Financial Reporting Council

IASB
30 Cannon Street
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Submitted electronically via www.iasb.co.uk

17 February 2014

Dear Sirs

Exposure Draft ED/2013/9 - IFRS for SMEs

I am writing on behalf of the UK's Financial Reporting Council (FRC) in response to the IASB's Exposure Draft on the IFRS for SMEs *Proposed amendments to the International Financial Reporting Standard for Small and Medium-sized Entities* (the ED).

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.

Proposed amendments

Although the FRC does not disagree with the amendments that have been proposed, we believe that the IASB could have taken this opportunity to develop a more comprehensive standard that is fit for purpose for a broader range of SME businesses rather than the narrow focus taken. We note that the SME Implementation Group made several sensible recommendations that we believe would have improved the quality of the standard, but these have not been taken forward.

The FRC is pleased to note that the IASB has acknowledged and incorporated into its proposals a significant number of drafting improvements that the FRC identified in developing FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Since developing FRS 102 we have encountered some additional issues, which we feel are significant enough to draw to your attention. They deal with the classification of financial instruments and we have also proposed amendments to the hedge accounting requirements.

Scope

We are concerned by the discrepancy between the stated scope of the IFRS for SMEs (ie "*entities that do not have public accountability and publish general purpose financial statements for external users*") and the IASB's interpretation of that scope being "*entities that do not have public accountability and that typically have less complex transactions, limited resources to apply full IFRSs and that operate in circumstances in which comparability with their listed peers is not an important consideration*"[1]. The impact of this is that the IASB focuses only on entities at the smallest end of the SME scale leaving a significant gap in the standard setting framework. Accordingly, the IASB may be limiting the ability of jurisdictions to adopt the IFRS for SMEs, forcing them to either maintain a set of local GAAP not based on IFRS or to take the IFRS for SMEs and adapt it to suit their needs; neither of which meets the IASB's principle objective "*to develop a single set of high quality, understandable, enforceable and globally accepted IFRSs*".

As you are aware, the FRC adopted the second approach and took the IFRS for SMEs and adapted it to suit our needs in the UK and Republic of Ireland, developing FRS 102 which was issued in March 2013. This approach was widely welcomed in the UK and Republic of Ireland and has resulted in a standard that is fit for purpose and is suitable for application by a wide range of entities that span from very large private companies to those that are small, but not small enough to apply the Financial Reporting Standard for Small Entities (the FRSSE).

The FRC anticipates that this discrepancy between the stated scope of the IFRS for SMEs and the IASB's interpretation of that scope will cause confusion for respondents in assessing the appropriateness of the amendments proposed and thus may reduce the overall value of the consultation.

The FRC encourages the IASB to reconsider whether:

a) its interpretation of the scope is appropriate for an international accounting standard that if applied in economies with more advanced financial reporting and regulatory frameworks, such as the UK, some very large and complex entities would fall within its scope; or

b) whether the stated scope of the IFRS for SMEs should be amended to reflect the IASB's intention.

Principles for dealing with new and revised IFRSs

The FRC does not agree that the list of principles[2] developed for dealing with new and revised IFRSs is appropriate or that the principles are clear enough to indicate to constituents when amendments to the IFRS for SMEs could be expected as a result of changes to full IFRSs. For example, it is unclear whether amendments made to the hedge accounting requirements of IFRS 9 *Financial Instruments* will result in amendments to the IFRS for SMEs.

In its response letter to the IASB's Request for Information in 2012, the FRC suggested a number of principles within which the IASB could decide if amendments should be made for

[1] Paragraph BC29 of the Basis of Conclusions to this ED
[2] Paragraph BC 30 of the Basis of Conclusions to this ED

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new and updated IFRSs. After some consideration, the FRC believe those principles are still applicable but could be developed further as follows:

The IFRS for SMEs should be updated to reflect changes in new and updated IFRS if:

(a) the quality of the financial reporting for entities within the scope of the IFRS for SMEs would be improved by the change (for example, by more transparent information being available to users, such as lenders);

(b) the issue that gave rise to the amendment in the context of full IFRS applies equally to entities within the scope of the IFRS for SMEs;

(c) given the single conceptual framework, a divergence in treatment between the recognition and measurement requirements of full IFRS and the IFRS for SMEs cannot be justified.

In assessing whether amendments should be made to the IFRS for SMEs, the IASB will consider the balance between:

(a) the costs to preparers of following the changed accounting requirements and the relative benefits to users of the resulting information; and

(b) the benefit of changed accounting requirements and understandability by users of financial statements.

The FRC would strongly encourage the IASB to revisit this area and develop a clearer set of principles.

In developing FRS 102, the Accounting Council (the advisory council to the FRC on accounting matters) set the following guidelines for considering amendments to the IFRS for SMEs:

(a) changes should be made to permit accounting treatments that exist in FRSs at the transition date that align with EU-adopted IFRS;

(b) changes should be consistent with EU-adopted IFRS unless a non-IFRS-based solution clearly better meets the objective of providing high-quality understandable financial reporting proportionate to the size and complexity of the entity and the users' information needs. In these cases elements of an IFRS-based solution may nevertheless be retained;

(c) use should be made, where possible, of existing exemptions in company law to avoid gold plating; and

(d) changes should be made to provide clarification, by reference to EU-adopted IFRS, that will avoid unnecessary diversity in practice.

These guidelines provided a clear framework within which the FRC (and our constituents) could challenge amendments being proposed, and conversely, challenge instances where amendments were not proposed. It enabled the FRC to step back and sense-check the amendments, thus achieving consistency throughout the standard.

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Technical issues

Classification of financial instruments

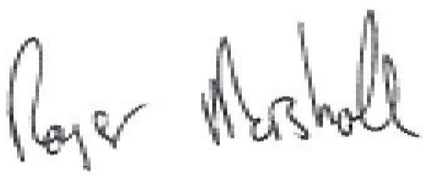
As the implementation date of FRS 102 draws closer (1 January 2015), it has been drawn to our attention that paragraph 11.9 of FRS 102 (which is largely unchanged from the IFRS for SMEs issued in 2009) forces more instruments to be classified as 'non-basic' and accounted for under Section 12 *Other Financial Instruments* (and thus be measured at fair value) compared to full IFRS. This has the effect of increasing the cost burden for SMEs, which does not seem to be a satisfactory outcome. The FRC is currently working on revising the text of paragraph 11.9. Our objective is to ensure that commonly occurring financial instruments that would be measured at amortised cost under full IFRS (and where measurement at fair value would not provide more relevant information) are accounted for in the same manner under FRS 102, thus reducing the cost burden on entities applying FRS 102. FRED 54 *Amendment to FRS 102 – Basic Financial Instruments* sets out our proposed amendments and is enclosed with this letter for your reference.

Hedge accounting

Another issue we have encountered relates to the hedge accounting requirements. The IFRS for SMEs is currently more restrictive than full IFRS. Although this in itself is not a reason to champion a change in the IFRS for SMEs, the practical consequence of this is that if an SME enters into an economic hedge it may not be able to account for the transaction using hedge accounting. This would result in more volatility in the SME's financial statements, which does not reflect the economic reality of the transaction. The FRC would encourage the IASB to consider aligning the hedge accounting requirements of the IFRS for SMEs with the principles of IFRS 9 on the basis that the principles of IFRS 9 bring the reporting of economic hedges in line with the risk management strategy of the entity. FRED 51 *Amendments to FRS 102 – Hedge Accounting* sets out our proposed amendments and is enclosed with this letter for your reference.

The FRC's detailed responses to the Invitation to Comment can be found in the appendix to this letter.

Yours faithfully



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Appendix A

Detailed responses to the Invitation to Comment

The responses contained in this appendix assume that we accepted the IASB's interpretation of the scope of the IFRS for SMEs (ie that it is intended for small entities in emerging economies) rather than the wider stated scope of the standard we would prefer. We have already set out our concerns over the scope in our covering letter.

Question 1 – Definition of 'fiduciary capacity'

The IASB has received feedback that the meaning of 'fiduciary capacity' in the definition of 'public accountability' (see paragraph 1.3(b) of the IFRS for SMEs) is unclear as it is a term with different implications across jurisdictions. However, respondents generally did not suggest alternative ways of describing public accountability or indicate what guidance would help to clarify the meaning of 'fiduciary capacity'. Based on the outreach activities to date, the IASB has determined that the use of this term does not appear to create significant uncertainty or diversity in practice.

(a) Are you aware of circumstances where the use of the term 'fiduciary capacity' has created uncertainty or diversity in practice? If so, please provide details.

(b) Does the term 'fiduciary capacity' need to be clarified or replaced? Why or why not? If you think it needs to be clarified or replaced, what changes do you propose and why?

Response

The proposed application, in the UK and Republic of Ireland, of the definition of public accountability (including the term fiduciary capacity) created some uncertainty when it was included in an Exposure Draft preceding FRS 102. This contributed to the FRC's decision not to use public accountability in determining the scope of FRS 102.

However, if those jurisdictions applying the IFRS for SMEs have not reported problems in practice perhaps any necessary clarification of the term can be carried out on a jurisdictional basis when permitting or requiring use of the IFRS for SMEs.

Question 2 – Accounting for income tax

The proposal to align the main principles of Section 29 Income Tax with IAS 12 Income Taxes for the recognition and measurement of deferred tax (see amendment number 44 in the list of proposed amendments at the beginning of this Exposure Draft) is the most significant change being proposed to the IFRS for SMEs.

When the IFRS for SMEs was issued in 2009, Section 29 was based on the IASB's Exposure Draft Income Tax (the '2009 ED'), which was issued in March 2009. However, the 2009 ED was never finalised by the IASB. Consequently, the IASB has concluded that it is better to base Section 29 on IAS 12. The IASB proposes to align the recognition and measurement principles in Section 29 with IAS 12 (see paragraphs BC55–BC60) whilst retaining some of the presentation and disclosure simplifications from the original version of Section 29.

The IASB continues to support its reasoning for not permitting the 'taxes payable' approach as set out in paragraph BC145 of the IFRS for SMEs that was issued in 2009. However, while the IASB believes that the principle of recognising deferred tax assets and liabilities is appropriate for SMEs, it would like feedback on whether Section 29 (revised) can currently be applied (operationalised) by SMEs, or whether further simplifications or guidance should

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be considered.

A 'clean' version of Section 29 (revised) with the proposed changes to Section 29 already incorporated is set out in the appendix at the end of this Exposure Draft.

Are the proposed changes to Section 29 appropriate for SMEs and users of their financial statements? If not, what modifications, for example further simplifications or additional guidance, do you propose and why?

Response

The FRC acknowledges that this approach to Section 29 was the most appropriate given the circumstances and the scope of the IFRS for SMEs, and we agree with the IFRS for SMEs including a requirement to recognise deferred tax.

However, returning to the issue of the scope of the IFRS for SMEs, if the IASB's intended user of the IFRS for SMEs is a small entity with limited resources, and the IASB therefore wishes to limit complex accounting requirements, we wonder whether the IASB might have reconsidered its earlier decision about flow-through.

Question 3 – Other proposed amendments to the IFRS for SMEs

The IASB proposes to make a number of other amendments to the IFRS for SMEs. The proposed amendments are listed and numbered 1–43 and 45–57 in the list of proposed amendments. Most of those amendments are minor and/or clarify existing requirements.

(a) Are there any amendments that you do not agree with or have comments on?

(b) Do any of the amendments require additional guidance or disclosure requirements to be added to the IFRS for SMEs? If so, which ones and what are your suggestions?

If you disagree with an amendment please state any alternatives you propose and give your reasoning.

Response

Putting our concerns over the scope of the IFRS for SMEs to one side, the FRC largely supports the amendments proposed in the ED.

With respect to the fair value hierarchy contained in paragraph 11.27 of the standard, we agree with the proposed amendment to include "a price in a binding sale agreement in an arm's length transactions" to subparagraph (a), however we believe that some indication of how recently the binding sale agreement was agreed relative to the entity's year end is necessary. A binding sale agreement that was agreed a number of years prior to the current year end would not give the best evidence of an asset's fair value.

Question 4 – Additional issues

In June 2012 the IASB issued a Request for Information (RfI) seeking public comment on whether there is a need to make any amendments to the IFRS for SMEs (see paragraphs BC2–BC15). The RfI noted a number of specific issues that had been previously identified and asked respondents whether the issues warranted changes to the IFRS for SMEs. Additionally, the RfI asked respondents to identify any additional issues that needed to be addressed during the review process. Any issues so identified were discussed by the IASB during its deliberations.

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Do respondents have any further issues that are not addressed by the 57 amendments in the list of proposed amendments that they think the IASB should consider during this comprehensive review of the IFRS for SMEs? Please state these issues, if any, and give your reasoning.

Response

The FRC believes that the IASB should reconsider whether it is appropriate to exclude certain accounting policy options from the proposed amendments to the standard. The IASB argues that introducing accounting policy options would result in more complexity in other areas of the standard (for example impairments and deferred tax) and the users of SME financial statements need to understand the accounting policies used and that less variation in accounting requirements would be of benefit[3].

This argument is difficult to support when there are many accounting areas included within the IFRS for SMEs (deferred tax to name but one) that are far more complex to apply than revaluations of property, plant and equipment and intangibles, and the capitalisation of borrowing costs and development costs.

As a result, the FRC is concerned that the IFRS for SMEs may not be sufficiently complex for all entities that may fall within its stated scope. We reiterate our view that there is a real need for the IASB to revisit the scope of the standard.

We have also set out in the covering letter our suggestion that the IASB reconsiders the classification of financial instruments and hedge accounting.

Question 5 – Transition provisions

The IASB does not expect retrospective application of any of the proposed amendments to be significantly burdensome for SMEs and has therefore proposed that the amendments to the IFRS for SMEs in Sections 2–34 are applied retrospectively.

Do you agree with the proposed transition provisions for the amendments to the IFRS for SMEs? Why or why not? If not, what alternative do you propose?

Response

The FRC agrees with the proposed transition provisions.

[3] Paragraphs BC39 to BC48 of the Basis for Conclusions to this ED.

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Question 6 – Effective date

The IASB does not think that any of the proposed amendments to the IFRS for SMEs will result in significant changes in practice for SMEs or have a significant impact on their financial statements. It has therefore proposed that the effective date of the amendments to the IFRS for SMEs should be one year after the final amendments are issued. The IASB also proposes that early adoption of the amendments should be permitted.

Do you agree with the proposed effective date and the proposal to permit early adoption? Why or why not? If not, what alternative do you propose?

Response

The FRC agrees with the proposed effective date and the proposal to permit early adoption.

Question 7 – Future reviews of the IFRS for SMEs

When the IFRS for SMEs was issued in 2009 the IASB stated that after the initial comprehensive review, the IASB expects to propose amendments to the IFRS for SMEs by publishing an omnibus Exposure Draft approximately once every three years. The IASB further stated that it intended this three-year cycle to be a tentative plan, not a firm commitment. It also noted that, on occasion, it may identify a matter for which an amendment to the IFRS for SMEs may need to be considered earlier than in the normal three-year cycle; for example to address an urgent issue.

During the comprehensive review, the IASB has received feedback that amendments to the IFRS for SMEs once every three years (three-year cycle) may be too frequent and that a five-year cycle, with the ability for an urgent issue to be addressed earlier, may be more appropriate.

Do you agree with the current tentative three-year cycle for maintaining the IFRS for SMEs, with the possibility for urgent issues to be addressed more frequently? Why or why not? If not, how should this process be modified?

Response

The FRC agrees with the currently proposed three-year review cycle for the IFRS for SMEs. In general this should balance stability and minimising changes in quick succession with keeping the IFRS for SMEs up-to-date and addressing implementation issues or other developments. We also agree that the possibility of urgent issues being addressed more frequently should not be precluded.

We have already noted in our covering letter, our view that the IASB should revisit the principles it has developed in relation to dealing with new and revised IFRSs.

Question 8 – Any other comments

Do you have any other comments on the proposals?

Response

Please see our detailed comments set out in the covering letter to this response.

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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.

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

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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~~) Financial assets and financial liabilities 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~~ financial liabilities or financial assets and ~~debt instruments~~ financial liabilities 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 entries 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 <u>either</u>:

<u>(i)</u> 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<u>; or</u>

<u>(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.</u>

<u>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.</u>

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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Exposure Draft

Financial Reporting Council

February 2014

FRED 54

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

Basic financial instruments

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.

Financial Reporting Council

February 2014

FRED 54

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

Basic financial instruments

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 basic financial instruments.

(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 – Basic financial instruments

(iv) After the publication of FRS 102 in March 2013 entities and their advisers considered the implementation of the requirements of FRS 102 in more detail. In the process they raised concerns about the possibility of unintended accounting consequences in relation to basic debt instruments, which had not been identified during the consultations preceding the issue of FRS 102. Their feedback was that the conditions which debt instruments have to meet in order to be measured at amortised cost are too restrictive and only very simple financial assets and liabilities would be measured on that basis. More sophisticated financial instruments are required to be measured at fair value. As a consequence some financial instruments would need to be measured at fair value, although amortised cost is a relevant measurement basis as it captures the risks associated with those instruments adequately. It was also highlighted that IFRS permits the measurements of these instruments at amortised cost.

(v) The draft amendments set out in this Financial Reporting Exposure Draft (FRED) propose to change the conditions which debt instruments have to satisfy in order to be accounted for in accordance with Section 11 *Basic Financial Instruments* of FRS 102. The draft amendments propose to make the conditions that basic debt instruments have to meet less restrictive and aim to achieve the following:

(a) to allow a wider range of debt instruments to be measured at amortised cost where this is a relevant measurement basis;

(b) to align the measurement requirements for financial instruments more closely with those of IFRS 9 *Financial Instruments* issued by the IASB; and

(c) to reduce the cost of compliance with FRS 102.

(vi) The proposals retain the current approach of FRS 102, and set prescriptive conditions for debt instruments to be measured at amortised cost. Debt instruments that fail the proposed conditions continue to be measured at fair value.

(vii) The consultation period on this Exposure Draft ends on 30 April 2014. The comment period is slightly shorter than the standard consultation period of three months, in order to allow for the publication of the final amendments to FRS 102 by summer 2014.

(viii) The draft amendments are proposed to come into effect for financial years ending on or after 1 January 2015, the same date FRS 102 becomes effective.

Invitation to comment

1. The FRC is requesting comments on FRED 54 by 30 April 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.

2. Information on how to submit comments and the FRC's policy in relation to responses are set out on page 16.

Question 1

Do you support the proposal to amend the conditions of paragraph 11.9 and make the requirements less restrictive?

Question 2

In your view, under the amended conditions will debt instruments be classified appropriately, ie will the proposal have the effect that debt instruments that are basic in nature are measured at amortised cost and debt instruments that are non-basic in nature are measured at fair value? If you have reservations, please specify the financial instruments that you believe would not be measured appropriately under the proposed requirements.

Question 3

It is proposed that the Appendix to Section 11 *Basic Financial Instruments* will contain some illustrative examples. In your view, are the proposed examples helpful? If not, what other examples would you suggest should be included instead?

Question 4

The proposed amendments would be effective from 1 January 2015. Do you have reservations concerning the proposed effective date?

Question 5

The exposure draft does not contain specific transitional requirements and the requirements of Section 35 *Transition to this FRS* of FRS 102 will therefore apply. In your view, are any specific transitional provisions in relation to the proposed amendments necessary? If so, please tell us what transitional provisions you would suggest and why?

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

Basic financial instruments

Amendments to Section 11
Basic Financial Instruments

Paragraphs 11.8, 11.9 and 11.11 are amended as follows (deleted text is struck through, inserted text is underlined):

11.8 An entity shall account for the following financial instruments as basic financial instruments in accordance with Section 11:

(a) cash;

(b) a debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9 and is not a financial instrument described in paragraph 11.6(b);

(c) ...

11.9 ~~A debt instrument that satisfies all of t~~The conditions a debt instrument shall satisfy in accordance with paragraph 11.8(b) are~~(a) to (d) below shall be accounted for in accordance with Section 11~~:

(a) The contractual r~~R~~eturn~~s~~ to the holder (the lender), assessed in the currency in which the debt instrument is denominated, ~~are~~ is:

(i) a fixed amount;

(ii) a positive fixed rate or a positive **variable rate** ~~over the life of the instrument~~; or

~~(iii) variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR) or~~

(i~~v~~ii) ~~some~~ a combination of ~~such~~ a positive or a negative fixed rate and a positive variable rate~~s~~ (eg ~~such as~~ LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR).~~, provided that both the fixed and variable rates are positive (eg an interest rate swap with a positive fixed rate and negative variable rate would not meet this criterion). For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.~~

A variable rate is a rate equal to a single referenced quoted or observable interest rate (eg LIBOR).

(b) The contract may provide for repayments of the principal and/or the return to the holder to be linked to a single observable index of general price inflation of the currency in which the debt instrument is denominated.

(c) The contract may provide for a variation of the return to the holder during the life of the instrument, provided that:

(i) the new rate satisfies condition (a) and the variation is not contingent on future events other than:

(1) a change of a contractual variable rate; or

(2) to protect the holder against credit deterioration of the issuer; or

(ii) the new rate is a market rate of interest and satisfies condition (a).

(~~b~~d) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

(~~c~~e) Contractual provisions that permit the issuer (the borrower) to prepay a debt instrument or permit the holder ~~(the lender)~~ to put it back to the issuer before maturity are not contingent on future events other than to protect:

(i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or

(ii) the holder or issuer against changes in relevant taxation or law.

Such contractual prepayment provisions may include terms that require the issuer to compensate the holder for loss of interest as a result of the early termination.

(f) Contractual provisions may permit the extension of the term of the debt instrument, provided that the return to the holder and any other contractual provisions applicable during the extended term satisfy the conditions of paragraphs (a) to (e).

~~(d) There are no conditional returns or repayment provisions except for the variable rate return described in (a) and prepayment provisions described in (c).~~

11.11 Examples of financial instruments that do not satisfy the conditions in paragraph 11.9 (and are therefore within the scope of Section 12) include:

(a) an investment in another entity's equity instruments other than non-convertible preference shares and non-puttable ordinary and preference shares (see paragraph 11.8(d));

~~(b) an interest rate swap that returns a **cash flow** that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow, because such swaps and forwards do not meet the condition in paragraph 11.9(a);~~

~~(c) options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 11.9(a) is not met;~~ and

(~~d~~b) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates.

~~(e) [not used]~~

The following Appendix to Section 11 is inserted.

Appendix to Section 11

Illustrative examples of debt instruments

This appendix accompanies, but is not part of, Section 11. It provides guidance for applying the requirements of paragraph 11.9. The examples aim to illustrate the application of the requirements in paragraph 11.9, however they only analyse the specific terms of the instruments identified in each of the scenarios. These examples are not a substitute for a comprehensive analysis of all terms and conditions of an instrument and whether they meet or fail the conditions of paragraph 11.9.

11A.1 **Example 1:** A zero-coupon loan.

For a zero-coupon loan, the holder's return is the difference between the nominal value of the loan and the discounted issue price. The holder (lender) receives a fixed amount when the loan matures and the issuer (borrower) repays the loan. The return to the holder meets the condition of paragraph 11.9(a)(i).

11A.2 **Example 2:** A fixed interest rate loan for initial tie-in period. The same loan reverts to the bank's standard variable interest rate after the tie-in period

The initial fixed rate is a return permitted by paragraph 11.9(a)(ii). A bank's standard variable interest rate is an observable interest rate and in accordance with the definition in paragraph 11.9(a) a permissible reference for a variable rate. In accordance with paragraph 11.9(a)(ii) the variable rate should be a positive rate. Unless there are indications to the contrary, it can be assumed that a bank's standard variable rate would under normal economic conditions not fall below 0%.

The variation of the interest rate after the tie-in period is non-contingent and since the new rate (ie the bank's standard variable rate) meets the condition of paragraph 11.9(a), paragraph 11.9(c)(i) is met.

11A.3 **Example 3:** A loan with interest payable at the bank's standard variable rate less 1% throughout the life of the loan, with the condition that the interest rate can never fall below 1.5%.

As discussed under Example 2 above, a bank's standard variable rate is a permitted variable rate in accordance with the definition of variable rate paragraph 11.9(a). The combination of a negative fixed rate (ie minus 1%) and a positive variable rate is a permitted return under paragraph 11.9(a)(iii). The combination of a bank's standard variable rate less a fixed interest rate of 1% therefore meets condition 11.9(a)(iii). The fixed interest rate floor of 1.5% meets the requirement of paragraph 11.9(a)(ii).

Paragraph 11.9(c)(i)(1) permits variation of a return to a holder (lender) that is contingent on a change of a contractual variable rate. In this example the contractual variable rate is the bank's standard variable rate. The variation of the return to the holder is between the bank's standard variable rate less 1% and 1.5%, depending on the bank's standard variable rate. For example, if the bank's standard variable rate is less than 2.5%, the return to the holder is fixed at 1.5%, if the bank's standard variable rate is higher than 2.5% the return to the holder is the bank's standard variable rate less 1%. The contractual variation meets the condition of paragraph 11.9(c)(i)(1).

The holder is protected against the risk of losing the principal amount of the loan via the interest rate floor of 1.5%, in case the bank's standard variable rate falls below 1%. The requirement of paragraph 11.9(d) is therefore met.

11A.4 **Example 4:** Interest on a loan is referenced to 1.5 times the bank's standard variable rate.

In accordance with the definition of a variable rate in paragraph 11.9(a), the contractual interest rate payable can be referenced to a single observable interest rate. A bank's standard variable rate is an observable rate and meets the definition of a variable rate, but the rate in this example is 1.5 times the bank's standard variable rate. Leverage, ie more than a single observable interest rate, is not permitted in accordance with the definition of a variable rate and therefore the rate in this example is not a variable rate as described in paragraph 11.9(a)(ii). The instrument is measured at fair value in accordance with Section 12.

11A.5 **Example 5:** Interest on a loan is charged at 10% less 6-month LIBOR over the life of the loan.

The effect of combining a negative variable rate with a positive fixed rate is that the interest on the loan increases as and when the variable rate decreases and vice versa (so called inverse floating interest).

Under paragraph 11.9(a)(iii) the combination of positive or negative fixed rate and positive variable rate is a permitted return. The variable rate (6-month LIBOR) meets the definition of a variable rate in paragraph 11.9(a), as the rate is a quoted interest rate, however, since the variable rate is negative, (minus 6-month LIBOR) the rate is in breach of paragraph 11.9(a)(iii). The instrument is measured at fair value in accordance with Section 12.

11A.6 **Example 6:** Interest on a £-Sterling denominated mortgage is linked to the UK Land Registry House Price Index (HPI) plus 3%.

In accordance with paragraph 11.9(b) the holder's return may be linked to an index of general price inflation of the currency of the debt instrument. The mortgage is denominated in £-Sterling and a permitted inflation index would be an index that measures general price inflation of goods and services denominated in £-Sterling.

The HPI measures inflation for residential properties in the UK and is not a measure of general price inflation. The return to the holder therefore fails to meet the requirements of paragraph 11.9(b). The instrument is measured at fair value in accordance with Section 12.

Amendments to Appendix I: Glossary

The following definition is added:

Variable rate	A rate equal to a single referenced quoted or observable interest rate (eg LIBOR).

The Accounting Council's Advice to the FRC to issue FRED 54: Draft Amendments to FRS 102 – Basic financial instruments

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 54: *Draft Amendments to FRS 102 – Basic financial instruments*. 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's regulatory policies *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. The FRC has established the Accounting Council as the relevant Council to assist it in the setting of accounting standards.

Advice

3 The Accounting Council is advising the FRC Board to issue FRED 54: *Draft Amendments to Draft FRS 102 – Basic financial instruments* for consultation.

4 After the publication of FRS 102, feedback from constituents indicated that the implementation of the accounting requirements of FRS 102 for loans with common contractual features could have unintended consequences for many entities. The draft amendments address the identified issues and allow for these loans to be measured at amortised cost, which in turn is expected to reduce the cost of compliance with FRS 102. Given that the amendments come into force on the same day as FRS 102, ie 1 January 2015, constituents have requested that the amendments are finalised as soon as practically possible.

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 these amendments are 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 FRS 102 contains the accounting requirements for financial instruments in Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments*. FRS 102 separates financial instruments into two main categories, basic financial instruments and other financial instruments. Whether a financial instrument is classified as 'basic' or 'other' depends on the instrument meeting certain criteria which are contained in Section 11 of FRS 102.

7 The conditions set out in Section 11 of FRS 102 are those set out in the IFRS for SMEs with some amendment to allow for certain loan covenants that are common in the UK and Republic of Ireland and should not affect the measurement basis of an instrument.

8 Following the publication of FRS 102, the FRC was informed that the classification conditions of basic financial instruments are, despite the amendment for loan covenant clauses, too restrictive. Some simple financial instruments with common contractual terms

would breach the conditions as currently drafted and as a consequence entities applying FRS 102 would incur unnecessary costs in measuring these financial instruments at fair value. Amortised cost is, in these situations, an appropriate measurement basis that reflects the risks of the instruments in question and is less costly to apply.

9 In order to gather more evidence about the issue and to substantiate whether the problems are confined to a small number of entities or are more pervasive, some initial outreach was conducted.

Outreach

10 The outreach included the views of a diverse range of constituents including entities that would be applying FRS 102, their representative bodies and advisers. Participants were in agreement that the conditions set for basic financial instruments in Section 11 of FRS 102 were overly restrictive. It was noted that a number of instruments which are common in practice were affected. The accounting issues would therefore affect a large number of entities, including many small businesses. It was also highlighted that there are inconsistencies between the accounting treatment under FRS 102 and IFRS 9 *Financial Instruments* for these instruments. A majority of participants was in favour of an amendment to FRS 102 prior to its effective date of 1 January 2015.

11 The Accounting Council considered whether it was appropriate for instruments, with the terms identified during the outreach, to be measured at amortised cost or whether such instruments should be measured at fair value. The Accounting Council was conscious that just because a certain type of financial instrument is common in practice does not necessarily imply that the financial instrument should be measured at amortised cost.

12 The Accounting Council also noted that FRS 102 as currently drafted may impose a greater reporting burden and therefore higher costs on entities reporting in accordance with Sections 11 and 12 of FRS 102, compared to those entities reporting under IAS 39 *Financial Instruments* or IFRS 9, because certain financial instruments would be measured at fair value under FRS 102, whilst under IFRS the same instrument is measured at amortised cost.

Objective

13 In developing this advice to the FRC Board, the Accounting Council was guided by the following overriding objective:

> 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.

14 The Accounting Council considered the evidence from the outreach and agreed that the application of the classification conditions for basic financial instruments contained in Section 11 of FRS 102 could, in practice, result in unintended accounting outcomes for certain financial instruments. In order to meet the overriding objective for financial reporting, the Accounting Council advises that it is necessary to amend the requirements of FRS 102 as currently in issue.

15 In developing the draft amendments to FRS 102 the Accounting Council was guided by the principles for succinct financial reporting which state that financial reporting standards issued by the FRC should:

- 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
- be cost-effective to apply.

Rule vs principle-based solution

16 The accounting requirements of FRS 102 in respect of the classification conditions are rule-based and set out a list of prescriptive criteria that financial instruments have to meet in order to be measured at amortised cost. The Accounting Council considered whether a principle-based solution based on the principle articulated in IFRS 9 in respect of the classification of financial assets, would be more effective, but advises to retain the rule-based conditions of FRS 102 instead, for the following reasons:

- the IFRS 9 principle is yet untested in practice and the IASB is currently debating possible amendments to IFRS 9; and
- the IFRS 9 principle in relation to the classification of financial instruments only applies to financial assets. The classification conditions in FRS 102, however, apply equally to debt instruments that are assets and liabilities.

Further analysis of the effects of the adoption of the principle as stated in IFRS 9 is required in order to avoid unintended consequences. The possible adoption of the IFRS 9 principle in respect of the classification of financial instruments in FRS 102 may be revisited at the next three-year review cycle of FRS 102.

17 The Accounting Council is conscious that rules cannot address all possible scenarios and situations, but advises that under the proposal, common financial instruments will be permitted to be measured at amortised cost, where measurement at amortised cost is appropriate. The draft amendments also align the accounting for these financial instruments with IFRS.

Effective date

18 The Accounting Council advises that, subject to the final amendments being issued later in 2014, the amendments should be effective from the effective date of FRS 102 (ie accounting periods beginning on or after 1 January 2015), and therefore no amendment to the effective date is required.

Consultation period

19 It is the FRC's stated policy to allow at least three months for representations to be made on proposals, unless circumstances require a shorter period. Given that the effective date of the final amendments, which are subject to the FRC Board's approval, is 1 January 2015, the Accounting Council advises that progress towards the publication of the final amendments should be as timely as possible. On that basis, the Accounting Council advises that the comment period should be reduced from the standard three months to a period ending 30 April 2014. The Accounting Council advises that this shorter period provides constituents with sufficient time to reflect on the proposals and provide their feedback, whilst it may bring forward the publication of the final amendments by over two months.

Consultation Stage Impact Assessment

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 entities.

2 The cost-benefit impact of the adoption of the requirements of FRS 102 as issued in March 2013 was estimated in the original Impact Assessment and this Consultation Stage Impact Assessment only analyses the potential changes to the original assessment. The Consultation Impact Assessment evaluates whether cost increases or cost savings are likely to arise for entities as a result of the introduction of these amendments.

3 The draft amendments to FRS 102 are intended to increase the number of financial instruments that can be measured at amortised cost. Based on the assumption that amortised cost valuation of a financial instrument is less costly than its measurement at fair value, the FRC believes that these proposals will reduce the reporting costs of entities that hold financial instruments covered by the draft amendments. The proposal is cost neutral for entities that are unaffected by this proposal, ie those entities that do not hold financial instruments where the classification as basic, or other, financial instruments will be changed by these draft proposals. Entities that wish to value their financial instruments at fair value instead of amortised cost, retain this option and the proposal has therefore no effect on them.

4 Given that the effective date of FRS 102 is accounting periods beginning on or after 1 January 2015, some entities may have already performed an initial assessment of their financial instruments based on the conditions set out in FRS 102 (as currently in issue). Provided the amendments are finalised as proposed, these entities will be required to re-analyse their financial instruments based on the new conditions for basic debt instruments. Entities will incur some extra cost in respect of this new analysis, however, the FRC believes the additional cost is outweighed by the benefits (ie cost savings) of allowing entities to measure more financial instruments at amortised cost on a continuing basis.

5 The FRC believes that the amendment of FRS 102 in accordance with these proposals will have a positive impact on financial reporting.

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:

Susanne Pust Shah
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Comments should be despatched so as to be received no later than 30 April 2014.

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

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