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A closer look
Transition to FRS 102 for financial instruments

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The accounting for financial instruments will be one of the biggest challenges for entities adopting FRS 102 *'The Financial Reporting Standard applicable in the UK and Republic of Ireland'* for the first time. There are substantial changes, particularly for those entities transitioning from old UK GAAP excluding FRS 26 '*Financial Instruments: Recognition and Measurement*', and the requirements of FRS 102 in this area are complex.

The accounting for financial instruments was an area of uncertainty until the publication of major amendments to FRS 102 in this area in July 2014. The amendments addressed concerns in relation to the classification of financial instruments. They also introduced a new hedge accounting model based on the requirements of IFRS 9 *'Financial Instruments'*. These are expected to be the final amendments to FRS 102 in relation to financial instruments before UK GAAP reporters will be required to produce their first financial statements under one of the new frameworks. This allows entities adopting FRS 102 to finalise their transition planning. First time adopters need only consider the revised requirements as part of this process.

FRS 102 provides entities with a choice in relation to the recognition and measurement requirements they apply for financial instruments. In this publication we take a brief look at that choice, then consider the key steps an entity should follow on transition and some of the associated issues that may arise on implementation. This publication covers the following issues:

- identifying financial instruments;
- identifying derivatives;
- derecognition of items that do not qualify as assets/liabilities under FRS 102;
- debt/equity classification;
- classification as basic or non-basic;
- amortised cost and impact on intercompany loans;
- fair value measurement;
- debt restructuring and the exception to retrospective application for FRS 102's derecognition requirements; and
- hedge accounting.

For the purpose of this analysis we assume the entity is applying the requirements of FRS 102 in its entirety.

Overview of financial instruments requirements

In FRS 102 four sections deal with the accounting for financial instruments:

- Section 11 *'Basic Financial Instruments'* sets out the conditions an instrument must meet in order to be 'basic' and the recognition and measurement requirements for those instruments. It also contains impairment, derecognition and disclosure requirements that are applicable to financial instruments more generally as well as guidance on fair value and amortised cost measurement;

- Section 12 *'Other Financial Instrument Issues'* contains the recognition and measurement requirements for 'non-basic' financial instruments. It also deals with hedge accounting and accompanying disclosures;

- Section 22 *'Liabilities and Equity'* establishes principles for classifying financial instruments as liabilities or equity and deals with the accounting for compound instruments. It also addresses the issue of equity instruments, distributions to investors in equity instruments, the purchase of own equity and the accounting for non-controlling interests in consolidated financial statements; and

- Section 34 *'Specialised Activities'* includes subsections dealing with public benefit entity concessionary loans and financial institutions. The subsection on financial institutions sets out additional disclosures required for financial institutions in respect of financial instruments.

In addition Section 35 *'Transition to FRS 102'*, which sets out the general requirements for an entity's first financial statements that conform to FRS 102, contains some specific requirements relating to financial instruments.

Accounting policy choice

FRS 102 allows an entity to apply the recognition and measurement provisions of IAS 39 *'Financial Instruments: Recognition and Measurement'* or IFRS 9 in place of those in Sections 11 and 12. Whichever recognition and measurement provisions an entity chooses, the presentation and disclosure requirements of FRS 102 will apply. All options are available to all entities as an accounting policy choice, unlike under old UK GAAP which mandated the application of FRS 26 for certain entities. The option to apply the recognition and measurement requirements of IFRS 9 is available now, unlike for UK entities reporting under IFRSs or FRS 101 'Reduced Disclosure Framework' which will have to wait for the standard to be endorsed by the EU before they can adopt it. Whichever recognition and measurement provisions are chosen, they must be applied to all relevant financial instruments of the entity i.e. it is not possible to mix and match the different requirements.

The most suitable accounting policy choice may not be clear without a detailed analysis of the requirements specific to an entity. For example, because the requirements of IAS 39 are almost exactly the same as those of FRS 26, an entity currently applying old UK GAAP including FRS 26 could minimise change in the short term by choosing to apply the recognition and measurement provisions of IAS 39. However, it should not be assumed on this basis that applying the recognition and measurement provisions of IAS 39 is the most suitable accounting policy for all such entities. In particular, entities taking this option need to be aware that they will be required to adopt the equivalent requirements of Sections 11 and 12 or IFRS 9 once IAS 39 is withdrawn by the International Accounting Standards Board (the 'IASB')[1]. Therefore, active consideration, by entities currently applying FRS 26, of the alternatives available under FRS 102 on adoption of that standard will not only identify the potential benefits of any change, but will also help evaluate the best time to make that change.

An entity that is transitioning from applying old UK GAAP excluding FRS 26 should also not automatically assume that it would be best placed to apply the provisions of Section 11 and 12 in full. Although simplified, the requirements of Sections 11 and 12 can be restrictive in certain areas, even for financial instruments regarded by some as simple. The accounting policy choice was included expressly to provide an alternative because it was acknowledged that the simplified requirements would not always give the most desirable outcome. This publication focuses on the requirements of Sections 11 and 12, but where the treatment set out is not desirable, it can be considered whether an alternative treatment is available under IAS 39 or IFRS 9.

1 With the exception of the hedge accounting requirements, IAS 39 will be withdrawn once IFRS 9 becomes mandatorily effective. IFRS 9 as published by the IASB in July 2014 is effective for annual periods beginning on or after 1 January 2018. However, this is subject to EU endorsement for entities applying IFRS as adopted for use in the EU.

Key steps on adoption of FRS 102 for financial instruments

Section 35 establishes the requirements for an entity's first financial statements that conform to FRS 102. The general principle underlying Section 35 is that a first-time adopter should apply the version of FRS 102 effective at the reporting date retrospectively i.e. effectively applying FRS 102 as if it had been the entity's financial reporting framework since inception. However, Section 35 adapts this general principle of retrospective application by adding a limited number of exceptions and exemptions, including some relating to financial instruments.

An entity's first set of financial statements that conform to FRS 102 must include full comparative information in respect of at least the preceding period. The date of transition to FRS 102 is the beginning of the earliest period for which an entity presents full comparative information under FRS 102 in its first financial statements that comply with FRS 102. For example an entity preparing its first set of FRS 102 financial statements for the annual period ending on the 31 December 2015, that presents one year of comparative information will have a date of transition of 1 January 2014. The date of transition is the starting point for accounting under FRS 102, because it is the date at which an entity prepares its opening FRS 102 statement of financial position.

For an entity choosing to apply the requirements of Sections 11 and 12 in full, the key steps to ensure compliance with the financial instruments requirements on transition to FRS 102, can be summarised as follows:

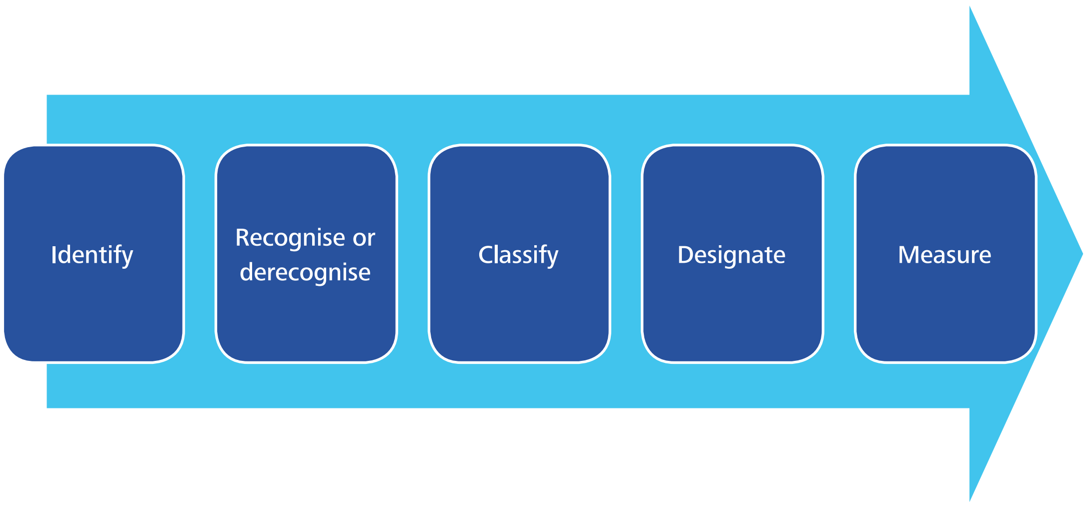
- identify all financial instruments and other contracts that fall within the scope of Sections 11, 12 and 22, such as derivatives, which may not have been accounted for as financial instruments under old UK GAAP;

- recognise all financial instruments and other contracts that fall within the scope of Sections 11, 12 and 22 and derecognise items if FRS 102 does not permit their recognition. For example, this includes gains and losses deferred as assets and/or liabilities in the statement of financial position in respect of hedge relationships under old UK GAAP. This is subject to a transitional exception to retrospective application for the derecognition requirements which is discussed below;

- classify financial instruments in accordance with the rules on liability and equity classification in Section 22 and 'basic' and 'non-basic' classification in Section 11;

- designate items as at fair value through profit or loss, or in hedge relationships. These designations are optional, and entities have until their first set of FRS 102 financial statements are authorised for issue to make these designations; and

- apply the requirements of Sections 11, 12 and 22 in measuring financial instruments.



In the following sections we highlight some of the key considerations and associated issues that will arise as part of the process of transition for financial instruments.

Identifying financial instruments

Many items that meet the definition of a financial instrument will be within the scope of other sections of FRS 102, for example share based payments and finance leases. As a consequence the challenge is not just identifying financial instruments, but also determining which financial instruments are within the scope of Sections 11, 12 and 22.

What is a financial instrument?
FRS 102 defines a financial instrument as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. This definition is broad, and includes many items that are outside the scope of Sections 11, 12 and 22. Trade receivables and payables, bank loans, insurance contracts, finance leases and ordinary shares are just some examples of financial instruments.

Items such as deferred revenue and warranty obligations, where they require delivery of goods or services rather than an obligation to deliver cash or another financial asset, are not financial instruments.

A financial instrument can only arise from a contract. Assets or liabilities that are not contractual (such as income taxes that result from statutory requirements imposed by governments or constructive obligations as defined in Section 21 ‘*Provisions and Contingencies*’) are not financial assets or financial liabilities.

Therefore, in addition to considering how the requirements for accounting for a particular type of item have changed, it may also be necessary to reconsider the nature of those items which can affect their accounting treatment. For example:

- a contract entered in to by a gas supplier that pays out in the event of unseasonably warm weather (i.e. a weather derivative) may have been accounted for at cost less amortisation of the premium under old UK GAAP excluding FRS 26. Under FRS 102 this contract would be with in the scope of Sections 11, 12 and 22; or

- an issued floating rate debt instrument and an interest rate swap may have been accounted for in combination as a fixed rate debt instrument under old UK GAAP excluding FRS 26. Under FRS 102 the two contracts would need to be accounted for separately.

In order to make this assessment it may be necessary to look back to the underlying contracts rather than the information stored in the financial reporting system.

An entity will also need to identify any non-financial contracts that are within the scope of Section 12.
Some non-financial contracts are brought into the scope of Section 12 if they contain certain “non-typical” features. Such contracts are expected to be comparatively rare. Other non-financial contracts will be brought within the scope of Section 12 if they meet the definition of a derivative. Such contracts are discussed further below.

Identifying derivatives
In practice, standalone derivatives will generally be either in the scope of Section 12 and measured at fair value or outside the scope of Section 12 and measured at cost (which may be nil).

What is a derivative?
FRS 102 defines a derivative as a financial instrument or other contract with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the ‘underlying’), provided in the case of a non-financial variable that the variable is not specific to a party to the contract;

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors;

(c) and it is settled at a future date.

This definition is broad and includes many contracts to buy or sell non-financial items but not all derivatives are within the scope of Sections 11 and 12. Where derivatives are not within the scope of Sections 11 and 12, they will need to be identified in order to confirm that a scope exception is applicable.

Some derivative financial instruments are explicitly scoped out of both Sections 11 and 12, for example financial guarantee contracts.

Contracts to buy or sell non-financial items are not within the scope of Section 11 because they are not financial instruments. However, if they can be settled net they will be within the scope of Section 12, unless they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (the 'Own Use Exception').

The Own Use Exception can be difficult to interpret and entities should not assume they meet the conditions without analysis. FRS 102 does not contain guidance on how 'settled net' should be interpreted. However, it should be considered whether net settlement can be achieved other than by express terms included in the contract (e.g. some non-performance penalties). The existence of the option to settle net will not bring a contract within scope if the entity intends there to be physical delivery in accordance with its expected purchase, sale or usage requirements. However, physical delivery alone is not sufficient to meet the Own Use Exception.

There is a similar scope exception under FRS 26 and although the wording of the exception is consistent with Section 12, there may be differences in application because FRS 26 contains additional requirements.

Derecognition of items that do not qualify as assets/liabilities under FRS 102

Subject to the exception discussed below relating to the retrospective application of FRS 102's derecognition rules, at the date of transition to FRS 102 an entity is required to recognise all financial assets and financial liabilities that qualify for recognition under Sections 11 and 12 of FRS 102.

An entity must also derecognise items that would have never qualified for recognition as assets or liabilities under FRS 102. For example, consider an entity that had closed out an interest rate swap which was previously hedging the variability in cash flows on a floating rate debt instrument that continues to be recognised. Under old UK GAAP excluding FRS 26, the entity would have typically recognised an asset or liability on the balance sheet (representing the deferred gain or loss) when the derivative was closed out. Any such asset or liability would usually have been amortised through profit or loss over the remaining hedged period of the debt. On transition to FRS 102, this amount would need to be derecognised and the corresponding entry taken to retained earnings. The entity would not have the option to create a cash flow hedge reserve, because the hedge relationship ceased to exist before the date of transition.

Debt/equity classification

Section 22 of FRS 102 prescribes whether a financial instrument is a financial liability or equity. Section 22 is very similar to FRS 25 *'Financial Instruments: Presentation'* in terms of its underlying principles and the terminology used. However, FRS 25 provides much more specific requirements in some areas (e.g. puttable instruments) and as a result, in rare cases, some classification differences may arise.

One area of difference between FRS 25 and Section 22 is the accounting for contracts that could require an entity to purchase its own equity instruments, for example a forward to buy back own equity[2] or a written put option over own equity[3]. Under FRS 25 such contracts are recognised as "gross" financial liabilities where the amount of the liability recognised equals the present value of the consideration payable under the contract. Such "gross" accounting does not apply under Section 22.

Classification as basic or non-basic

Basic financial instruments are those within the scope of Section 11 rather than Section 12 of FRS 102. There are four types of basic financial instrument:

- cash;
- debt instruments meeting certain conditions;
- commitments to make or receive a loan that will be basic that cannot be settled net in cash; and
- investments in non-convertible preference shares and non-puttable[4] ordinary or preference shares.

With the exception of basic loan commitments, all derivatives within the scope of Sections 11 and 12 will be non-basic.

2 A contract under which an entity is obliged to purchase their own equity instruments at an agreed price on a set date in the future where the counterparty is also obliged to sell them.

3 A contract under which an entity is obliged to purchase their own equity instruments at an agreed price on a set date or range of dates in the future if the counterparty chooses to sell them.

4 Non-puttable shares are those which the issuer cannot be required to repurchase by the holder.

The measurement of a financial instrument depends on the type of instrument as well its classification as basic or non-basic. For debt instruments classification determines whether amortised cost measurement is available, whereas for equity investments classification has no impact on measurement. Equity investments are always measured at fair value through profit or loss ('FVTPL'), unless fair value cannot be measured reliably.

Basic debt instruments are accounted for at amortised cost under Section 11, unless they are designated as at FVTPL. Section 12 generally requires non-basic debt instruments to be measured as at FVTPL. The option to designate an instrument at fair value can be taken if doing so reduces an accounting mismatch or if the instrument is part of a portfolio which is managed, and has its performance evaluated on, a fair value basis. The designation is irrevocable, and must normally be made on initial recognition. However, there is a transitional exemption that allows this designation to be made retrospectively until an entity authorises its first set of FRS 102 financial statements for issue.

Basic/non-basic classification for a debt instrument is based on specific criteria (set out in FRS 102.11.9, the "Conditions") rather than an overarching principle. The Conditions place restrictions on the returns of an instrument, how those returns change over the life of the instrument and prepayment and extension features. They also prohibit instruments with contractual terms that could result in the loss of principal or accrued interest being classified as basic. To be basic, a debt instrument must comply with all of the Conditions; this means the presence of a single non-basic feature will cause a debt instrument to be classified as non-basic. Therefore, on transition, all the terms of a debt instrument will need to be identified and assessed to determine if the Conditions are met. A detailed analysis of the Conditions and examples illustrating their application can be found in *A Closer Look: 'Basic/Non-Basic' Classification of Debt instruments under FRS 102'.*

FRS 102 was amended in July 2014 to address concerns raised about the restrictive nature of the criteria for classifying debt instruments as basic. The amendments have increased the number of instruments that will qualify as basic. However, it still should not be assumed that because a debt instruments is regarded as simple and/or common it will be classified as basic. For example, an investment in a bond that converts into a fixed number of the issuer's ordinary shares would not meet the Condition relating to returns.

Care also needs to be taken in establishing which instruments should be assessed on the basis of the Conditions for debt instruments. Debt instrument is not a defined term and judgement will be required to interpret it. One possible reading of the term in this context could be any financial instrument that would not be classified as an equity instrument of the issuer. However, since preference shares have a specific legal meaning, the more specific requirements for preference shares should be followed in cases where preference shares are not classified as equity by the issuer. This means that where an investment in preference shares is classified as basic it will be measured at FVTPL (or cost if its fair value cannot be measured reliably), even if a bond with the same terms would be measured at cost i.e. in this case the legal form of a financial instrument can impact the accounting outcome.

Amortised cost and impact on intercompany loans

How is the amortised cost of a financial instrument calculated?

Section 11 of FRS 102 requires that the amortised cost of a financial instrument be calculated using the 'effective interest method'. This method allocates interest income/expense over the relevant period by applying the 'effective interest rate' to the carrying amount of the financial instrument. 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 instrument. When estimating the future cash flows arising from the financial instrument all contractual terms (e.g. prepayment options) should be considered, but future credit losses should not be taken into account.

The effective interest rate is determined on the basis of the carrying amount of the financial instrument at initial recognition. Financial instruments that are subsequently measured at amortised cost are initially measured at the transaction price including transaction costs, unless the transaction price does not represent the value of a financing transaction. In this case the present value of future payments discounted at a market rate of interest for a similar debt instrument is used in place of the transaction price.

Under the effective interest method the amortised cost of a financial instrument is the present value of future cash payments or receipts discounted at the effective interest rate. For financial assets, the amortised cost may be reduced for impairment.

Where applicable amortised cost accounting must be applied fully retrospectively i.e. the carrying amount of a financial instrument measured at amortised cost at the date of transition must be the same as if amortised cost measurement had been applied to that instrument since initial recognition. This amount may differ from the carrying amount under old UK GAAP excluding FRS 26.

Under old UK GAAP excluding FRS 26, FRS 4 required the initial carrying amount of a financial liability to be based on the value of the consideration received, whereas under Section 11 it is based on the present value of the future cash flows of the instrument. Differences can arise if a loan is 'off-market' (i.e. the rate of interest on the cash received is not a market rate of interest). Whether there is a difference will depend on whether the loan is repayable on demand and if so the amount that can be demanded.

FRS 102 states that the fair value of a liability that is due on demand is not less than the amount payable on demand, discounted from the first date that amount could be required to be paid. This guidance can be applied by analogy to the present value of future cash flows for the purpose of initial recognition of both financial assets and liabilities within the scope of Section 11. A loan is only considered to be repayable on demand if the lender can demand repayment. Although the present value of a loan repayable on demand cannot be less than the amount repayable on demand discounted from the first date that amount could be required to be paid, it could be more. This may arise where the loan pays an above market interest rate, or where repayment may be demanded at less than the present value of future cash flows.

Off-market loans are most commonly found between entities under common control. In this context any difference between the fair value of consideration received and the initial carrying amount of the loan is accounted for as a capital contribution or distribution. In a subsidiary, any amount credited to/debited from equity (as a capital contribution or distribution) is not subsequently remeasured. In a parent, any distribution income is not subsequently remeasured and an investment in subsidiary increased by a capital contribution is not subsequently reduced unless the investment is impaired.

Although the making of an interest-free loan may be accounted for as a distribution, it is not necessarily a distribution for legal purposes. It has been accepted practice for group companies to make interest free loans to each other and this has not generally been regarded as giving rise to distributions for legal purposes in the past. However, accounting for the transaction as a distribution will draw attention to the issue and companies may therefore wish to exercise caution when entering into such transactions in the absence of distributable reserves or to seek their own legal advice.

Fair value measurement

FRS 102 requires most non-basic financial instruments to be measured as at FVTPL. In addition it requires investments in ordinary and preference shares to be measured at FVTPL unless the fair value cannot be reliably determined. Where financial instruments are measured at FVTPL a valuation must be obtained at each reporting date. This may be a challenge for many entities transitioning from old UK GAAP excluding FRS 26. For such entities it is advisable for them to consider how they are to obtain the necessary valuations well in advance of preparing their first set of FRS 102 financial statements.

FRS 102 defines fair value as the amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction. It should be noted that the definition of fair value under FRS 102 is broadly similar to that previously found in FRS 26 and IAS 39. However, it is different from the new definition under IFRS 13 *'Fair Value Measurement'*. The difference applies to the definition of fair value for a financial liability. Under IFRS 13, the definition of fair value for a financial liability is based on the price at which it could be transferred to a market participant where the liability remains outstanding (rather than what it could be settled for with the counterparty). In practice this means that entities applying the IFRS 13 definition may be required to make larger adjustments for "own credit" than entities applying the FRS 102 definition. Entities applying the recognition and measurement requirements of IAS 39 or IFRS 9 under FRS 102 will be required to use the IFRS 13 definition of fair value.

In determining fair value, Section 11 sets out a hierarchy where the best evidence of fair value is a quoted price for an identical asset in an active market in the absence of which a valuation technique should be used that makes maximum use of market inputs and the minimum use of entity-determined inputs. The use of market inputs, as opposed to entity-specific information, is intended to promote consistent measurement across entities.

It should not be assumed that because a financial instrument is not quoted in an active market that its fair value is not reliably measurable. In many cases the valuation techniques will be able to determine a reliable estimate of fair value. However, there will be instances where this is not the case and in those cases an entity is precluded from measuring investments in ordinary shares and preference shares at fair value. For example, such investments may include small holdings of shares in private companies. It is possible to value such investments using a valuation technique, if appropriate data is available. In such cases, the holder of the instrument may not have accesses to the required data and it would be reasonable to conclude that fair value could not be measured reliably.

Debt restructuring and the exception to retrospective application for FRS 102's derecognition requirements

Financial assets and liabilities that were derecognised under an entity's previous accounting framework before the date of transition should not be recognised upon adoption of FRS 102. This is true even if such items would not have been derecognised under FRS 102 had the entity applied FRS 102 since the asset or liability's initial recognition. Such items must not be recognised again unless they qualify for recognition under FRS 102 as a result of a later transaction or event occurring on or after the date of transition.

Conversely, for financial assets and liabilities that would have been derecognised under FRS 102 in a transaction that took place before the date of transition, but that were not derecognised under an entity's previous accounting framework, an entity has a choice of either:

(a) derecognising them on adoption of FRS 102 (hence they will not appear in the opening statement of financial position prepared at the date of transition), or

(b) continuing to recognise them until disposed of or settled. In this case the entity must test the financial asset for impairment (if it is measured at cost or amortised cost under FRS 102) or remeasure the financial asset or financial liability at fair value (if measured at fair value under FRS 102) on the date of transition, and for all subsequent reporting dates (including those of comparative periods).

This exception does not apply to transactions after the date of transition, including those in the comparative period. Therefore, where an entity is undergoing a debt restructuring in the financial year before the one in which they will first adopt FRS 102, they should consider the accounting impact under both their existing GAAP and under FRS 102. In particular, if on modification of a debt instrument the existing liability is derecognised and a new liability is recognised this could result in a gain or loss on extinguishment that would not have arisen under old UK GAAP excluding FRS 26. This is because FRS 102 would require the new liability to be recognised at an amount based on the present value of the future cash flows which may differ from the carrying amount of the old liability (see section on amortised cost measurement above).

Hedge accounting

What is hedge accounting? And why is it needed?

Under FRS 102 derivative financial instruments are measured at FVTPL because they are not basic. 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 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 the 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 of Section 12 of FRS 102 for hedge accounting will be one of the biggest challenges for many companies previously reporting under UK GAAP. Even those previously applying FRS 26 will find that the rules are different because they are based on the requirements of IFRS 9 rather than those of IAS 39. The hedge accounting requirements discussed in this section are those published in July 2014 in "Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland: Basic Financial Instruments and Hedge Accounting*". Entities preparing their first set of financial statements under FRS 102 following the publication of the amendments will only need to consider the amended requirements.

As the amendments to the hedge accounting requirements in Section 12 were published after the date of transition to FRS 102 for many entities, the Financial Reporting Council (the 'FRC') has provided flexible transitional requirements. Section 35 contains an optional exemption from (rather than a mandatory 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 requirement an entity chooses to adopt. Entities choosing to apply the recognition and measurement provisions of Sections 11 and 12 in full, may decide on a hedge by hedge basis whether they commence, continue or end hedge accounting on transition to FRS 102. The transitional provisions allow retrospective (backdated) designation and documentation of hedging relationships at any time up to the date when the first FRS 102 financial statements are authorised for issue i.e. a relationship can be designated 'as at' the date of transition or any other date. This applies to all hedges that exist on or after the date of transition, but only to some hedges that had ceased to exist by the date of transition.

Section 12 of FRS 102 places some restrictions on which financial instruments can be considered hedging instruments and which items can be considered hedged items. Entities should not assume that their economic hedges will qualify for hedge accounting without careful analysis. The type of exposure hedged will also determine the type of hedge accounting that can be applied. There are three types of hedge relationship under FRS 102:

- **Fair value hedges**, where changes in the fair value of the hedging instrument are recognised in profit or loss at the same time that a recognised asset or liability that is being hedged is adjusted, via profit or loss, for fair value changes due to the hedged risk;

- **Cash flow hedges**, where changes in the fair value of the hedging instrument are recognised initially in OCI and later removed or reclassified and ultimately recognised in profit or loss at the same time as the hedged item; and

- **Net investment hedges**, accounted for similarly to cash flow hedges but gains and losses are never reclassified to profit or loss.

Hedge accounting is only permitted if there is an economic relationship between the hedged item and hedging instrument. This may in some cases be established using qualitative analysis only. However, the hedge ineffectiveness in each period must be measured and so a valuation of both the hedging instrument and hedged item will need to be obtained at each reporting date. Even when the critical terms of the hedging instrument and the hedged item are the same, an entity cannot assume the hedge will be perfectly effective.

Hedge accounting under FRS 102 is voluntary. However, many entities will wish to use hedge accounting to avoid volatility in profit or loss and net assets. Volatility may have effects going beyond just the reported results and financial position. For example, it may impact on banking covenants and the availability of distributable reserves to pay dividends. When an entity wishes to apply hedge accounting, it must document its intention to do so. The hedge documentation must identify the hedging instrument, the hedged item, the nature of the risk being hedged and any sources of ineffectiveness.

The hedge accounting requirements of Section 12 are based on the corresponding requirements of IFRS 9. In some cases simplifications have been made by intentionally offering a more limited range of alternatives. For example, it is not possible to exclude the time value of an option from the designation of a hedging instrument. In addition to the explicit simplifications, the requirements of FRS 102 are less prescriptive which may allow more room for interpretation and potentially wider application of hedge accounting.

Closing remarks

The generous transitional provisions provided by the FRC mean that entities theoretically have until their first set of FRS 102 financial statements are authorised for issue to make any optional designations they may wish to make. However, this does not mean that analysis of the impact of transition on financial instruments should be left until the last minute. This publication illustrates that there is a range of issues relating to financial instruments that could impact even the simplest of entities. Time will be needed to establish the correct accounting treatment under FRS 102 and to either implement that treatment or consider the alternatives under IAS 39 or IFRS 9.

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 of 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**.

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