

Need to know FRC proposes hedge accounting amendments to FRS 102



In a nutshell

- The Financial Reporting Council (FRC) has issued FRED 51 'Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland, Hedge Accounting*'.
- This amendment proposes to replace the restrictive hedge accounting requirements in FRS 102 with a set of hedge accounting principles based on the International Accounting Standards Board's draft IFRS 9 *Financial Instruments* hedge accounting model.
- The proposed amendment to FRS 102 would allow more opportunities to apply hedge accounting, reducing profit or loss volatility from hedging instruments such as interest rate swaps, FX forwards and option contracts recognised and measured at fair value.
- The proposed criteria for qualifying for hedge accounting are less onerous than those in FRS 102 and the proposed IFRS 9 hedge accounting model.

Why propose an amendment to FRS 102 so soon after it was issued?

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* issued in March 2013 includes new accounting requirements for financial instruments based on the IFRS for SMEs, a simplified version of full IFRSs. Subsequent to the issue of the IFRS for SMEs, the International Accounting Standards Board (IASB) began a project to simplify financial instrument accounting under IFRSs. The Financial Reporting Council (FRC) has always intended to consider these simplifications for incorporation into UK GAAP but did not want to delay the issue of FRS 102 solely for this purpose. As a result, it issued FRS 102 with the express intent to reconsider the requirements regarding hedge accounting and impairment of financial assets once the IASB was closer to completing these aspects of its financial instruments project. FRED 51 proposes new hedge accounting requirements based on the IASB's hedge accounting model in the review draft of IFRS 9 *Financial Instruments*.¹

The IASB's new hedge accounting model is designed to reflect risk management more closely and be less rules-based than current IAS 39 *Financial Instruments: Recognition and Measurement*. As a result, more hedge relationships are expected to be eligible for hedge accounting under the new model with less onerous qualification criteria. The FRC wanted to reflect this more principles-based approach in UK GAAP rather than keep the restrictive hedge accounting requirements that are currently included in FRS 102.

¹ A further proposed amendment to FRS 102 in respect of impairment of financial assets is expected in 2014 in line with the expected completion of the IASB's impairment project.

What is hedge accounting and why is it needed?

Under FRS 102, the default measurement for derivative instruments such as interest rate swaps, forward contracts and option contracts, is fair value through profit or loss. In addition, certain equity investments and debt instruments are required to be measured at fair value through profit or loss. Derivatives (and sometimes equity investments and debt instruments) are used to hedge 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 liability that is measured at cost. This can give rise to volatility in profit or loss which hedge accounting is designed to reduce by matching gains and losses on hedging instruments with the recognition of losses or gains on hedged items.

How are these proposals different from what is currently in FRS 102?

The hedge accounting requirements in FRS 102 may be applied when an eligible hedging instrument is formally designated as a hedge of an eligible risk in an eligible hedged item and there is an expectation that the hedging instrument will be *highly effective* in offsetting the designated hedged risk.

Eligibility criteria

Under FRED 51 a broader range of hedging instruments, hedged risks and hedged items would be eligible for hedge accounting.

The specific eligibility criteria in FRS 102 for hedging instruments, hedged items and hedged risks were designed to simplify hedge accounting and were thought to cover the most common hedging relationships expected to arise in UK GAAP reporters. However, in practice, the FRS 102 requirements are narrow and would not permit hedge accounting 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.

FRED 51 proposes to remove these specific restrictions and broaden the eligibility criteria so that more risk management hedges qualify for hedge accounting.

Economic relationship between hedged item and hedging instrument

In addition to broadening the eligibility criteria, FRED 51 also proposes to remove the requirement that an entity must expect the hedging instrument to be *highly effective* in offsetting the hedged risk. This criterion in FRS 102 is viewed as a simplification from IAS 39 but it is still viewed as onerous because it involves an offset threshold, outside of which hedge accounting would not be permitted.

In place of the highly effective criterion, FRED 51 would require there to be "an economic relationship between the hedged item and hedging instrument" but does not provide any further guidance on how this should be determined. In most common hedging scenarios it would be obvious that an economic relationship exists. For example, where an entity hedges interest rate risk on a loan with a matching interest rate swap, it is clear that an economic relationship exists. Similarly, an economic relationship can easily be demonstrated when an entity hedges foreign exchange risk on forecast revenue with a matching foreign exchange contract.

Hedge accounting terminology, mechanics and illustrative examples

FRS 102 describes different types of hedging relationships and explains the accounting that should be applied. For example, in some cases the mechanics require the hedged item, such as a fixed rate loan hedged for interest rate risk, to be remeasured through profit or loss for changes in the hedged risk to match the remeasurement of the hedging instrument, such as an interest rate swap. In other cases FRS 102 requires changes in fair value of the hedging instrument to be deferred in reserves and later reclassified to profit or loss to match the recognition of the hedged forecast transaction. The double entries associated with hedge accounting are referred to as the hedge accounting mechanics.

FRED 51 articulates more clearly the different hedge accounting mechanics and characterises them using established terminology from IFRSs as either:

- **cash flow hedges** – hedges of variability in cash flows that could affect profit or loss, where gains and losses on the hedging instrument are deferred in reserves via other comprehensive income and later reclassified to profit or loss to match the recognition of the hedged item;

- **fair value hedges** – hedges of the change in fair value of assets or liabilities that could affect profit or loss, where the gain or loss on the hedged item is recognised in profit or loss to match the hedging instrument; or
- **net investment hedges** – hedges of foreign exchange risk in foreign net investments, where gains or losses on the hedging instrument are matched in other comprehensive income against the foreign currency losses or gains on the hedged net investment.

FRED 51 illustrates each of the above three types of hedges with examples.

Is FRED 51 the same as the IASB’s proposed hedge accounting requirements in IFRS 9?

FRED 51 is based on the IASB’s review draft of its IFRS 9 hedge accounting model, but it is simplified. In comparison, the proposed requirements in FRED 51 are very brief and represent a broad set of basic principles. As a result differences exist. For example, hedge accounting can be discontinued voluntarily under FRED 51, but would not be permitted under the IFRS 9 model. The accounting for option contracts used as hedging instruments is very different and represents a simplification that could lead to more volatile accounting in profit or loss under FRS 102 compared to the IFRS 9 model. Also FRED 51 does not include any requirements for the ratio of hedged item versus hedging instrument or any guidance on how the existence of an economic relationship between the hedged item and hedging instrument should be assessed.

Outside of some of these explicit or more obvious differences, further differences are likely to exist due to FRED 51 allowing more room for interpretation and potentially wider application of hedge accounting.

When will the final amendment be issued?

FRED 51 is currently available for comment and a final amendment could be expected later in 2014 once the FRC has considered the feedback received. For FRS 102 reporters with calendar year ends, this will be well into the comparative period for their first set of FRS 102 financial statements which may impact current planning decisions in relation to hedge accounting.

How Deloitte can help

Our integrated team of accounting and taxation specialists can assist you in managing the impact of the changes to UK financial reporting. Information about the services we offer can be found at www.deloitte.co.uk/futureofukgaap.

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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