendix.

- *11.9(c)* – We found this paragraph difficult to follow. It would appear that a rate change meets the requirements for 'basic financial instrument' classification if

A) The new rate satisfies paragraph 11.9(a); AND

B) (i) The variation is not contingent on future events; OR

(ii) The variation is due to a change in contractual variable rate (e.g. interest rate caps and floors); OR

(iii) The variation is to protect the holder against credit deterioration of the issuer (e.g. a step-up if the credit rating falls below a certain level); OR

(iv) The variation is contingent on a future event other than those listed above AND the interest rate is reset to the market interest rate.

Further, we assume that the following rate changes would not be viewed as 'contingent on future events'

- A pre-agreed contractual change in interest rate due to the passage of time, e.g. 6% in years 1 to 3 and 7% in years 4 to 6;
- A renegotiated rate, mutually agreed between borrower and lender;
- A lender option / borrower option (LOBO) loan whereby either the lender or the borrower can unilaterally switch the interest rate from a fixed to a floating rate or vice versa.

We also assume that paragraph 11.9(c)(ii) refers to a market rate of interest *at the date of reset*.

In addition, we note that paragraph 11.9(e) also lists 'change in control of the issuer' and 'change in taxation laws' as permissible contingent events (in the context of prepayment of the debt instrument). It is unclear why these contingent events aren't also included in paragraph 11.9(c)(i).

The FRC may wish to consider redrafting paragraph 11.9(c) along the above lines for clarity. Further, as already mentioned in response to Question 4, we would welcome additional illustrative examples to clarify the application of these rules.

- *11.9(d)* – This paragraph, read in conjunction with Example 3, implies that a debt instrument fails the definition of 'basic financial instrument' if the interest rate thereon can become negative. Thus, for example, if the interest rate is a combination of a positive variable rate and a negative fixed rate (such as LIBOR less 50 basis points), then the loan agreement would also need to provide for a 'floor' to avoid the overall interest rate going negative. Is this the FRC's intention?
- *11.9(e)* – We suggest that the opening line be changed to 'contractual provisions that permit or *require* the issuer ...' so as to include the typical clause in loan agreements whereby loans become immediately repayable on breach of a loan covenant.
- *11.9(e)* – The exact meaning of the last sentence ('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') is unclear. Firstly, is the implication that such compensation

would not breach the requirements of 11.9(a)? Further, would the amount of 'compensation' need to be the exact amount of lost interest, or could it be more or less? Again, an illustrative example could clarify these questions.

- *11.11* – Given that there is now an Appendix with illustrative examples of debt instruments, paragraph 11.11 could simply be deleted. Any examples therein that are still deemed to be useful could then be transferred to the Appendix.