Exposure Draft

Financial Reporting Council

November 2013

FRED 51

Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Hedge Accounting

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Contents

Introduction

(i) In 2012 and 2013 the Financial Reporting Council (FRC) revised financial reporting standards in the United Kingdom and Republic of Ireland. The revisions fundamentally reformed financial reporting, replacing almost all extant standards with three Financial Reporting Standards:

FRS 100 *Application of Financial Reporting Requirements*;

FRS 101 *Reduced Disclosure Framework*; and

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland.*

This Exposure Draft proposes limited amendments to FRS 102 in respect of hedge accounting.

(ii) The FRC's overriding objective in setting accounting standards is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

(iii) In meeting this objective, the FRC aims to provide succinct financial reporting standards that:

- (a) have consistency with international accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;
- (b) reflect up-to-date thinking and developments in the way entities operate and the transactions they undertake;
- (c) balance consistent principles for accounting by all UK and Republic of Ireland entities with practical solutions, based on size, complexity, public interest and users' information needs;
- (d) promote efficiency within groups; and
- (e) are cost-effective to apply.

Draft Amendments to FRS 102 – Hedge Accounting

(iv) The draft amendments set out in this Financial Reporting Exposure Draft (FRED), issued in accordance with the FRC's previously stated plans, aim to update the requirements for hedge accounting in FRS 102 to achieve two ends:

- (a) to allow entities to apply hedge accounting when this reflects their economic and risk management strategies, without onerous conditions; and
- (b) to use concepts and language that are, as far as possible, consistent with those included in IFRS 9 *Financial Instruments*, the IASB's standard that includes hedge accounting.

(v) The draft amendments to FRS 102 propose to allow entities to use hedge accounting where the hedging instrument, hedged item and hedging relationship meet certain broad conditions. It permits these relationships to be discontinued at any point, and prescribes the accounting treatment for their ongoing use and their discontinuation.

Invitation to comment

1. The FRC is requesting comments on FRED 51 by 14 February 2014. The FRC is committed to developing standards based on evidence from consultation with users, preparers and others. Comments are invited in writing on all aspects of the draft amendments to the standard. In particular, comments are sought in relation to the questions below.

Question 1

Do you support the adoption in FRS 102 of the three hedge accounting models as set out in this FRED? If not, why not?

Question 2

Do you agree with the overarching principle of setting the requirements for hedge accounting in a way that can be straightforwardly applied by entities undertaking relatively simple economic steps to manage risk? If not, why not?

Question 3

The draft amendments to FRS 102 require an economic relationship between the hedging instrument and hedged item. Do you agree with this approach to establishing whether a hedging relationship exists? If not, why not?

Question 4

The draft amendments have the effect of removing the requirement to make a binary assessment at the beginning of a hedging relationship that defines that hedge as effective or ineffective. The effect of this would be to allow hedge accounting to be used for the effective portion of any relationship meeting the qualifying conditions.

Do you agree with this approach? If not, why not? If you envisage practical application difficulties, please provide an illustration of these.

Question 5

The draft requirements for net investment hedges state that when a hedging relationship is discontinued, amounts deferred in equity may not be reclassified to profit or loss. This is to achieve consistency with paragraphs 9.18A and 30.13 of FRS 102. Do you agree with this proposal, or should recycling of gains or losses on hedging instruments be permitted regardless of the mismatch with the foreign currency movements?

Question 6

The draft amendments propose an alteration to Section 11 of FRS 102 to broaden the range of instruments that may be designated at fair value through profit or loss, with the effect of allowing, in some cases, economic hedging. Do you agree with these changes? If not, why not?

Question 7

Included as non-mandatory guidance in the draft amendments are examples of the three proposed hedge accounting models (Appendix to Section 12). In your view, are these examples helpful application guidance of the requirements of paragraphs 12.15 to 12.25? If not, please provide examples of hedges that could be more usefully included.

Question 8

The draft amendments propose a transitional exemption which will allow certain one-off remeasurements of hedging instruments and hedged items at the transition date. Do you believe that these exemptions facilitate application of hedge accounting to arrangements in place at transition? If you have reservations, please tell us why and provide details of alternative transitional arrangements.

2. Information on how to submit comments and the FRC's policy in relation to responses are set out on page 29.

[Draft] Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Hedge Accounting

Amendments to Section 11
Basic Financial Instruments

Paragraph 11.14(b) is amended as follows (deleted text is struck through, additional text is underlined):

11.14(b) ~~Debt instruments that meet the conditions in paragraph 11.8(b~~) <u>Financial assets and financial liabilities</u> may upon their initial recognition be designated by the entity as at fair value through profit or loss (paragraphs 11.27 to 11.32 provide guidance on fair value) provided doing so results in more relevant information, because either:

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or debt instruments or recognising the **gains** and losses on them on different bases; or

(ii) a group of ~~debt instruments~~ <u>financial liabilities</u> or financial assets and ~~debt instruments~~ <u>financial liabilities</u> is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's **key management personnel** (as defined in Section 33 *Related Party Disclosures*, paragraph 33.6), for example members of the entity's board of directors and its chief executive officer.

Amendments to Section 12
Other Financial Instruments Issues

Paragraphs 12.15 to 12.29 are deleted and replaced with the following:

Hedge accounting

12.15 If specified criteria are met, an entity may designate a hedging relationship between a **hedging instrument** and a **hedged item** in such a way as to qualify for hedge accounting.

12.16 To qualify for hedge accounting, an entity shall comply with all of the following conditions at the inception of the hedge:

(a) the entity designates and documents the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument or portion thereof are clearly identified and the risk in the hedged item is the risk being hedged with the hedging instrument;

(b) the designation of the hedging relationship is consistent with the entity's risk management objectives and its strategy for undertaking hedges;

(c) the hedging relationship consists only of hedging instruments and hedged items as defined in paragraphs 12.17 and 12.18 [of this draft amendment to FRS 102];

(d) there is an economic relationship between the hedged item and the hedging instrument; and

(e) the entity has determined how it will identify and measure hedge ineffectiveness.

12.17 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation, or a portion of any such item, with the following additional conditions:

(a) the hedged item must be reliably measurable; and

(b) in consolidated financial statements the hedged item must be an asset, liability, firm commitment or highly probable forecast transaction with a party external to the reporting entity. This means that hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities.

12.18 A derivative or non-derivative instrument measured at fair value through profit or loss may be designated as a hedging instrument, providing that it meets all of the following terms and conditions:

(a) it is a contract with a party external to the reporting entity (ie external to the group or individual entity that is being reported on);

(b) it is designated in its entirety in a hedging relationship, or a portion of its nominal amount is designated; and

(c) it is not a net written option (unless it is designated as an offset to a purchased option).

12.18A For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or financial liability may be designated as a hedging instrument.

Accounting for qualifying hedging relationships

12.19 There are three types of hedging relationships:

(a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that are attributable to a particular risk and could affect profit or loss;

(b) cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction, and could affect profit or loss; and

(c) hedge of a **net investment in a foreign operation.**

12.19A A hedge of the foreign currency risk of an unrecognised firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

Fair value hedges

12.20 A fair value hedge that meets the basic criteria in paragraph 12.16 shall be accounted for as follows:

(a) the gain or loss on the hedging instrument shall be recognised in profit or loss; and

(b) the **hedging gain or loss** on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss. When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative hedging gain or loss on the hedged item is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss.

12.21 When a hedged item in a fair value hedge is an unrecognised firm commitment (or a component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative hedging gain or loss of the hedged item that was recognised in the statement of financial position.

12.22 Any adjustment arising from paragraph 12.20(b) shall be amortised to profit or loss if the hedged item is a financial instrument (or component thereof) measured at amortised cost. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The amortisation is based on a recalculated effective interest rate at the date amortisation begins.

Cash flow hedges

12.23 A cash flow hedge that meets the basic criteria in paragraph 12.16 shall be accounted for as follows:

(a) the separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):

(i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge.

(b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)), is hedge ineffectiveness that shall be recognised in profit or loss.

(d) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

(i) if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability.

(ii) for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

Hedges of a net investment in a foreign operation

12.24 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see Section 30), shall be accounted for similarly to cash flow hedges:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income.

(b) the ineffective portion shall be recognised in profit or loss.

However, the cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in equity shall not be reclassified from equity to profit or loss on the disposal or partial disposal of the foreign operation.

Discontinuing hedge accounting

12.25 The entity shall discontinue hedge accounting if:

(a) the hedging instrument expires, is sold or terminated;

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 12.16;

(c) in a hedge of a forecast transaction, the forecast transaction is no longer highly probable; or

(d) the entity revokes the designation.

In a cash flow hedge, if the hedged future cash flows are no longer expected to occur, any cumulative gain or loss on the hedging instrument shall be reclassified from the cash flow hedge reserve to profit or loss immediately. A future cash flow that is no longer highly probable may still be expected to occur. If the hedged future cash flows are still expected to occur (for example when a cash flow hedge is voluntarily discontinued before the hedged future cash flows occur), the cumulative gain or loss in the cash flow hedge reserve is dealt with in accordance with 12.23(d). In a net investment hedge, for consistency with paragraph 30.13, cumulative gains or losses on the hedged item are not reclassified to profit or loss.

Presentation

12.25A A financial asset and a financial liability shall be offset and the net amount presented in the **statement of financial position** when, and only when, an entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Disclosures

12.26 An entity applying this section shall make all of the disclosures required in Section 11, incorporating in those disclosures financial instruments that are within the scope of this section as well as those within the scope of Section 11. For financial instruments in the scope of this section that are not held as part of a trading portfolio and are not **derivative** instruments, an entity shall provide additional disclosures as set out in paragraph 11.48A. In addition, if the entity uses hedge accounting, it shall make the disclosures in paragraphs 12.27 to 12.29A.

12.27 An entity shall disclose the following separately for hedging relationships of any of the three types described in paragraph 12.19:

(a) a description of the hedge;

(b) a description of the financial instruments designated as hedging instruments and their fair values at the **reporting date**; and

(c) the nature of the risks being hedged, including a description of the hedged item.

12.28 If an entity uses hedge accounting for a fair value hedge it shall disclose the following:

(a) the amount of the change in fair value of the hedging instrument recognised in profit or loss for the period.

(b) the amount of the change in fair value of the hedged item recognised in profit or loss for the period.

12.29 If an entity uses hedge accounting for a cash flow hedge it shall disclose the following:

(a) the periods when the cash flows are expected to occur and when, if at all, they are expected to affect profit or loss;

(b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;

(c) the amount of the change in fair value of the hedging instrument that was recognised in other comprehensive income during the period;

(d) the amount, if any, that was reclassified from equity to profit or loss for the period; and

(e) the amount, if any, of any excess of the fair value of the hedging instrument over the change in the fair value of the expected cash flows that was recognised in profit or loss for the period.

12.29A If an entity uses hedge accounting for a net investment in a foreign operation it shall disclose separately the amounts recognised in other comprehensive income in accordance with paragraph 12.24(a) and the amounts recognised in profit or loss in accordance with paragraph 12.24(b).

Appendix to Section 12

Examples of hedge accounting under the principles in Section 12

This appendix accompanies, but is not part of, Section 12. It provides guidance for applying the requirements of paragraphs 12.15 to 12.25.

Example 1 Cash flow hedge

This example illustrates cash flow hedging for the foreign currency risk associated with a committed future asset purchase in a foreign currency. It includes simplifying assumptions, including ignoring any ineffectiveness that may arise relating to the interest rate differential between the two currencies involved. Please note, in accordance with paragraph 12.19A the hedge of a foreign currency risk of an unrecognised firm commitment may also be accounted for as a fair value hedge, which is not demonstrated here.

12A.1 On 9 June 20X5, an entity with functional currency CU commits to purchasing an item of industrial plant on 29 March 20X6. The purchase, which will be denominated in foreign currency FC, has an agreed price of FC500,000.

To manage its exposure to changes in exchange rates in the nine months between commitment and purchase, the entity enters into a forward currency contract to buy FC500,000 for CU1,000,000 to be settled on 29 March 20X6.

The entity has a risk management strategy that includes the use of forward contracts to cover large known future cash flows. It has confirmed that the hedged item and hedging instrument meet the requirements of FRS 102, and the qualifying conditions of paragraph 12.16 for hedge accounting are met.

The whole of the derivative is designated as hedging the future purchase.

At the inception of the hedge, the fair value of the forward contract is zero (it reflects the expected exchange rate on 29 March 20X6).

At 31 December 20X5, the fair value of the forward contract has increased to an asset of CU100,000, because the CU has weakened against FC (so, a contract to purchase at CU2:FC has positive value).

On 29 March 20X6, the transaction occurs as expected. There has been a further shift in currency values, so the value of the forward contract by this point has fallen to CU80,000.

12A.2 The required accounting entries at inception, the reporting date, and the settlement date, are as follows:

9 June 20X5

There are no accounting entries at this point, since the commitment to purchase is not recognised in the statement of financial position, and the forward contract (the derivative instrument) has a fair value of zero.

31 December 20X5

At the reporting date, there is still nothing to recognise in respect of the commitment, but the CU100,000 value of the forward contract must be recognised.

In this case, because no ineffectiveness has been observed, the whole movement in value is recognised in other comprehensive income:

Dr Forward contract (derivative) asset	CU100,000	
Cr Other comprehensive income		CU100,000

29 March 20X6

Several entries are required when the purchase takes place and the contract is settled. Here each is shown separately, though in practice they could be combined as one journal entry.

First, the forward contract is revalued to its fair value of CU80,000, again through other comprehensive income, assuming that all of the movements are again due to the hedged risk:

Dr Other comprehensive income	CU20,000	
Cr Forward contract asset		CU20,000

The forward contract is then settled in cash for its closing value of CU80,000:

Dr Cash	CU80,000	
Cr Forward contract asset		CU80,000

The cash purchase of the asset is accounted for at the spot rate of FC2.16:CU

Dr PPE	CU1,080,000	
Cr Cash		CU1,080,000

Then, finally, paragraph 12.23(d)(i) is applied and the amounts in the cash flow hedge reserve are included in the asset's initial carrying amount.

Dr Cash flow hedge reserve	CU80,000	
Cr PPE		CU80,000

Note that this has the effect of setting the initial carrying amount of the plant to CU1,000,000, the rate originally specified in the contract.

Alternative – including ineffectiveness

12A.3 Suppose the fact pattern above, with the only difference being that the forward contract to which the entity is committed covered a larger currency value, so the purchase would be of FC600,000 for a price of CU1.2m (ie at the same rate).

In this case, the most straightforward approach would be to designate only 5/6 of the hedging instrument in the relationship. The fair value movements on the remaining 1/6 (or, to put it another way, 1/6 of the fair value movements on the whole instrument) are recognised in profit or loss each period as would be the case for any derivative outside a hedging relationship.

Example 2 Fair value hedge

This example illustrates fair value hedging when an entity borrows money at a fixed rate and at the same time enters into an interest rate swap with the effect of paying a variable rate overall.

12A.4 The entity, with a March reporting date, borrows CU10m at a fixed rate of interest of 9% on 1 April 20X0. The interest is accrued and settled six-monthly, and the principal is repayable after five years, on 1 April 20X5. At the same time it enters into an interest rate swap, under which it will pay LIBOR rate, and receive 7%. The notional amount of the swap is CU10m (ie the same as the debt's face value) and it also shares the five-year term and is settled six-monthly.

The Board of Directors authorised the company's Finance Director to enter into such swap arrangements, as it is consistent with the entity's risk management objective and strategy to make variable interest payments on its debt. The details of individual arrangements were left to the Finance Director, who has documented the terms of this swap and the way in which it is economically related to the loan by virtue of having the same underlying (its fair value fluctuates with the base rate, as does the fair value of the loan). The hedge meets all of the other qualifying conditions of paragraph 12.16.

Ineffectiveness will be measured at each reporting date based on the difference (if any) between the fair value movement on the swap and the change in fair value of the loan attributable to the hedged risk.

In accordance with paragraphs 12.20 to 12.22, at each reporting date the entity remeasures the swap to fair value, and also adjusts the carrying value of the debt for its change in fair value attributable to interest rate risk.

The fair value of the swap, and the carrying amount of the debt after adjustments to reflect the change in fair value attributable to interest rate risk, at each relevant date are as follows:

	1 April 20X0	31 March 20X1	31 March 20X2
Swap	nil	CU0.3m	CU0.1m
Debt	(CU10m)	(CU10.3m)	(CU10.1m)

Note that in practice the fair value of the loan may be affected by other risk factors such as credit risk. These effects need to be separated as part of the exercise of determining the hedging gain or loss, because the hedged item is only adjusted for changes in fair value attributable to the hedged risk.

12A.5 The entities at each relevant date, excluding interest charges and cash payments, are as follows:

1 April 20X0

Account for drawdown of debt (as a simplification assume no transaction costs)

Dr Cash	CU10m	
Cr Loan liability		CU10m

No entries are required for the inception of the swap, as it has a fair value of zero at the outset.

31 March 20X1

At the first year end since the arrangements were entered into, the swap is revalued through profit or loss, and the change in the debt's fair value attributable to interest rate risk is also recognised in profit or loss.

Dr Swap asset	CU0.3m	
Cr Profit or loss		CU0.3m
Dr Profit or loss	CU0.3m	
Cr Loan liability		CU0.3m

31 March 20X2

Again, entries to profit or loss are made in respect of the revaluation of the swap and the recognition of the element of the change in the debt's fair value attributable to interest rate risk.

Dr Profit or loss	CU0.2m	
Cr Swap asset		CU0.2m
Dr Loan liability	CU0.2m	
Cr Profit or loss		CU0.2m

Example 3 Net investment hedge

This example illustrates simple net investment hedging in the consolidated financial statements permitted in accordance with paragraph 12.18A, when an entity has a foreign operation and covers its exposure to foreign currency risk by the use of a foreign currency loan.

12A.6 An entity with functional currency CU acquires an investment in an overseas subsidiary (functional currency FC) at a cost of FC1.2m, which in this case is equal to the fair value of the net assets acquired.

At the same time, and in line with its risk management strategy, it takes out a loan of FC1.2m to finance the investment, with the effect that fluctuations in the loan's fair value caused by foreign exchange movements will mirror the comparable movements in the subsidiary's net assets included in the consolidated financial statements.

The foreign currency risk component of the loan is designated as a hedging instrument for the first FC1.2m of the subsidiary's net assets.

The spot rate when the subsidiary is acquired and the loan drawn down is 2.9, and by the entity's first year end it has moved to 3.3. The subsidiary's net assets to be included in the consolidation at that point are higher than FC1.2m, meaning that the whole FC1.2m is still available to be hedged.

12A.7 Two sets of accounting entries are made at the reporting date.

First, the net assets are retranslated into CU, at the new spot rate of 3.3:

Dr Other comprehensive income	CU50,157	
Cr Net assets		CU50,157

Then the foreign exchange gain on the loan is recognised, in other comprehensive income because of the net investment hedging:

Dr Loan liability	CU50,157	
Cr Other comprehensive income		CU50,157

Notes:

(a) The movement on the loan and on the net assets retranslation are, in this example, of the same value because the net asset value was higher than the original FC1.2m.

(b) If the loan had been taken out for an initial value lower than the acquisition net assets, it would have been designated as a hedge of the first portion of those net assets (equal to the loan value).

(c) If, in future periods, the subsidiary's net assets included in the consolidation fall below this starting point, the hedge will have an ineffective portion because the loan's fair value will change more than the value of the net assets. This ineffective portion will be recognised in profit or loss.

Amendments to Section 35
Transition to this FRS

Paragraph 35.9(b) is amended as follows (additional text is underlined):

An entity shall not change its hedge accounting before the date of transition to this FRS for hedging relationships that no longer exist at the date of transition.

For hedging relationships that exist at the date of transition, the entity shall either:

(i) follow the hedge accounting requirements of Section 12 *Other Financial Instruments Issues*, including the requirements for discontinuing hedge accounting for hedging relationships that do not meet the conditions of Section 12; or

(ii) designate any or all of its hedging relationships from that date, providing all requirements of paragraph 12.16 are met. The entity shall apply the measurement requirements of Section 12 to the hedging instruments and hedged items. Gains or losses arising in respect of fair value hedges on the hedging instrument and hedged item should be accounted for in accordance with paragraph 35.8. Gains or losses arising in respect of a hedging instrument in a cash flow hedge and net investment hedge should be recorded in equity (in respect of cash flow hedges in the cash flow hedge reserve). The requirements of paragraph 12.23(a) shall be applied from the date of transition, where applicable.

If an entity has made the accounting policy choice under paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) to apply the recognition and measurement provisions of IAS 39 or IFRS 9 and IAS 39, it shall apply the transition requirements in IFRS 1 paragraphs B4-B6.

Amendments to Appendix I: Glossary

The glossary definitions of a hedged item and hedging instrument are deleted and replaced with the following:

Hedged item	A hedged item can be a recognised **asset** or **liability**, an unrecognised firm commitment, a highly probable forecast transaction or a **net investment in a foreign operation**, or a portion of any such item, with the following additional conditions: (a) the hedged item must be reliably measurable; and (b) in **consolidated financial statements** the hedged item must be an asset, liability, firm commitment or highly probable transaction with a party external to the reporting entity**.** This means that hedge accounting can be applied to transactions between entities in the same group only in the **individual** or **separate financial statements** of those entities.
Hedging instrument	A **derivative** or non-derivative instrument measured at **fair value** through **profit or loss** may be designated as a hedging instrument, providing that it meets all of the following terms and conditions: (a) it is a contract with a party external to the reporting entity (ie external to the group or individual entity that is being reported on); (b) it is designated in its entirety in a hedging relationship, or a proportion of its nominal amount is designated; and (c) it is not a net written option (unless it is designated as an offset to a purchased option).

The following definition is added:

Hedging gain or loss	The change in fair value of a **hedged item** that is attributable to the hedged risk.

The Accounting Council's Advice to the FRC to issue FRED 51: Draft Amendments to FRS 102 – Hedge Accounting

Introduction

1 This report provides an overview of the main issues that have been considered by the Accounting Council in advising the Financial Reporting Council (FRC) to issue FRED 51: *Draft Amendments to FRS 102 – Hedge Accounting*. The FRC, in accordance with the Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012 (SI 2012/1741), is the prescribed body for issuing accounting standards in the UK. The Foreword to Accounting Standards sets out the application of accounting standards in the Republic of Ireland.

2 In accordance with the *FRC Codes and Standards: procedures*, any proposal to issue, amend or withdraw a code or standard is put to the FRC Board with the full advice of the relevant Councils and/or the Codes & Standards Committee. Ordinarily, the FRC Board will only reject the advice put to it where:

- it is apparent that a significant group of stakeholders has not been adequately consulted;
- the necessary assessment of the impact of the proposal has not been completed, including an analysis of costs and benefits;
- insufficient consideration has been given to the timing or cost of implementation; or
- the cumulative impact of a number of proposals would make the adoption of an otherwise satisfactory proposal inappropriate.

3 The FRC has established the Accounting Council as the relevant Council to assist it in the setting of accounting standards.

Advice

4 The Accounting Council is advising the FRC to issue FRED 51: Draft Amendments to Draft FRS 102 *Hedge Accounting*.

5 FRS 100 *Application of Financial Reporting Requirements* and FRS 101 *Reduced Disclosure Framework* were both issued in November 2012, and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* was issued in March 2013. The Accounting Council's advice to the FRC on those standards is contained in those standards. When this draft amendment is finalised, the Accounting Council's Advice to the FRC in FRS 102 will be updated to include its advice on this proposed amendment.

Background

6 Accounting standards were formerly developed by the Accounting Standards Board (ASB)[1]. The ASB commenced its project to update accounting standards in 2002; the FRC issued FRS 100 and FRS 101 in November 2012 and FRS 102 in March 2013.

7 In the Accounting Council's Advice to the FRC accompanying the issue of FRS 102, it stated that:

> ...the Accounting Council agreed that a proposed amendment to FRS 102 would be issued for public consultation once the IASB has completed the hedge accounting

[1] References in this section are made to the FRC, ASB or Accounting Council, as appropriate in terms of the time period and context of the reference.

and impairment projects and IFRS 9 has been updated; it is likely that there will be two separate exposure drafts, one addressing each topic. The Accounting Council intends to make amendments to FRS 102 (should the consultation determine this is appropriate) prior its effective date,...

These draft amendments cover hedge accounting only as the IASB's impairment proposals are still under discussion.

8 The draft hedge accounting amendments to FRS 102 were developed from the IASB's review draft of the parts of IFRS 9 *Financial Instruments* relating to micro hedging, adapted for entities in the scope of FRS 102.

Objective

9 During its consultations on updating accounting standards, the ASB (and subsequently the FRC) gave careful consideration to its objective and the intended effects. In developing the requirements for the future of UK GAAP, including this FRS, the overriding objective is:

> To enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

10 In achieving this objective, the Accounting Council decided (and the FRC subsequently adopted this decision) that it should provide succinct financial reporting standards that:

- have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;
- reflect up-to-date thinking and developments in the way businesses operate and the transactions they undertake;
- balance consistent principles for accounting by all UK and Republic of Ireland entities with practical solutions, based on size, complexity, public interest and users' information needs;
- promote efficiency within groups; and
- are cost-effective to apply.

11 The overarching objective of these draft amendments to FRS 102 is to set the requirements for hedge accounting in a way that can be straightforwardly applied by entities undertaking relatively simple economic steps to manage risk. This has, in the drafting, taken precedence over an attempt to address every possible hedging relationship that might arise and instead, it sets out broad principles which can be interpreted for preparers' individual circumstances. This may have the effect of giving some accounting outcomes which are different from those that would arise from applying IFRS 9, but the Accounting Council considers it more important to have clear and simple requirements than to achieve consistency with IFRS on all points of detail. It is to be expected that a measure of judgement will be needed in the application of the requirements.

Departures from IFRS

12 The most significant departures from the requirements of IFRS 9 relate to:

- elimination of the requirement to quantify at the outset that a hedge is effective;
- the option to discontinue a hedge voluntarily; and
- the prohibition on recycling gains or losses initially recognised in equity in a net investment hedge.

13 The Accounting Council's advice in relation to each of these departures is discussed in the relevant sections below, which also describe the other key elements of the requirements.

Types of hedge relationship

14 Currently FRS 102 defines two types of hedging relationship. Although these correspond (in accounting terms, although not in scope) to fair value hedging and cash flow hedging in IFRS 9, they were named with reference to the exact types of permitted arrangements.

15 The Accounting Council advises that the benefit from restricting hedge accounting in this way was outweighed by the difficulties of using such unwieldy definitions, and that the restrictions brought in by the definitions was unnecessary in practice, given the low likelihood of preparers using arrangements that were outside the scope of the definitions. Accordingly, the draft amendments adopt the terminology of IFRS 9, referring to cash flow hedges, fair value hedges and hedges of a net investment in a foreign operation. With a small number of exceptions (discussed further below), the accounting requirements for each of these types of hedge follow IFRS 9.

Permitted hedging instruments

16 While FRS 102 currently applies detailed restrictions on the type of instrument that could be designated as a hedging instrument, this was felt to be unnecessary, with reference to the typical arrangements entered into by an entity in the scope of FRS 102. The draft amendments broaden the scope of permitted hedging instruments, in line with IFRS 9.

Hedge effectiveness

17 The draft amendments are a significant step away from the requirements of IFRS 9, with the intention of simplifying the application of the requirements. Preparers applying the draft amendments to FRS 102 would not be required to make an assessment at the beginning of a hedging relationship of whether the hedge as a whole was effective or ineffective. Rather, hedge accounting may be used, providing there is an economic relationship between the hedged item and the hedging instrument. For an economic relationship to exist, there must be an expectation that management's objective in entering into the hedge will be met. This includes the values of the hedging instrument and hedged item changing systematically in response to movements in the same or similar underlying variables.

18 To some extent, this moves the accounting difficulty away from the initial assessment to the point of measuring ineffectiveness, but the Accounting Council expects that most arrangements to which Section 12 *Other Financial Instruments Issues* is applied will not be complex, so it should be straightforward for preparers to document how they will measure ineffectiveness.

19 It should be noted that the removal of the requirement to make an initial binary assessment does not have the effect of giving free rein to manipulate profits. Entities must still, at the inception of the hedge relationship, designate the hedged item and hedging instrument and document how they are economically related, how they fit into the risk management strategy, and how ineffectiveness will be measured.

Discontinuing hedge accounting

20 IFRS 9, on which these draft amendments are based, prohibits voluntary discontinuation of hedge accounting, and requires a rebalancing exercise when a hedge becomes ineffective. The Accounting Council considered these requirements to be unnecessarily onerous for its constituents, so instead has retained the current requirement of FRS 102 which permits voluntary discontinuation. The rebalancing requirement would not be relevant in the context of these draft amendments because the whole ineffective portion of any relationship is recognised in full each period.

Alternative reporting of economic hedges

21 The Accounting Council advises modifying the provision in Section 11 *Basic Financial Instruments* to allow certain instruments to be designated at fair value through profit or loss, so that it has a wider scope than in the previous version of FRS 102. This will have the effect of allowing economic hedge accounting where an entity balances the risks from a first instrument by taking out a second which is measured at fair value: it will be able to choose to measure the first at fair value too, thus matching the movements in profit and reflecting, in financial reporting, the combined economic effect of the instruments.

Net investment hedges

22 Although the accounting for the hedge of a net investment in a foreign operation follows, in general, the accounting for a cash flow hedge, an issue arises in relation to the treatment of amounts recognised in other comprehensive income relating to movements in the value of the hedging instrument. For consistency with cash flow hedges, these amounts would be reclassified to profit or loss when the hedge relationship was discontinued. This leads, however, to an inconsistency with Section 30 *Foreign Currency Translation* of FRS 102, which requires that foreign exchange gains or losses relating to the consolidation of a subsidiary are not recycled on disposal of the subsidiary.

23 Two possible approaches to this problem were to maintain consistency within Section 12, and allow the mismatch arising from Section 30 to remain, or to align the treatment with Section 30, leading to inconsistency between net investment hedges and cash flow hedges. The Accounting Council advises the latter option, as this allows more meaningful overall reporting related to investments in overseas subsidiaries, and thus seems more valuable than a theoretical consistency between types of hedge accounting.

‘Macro hedging’

24 The Council has noted that the IASB has not yet finalised its revisions to IFRS 9 in respect of macro hedging. It does not consider that the requirements in these draft amendments to FRS 102 are sufficient to cover this type of hedge accounting, and therefore expects that entities wishing to hedge the risk associated with portfolios will take the accounting policy choice in paragraph 11.2(b) or (c) or paragraphs 12.2(b) or (c) of FRS 102 to apply the recognition and measurement requirements of IFRS 9 or a combination of IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9.

Transitional provisions

25 The Accounting Council’s proposed transitional provisions, covering arrangements existing at the date of transition, are drafted to allow practical means for entities to hedge account from the date of transition where this represents the economic substance of the transaction. If there were no such transitional provisions, hedge accounting would not be available, unless the necessary documentation and designation were in place at inception of the hedging relationship. The ability in a cash flow hedge to recognise in the cash flow hedge reserve all fair value movements to date on the hedging instrument, rather than just the effective portion, is again, a pragmatic solution.

Partial hedging

26 No explicit mention is made in the draft amendments of the possibility of ‘partial hedging’, whereby a hedging instrument can be used to hedge the risk associated with only a portion of a hedged item. However the wording of paragraph 12.16(a) of FRS 102, which refers to ‘the hedging instrument or portion thereof’, allows such a designation, provided that the other conditions are met.

Consultation Stage Impact Assessment

Introduction

1 The Financial Reporting Council (FRC) is committed to a proportionate approach to the use of its powers, making effective use of impact assessments and having regard to the impact of regulation on small enterprises. The FRC issued an Impact Assessment with FRS 100 *Application of Financial Reporting Requirements*, FRS 101 *Reduced Disclosure Framework* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* which included 12 example case studies to illustrate the impact of the new accounting standards on a wide range of UK entities.

2 As these draft amendments are proposed to FRS 102, this consultation stage impact assessment has been prepared using certain of the case study scenarios originally presented in the Impact Assessment for FRSs 100, 101 and 102. The scenarios have been selected based on whether the entities discussed were said to use financial instruments that were not basic, as this appears likely to capture the whole base of entities that might choose to apply hedge accounting.

3 It should be noted that FRS 102, as currently in issue, already contains provisions on hedge accounting, the effects of which were already estimated in the original Impact Assessment. This consultation stage Impact Assessment looks only at the changes, whether cost increases or cost savings, that are likely to apply to the entities in question from the introduction of these proposed amendments.

4 The FRC believes that the amendment of FRS 102 in accordance with these proposals will have a positive impact on financial reporting and make the application of hedge accounting more accessible. However, since hedge accounting is always optional, entities can make their own cost-benefit based decision on whether they wish to apply these methods.

Scenario	
Company C	Medium-sized company with overseas operations
Company D	Large unquoted parent company
Entity F	Building society
Entity H	Registered provider of social housing
Entity J	Pension scheme

Company C – Medium-sized company with overseas operations

Scenario

Company C is a medium-sized company. It is an importer and exporter, conducting many transactions in currencies other than GBP. As a result Company C enters into forward foreign exchange contracts for a proportion of its cash flows (both inflows and outflows).

Company C has a small finance team but also has an experienced treasurer. It takes advice from its auditors on the presentation of its financial statements.

Company C has not voluntarily adopted FRS 26 (IAS 39) *Financial instruments: recognition and measurement* in the past.

Applicable accounting standards

Company C applies FRS 102.

Company C previously reduced its exposure to volatility in the profit and loss account by accounting for foreign currency transactions at the rates of exchange specified in those forward foreign exchange contracts as set out in SSAP 20 *Foreign currency translation*. To achieve an element of matching gains and losses on foreign currency transactions going forward, Company C would need to apply hedge accounting. It decided, based on the original version of FRS 102, not to adopt hedge accounting because the administrative burden of maintaining the relevant documentation outweighed the benefits of the accounting treatment permitted.

Costs of implementing the applicable accounting standards

Hedge accounting is an accounting policy choice.

If Company C retains its decision not to adopt hedge accounting, then the proposed amendments will have no effect on it.

If it reviews the new requirements and concludes that the cost of applying hedge accounting including maintaining documentation justifies the positive financial reporting outcome, then this suggests that the costs are moderate and the balance of costs and benefits is positive. The costs will mainly consist of administration at inception of each hedge and at each reporting date, as well as staff time for the assessment of ineffectiveness, and senior management time reviewing the decisions as to which relationships are designated as hedges.

Company D – Large unquoted parent company

Scenario

Company D is a large unquoted parent company. It has a number of subsidiaries and is the ultimate parent company within its group. Company D's business is based in the UK, although it has a small number of transactions in foreign currencies for which it takes out forward foreign exchange contracts. It has financing arrangements (bank loans and leases) which are considered to be basic financial instruments.

Applicable accounting standards

This case study looks only at the situation where Company D applies FRS 102 to its separate and group financial statements (rather than choosing to use EU-adopted IFRS).

Company D reduced its exposure to volatility in the profit and loss account by accounting for foreign currency transactions at the rates of exchange specified in those forward foreign exchange contracts as set out in SSAP 20 *Foreign currency translation*. To achieve an element of matching gains and losses on foreign currency transactions going forward, Company D had decided, based on the original version of FRS 102, to adopt a policy of hedge accounting. It believed that the administrative burden was outweighed by the benefits of the accounting treatment permitted.

Costs of implementing the applicable accounting standards

For the relationships where Company D was eligible to apply hedge accounting under FRS 102, it will continue to be able to apply it under the proposed amendments. Therefore the costs should be no higher than those already planned, and may be reduced through the simplified requirements in respect of hedge effectiveness.

Entity F – Building Society

Scenario

Entity F is a building society. It has been preparing its financial statements in accordance with the Building Societies Act 1986 and current FRSs. It has not adopted FRS 26 (IAS 39) *Financial instruments: recognition and* measurement, but it has provided certain disclosures about financial instruments in accordance with FRS 13 *Derivatives and other financial instruments: disclosures.*

Applicable accounting standards

Entity F will apply FRS 102 and as a financial institution it must provide additional disclosures as set out in section 34 *Specialised Activities.*

Entity F is likely to seek to apply hedge accounting where possible.

Costs of implementing the applicable accounting standards

As for Company D above, it is likely that under the proposed amendments Entity F will find it can apply hedge accounting to the same relationships as it previously could, with the possibility that more relationships are in scope. The basic costs of applying the mechanics of hedge accounting should not exceed those under FRS 102, and indeed may provide savings because of the less onerous requirements in respect of effectiveness, and the clearer guidance in other areas.

Entity H – Registered provider of social housing

Scenario

Entity H is a registered provider of social housing. It has been preparing its financial statements in accordance with the Industrial and Provident Societies Acts and UK accounting standards. It has not adopted FRS 26 (IAS 39) *Financial Instruments: recognition and measurement.*

Entity H has a significant amount of borrowings from financial institutions. Some of these loans may have terms that mean that they are non-basic financial instruments. In addition, Entity H has taken out interest rate swaps which are also non-basic financial instruments. Entity H has dedicated treasury staff.

Applicable accounting standards

Entity H will apply FRS 102 including any relevant requirements for public benefit entities.

Costs of implementing the applicable accounting standards

Entity H may choose to apply the new hedge accounting requirements in the draft amendments. Since it has dedicated treasury staff, the costs of information gathering should be reasonably low, and the costs of valuations of hedging instruments will not be incremental, as they are already required to be valued by Section 12.

If Entity H determines that the cost, in terms of staff time, of applying hedge accounting, outweighs the benefits for its financial reporting, it may choose not to apply hedge accounting. This means that there is no mandatory additional cost brought about by the proposed amendments, and indeed the proposed amendments may provide savings because of the less onerous requirements in respect of effectiveness, and the clearer guidance in other areas.

Entity J – Pension Scheme

Scenario

Entity J is a pension scheme. It prepares its financial statements in accordance with current FRSs and the SORP for pension schemes.

Applicable accounting standards

Entity J will apply FRS 102, specifically section 34 *Specialised Activities – Retirement Benefit Plans: Financial Statements.*

Costs of implementing the applicable accounting standards

It is considered unlikely that Entity J would choose to apply hedge accounting, since its primary purpose is simply to report the valuation of its assets, and the returns thereon.

This draft is issued by the Financial Reporting Council for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by e-mail to:

ukfrs@frc.org.uk

Comments may also be sent in hard copy to:

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Comments should be despatched so as to be received no later than 14 February 2014.

The FRC's policy is to publish on its website all responses to formal consultations issued by the FRC unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or postal or e-mail addresses) from submissions; therefore, only information that you wish to be published should be submitted.

The FRC aims to publish responses within 10 working days of receipt.

The FRC will publish a summary of the consultation responses, either as part of, or alongside, its final decision.

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