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Dear Ms Shah

FRED 54 Draft Amendments to FRS 102 – Basic Financial Instruments

Introduction

Ernst & Young LLP welcomes the opportunity to comment on FRED 54 Draft Amendments to FRS 102 – Basic Financial Instruments ('the exposure draft') issued by the Financial Reporting Council ('the FRC').

Overall comments

We agree that the existing requirements for basic financial instruments in FRS 102 are too restrictive. Therefore, we support proposals that allow a wider range of debt instruments to be measured at amortised cost where this is a relevant measurement basis. We also support aligning the measurement requirements for financial instruments more closely with those of IFRS 9 – *Financial Instruments* thereby reducing the cost of compliance with FRS 102.

The exposure draft does not define a 'basic' financial instrument other than by listing a series of rules which a debt instrument has to meet in order to qualify as 'basic'. Although we have not identified any commonly used financial instruments for which the proposed accounting would not be appropriate, this approach creates a risk that such instruments may be identified at a later date. We note that the FRC decided not use a principle-based solution based on IFRS 9 as the IFRS principle is untested, further amendments may be made and it only applies to financial assets. In this context we believe a rules-based approach is acceptable to overcome the shortcomings in the existing requirements provided, as envisaged by the FRC, that this approach is revisited as part of the first three year cycle review of FRS 102.

We have a number of comments of detail on the proposals which are included in the body of this response.

If you have any matters arising concerning the content of our response, please do not hesitate to contact me.

Yours sincerely

Tony Clifford
Partner, Financial Reporting Group

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Responses to FRC questions

Question 1

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

Overall, we support proposals that are designed to allow a wider range of debt instruments to be measured at amortised cost where this is a relevant measurement basis. This will also align the measurement requirements for financial instruments more closely with those of IFRS 9 – *Financial Instruments* thereby reducing the cost of compliance with FRS 102.

However, we have reservations as to whether these proposals fully achieve those ends (see answer to Question 2 below).

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 requirement.

The exposure draft does not define a 'basic' financial instrument other than by listing a series of rules which a debt instrument has to meet in order to qualify as 'basic'. Although we have not identified any commonly used financial instruments for which the proposed accounting would not be appropriate, there will always be a risk that such instruments may be identified at a later date. Conversely, there is the potential for financial instruments to meet (including to be structured to meet) the criteria for a 'basic' financial instrument in the exposure draft but for which amortised cost is not the most appropriate treatment. We believe a rules-based approach is acceptable to overcome the shortcomings in the existing requirements provided, as envisaged by the FRC, that this approach is revisited as part of the first three year cycle review of FRS 102.

There are also some areas where the accounting treatment of certain products is unclear as follows:

- Non-recourse loans

  Our interpretation of paragraph 11.9(d) is that non-recourse loans (i.e. loans where the lender has no recourse to the borrower if the value of the collateral is less than the value of the loan) are not basic financial instruments. However, we would welcome clarity on this matter, preferably supported by an illustrative example.

Reassessment of the 'basic' criteria

It is unclear whether a reassessment of the 'basic' criteria is required if there is a failure to meet the criteria subsequent to origination (e.g. if the interest rate becomes negative, for instance if abnormal conditions are subsequently encountered in Example 2) or whether reassessment is only required if there is a modification to the financial terms. The exposure draft is silent on this matter or on how a reclassification of a financial instrument previously held at fair value to a basic financial instrument should be accounted for.

- Prepayment provisions

As constructed, it is not clear to us whether the sentence in paragraph 11.9(e), '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' (emphasis added), is intended to be a constraint against the use of amortised cost accounting. As worded, this sentence does not seem to preclude other terms being acceptable as well.

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 be included instead?

We believe that illustrative examples to support the rules in Section 11 are useful.

However, we would like to see additional examples illustrating:

- Non-recourse loans (particularly in the context of paragraph 11.9(d) – see response to Q2 above)

- Stepped interest rates

- Interest rates, when the interest rate charged on the loan may vary if there is a decline in the borrower's EBITDA or debt to equity ratio

- Loans that may be prepaid or extended

In addition, we have the following comments on two examples:

Example 2 (11A.2)

The words '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%' would appear to be adding to the requirements of Section 11 rather than an illustration. It introduces a principle that it is possible to

make assumptions about what might or might not be expected to occur in future. Also, as worded, we believe that there is a potential contradiction between this sentence and paragraph 11.9(a)(iii) which appears to not prohibit negative interest rates.

Example 4 (11A.4)

This example refers to 'leverage' which is a concept not otherwise mentioned or defined in FRS 102. In our view, this instrument is not a basic financial instrument under the rules of paragraph 11.9(a) because '1.5 times the bank's standard variable rate' is a multiple of a variable rate and therefore not "a rate *equal* to a single referenced quoted or observable interest rate". We believe that the example should be rewritten to this effect, with the inclusion of the word 'equal' and the references to 'leverage' deleted.

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 of accounting periods beginning on or after 1 January 2015 provided early-adoption is permitted (given that early adoption is permitted for FRS 102). Early-adoption is not mentioned in the exposure draft.

The introduction has a typographical in (viii) incorrectly referring to the effective date as accounting periods ending on or after 1 January 2015.

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 specific transitional provisions in relation to the proposed amendments necessary? If so, please tell us what transitional provisions you would suggest and why?

These amendments are unlikely to be issued until the second half of 2014 which is subsequent to the date of transition to FRS 102. Therefore, we believe that there should be transitional relief to permit entities to use paragraph 35.10(s) to designate a financial instrument at fair value through profit or loss on transition where the accounting for that instrument has been changed by these amendments from fair value through profit or loss to amortised cost. In these cases, entities may have chosen to make the designation on transition, had Section 11 not already required the use of fair value.