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FRS 102: The Final Amendments

Ahead of its implementation on 1st January 2015 Professor Robert Kirk outlines the final amendments to the New GAAP, FRS 102.

The Financial Reporting Council (FRC) has just announced (July 2014) what are hoped to be the final amendments to FRS 102. These have been introduced to improve the accounting treatment of certain financial instruments and transactions. The amendments to FRS 102 can basically be broken down into three main issues:

- **Hedge accounting**
Major changes to hedge accounting, making it more readily available to entities as long as it is consistent with their risk management processes.
- **Basic instruments**
Relaxing the conditions for regarding financial instruments as 'basic', with the effect that more financial instruments will be measured by reference to cost rather than fair value.
- **Transition rules**
More relaxation has been introduced of the transition rules in order to make it less expensive for FRS 102 first time adopters.

These amendments were originally published as *FRED 51 Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland: Hedge Accounting* in November 2013 and *FRED 54 Draft Amendments to FRS 102 – Basic financial instruments* in February 2014. The changes to the final amended FRS 102 are largely cosmetic and therefore should not pose too many problems for preparers.

Hedge Accounting

FRED 51 proposed changes that would broadly make hedge accounting more achievable where entities are using financial instruments to manage risk. Although they use concepts and language from the full IFRS 9 *Financial Instruments*, they also include simplifications to make them more appropriate for a typical FRS 102 preparer. The three key issues concern:

- the initial designation of a hedging relationship;
- the permitted types of hedge; and
- discontinuation of hedge accounting.

To designate a hedge relationship at the outset, it will not be necessary to expect the hedge to be 'highly effective'. Instead, there must be an economic relationship between the hedging instrument and hedged item, with an expectation that management's objective on entering into the hedge will be met and the values of the hedged item and hedging instrument will typically move in opposite directions in response to movements in the same risk. The reporting entity, however, has to determine and document causes of hedge effectiveness.

FRS 102 (amended) has also moved away from the original convoluted descriptions of two types of hedge, instead using the three familiar types (cash flow hedge, fair value hedge and net investment hedge) with accounting entries very similar to those in the IFRS 9 proposals.

Finally, there is a permissive approach to discontinuing hedge accounting: an entity may stop at any point as long as it documents its election. This is considerably less onerous than the rebasing requirements of IFRS 9.

Under the amended FRS 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 component of any of the above as long as it can be reliably measured.

Hedge accounting can only be applied to transactions with external parties to the entity itself and in group situations only to individual statements not the consolidated statements where the transactions are between entities in the same group.

In order to qualify as a hedging instrument it must meet the following conditions:

- it is a financial instrument measured at fair value through profit or loss;
- it is a contract with an external party; and
- it is not a written option unless it is an offset to or is combined with a purchased option and the effect is not a net written option e.g. a zero cost interest rate collar.

Hedge accounting will only be permissible provided ALL of the following conditions are met:

- the hedging relationship consists only of a hedging instrument and a hedged item meeting the conditions described above;
- the hedging relationship is consistent with the entity's risk management objectives for undertaking hedges;
- there is an economic relationship

between the hedged item and the hedging instrument;

- the entity has documented the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified; and
- the entity has determined and documented causes of hedge ineffectiveness

There are no changes in the accounting entries required as gains and losses on fair value hedges all are reported in profit and loss whereas effective cash flow hedges are reported in equity (and comprehensive income) with any ineffectiveness being reported in profit. Subsequently, in cash flow hedges, the cumulative cash flow hedge reserve will either be transferred to the profit and loss reserve (recycled) or if a hedged forecast transaction subsequently results in the creation of a non financial asset then

it is included in the initial cost of that asset. However, if a cash flow hedge results in loss on the cash flow reserve it must be recycled immediately to profit and loss.

Hedges of a net investment in a foreign operation are accounted for similarly to cash flow hedges.

The disclosures required under the amended FRS are largely identical to those in the original FRS 102.

The Appendix provides some examples of how the three types of hedge might be accounted for using journal entries to illustrate and readers are encouraged to review these if they are involved in hedging activity. The following is a slight variation of example 1 in the FRS:

Example

Fair value hedge accounting Hedge of a forward foreign currency risk of an unrecognised firm commitment

Facts

On 30 September 2015 Finist Ltd enters into a purchase agreement to buy goods for £300,000. On the same day it entered a forward foreign currency contract to buy £300,000 for €600,000. The goods will be paid for on 31 March 2016.

The hedged item is the commitment to buy £300,000 of goods and the hedging instrument is the forward contract to be settled on the same day as the goods are to be delivered.

Solution

Assuming the qualifying conditions are met for hedge accounting on 30 September 2015 and the forward rates are as follows:

30 September 2015 2:1 31 December 2015 (year end) 2.4:1 31 March 2016 2.2:1

Hedging instrument (foreign currency contract)

| | | | | | | |
|------------|----------|-----|----------|----------------|----------|----------------|
| Fair value | 30/09/15 | Nil | 31/12/15 | £300,000 x 0.4 | 31/03/16 | £300,000 x 0.2 |
| | | | | = €120,000 | | = €60,000 |
| Change | | | | €120,000 | | (€60,000) |

Hedged item

| | | | |
|------|--|----------------|----------------|
| Loss | | £300,000 x 0.2 | £300,000 x 0.2 |
| | | = €120,000 | = €60,000 |

30 September 2015

No hedge accounting entries

31 December 2015 (year end)

The fair value gain of €120,000 is recognised in profit and loss and the €120,000 hedging loss also recognised in the profit and loss but, in addition, an asset of €120,000 (foreign currency contract) is created as well as a liability of €120,000 and reported on the balance sheet.

31 March 2016 (date of settlement and delivery of goods)

The fair value loss of €60,000 is recognised in profit and loss and the €60,000 hedging gain also recognised in the profit and loss.

The purchase of goods (non financial asset) is adjusted to include the cumulative hedging loss on the hedged item of €60,000 i.e.

| | |
|----------------|---------|
| Dr Hedged item | €60,000 |
| Cr Purchases | €60,000 |

The hedging instrument is then settled as follows:

| | |
|-----------------------|---------|
| Dr Bank | €60,000 |
| Cr Hedging instrument | €60,000 |

The goods are then settled at the spot rate of 2.2:1 as follows:

| | |
|--------------|---------|
| Dr Purchases | €60,000 |
| Cr Bank | €60,000 |

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Although hedge accounting appears to be a little complex at times it must be remembered that a reporting entity does NOT have to apply these rules. Each entity must decide on cost benefit grounds whether or not it is worthwhile adopting them.

Relaxation of conditions to be classified as a basic instrument

A number of commentators on FRS 102 have been concerned about the conditions required to be passed in order for a financial instrument to be classified as a basic instrument. These particularly concerned some simple debt instruments which clearly had the characteristics of being basic but failed the conditions in paragraph 11.9. It was felt, therefore, that the conditions were too restrictive. Also, under the full international financial reporting standards (IFRS 9) they would have passed the amortised cost tests.

FRED 54 was therefore issued in February 2014 and, as a result, the conditions have been made more permissive thereby enabling a wider range of debt instruments to be measured at amortised cost, and not fair value. Paragraph 11.9 has therefore been substantially changed to open up amortised cost to more instruments.

FRS 102 (amended) has also included a number of additional examples of debt instruments which, in the opinion of the FRC, are now to be classified as basic. These include:

- Zero coupon bonds
- Fixed rate loans but revert to variable rate after a tie in period
- Loan with interest payable at standard variable rate plus 1% throughout its life
- Loan with interest payable at standard variable rate less 1% throughout the life of the loan BUT with the condition that the interest rate never falls below 2%
- Interest on a loan referenced to twice the banks standard variable rate
- Interest on a loan at 10% less 6 month LIBOR over the life of the loan; and
- Interest on GSP denominated mortgage linked to the UK Registry House Price Index plus 3%.



Readers are encouraged to read paragraph 11.9 carefully when analysing their financial instruments between basic and the more complex instruments. This is important as basic financial instruments are recorded at cost or amortised cost whereas the more complex instruments are reported at fair value through profit and loss.

One area where there has been some debate is that of inter company loans. It is clear, from the feedback statement issued with the revised rules, that the FRC requires the adoption of the amortised approach to those instruments. They have also stated they have no desire to implement the fair value hierarchy disclosures required under IFRS 13 at present.

These amendments should be cost neutral for most reporting entities unless they have already carried out a reclassification of their financial instruments and therefore may need to reverse some instruments back from fair value to amortised cost

Transition rules

The amendments to FRS 102 permit a financial instrument (provided it meets certain criteria) to be initially designated as a financial asset or liability at fair value through profit or loss. On transition any financial asset or liability is permitted to be designated at fair value through profit or loss provided they meet the hedging criteria. There were concerns that this flexibility could be abused as it allows entities to apply a degree of hindsight but the FRC, on balance, felt that flexibility should take precedence over restrictions aimed at preventing abuse.

Under the transitional rules, regardless of previous accounting practice, entities will have a choice of continuing hedge accounting under FRS 102 provided the conditions for hedge accounting are met.

Because these amendments have been issued after the date of transition for many companies (particularly all with a December to June year end) an extended deadline for hedge accounting on first time adoption has been introduced.

Conclusion

These latest changes to FRS 102 are unfortunate in that the standard was supposed to be 'written in stone' for three years before being amended but the FRC are trying to make life as simple as possible when reporting on financial instruments and in that regard the changes must be welcomed. All of these changes will be implemented on the same day as the rest of FRS 102 i.e. for all accounting periods commencing on or after the 1st January 2015.

The current CPA Ireland Skillnet Certificate in FRS 102 commenced on August 30th. It is hoped to run the Certificate again, to register your interest in a future certificate please contact Jenny Andersson, jandersson@cpaireland.ie.