

Need to know

FRC publishes final amendments to the financial instruments requirements of FRS 102

In a nutshell

- The Financial Reporting Council (FRC) has issued 'Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland, Basic financial instruments and Hedge accounting*' ('the amendments').
- The amendments make hedge accounting available in more circumstances and less onerous to apply.
- The revised standard also permits amortised cost measurement for a broader range of debt instruments.
- These are the final amendments to FRS 102 for financial instruments before its mandatory effective date (1 January 2015), enabling FRS 102 reporters to make an informed decision about which recognition and measurement rules to apply.
- The amendments include flexible transition provisions allowing retrospective designation of hedge relationships irrespective of which recognition and measurement rules are applied.

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An end to uncertainty

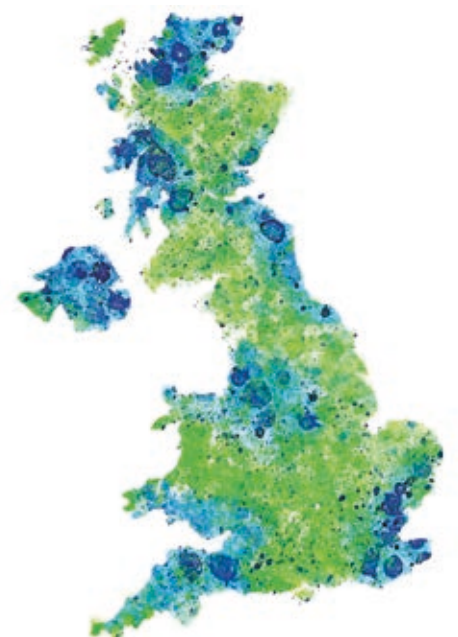
FRS 102 has been amended following consultation on the proposals set out in both FRED 51¹ (Hedge accounting) and FRED 54² (Basic financial instruments). They are the final changes to FRS 102 for financial instruments prior to its 1 January 2015 effective date and will remove the uncertainty that has surrounded financial instrument accounting under FRS 102 since its publication in March 2013.

The period of stability following the amendments, combined with the flexible transition requirements, will allow entities to make an informed choice between the various recognition and measurement rules available to them (see box below).

One of the reasons for amending FRS 102 was to align it with the new IFRS requirements in IFRS 9 *Financial Instruments*, but, some important differences remain between the two standards.

¹ FRED 51 Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland, Hedge accounting*

² FRED 54 Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland, Basic financial instruments*



Accounting policy choice

Entities applying FRS 102 have an accounting policy choice in relation to which recognition and measurement provisions they apply. They may choose to apply the requirements of either IAS 39 *Financial Instruments: recognition and measurement* or IFRS 9 as an alternative to those of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* of FRS 102. However, the presentation and disclosure requirements of Sections 11 and 12 are always applicable.

IAS 39 is the currently applicable IFRS for the recognition and measurement of financial instruments and is the direct equivalent of FRS 26 *Financial instruments: recognition and measurement* currently applied by some UK GAAP reporters. However, IAS 39 is due to be replaced by IFRS 9 effective for periods beginning on or after 1 January 2018 with early adoption permitted (subject to EU endorsement).

The requirements of Sections 11 and 12 are intended to be simpler than the corresponding requirements of IAS 39 and IFRS 9. This has been achieved, to an extent, by reducing some of the choices that are available in IAS 39 and IFRS 9. The accounting policy choice allows entities willing to accept the increased complexity of the IAS 39 and IFRS 9 requirements the option to apply them.

'Basic' financial instruments

A 'basic' financial instrument is within the scope of Section 11; all other 'non-basic' financial instruments are within the scope of Section 12. An equity instrument is measured at fair value through profit or loss (FVTPL) or cost if fair value cannot be measured reliably irrespective of whether it is classified as 'basic' or 'non-basic'. However, for debt instruments, in general only 'basic' financial instruments can be measured at amortised cost. All 'non-basic' debt instruments would fall within the scope of Section 12 and always be measured at FVTPL except in rare cases when this would not be permitted by law.

Classification as 'basic' or 'non-basic' under FRS 102 is based on a set of rules rather than on an overarching principle. FRED 54 was published in response to feedback received by the FRC that the rules determining whether a debt instrument is 'basic' or 'non-basic' were overly restrictive. As a consequence of this, some common instruments that would be accounted for at amortised cost under IAS 39 or IFRS 9 would have been classified as 'non-basic,' and therefore accounted for at FVTPL under FRS 102.

The Amendments to FRS 102 do not alter the fundamental approach of FRS 102 in respect of 'basic' or 'non-basic' classification. It continues to be rules-based, but the rules have been refined in some areas, so that some instruments with links to inflation and termination payments will now be accounted for at amortised cost. Although the effect of the amendments will be to allow amortised cost measurement in more cases, it should not be assumed that because a particular type of instrument is common, it will be measured at amortised cost. Each instrument will need to be assessed in relation to the revised criteria. For example it is common for entities to hold investments in convertible debt. Such an investment would be classified as 'non-basic' under both the existing and the revised requirements of FRS 102.

The amendments also allow a 'non-basic' debt instrument to be measured at amortised cost if measurement at FVTPL would not be permitted under the law³. This is expected to be rare.

Hedge accounting

Under FRS 102, derivatives such as interest rate swaps, forward contracts and option contracts are not 'basic' financial instruments and will be measured at FVTPL. Derivatives are commonly used to manage the risks an entity is exposed to (i.e. they are 'hedging instruments'). However, the risks hedged by these hedging instruments may not be measured on the same basis. For example, the hedged item may be a forecast transaction not yet recorded in the financial statements, or it may be an existing asset or a liability measured at cost. This can give rise to volatility in profit or loss, which hedge accounting is designed to reduce by matching gains or losses on hedging instruments with the recognition of losses or gains on hedged items. Hedge accounting under FRS 102 is optional, and may be applied only when the relationship is formally designated as a hedge.

The requirements for financial instruments in FRS 102 were based on those in the IFRS for SMEs, a simplified version of IFRSs. The IFRS for SMEs was published in 2009 and based on IFRSs at that time (i.e. based on IAS 39 for hedge accounting). The FRC published FRS 102 with the express intent to reconsider the requirements for hedge accounting and impairment on completion of the relevant phases of IFRS 9. The amendments for hedge accounting are based on the IFRS 9 requirements.

³ All preparers of Companies Act accounts must comply with the requirements of paragraph 36 of Schedule 1 to the Regulations, which provide that certain financial instruments may only be included at fair value only if EU endorsed IFRSs on or before 5 September 2006 would allow this.

The specific eligibility criteria in FRS 102 prior to the amendments were deliberately restrictive, seeking to simplify hedge accounting by only allowing its application to the most simple and effective hedges. In practice, the restrictive nature of these requirements meant that hedge accounting would not have been permitted in a number of common hedging scenarios leading to volatility in profit or loss when hedging instruments are transacted to reduce rather than increase risk. The amendments remove these specific restrictions and broaden the eligibility criteria so that more risk management hedges qualify for hedge accounting.

Prior to the amendments, FRS 102 also required an entity to expect the hedging instrument to be 'highly effective' in offsetting the hedged risk before hedge accounting could be applied. This was viewed as onerous as it involves an offset threshold, outside of which hedge accounting would not be permitted. This criterion has now been removed and instead the amendments require only that there is 'an economic relationship' between the hedged item and hedging instrument.

Comparison to IFRS 9

The approach to classification and measurement of financial instruments under the revised FRS 102 is very different from that under IFRS 9. IFRS 9 has two separate models for the classification of financial assets and financial liabilities, and allows some financial assets to be classified at FVTOCI. The classification of financial assets under IFRS 9 is based on both the contractual cash flows of the asset and the business model it is held in. The assessment of the contractual cash flows is principles-based rather than rules-based. However, although the approach is very different, the application of the rules set out in the amendments should ultimately result in accounting outcomes that are closer to those under IFRS 9, compared to the previous FRS 102 requirements.

In contrast, the FRS 102 hedge requirements are based on the corresponding requirements in IFRS 9, but are simplified. In some cases these simplifications have been made by intentionally offering a more limited range of options. For example, under FRS 102 it is not possible to exclude the time value of an option from the designation of a hedging instrument, or to designate a net position as a hedged item. In addition to the explicit differences, further differences may exist due to less prescriptive requirements of FRS 102 which may allow more room for interpretation and potentially wider application of hedge accounting.

Transition provisions

FRS 102 is mandatorily effective for periods beginning on or after 1 January 2015 with prior year comparatives required. The amendments have been published after the mandatory date of transition for many entities (i.e. after the beginning of the comparative period presented under FRS 102). The FRC has acknowledged the difficulties this creates, and as a consequence the amendments will allow retrospective designation at FVTPL and retrospective designation of hedge relationships, up until their first set of FRS 102 financial statements are authorised for issue. Retrospective designation will be possible irrespective of which recognition and measurement provisions the entity chooses to apply.

The transition provisions for hedge accounting set out in Section 35 *Transition to this FRS* of FRS 102 following the amendments are an optional exemption from (rather than an exception to) fully retrospective application. The transitional provisions are the same regardless of the GAAP that was applied previously (i.e. the same requirements apply to those entities that do not currently apply FRS 26 as to those that do), but will differ depending on which recognition and measurement requirements an entity chooses (i.e. there are different transition requirements for entities choosing to apply the recognition and measurement requirements of IFRS 9 or IAS 39 from those choosing to apply Sections 11 and 12 in their entirety). The requirements give entities considerable flexibility in the treatment of their hedging arrangements on adoption of FRS 102.

How Deloitte can help

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More information on the new UK financial reporting regime, as well as other UK accounting, reporting and corporate governance news and publications, can be found at www.ukaccountingplus.co.uk.

Contacts

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