Financial Reporting Council

Accounting and Reporting Policy FRS 102

Staff Education Note 2 Debt instruments - Amortised cost

This Staff Education Note was updated on 27 October 2015 as a result of the issuance of Staff Education Note 16 *Financing transactions*. The guidance on financing transactions has been incorporated into Staff Education Note 16 and deleted from this Staff Education Note.

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Introduction

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 11 *Basic Financial Instruments* requires that basic debt instruments, which include basic types of loans and other receivables and payables, shall be measured at amortised cost using the effective interest method. This Education Note discusses aspects of the application of the amortised cost measurement requirements in FRS 102 and indicates whether entities should expect accounting differences on transition when applying the amortised cost measurement requirements of FRS 102 for the first time. This Education Note is written from the perspective of reporting entities that do not apply FRS 26 (IAS 39) *Financial instruments: recognition and measurement* and assumes that pre-transition accounting policies are based on the requirements of FRS 4 *Capital instruments*.

This Education Note highlights some common key areas for consideration when transitioning to FRS 102, but is not in any way meant to be exhaustive and should therefore not be used as a substitute for a thorough analysis.

Amortised cost measurement requirements in FRS 102

Paragraphs 11.15 to 11.20 of FRS 102 provide guidance on how to calculate amortised cost using the effective interest method. Paragraphs 11.15 and 11.16 are reproduced below:

*11.15 The amortised cost of a financial asset or financial liability at each **reporting date** is the net of the following amounts:*

(a) the amount at which the financial asset or financial liability is measured at initial recognition;

(b) minus any repayments of the principal;

(c) plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount;

(d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

Financial assets and financial liabilities that have no stated interest rate (and do not constitute a financing transaction) and are classified as payable or receivable within one year are initially measured at an undiscounted amount in accordance with paragraph 11.14(a). Therefore, (c) above does not apply to them.

*11.16 The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the **carrying amount** of the financial asset or financial liability. The effective interest rate is determined on the basis of the carrying amount of the financial asset or liability at initial recognition. Under the effective interest method:*

(a) the amortised cost of a financial asset (liability) is the present value of future cash receipts (payments) discounted at the effective interest rate; and

(b) the interest expense (income) in a period equals the carrying amount of the financial liability (asset) at the beginning of a period multiplied by the effective interest rate for the period.

Effective interest method

In accordance with paragraph 11.14(a) of FRS 102 debt instruments that meet the conditions of paragraphs 11.8(b) and 11.9 shall, following initial recognition, be measured at amortised cost using the effective interest method. Debt instruments include basic types of financial assets and liabilities, eg trade receivables and payables and variable or fixed rate loans. Please note that paragraph 11.14(b) also provides an alternative accounting treatment and entities may elect to measure their debt instruments at fair value which is not discussed further in this document.

Paragraphs 11.15 and 11.16 of FRS 102 (reproduced above) set out the basic principles of an amortised cost calculation and describe how the effective interest method should be applied. The effective interest rate of a debt instrument may equal its coupon rate, but, often an entity will also incur other costs or receive other income associated with the instrument, eg finance charges or premiums and discounts which affect the effective interest rate. The effective interest rate includes, besides interest, other related finance fees and charges (refer also to paragraph 11.18 of FRS 102). Please also refer to the example of an amortisation cost calculation in Section 11 of FRS 102.

It is not expected that accounting differences will arise in respect of the determination of the effective interest rate when transitioning to FRS 102, since similar principles apply under FRS 4 *Capital Instruments*, provided the interest rate of the loan is a market rate of interest (see Staff Education Note 16 *Financing transactions* for the measurement requirements applying to loans with a below market rate of interest)).

Amortisation period

In order to calculate the effective interest rate, an entity has to determine the expected life of the debt instrument. A shorter period than the expected life should be used under certain circumstances. This is typically the case when certain fees, finance charges or other transaction costs relate to a period shorter than the expected life of the debt instrument (paragraphs 11.16 and 11.18 of FRS 102).

On transition, entities should assess whether amortisation periods used to calculate the effective interest rate are in accordance with the requirements of FRS 102. Generally no accounting difference is expected, however, in some specific situations, eg debts with early redemption options differences may arise.

Measurement of common debt instruments

Overdraft repayable on demand

If a creditor has the right to demand repayment at any time, the borrower measures the liability at the undiscounted amount of cash repayable.

A standard bank overdraft repayable on demand would be measured at the principal amount of the overdraft.

Current trade debtors (receivables) and trade creditors (payables)

Under FRS 102, trade receivables (debtors) and trade payables (creditors) are recognised at the transaction price (unless the arrangement is a financing transaction as described in paragraph 11.13 of FRS 102, see Staff Education Note 16 for more detail), which in most cases is the invoiced amount (refer to the examples in paragraph 11.13 of FRS 102). In accordance with paragraph 11.14(a) of FRS 102 receivables and payables due within one year continue to be measured after their initial recognition at the undiscounted amount of cash or other consideration expected to be paid or received. Therefore in most situations short term receivables and payables are measured at their invoiced amount until they are settled or otherwise extinguished.

Trade receivables are subject to impairment and must not be stated at a value higher than their recoverable amount. More information on the accounting for impairment of trade receivables can be found in Staff Education Note 3 *Impairment of trade debtors*.

It is not expected that accounting differences will arise in respect of current trade receivables and trade payables when transitioning to FRS 102.

Loans bearing a market rate of interest

Paragraph 11.13 of FRS 102 requires that all financial assets and financial liabilities are initially recorded at the transaction price (unless it is a financing transaction as described in paragraph 11.13 of FRS 102, see Staff Education Note 16 for more detail). Loans bearing a market rate of interest will therefore be recognised at the initial value exchanged (ie the amount of the cash lent or received) including transaction costs.

Loans that meet the conditions of a basic debt instrument set out in paragraphs 11.8(b) and 11.9 of FRS 102 are measured at amortised cost after initial recognition. Provided no transaction costs have been incurred or premiums/discounts have been paid/received, for loans bearing a market rate of interest, the effective interest rate is equal to the market rate of interest at the date of initial recognition.

It is not expected that accounting differences will arise in respect of loans bearing a market rate of interest when transitioning to FRS 102.

Financing transactions

The term financing transaction is used in FRS 102 to specifically refer to transactions with deferred payments or repayments, for which there is no explicit interest rate or the interest charged is not at a market rate. Examples of such transactions include:

- the sale of goods or services, if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate (paragraph 11.13 of FRS 102);
- below market rate and interest-free loans between group entities; and
- below market rate and interest-free loans to or from directors.

More detailed guidance on financing transactions can be found in Staff Education Note 16.