Financial Instruments
FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland includes requirements in relation to financial instruments that are significantly different from those under old UK GAAP. This factsheet provides a summary of what has proven to be one of the biggest challenges for many entities applying FRS 102 for the first time.

Key regulations for this factsheet
This factsheet includes links and references to key regulations. There’s a summary of the links, and guidance on how to use them, on page 2.

Section 1
Introduction
FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland replaced all extant FRSSs, SSAPs and UITF Abstracts for accounting periods beginning on or after 1 January 2015. In addition, the withdrawal of the FRSSE means that many small entities will now be applying the standard for the first time in accounting periods beginning on or after 1 January 2016.

Moving to a new reporting regime is never easy. Each entity will face its own unique challenges depending on its individual circumstances. It is likely, however, that many entities will find that the new financial instruments requirements pose one of the most significant challenges, both on transition to the new regime and on an ongoing basis.

It’s important to remember that financial instruments include common items such as cash, debtors, creditors and bank loans as well as more complex items such as derivatives and asset-backed securities, meaning that businesses of all shapes and sizes invariably have at least some financial instruments.

Requirements relating to ‘basic’ and ‘other’ financial instruments are set out in Sections 11 and 12 of FRS 102 respectively. The former are mostly measured at amortised cost and the latter are mostly measured at fair value with movements recognised in profit or loss. Matters are, however, further complicated by the fact that entities can instead choose to apply the recognition and measurement requirements of the equivalent international standards.

This factsheet reflects the requirements of the version of FRS 102 that was published in September 2015, together with the amendments to the standard’s fair value hierarchy disclosures issued in March 2016.
Section 2

Links to regulations

Using the links and margin notes in this document
The margin notes in this factsheet identify relevant sections of standards and other regulations—these sections cannot be considered in isolation when applying them in practice.

You might find it useful to download, or print out, relevant section(s) of the standard(s) so that you can refer to them when using this document.

Make sure that you use the right version of the regulations or standards
Standards and regulations are often updated and amended, and may have transitional provisions. It is important to use the right version, and to make sure that it applies to the relevant time period. The standards below are linked to the faculty’s standards tracker which shows when standards are amended, and when the amendments come into effect. Links are then provided to the version of the standard relevant to specific time periods.

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Section 3
Overview

Financial instruments
FRS 102 defines a financial instrument as ‘a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity’.

Financial instruments include common items such as cash, bank balances, debtors, creditors and bank loans as well as more complex items such as derivatives and asset-backed securities, meaning that businesses of all shapes and sizes invariably have at least some financial instruments.

Practical tip: small entities
While small entities applying FRS 102 can benefit from some disclosure exemptions, there are no recognition and measurement simplifications for such entities. This means that they will face all the same financial instruments related issues when transitioning from the FRSSE to FRS 102 as their larger cousins faced when first applying the new standard a year or two ago.

Basic and other financial instruments
Sections 11 Basic Financial Instruments and 12 Other Financial Instruments Issues divide financial instruments into ‘basic’ and ‘other’ instruments, with the former mostly measured at amortised cost and the latter mostly measured at fair value with movements recognised in profit or loss. These are considered further in sections 4, 5 and 6 of this factsheet.

Hedge accounting
Many entities engage in hedging activities to manage the risks they face. Section 12 of FRS 102 includes special hedge accounting rules that in many instances will allow entities better to reflect the economic substance of such arrangements in their financial statements. These are considered in section 7 of this factsheet.

Accounting policy choice
An entity can choose to apply either:

- Sections 11 and 12 of FRS 102 in full; or
- The recognition and measurement provisions of IAS 39 Financial Instruments: Recognition and Measurement as adopted for use in the EU together with the disclosure and presentation requirements of Sections 11 and 12 of FRS 102; or
- The recognition and measurement provisions of IFRS 9 Financial Instruments and/or IAS 39 (as amended following the publication of IFRS 9), together with the disclosure and presentation requirements of Sections 11 and 12 of FRS 102.

This accounting policy choice must be applied to all of an entity’s financial instruments, it cannot choose to account for some instruments under Sections 11 and 12 of FRS 102 and others under IAS 39 or IFRS 9.

Only for financial instruments is there an option to apply the requirements of IFRSs instead of the requirements contained in FRS 102.
Practical tip: choosing to apply the requirements of IAS 39 and/or IFRS 9

The option to apply the recognition and measurement requirements of IAS 39 and/or IFRS 9 instead of the equivalent requirements of Sections 11 and 12 of FRS 102 may be an attractive option for some, particularly for those with more complex financial instruments, entities that have previously applied FRS 26 (IAS 39) Financial Instruments: Recognition and Measurement or entities that are part of a group preparing IFRS consolidated accounts. The most appropriate choice for the individual entity will depend on the facts and circumstances.

The options to apply IAS 39 and/or IFRS 9 are not considered further in this factsheet.

Scope
Not all financial instruments are covered by Sections 11 and 12 of FRS 102 as in some instances there are requirements elsewhere in the standard that should instead be followed. For example, investments in subsidiaries, associates and joint ventures are accounted for under Sections 9 Consolidated and Separate Financial Statements, 14 Investments In Associates and 15 Investments in Joint Ventures respectively while leases are generally accounted for under Section 20 Leases. Moreover, insurance contracts¹ are accounted for in accordance with the requirements of FRS 103. Sections 11 and 12 of the standard provide a full list of scope exclusions.

Practical tip: it isn’t only insurance providers that issue insurance contracts
Some entities that are not legally constituted as insurance providers may be issuing contracts meeting FRS 103’s definition of an insurance contract. Examples include appliance servicing agreements and some product warranty arrangements. Moreover, the LLPs SORP points out that unconditional contractual obligations to make post-retirement payments to former members will be accounted for as insurance contracts if the total amount payable is significantly affected by how long the former members live (ie, there is significant longevity risk).

Section 22 Liabilities and Equity establishes principles for classifying financial instruments as either liabilities or equity and deals with the accounting for compound financial instruments. These requirements are beyond the scope of this factsheet.

Section 34 Specialised Activities sets out additional disclosures about financial assets and financial liabilities for both financial institutions and retirement benefit plans. These requirements are also beyond the scope of this factsheet.

Practical tip: what is a financial institution?
There has been a lot of debate about the definition of a financial institution. The definition includes a list of entities—such as banks, building societies and credit unions—that are considered to be financial institutions. While this makes it very clear that certain entities are within the scope of the definition, there is some confusion about the final part of the definition, which refers to ‘any other entity whose principal activity is to generate wealth or manage risk through financial instruments’. This could potentially capture a number of organisations that many would not normally consider to be financial institutions. However, this part of the definition goes on to say that it is ‘intended to cover entities that have business activities similar to those listed above’. Our understanding is that the intention was that the emphasis should be placed on the second sentence. The definition should be interpreted with this in mind.

¹ FRS 102 defines an insurance contract as ‘a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder’. 
Disclosure exemptions for non-financial institutions
Qualifying entities\(^2\) that are not financial institutions are exempt from making some of the disclosures required by Sections 11 and 12 in their individual financial statements, provided equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated.

The exemptions available to such entities were amended in 2015 to take into account the fact that company law requires certain disclosures to be made in relation to financial instruments. The disclosures required for all FRS 102 reporters are similar to those required by law.

Disclosure requirements for small entities
Section 1A Small Entities of FRS 102 sets out information that must be presented and disclosed in the financial statements of a small entity that is eligible for and chooses to apply the small entities regime. Such entities are not required to comply specifically with many of the disclosures included elsewhere in FRS 102.

The disclosures set out in Appendix C to Section 1A are the minimum required to comply with company law. Further disclosures are, however, encouraged. These are included in Appendix D to Section 1A.

**Practical tip: look out for items with an asterisk against them**
In many cases compliance with requirements found elsewhere in FRS 102 will result in compliance with the requirements of Section 1A. Small entities can identify disclosures throughout FRS 102 that are similar to those required by Section 1A by looking for the asterisk in the left-hand margin.

**Practical tip: true and fair**
Although there are legal restrictions on the information that can be mandated in small entity accounts, those accounts must still give a true and fair view. Therefore, judgement will need to be applied when considering whether further disclosures, over and above those specifically required and encouraged by Section 1A of the standard, will be needed in order for the accounts to show a true and fair view.

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\(^2\) Qualifying entities are those entities that are included in a group that prepares publicly available consolidated financial statements that are intended to give a true and fair view. They will typically include subsidiary undertakings and both intermediate and ultimate parents.
Section 4

Classification of financial instruments

Basic and other financial instruments
The standard sets out conditions for an instrument to qualify as ‘basic’; any instrument that fails those conditions is an ‘other’ financial instrument.

- Basic financial instruments include many financial instruments with relatively straightforward terms, such as debt instruments that meet the criteria set out in paragraph 11.9 of the standard (which will include most trade debtors and creditors and many relatively simple bank loans), investments in non-puttable ordinary shares and certain loan commitments.
- Other financial instruments include debt instruments that do not meet the criteria for basic financial instruments set out in paragraph 11.9 of the standard such as investments in convertible debt and derivatives such as foreign exchange forward contracts.

Care should be taken, however, as some common and straightforward contractual terms may result in loans and other debt instruments being classified as other.

Determining whether debt instruments qualify as basic
Paragraph 11.9 of FRS 102 holds the key to determining whether a debt instrument will be classified as basic or other. When the original version of the standard was published, concerns were raised that the wording of this paragraph meant that too many relatively straightforward debt instruments would be measured at fair value.

Following a public consultation, the FRC made important changes to this paragraph in July 2014 which moved that dividing line to allow more instruments to be classified as basic. However, the approach to determining whether an instrument is basic or other remains rules-based rather than principles-based.

Practical tip: basic and other debt instruments
While paragraph 11.9 can sometimes be hard to decipher, the examples that immediately follow it are helpful as they illustrate how the criteria should be applied to a number of commonly encountered debt instruments.

Practical tip: terminology
When talking about debt instruments, the standard makes frequent references to the ‘holder’ and the ‘issuer’. If you find these terms confusing, the more easily understood terms of ‘lender’ and ‘borrower’—which the standard occasionally adds in brackets after them—can be substituted for them. Throughout this factsheet we have used these terms interchangeably.

Contractual return
The first thing to consider when determining whether an instrument is basic or other is the contractual return to the holder.

The standard requires the contractual return to the holder to be assessed in the currency in which the debt instrument is denominated and to be either:

- a fixed amount;
- a positive fixed or variable rate; or
- a combination of a positive or negative fixed rate and positive variable rate eg, LIBOR plus 2%, LIBOR less 2% but not 5% less LIBOR.

This would include most trade debtors or creditors (being the payment of fixed amounts) and many straightforward bank loans.
**Practical tip: variable rates**

When paragraph 11.9 refers to a ‘variable rate’ it is specifically referring to a rate ‘which varies over time and is linked to a single observable interest rate or to a single relevant observable index of general price inflation of the currency in which the instrument is denominated, provided such links are not leveraged’. Hence, any return that is linked to something other than an interest rate or inflation index will prevent the instrument from being classified as basic. Moreover, not all linkages to interest rates or inflation indices will meet the criteria.

Basic financial instruments include certain financial instruments for which the return to the holder is linked to general price inflation, including most simple inflation linked bonds — such as loans paying a fixed or variable interest rate when the principal amount increases with the retail price index (RPI).

Examples of loans that are likely to fail the basic criteria and are therefore likely to be measured at fair value by both the lender and borrower include loans given by house builders to purchasers for which the return is based on the changing value of the house purchased and bonds with returns based on a multiple of an interest rate.

**Determinable variations of the return to the holder**

For some financial instruments, the cash flows may be uncertain or subject to change during the life of the instrument. Whether such instruments are classified as basic or other will depend on the nature of the changing cash flows.

Paragraph 11.9 allows financial instruments to be classified as basic if the contract provides for a determinable variation of the return to the lender, provided that the new rate meets the requirements listed above and other conditions such as:

- the new rate is a market rate; or
- the variation is not contingent on future events other than:
  - a change in the contractual variable rate;
  - to protect the holder against credit deterioration of the issuer; or
  - changes in levies applied by a central bank or arising from changes in relevant legislation or tax.

Examples include loans that move from an introductory fixed or discounted rate to a lender’s standard variable rate, capped rate loans or even loans with stepped interest rates based on time.

More elaborate loans may include terms that state that the interest rate will increase by a pre-agreed amount if the counterparty suffers a credit downgrade. This is an example of a variation to protect the holder against credit deterioration of the issuer. This variation in return would not, in itself, prevent the loan from being classified as basic.

If a variation in the return to the holder is contingent on something other than one of the three future events listed above, the instrument may fail the basic criteria. Examples of loans that are therefore likely to be measured at fair value by both the lender and borrower include loans that allow the lender unilaterally to change the terms of the contract (which are sometimes taken out by housing associations).

**Detrimental terms**

An instrument cannot be classified as basic if there are contractual provisions that could result in the holder losing the principal amount or any interest attributable to the current or prior periods. For example, an option to prepay at fair value would breach this condition.

**Practical tip: subordinated debt**

As holders of subordinated debt don’t get paid until senior debt holders have been paid in full, some may be concerned that such debt will automatically fail to qualify as basic. However, the standard makes it clear that the fact that a debt instrument is subordinated to other debt instruments does not, in itself, affect the instrument’s classification.
Prepayment terms
Prepayment terms appear in many guises. Virtually all third party loan arrangements include covenant terms under which the lender can require repayment on breach. Many loans will allow the borrower to prepay voluntarily.

In order for an instrument to be classified as basic, the right of the lender to demand repayment or the right of a borrower to prepay a debt cannot be contingent on future events other than to protect:

- the holder against credit deterioration of the issuer eg, default, credit downgrades and loan covenant breaches; or
- the holder against change in control of the issuer; or
- the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant law or taxation.

The inclusion of contractual provisions that require the issuer to compensate the holder for early termination does not, in itself, affect the instrument’s classification. Prepayment features that could result in the holder losing principal or interest would, however, prevent an instrument from being classified as basic as they would fall foul of the criterion highlighted above.

**Practical tip: loans with two-way compensation clauses**

It is common for loan agreements to include a provision setting out amounts to be paid by the borrower to the lender as compensation should the borrower repay the loan early when current market interest rates are lower than the fixed rate specified in the agreement. FRS 102 explicitly states that such provisions do not prevent the loans being classified as basic.

Many otherwise straightforward fixed rate loan agreements, particularly in the social housing sector, include a variant of such a provision. These provisions require the borrower to pay the lender or the lender to pay the borrower, depending on whether current market interest rates are below or above the agreed fixed rate. FRS 102 does not explicitly address compensation that can be paid to the borrower. There are differing views over whether such loans should be classified as basic or other.

The FRC has specifically commented on this matter, acknowledging that there may be some diversity in practice due to different interpretations of the standard and reminding preparers that FRS 102 requires disclosure about judgements that have had a significant effect on the amounts recognised in the financial statements.

Extension terms
The existence of extension terms will not cause an instrument to fail the basic classification criteria provided the terms of the debt in the extended period would, on a standalone test, meet the basic conditions noted above.

**Intercompany and directors’ loans**

There are no special requirements for loans between group companies or between a company and one of its directors ie, the normal requirements of paragraph 11.9 apply. Such loans can take a variety of forms: they may or may not attract interest and they may or may not be repayable on demand. Although many such loans will meet the criteria to be classified as basic instruments, classification as such should not be assumed without a thorough analysis of all contractual terms. See section 5 below for more details.

**Practical tip: terms of intercompany and directors’ loans**

While in many cases intercompany and directors’ loan agreements will not be formally documented, it should be remembered that the terms of the loan don’t necessarily need to be set out in a formal agreement. They could, for example, be evidenced in a board minute. However, without written evidence it may be hard to demonstrate what the agreed terms and conditions are. Therefore, to avoid any uncertainty about the accounting, it makes sense to ensure, whenever possible, that the terms of any such loans are adequately documented.
Practical tip: going concern

If there is no evidence of what the agreed terms and conditions are, it is likely that a loan will be considered to be repayable on demand and classified as a current liability in the financial statements of the borrower. This may significantly weaken the borrower’s balance sheet. Importantly, the classification of the loan will not be altered if the lender simply confirms a willingness to wait for repayment, as this does not change its entitlement to require repayment on demand. Such a forbearing approach to repayment may, however, have an impact on the going concern assessment undertaken by the borrower’s directors and, when applicable, its auditors.
Section 5

Basic financial instruments

Initial recognition
Financial assets and financial liabilities are recognised when an entity becomes party to the contractual provisions of the instrument. FRS 102.11.12

Initial measurement
In most cases, basic financial assets and financial liabilities are initially measured at the transaction price. This will include transaction costs except when initially measuring items that will subsequently be measured at fair value through profit or loss. FRS 102.11.13

If an arrangement constitutes a financing transaction, initial measurement is at the present value of the future payments (including interest payments and repayment of the principal), discounted at a market rate of interest for a similar debt instrument. In many cases this will equal the transaction price. Financing transactions may take place in connection with the sale of goods or services eg, if payment for goods or services is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate.

Example: short-term credit
When goods are sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that customer. Likewise, when goods are purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier. In such cases, the amount recognised would normally be the invoice amount.

Example: financing transactions
When goods are sold on, for example, two years’ interest-free credit, a receivable is recognised at the present value of the future payments, discounted at a market rate of interest for a similar debt instrument. Helpfully, the standard includes an example that states that for financing transactions conducted on an arm’s length basis, the current cash sales price for that item may be used as this would normally approximate to the present value of future cash payments.

Practical tip: identifying financing transactions
The standard says that financing transactions arise when payments are ‘deferred beyond normal business terms or are financed at a rate of interest that is not a market rate’. What constitutes a financing arrangement may therefore vary from industry to industry or from entity to entity. For example, if one entity normally offers its customers one week’s credit but exceptionally extends three months’ credit to a particular customer then that arrangement could be considered to be a financing transaction. But if another company offered three months’ credit to all its customers it is unlikely that such arrangements would be considered financing transactions as they are on normal business terms. Judgement will therefore be needed.
Practical tip: finding the market rate of interest for a similar debt instrument

Identifying a market rate of interest for a similar debt instrument may be challenging when the borrower would struggle to obtain alternative finance in the open market. This may be the case when an entity has no collateral to offer, is a start-up or is experiencing financial difficulties. Similarly, it may be difficult to establish a market rate of interest for intercompany or directors’ loans with a term that is significantly longer than the period for which an entity typically borrows.

Entities will have to make reasonable enquiries and use their judgement to arrive at their best estimate, on the basis of the information available, of the interest rate the entity might need to pay to raise equivalent funds on a commercial basis. A good starting point would be for the entity to ask its bank what rate of interest might be charged to a similar business for a loan of a similar amount and duration. Adjustments to observable interest rates will be necessary to reflect the additional risk when commercial loans would not be readily available as an alternative source of finance.

Establishing an appropriate rate of interest is not a precise science. However, when a business has encountered significant difficulties in raising external finance, the interest rate used for discounting purposes is likely to be relatively high.

Practical tip: additional disclosures

In order to give a true and fair view, in some instances it may be necessary to disclose the judgements made in establishing the interest rate when it has a significant impact on the amounts recognised in the accounts.

Subsequent measurement

Basic debt instruments

At the end of each subsequent reporting period, most basic debt instruments will be measured at amortised cost using the effective interest method. This approach is similar to the one used previously under FRS 4 Capital Instruments, but there can be some differences.

Short-term receivables and short-term payables that are not considered to be financing transactions are simply measured at the amount of cash to be received or paid ie, no discounting is required.

An entity can elect on initial recognition irrevocably to designate debt instruments that meet certain conditions as to be measured at fair value through profit or loss.

Practical tip: designation at fair value through profit or loss

It is possible to designate a debt instrument as being measured at fair value through profit or loss only if (1) doing so eliminates or significantly reduces an accounting mismatch; or (2) when a group of instruments is managed on a fair value basis in accordance with a documented risk management or investment strategy. This option will not be relevant to many simple businesses, which will typically measure such instruments at amortised cost.

Investments in ordinary shares and preference shares

Basic financial instruments also include investments in ordinary shares and preference shares other than:

- investments in convertible preference shares ie, for which the investor has a right to convert the preference shares into ordinary shares; and
- investments in puttable ordinary or preference shares ie, for which the investor has a right to sell the share back to the issuing company.

If they are publicly traded – or their fair value can otherwise be reliably measured – such shares are measured at fair value with changes in fair value recognised in profit or loss. Otherwise they are measured at cost less impairment.
Practical tip: investments in shares in listed companies

One difference when compared to old UK GAAP that will affect a number of entities relates to investments in shares in listed companies. The Companies Act 2006’s alternative accounting method allows investments held in listed shares to be measured at either cost or market value. When market value is used, changes are recognised in the statement of total recognised gains and losses in most cases. FRS 102 requires the use of fair value for investments in listed shares and for other investments in shares whose fair value can be measured reliably. Movements in this fair value are recognised in profit or loss. For some entities this could result in increased earnings volatility.

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Practical tip: investments in shares in unlisted companies

In many instances it should be possible to estimate the fair value of ordinary or preference shares that do not have quoted market prices. It may be possible to estimate fair value reliably either by reference to recent transactions for identical or similar assets or by using valuation techniques such as discounted cash flow analysis. However, in other instances it may not be possible to measure fair value with sufficient reliability. In such instances, the relevant investments will instead be measured at cost less impairment.

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Investments in preference shares classified as debt instruments by the issuer

Section 22 Liabilities and Equity of FRS 102 establishes principles for classifying financial instruments as either debt or equity. It requires the classification of preference shares, in common with other financial instruments, to be based on an assessment of the substance of the contractual arrangement. In some instances, this may result in preference shares—including many mandatorily redeemable preference shares with non-discretionary dividend payments—being classified as debt instruments in the financial statements of the issuer. However, when viewed from the perspective of the holder all non-puttable and all non-convertible preference shares are subject to the same requirements irrespective of how they are classified by the issuer. Investments in such instruments are measured at fair value through profit or loss when fair value can be measured reliably.

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Practical tip: form over substance?

Care needs to be taken as the legal form of the instrument can make a difference to the required accounting. For example, a loan with fixed annual interest payments and a fixed repayment date will typically be classified as basic and measured at amortised cost by the holder. However, an investment in an instrument with identical cash flows that takes the legal form of a mandatorily redeemable preference share would typically be measured at fair value.

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Loan commitments

Commitments to receive a loan and to make a loan to another entity that qualify as basic are subsequently measured at cost (which will sometimes be nil) less impairment.

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Amortised cost

Under the amortised cost method, the carrying value of a financial asset or financial liability is measured at each reporting date as the net of:

- the amount initially recognised;
- minus any repayments of principal;
- plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount;
- minus any interest paid;
- minus, in the case of a financial asset, any reduction for impairment or uncollectability.

The effective interest method is a way of calculating the amortised cost of a financial asset or financial liability and of allocating the interest income or expense over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts through the expected life—or a shorter period when appropriate—of the financial instrument to the carrying amount of the financial asset or financial liability.
Example: the effective interest method – bank loans

On 1 January 20X1, an entity takes out a bank loan for £1m, incurring an arrangement fee of £100,000. Interest of £50,000 is payable annually, in arrears, over the next five years. The loan is repayable on 31 December 20X5.

The effective interest rate can be easily calculated as 7.4697% using the IRR function in Excel (or similar functions in other spreadsheet packages) which calculates the internal rate of return on a series of cash flows (which in this case are a net inflow of £900,000 on 1 January 20X1 followed by outflows of £50,000 as interest is paid on each of 31 December 20X1 to 31 December 20X4 and an outflow of £1,050,000 on 31 December 20X5 when the principal is repaid along with the final interest repayment).

The arrangement fee is spread over the life of the instrument as interest expense. As a result, the effective interest rate of 7.4697% is higher than the coupon rate of 5%.

The loan would be accounted for as follows:

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<th>Year</th>
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<th>Cash outflow £000</th>
<th>Carrying amount at end of period £000</th>
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<tr>
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<td>(50.00)</td>
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<td>977.02</td>
<td>72.98</td>
<td>(1,050.00)</td>
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</table>

Example: the effective interest method – zero-coupon bonds

On 1 January 20X1, a company issues a £6m zero-coupon bond for proceeds of £5m. It will be redeemed at face value on 31 December 20X3. No interest is paid as the holder’s return is simply the difference between the bond’s nominal value and its issue price. There are no issue costs. The effective interest rate can be calculated as 3.7137%.

The bond would be accounted for as follows:

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<th>Year</th>
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<th>Interest expense at 3.7137%</th>
<th>Cash outflow £m</th>
<th>Carrying amount at end of period £m</th>
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</tr>
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<td>20X5</td>
<td>5.785</td>
<td>0.215</td>
<td>(6.000)</td>
<td>0.000</td>
</tr>
</tbody>
</table>

Practical tip: determining the expected life of an instrument

The definition of the expected interest rate method, above, refers to discounting cash flows through the expected life of the instrument or, when appropriate, a shorter period. In some cases, determining the expected life will be very easy, for example when a loan is for a fixed five year term. In other instances it will be more challenging, for example when there are options to extend or redeem early. The expected life should be based on management intentions. Significant judgement is likely to be needed. Whatever life is used should be realistic and consistent with internal cash flow forecasts.
Practical tip: revised estimates of cash flows

An entity may need periodically to revise its estimates of future payments or receipts, for example to reflect changes in the expected life of the instrument. In such circumstances the entity will need to recalculate the carrying amount of the financial asset or financial liability by computing the present value of the estimated future cash flows at the financial instrument’s original effective interest rate. The resulting gain or loss is recognised in profit or loss at the date of the revision.

It should, however, be noted that the above approach does not apply when changes in market rates of interest affect forecast cash flows on variable rate financial instruments. In such circumstances, re-estimating the future interest payments will have no effect on the carrying amount of the instrument.

Fair value
See section 6 below for guidance on measuring fair value.

Intercompany loans
As noted in section 4 above, many intercompany loans are likely to be basic financial instruments. As such they will generally be measured at amortised cost.

For a loan with fixed maturity (that cannot be prepaid early) at zero or below market interest rates, the application of the standard will mean that it will be recorded on initial recognition at less than its nominal amount, reflecting the value of a similar loan with a market rate of interest. This difference will generally be accounted for as a capital contribution or distribution, though the appropriate treatment will depend on the individual facts and circumstances in each case.

Further faculty guidance
The faculty has a range of help sheets and FAQ documents dealing with intercompany loans, directors’ loans and much more. These are available for download at icaew.com/newukgaap.
Example: interest-free intercompany loan

On 1 January 20X1, a company lends its subsidiary £5m at a zero rate of interest. The loan is repayable on 31 January 20X4. The market rate of interest for similar debt instruments is 3%.

Under old UK GAAP\(^3\), the subsidiary would simply record the loan at £5m and no interest would be recognised. However, under FRS 102 the amortised cost method must be applied with the loan initially being recognised at its present value of £5m/1.03^4 = £4,442,435 and then subsequently being accounted for as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Carrying amount at beginning of period £m</th>
<th>Interest at 3%</th>
<th>Cash outflow £m</th>
<th>Carrying amount at end of period £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>4.442</td>
<td>0.134</td>
<td>0.000</td>
<td>4.576</td>
</tr>
<tr>
<td>20X2</td>
<td>4.576</td>
<td>0.137</td>
<td>0.000</td>
<td>4.713</td>
</tr>
<tr>
<td>20X3</td>
<td>4.713</td>
<td>0.141</td>
<td>0.000</td>
<td>4.854</td>
</tr>
<tr>
<td>20X4</td>
<td>4.854</td>
<td>0.146</td>
<td>(5.000)</td>
<td>-</td>
</tr>
</tbody>
</table>

The standard is silent on how the discount of £5,000,000 - £4,442,435 = £557,565 should be treated on initial recognition. However, it would make sense for it to be recognised directly in equity, as a transaction with owners.

In this example, when the loan is from the parent to the subsidiary, the difference between the face value of the loan and the present value of the future payments discounted at the market rate of interest for a similar debt instrument will generally be accounted for as a capital contribution. If the loan is from the subsidiary to the parent, it will generally be accounted for as a distribution. For loans between subsidiaries, assuming they are made at the behest of the parent, the difference would typically be accounted for by the lender as a distribution and by the borrower as a capital contribution. In such circumstances, no entries are generally required in the parent’s accounts.

Further guidance on the appropriate accounting treatment is provided in SEN 16: Financing Transactions.

Practical tip: rolling intragroup loans with a notice period of a year and a day

Some entities and their advisors are unhappy with how intercompany loans are accounted for under FRS 102. They see the amortised cost model as cumbersome and difficult to apply. But at the same time they do not want to treat the loans as repayable on demand as this would weaken their balance sheet. They have, therefore, suggested creating loans with a rolling notice period of one year and one day. This, they claim, results in the best of both worlds as the loan is classified as non-current as it is repayable after one year but the fiddly amortised cost calculations might be avoided on the grounds of materiality. While structuring loans in this way may achieve the desired outcome in some instances, care should be taken as this may not always be the case e.g., when an entity borrows a large sum of money the effect of discounting could be material even if the term of the loan is relatively short.

Directors’ loans

Many loans between a company and its directors are likely to be basic financial instruments, although this cannot be assumed always to be the case. Basic financial instrument are measured at amortised cost, which for loans repayable immediately on demand will typically be equal to their face value. When a loan has been provided interest-free or at below market interest rates and is not repayable immediately on demand, the application of the amortised cost method will mean that the loan will be recorded on initial recognition.

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\(^3\) Assuming the company has not adopted FRS 26.
at less than its face value. The standard is silent on how this difference should be accounted for. Some guidance is, however, provided in SEN 16 Financing Transactions.

The treatment of the difference will be a matter of judgment dependent on the facts and circumstances as in many cases directors may well be owners and/or employees of the business. If directors enter into such arrangements in the capacity of owners of the business the difference will be recognised directly in equity as a capital contribution or distribution. This is consistent with the treatment of loans between a parent and its subsidiary discussed above. If, however, an interest-free loan is made to a director to enable him or her to purchase a season ticket on terms available to other members of staff, it would seem appropriate to treat the difference as an employee benefit and account for it accordingly.

**Practical tip: debt or equity**

When a director pays cash into a company it may, subject to certain criteria being met, be classified in the financial statements as equity and shown on the balance sheet within share capital and reserves. This might be the case if an apparent loan was in reality a gift, or if the terms are that the director has no right to demand repayment. However, most loans from directors will be classified as financial liabilities because these criteria are not met.

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**Impairment**

At the end of each reporting period, an entity must assess whether there is objective evidence of impairment of any financial assets that are held at cost or amortised cost. Such evidence could include observable data about any of the following loss events:

- the issuer or obligor is in significant financial difficulty;
- there has been a breach of contract, such as a default or delinquency in interest or principal payments;
- the creditor has, for economic or legal reasons relating to the debtor’s financial difficulty, granted a concession that it would not otherwise consider;
- it has become probable that the debtor will enter bankruptcy or other financial reorganisation; and
- there is observable data that there has been a measurable decrease in estimated future cash flows from a group of financial assets even though the decrease cannot yet be identified with individual assets in the group eg adverse local or national economic conditions or adverse changes in industry conditions.

Significant changes in the technological, market, economic or legal environment in which the issuer operates may also provide evidence of impairment.

When objective evidence of impairment exists, an impairment loss must be recognised immediately in profit or loss.

Financial assets can generally be assessed for impairment either individually or grouped on the basis of similar credit risk characteristics. However, any significant financial assets and all equity instruments must be assessed individually.

For financial assets measured at amortised cost – eg, some trade debtors and loans receivable – the impairment loss is the difference between the asset’s carrying amount and the present value of the estimated future cash flows discounted at the asset’s original effective interest rate (or current effective rate if the instrument has a variable rate).

For financial assets measured at cost less impairment – eg, investments in ordinary or preference shares for which fair values cannot be reliably estimated – the impairment loss is the difference between the asset’s carrying amount and the best estimate of the amount the entity would receive if the asset were sold at the reporting date.

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FRS 102 Factsheet Financial Instruments Published 17 December 2014, last updated 13 December 2016
Example: impairment of a debenture

A company holds a £300,000 nominal value 4% debenture that is redeemable in 2018 at a premium of 5%. The investment had been acquired at par on the original issue date of 1 January 2014. The effective interest rate was calculated at 4.9066%.

As at 31 December 2015 the debenture is assessed and found to be impaired due to financial difficulties of the issuer. Following the impairment it is expected that interest will no longer be paid and only the nominal value repaid on the original redemption date. Prior to impairment the amortised cost carrying value of the debenture, calculated using the effective interest method, is £305,573.

The debenture will be written down to the present value of the estimated future cash flows discounted at the asset’s original effective interest rate. As £300,000 is now receivable in three years’ time, the debenture will be written down to £300,000/1.049066^3 = £259,844. In other words, an impairment of £45,729 will be recognised.

Impairment losses must be reversed when a subsequent change in the asset’s value or expected cash flows can be objectively linked to an event after the impairment was recognised, e.g., an improvement in the debtor’s credit rating. Any reversal is recognised immediately in profit or loss.

Derecognition of financial assets

A financial asset is derecognised when it is settled, e.g., when a debtor pays what is owed. Likewise a financial asset is derecognised when the contractual rights to its cash flows expire, e.g., when the holder no longer has any entitlement to future cash flows.

If instead the financial asset is transferred to another party, the treatment will depend on whether the entity retains the risks and rewards of ownership of the transferred financial asset:

• If substantially all of the risks and rewards of ownership are transferred to another party, the asset is derecognised.

• If the entity retains significant risks and rewards of ownership of the transferred asset, it will continue to recognise the transferred asset in its entirety together with a financial liability for the consideration received. The asset and liability should not be offset.

• However, if the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party – and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without the need to impose additional restrictions on the transfer – the entity will derecognise the asset and separately recognise any rights or obligations retained or created in the transfer.

Any difference between the consideration received and the amounts recognised and derecognised is recognised in profit or loss.

Practical tip: what is meant by ‘some significant risks and rewards’?

In this context, ‘some significant risks and rewards’ is considered to be less than ‘substantially all risks and rewards’. If an entity has retained substantially all risks and rewards of ownership, it would continue to recognise the asset regardless of whether control has been transferred. This is because FRS 102’s derecognition model is primarily a risk and reward based model rather than a control based model.
Example: debt factoring that does not qualify for derecognition

X Limited sells its short-term trade debtor balances to a bank for 90% of their face value and will be entitled to further payments dependent on when the debtors pay. Any advances in respect of debtors who do not pay will ultimately have to be repaid by X Limited. In this case, the entity has retained the risk of slow payment or non-payment by the debtors. As this is a significant risk with respect to debtors, the entity has retained substantially all the risks and rewards of ownership and therefore does not treat the debtor balances as having been sold to the bank and does not derecognise them. Instead it treats the proceeds as a loan secured on the debtor balances. The debtor balances and the loan should not be netted off.

Example: debt factoring that qualifies for derecognition

Y Limited sells its short-term trade debtor balances to a bank for 90% of their face value. Y Limited continues to handle collections from the debtors on behalf of the bank. It must remit promptly to the bank any and all amounts collected but it has no obligation to the bank for slow or non-payment by the debtors. Y Limited is paid a market-rate fee for servicing the debtors.

In this case, the entity has transferred substantially all the risks and rewards of ownership to the bank. Accordingly, it removes the debtor balances from its balance sheet and recognises a loss calculated as the difference between the carrying amount at the time of sale and the proceeds received from the bank. The only liability recognised is for funds collected from the debtors that have not yet been remitted to the bank.

Derecognition of financial liabilities

Financial liabilities are derecognised when they are wholly or partially extinguished i.e., when the obligation is discharged, cancelled or expires.

If an existing borrower and lender exchange financial instruments with substantially different terms or substantially modify the terms of an existing financial instrument, the entities should account for the transaction as the extinguishment of the original financial liability and the recognition of a new financial liability. In such circumstances, the difference between the carrying amount of the financial liability extinguished and the consideration paid – including any non-cash assets transferred or liabilities assumed – is recognised in profit or loss.
Example: renegotiating loans on substantially different terms

On 1 January 20X1, an entity takes out a bank loan for £5m, incurring an arrangement fee of £100,000. Interest of £400,000 is payable annually, in arrears, over the next four years. The loan is repayable on 31 December 20X4. The effective interest rate can be calculated as 8.6121%. Assuming the loan qualifies as a basic debt instrument, it would be accounted for using the amortised cost method as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Carrying amount at beginning of period £m</th>
<th>Interest expense at 8.6121% £m</th>
<th>Cash outflow £m</th>
<th>Carrying amount at end of period £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>4.900</td>
<td>0.422</td>
<td>(0.400)</td>
<td>4.922</td>
</tr>
<tr>
<td>20X2</td>
<td>4.922</td>
<td>0.424</td>
<td>(0.400)</td>
<td>4.946</td>
</tr>
<tr>
<td>20X3</td>
<td>4.946</td>
<td>0.426</td>
<td>(0.400)</td>
<td>4.972</td>
</tr>
<tr>
<td>20X4</td>
<td>4.972</td>
<td>0.428</td>
<td>(5.400)</td>
<td>-</td>
</tr>
</tbody>
</table>

On 31 December 20X1, the bank agreed to modify the terms of the loan. Under the revised arrangement, interest payments from 20X2 to 20X4 would be reduced to £200,000. The lender charges a fee of £50,000 relating to the modification.

The present value of the revised cash flows, including the modification fee, using the original effective interest rate can be calculated as £4.462m This compares with the book value of the original loan as at 31 December 20X1 of £4.922m, a difference of £0.460m or 9.3%.

Whether or not this is considered ‘substantially different’ to the existing terms is a matter of judgement. The guidance in AG62 of IAS 39, which might be referred to when making this judgement, suggests that a difference of greater than 10% is considered to be ‘substantially different’. Therefore, the entity may conclude that there is no need to derecognise the existing loan. There is, however, no obligation to follow the guidance in IAS 39 and the entity may conclude that the revised terms are ‘substantially different’. In such circumstances, it would derecognise the existing loan and recognise a new one with a gain or loss (here, a gain) being recognised in profit or loss as appropriate. Entities will, however, need to be consistent in their approach to deciding what is and is not a substantial modification.

FRS 102 does not specify how to account for modifications that are not ‘substantial’. One view is that the new carrying amount of the debt should be determined by computing the present value of the revised cash flows at the loan’s original effective interest rate with any adjustment recognised in profit or loss at the date of the revision together with any fees incurred. Other treatments may also be acceptable.

Presentation

Financial assets and financial liabilities are offset in the statement of financial position when, and only when, an entity currently has a legally enforceable right to offset the recognised amounts and intends to either settle on a net basis or realise the asset and settle the liability simultaneously. When the conditions are met offset is required.

Disclosures

Detailed disclosures are required, including:

- disclosure of accounting policies for financial instruments;
- the carrying amounts of each category of financial asset and financial liability;
- details of any transferred financial assets that do not qualify for derecognition;
- details of any financial assets pledged as collateral for liabilities or contingent liabilities;
- details of any defaults and breaches on loans payable;
- details of income, expenses, gains and losses; and
- details of any financial instruments measured at fair value through profit or loss.

Qualifying entities that are not financial institutions are exempt from these disclosures provided equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated. The exemptions available to such entities were
amended in 2015 to take into account the fact that company law requires certain disclosures to be made in relation to financial instruments. The disclosures required for all FRS 102 reporters are similar to those required by law.

Small entities applying the small entities regime should refer to Section 1A of FRS 102 for the minimum disclosures required by company law. Further disclosures may be necessary in order to ensure that the accounts give a true and fair view.

Section 34 sets out additional disclosures about financial assets and financial liabilities for both financial institutions and retirement benefit plans.
Section 6  
Other financial instruments

Initial recognition  
Financial assets and financial liabilities are recognised when an entity becomes party to the contractual provisions of the instrument.

Initial measurement  
Other financial assets and other financial liabilities are initially measured at their fair value, which is normally the transaction price. If payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate, the initial fair value is the present value of the future payments discounted at a market rate of interest for a similar debt instrument.

Transaction costs are expensed unless the instrument is subsequently measured at amortised cost or cost less impairment.

Subsequent measurement  
Almost all ‘other’ financial instruments are measured at fair value with movements recognised in profit or loss. The exceptions are:

• Investments in equity instruments\(^4\) that are not publicly traded and whose fair value cannot be otherwise measured reliably and certain contracts linked to such investments, which are instead measured at cost less impairment. However, as noted above, in many instances it should be possible to estimate the fair value of ordinary or preference shares that do not have quoted market prices.

• Financial instruments that are not permitted by law to be measured at fair value through profit or loss, which are instead measured at amortised cost.

• Hedging instruments in designated cash flow hedge and net investment hedge arrangements. Such instruments will still be measured at fair value but the portion of the gain or loss that is determined to be an effective hedge will be recognised in other comprehensive income rather than profit or loss. See section 7 below for more details.

Practical tip: not permitted by law to be measured at fair value through profit or loss  
The Companies Act 2006 limits the circumstances in which certain financial liabilities can be measured at fair value. There is considerable debate about when and to what instruments this restriction applies. However, there is agreement that instruments that are subject to this restriction are likely to be extremely rare in practice.

Practical tip: all change?  
For entities that have not adopted FRS 26 (IAS 39) Financial Instruments: Recognition and Measurement, most derivatives would not have been recognised under old UK GAAP but simply disclosed. They will now be recognised, measured at fair value.

Practical tip: reviewing the terms of loan arrangements  
Since determining fair values can be a complex, time-consuming and expensive process, entities should carefully review the terms of any potential new loan agreements to see whether they are basic or other financial instruments. If they are the latter, consideration should be given as to whether the terms could be amended to make them basic. However, care should be taken as there could have been a number of wider reasons why loan terms have been worded in the way that they have. Changing loan terms to ‘fix’ an accounting problem may not always be appropriate. Moreover, it may be an expensive exercise.

\(^4\) Investments in most equity instruments will be within the scope of Section 11. However, certain equity instruments – such as puttable ordinary or preference shares – are within the scope of Section 12. The treatment of equity instruments is, however, the same in both cases.
Measuring fair value
As explained above, most ‘other’ financial instruments are measured at fair value with
movements recognised in profit or loss.

The following hierarchy should be used to estimate fair value:

1. The quoted price for an identical asset in an active market.
2. When quoted prices are not available, the price of a recent transaction for an identical
asset can be used to provide evidence of fair value so long as there has not been a
significant change in economic circumstances or a significant time lapse since the
transaction took place. When necessary the price can be adjusted to ensure it reflects
the entity’s best estimate of fair value.
3. If neither of the above is available, valuation techniques – such as discounted cash flow
analysis or option pricing models – should be used, the objective of which should be to
estimate what the transaction price would have been on the measurement date in an
arm’s length exchange motivated by normal business considerations.

The same approach is also applied to any basic financial instruments measured at fair value.
Financial institutions and retirement benefit plans are required to disclose an analysis of
how fair value measurements are arrived at for each class of financial instrument measured
at fair value. This analysis was originally based on the above hierarchy. However, in March
2016 the FRC issued amendments to align these disclosures more closely with the
equivalent requirements of IFRS 13 Fair Value Measurement. These amendments are
effective for accounting periods beginning on or after 1 January 2017 with early adoption
permitted. They apply only to financial institutions and retirement benefit plans. Other
entities applying FRS 102 are unaffected by these amendments.

Practical tip: establishing fair values
In some cases establishing fair value will be relatively straightforward, particularly when quoted
market prices are available. However, it will be much more challenging in other instances. Fair
valuing derivatives will often entail using complicated valuation techniques. The same will often
be true for any debt instruments that are classified as other rather than basic. In such cases
entities will need to consider how to obtain a valuation eg, asking their bank or using a
valuation package. Doing so on a timely basis is advisable.

Impairment
For other financial assets measured at amortised cost and cost less impairment, the
requirements set out in Section 11 (and discussed above) are applied.

Derecognition
The derecognition requirements set out in Section 11 (and discussed above) are applied to
both basic and other financial instruments.

Presentation
Financial assets and financial liabilities are offset in the statement of financial position when,
and only when, an entity currently has a legally enforceable right to offset the recognised
amount and intends to either settle on a net basis or realise the asset and settle the liability
simultaneously. When the conditions are met offset is required.

Disclosures
All of the disclosures described in Section 11 are also required for instruments within the
scope of Section 12. Qualifying entities that are not financial institutions are exempt from
these disclosures provided equivalent disclosures are included in the consolidated financial
statements of the group in which the entity is consolidated. The exemptions available to
such entities were amended in 2015 to take into account the fact that company law
requires certain disclosures to be made in relation to financial instruments. The disclosures
required for all FRS 102 reportees are similar to those required by law.
Small entities applying the small entities regime should refer to Section 1A of FRS 102 for the minimum disclosures required by company law. Further disclosures may be necessary in order to ensure that the accounts give a true and fair view.

Additional disclosures are required for entities using hedge accounting (see section 7 below).

Section 34 sets out additional disclosures about financial assets and financial liabilities for both financial institutions and retirement benefit plans.
Section 7

Hedge accounting

What is hedging?
Many entities engage in hedging activities to manage the risks they face. Common examples include entering into forward contracts to manage exposures to exchange rate movements or using interest rate swaps to manage exposures to interest rate movements, though some entities will be involved in more complex hedging transactions.

When an entity enters into a hedging transaction it uses a hedging instrument to manage an exposure arising from a hedged item.

A hedged item is something that exposes an entity to risk of changes in fair value or future cash flows. It could be, for example, a recognised asset or liability such as a loan with variable interest rates, an unrecognised firm commitment to buy an asset from an overseas supplier, a highly probable forecast transaction involving a commodity whose price varies on a daily basis or a net investment in a foreign operation.

A hedging instrument is typically a derivative – such as a forward contract or an interest rate swap – that mitigates the risk associated with the hedged item.

The idea is that gains or losses on the hedging instrument will offset, to varying degrees, gains or losses on the hedged item. However, under FRS 102’s normal accounting rules, these gains and losses on the hedged item and hedging instrument can end up being recorded in profit or loss in different accounting periods, resulting in earnings volatility.

It should be remembered, however, that in some instances hedge accounting will not be necessary as gains and losses on the hedged item and hedging instrument will already be recognised in profit or loss in the same period. This would be the case, for example, for short-term hedges that do not cross a reporting period.

What is hedge accounting?
The standard therefore allows entities to reduce this volatility – and better reflect their risk management processes – by voluntarily applying special hedge accounting rules provided certain criteria are met.

An entity may apply hedge accounting to a hedging relationship provided all of the following conditions are met:

- the hedging relationship consists only of a hedging instrument and a hedged item that meet certain criteria;
- the hedging relationship is consistent with the entity’s risk management objectives for undertaking hedges;
- there is an economic relationship between the hedged item and the hedging instrument;
- the entity has documented the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified; and
- the entity has determined and documented causes of hedge ineffectiveness.

An entity can choose to apply hedge accounting on a hedge by hedge basis.

The standard goes on to describe three types of hedging relationship (fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation) and how they are accounted for when an entity meets the above criteria and elects to apply hedge accounting. An appendix to Section 12 includes a number of useful numerical examples of hedge accounting.

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5 An economic relationship exists when the entity expects that the values of the hedged item and hedging instrument will typically move in opposite directions in response to the hedged risk.
**Practical tip: hedge accounting**

Any entities considering entering into hedging arrangements in the near future should also consider whether they will be eligible for hedge accounting under FRS 102 and, if so, what the accounting implications will be. Some entities may even wish to reconsider their hedging strategies in order to achieve a particular accounting objective. However, care should be taken as there are likely to be a number of wider considerations that will be involved in determining an entity’s hedging strategies.

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**Hedged items**

As noted above, a hedged item is something that exposes an entity to risk of changes in fair value or future cash flows. It can be:

- a recognised asset or liability;
- an unrecognised firm commitment;
- a highly probable forecast transaction; or
- a net investment in a foreign operation.

A hedged item can also be a component of any such item or a group of such items provided certain additional criteria are met.

Generally, only assets, liabilities, firm commitments or highly probable forecast transactions with external parties can be hedged items. There are, however, very limited circumstances in which hedge accounting can be applied in the consolidated financial statements to transactions between entities in the same group.

**Practical tip: components**

A component of an item comprises less than the entire fair value change or cash flow variability of an item. It is common in some sectors for entities to hedge risk components. For example, in the aviation sector, airlines often economically hedge their exposure to jet fuel price movements by using crude oil futures. This can be an effective hedging strategy as movements in the jet fuel price are clearly affected by movements in the crude oil price. There are, however, other factors which affect the jet fuel price so by hedging in this way the airline is only hedging some of its exposure. There could therefore be some difficult analysis in identifying the risk component before hedge accounting can be applied.

**Practical tip: groups of items**

It is common for entities to group similar items together for risk management purposes. These groups of items can be eligible hedged items provided all the items in the group are individually eligible hedged items, share the same risk and are managed together for risk management purposes.

**Practical tip: offsetting risk positions**

It is also fairly common for entities to group similar items – such as sales or purchases in the same foreign currency in the same month – together for risk management purposes and hedge the net exposure. FRS 102 specifically does not allow items with ‘offsetting risk positions’ to qualify as hedged items. In practice entities may, however, be able to achieve a similar outcome by designating part of the gross position as the hedged item.
Practical tip: hedging arrangements with other group companies

Although there is a restriction which states that generally only assets, liabilities, firm commitments or highly probable forecast transactions with external parties can be hedged, items, this is applied from the perspective of the reporting entity’s financial statements. This means different designations may be required at the entity and group level in order to achieve hedge accounting, and in some circumstances hedge accounting can be applied in the parent or subsidiary’s own accounts but not in the consolidated financial statements of the group as a whole.

Hedging instruments

An instrument may be a hedging instrument provided all of the following conditions are met:

- it is a financial instrument measured at fair value through profit or loss;
- it is a contract with a party external to the reporting entity; and
- it is not a written option.

In addition it is possible to use non-derivatives to hedge foreign exchange risk (e.g., in a net investment hedge).

Practical tip: hedging instruments

In most cases the hedging instrument will be a derivative such as a futures contract, forward contract, interest rate swap, warrant or option. However, other instruments measured at fair value through profit or loss—including items that the entity has elected to measure as such—can also be hedging instruments.

Hedge effectiveness

Hedge accounting is only permitted if there is an economic relationship between the hedged item and hedging instrument. This may in some cases be established using only qualitative analysis and does not mean that the changes in the fair value of the hedged item due to the hedged risk must be perfectly offset by changes in the fair value of the hedging instrument. However, if the offset is not perfect this will result in hedge ineffectiveness. The extent to which this ineffectiveness is recognised in profit or loss will depend on the type of hedge (see below).

Hedge ineffectiveness can arise from many sources, for example, if the timing or amount of the hedged transaction does not match that of the hedging instrument. Even when the principal terms of the hedging instrument and the hedged item are the same, an entity cannot assume the hedge will be perfectly effective. Put another way, the hedged item and hedging instrument should be measured independently and it is not appropriate to impute the value change of the hedging instrument onto the hedged item, even when the critical terms match. For example, hedge ineffectiveness may arise in practice (even when the critical terms match) due to changes in fair value affecting the hedging instrument, such as credit risk, which are not replicated in the hedged item.

Fair value hedges

A fair value hedge is the 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 that could affect profit or loss.

A fair value hedge is accounted for as follows:

- the gain or loss on the hedging instrument is recognised in profit or loss; and
- the change in the fair value of the hedged item that is attributable to the hedged risk (which is referred to as the hedging gain or loss) adjusts the carrying amount of the hedged item and is recognised in profit or loss.

When the hedged item is an unrecognised firm commitment, the cumulative hedging gain or loss is recognised as an asset or liability with a corresponding gain or loss recognised in
profit or loss. When the asset or liability that results from the firm commitment is recognised, its initial carrying amount is adjusted to include the cumulative hedging gain or loss recognised on the balance sheet.

The effect of applying hedge accounting is that the gain or loss on the hedged item is recognised in profit or loss in the same period as the corresponding loss or gain on the hedging instrument. Hence volatility in earnings is reduced.

**Example: fixed to floating rate swap**

On 1 January 20X5, an entity issues a three year £10m debenture. Interest is fixed at 3.75% with semi-annual interest payments.

On the same day, in order to hedge against movements in the fair value of the debt, the entity enters into an interest rate swap to pay LIBOR and receive interest at 3.75%. The swap terms include a £10m notional principal, three year term and semi-annual variable rate reset. The entity will effectively be paying LIBOR on the debt rather than a fixed rate. The LIBOR rate that applies for the six months ending 30 June 20X5 is 3%.

Dealer quotes give the swap a fair value before settlement of £200,000 at 30 June 20X5.

### At 1 January 20X5 – issue the debenture

Record the issuance of the debenture:

| Dr Cash | £10,000,000 |
| Cr Debenture | £10,000,000 |

### At 30 June 20X5 – period-end

Recognise change in fair value of swap:

| Dr Derivative asset | £200,000 |
| Cr Interest expense | £200,000 |

Record cash receipts on period-end settlement of swap (receive £10m × 0.75% × 6/12):

| Dr Cash | £37,500 |
| Cr Derivative asset | £37,500 |

Record change in fair value of debt due to the hedged risk (which corresponds to the change in fair value of the swap after settlement):

| Dr Interest expense | £162,500 |
| Cr Debenture | £162,500 |

Record interest paid at fixed rate (pay £10m × 3.75% × 6/12)

| Dr Interest expense | £187,500 |
| Cr Cash | £187,500 |

The overall impact is that interest expense of £150,000 is recorded in profit or loss, reflecting the LIBOR rate of 3% applicable in the period.
Cash flow hedges

A cash flow hedge is the 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 or a highly probable forecast transaction and which could affect profit or loss.

A cash flow hedge is accounted for as follows;

- a separate component of equity (which is referred to as the cash flow hedge reserve) is created;
- each reporting period the balance on the cash flow hedge reserve is adjusted to the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value of the hedged item;
- the proportion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e., the portion that is offset by the change in the cash flow reserve calculated above) is recognised in other comprehensive income; and
- any remaining gain or loss on the hedging instrument (i.e., any hedge ineffectiveness) is recognised in profit or loss.

If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability—or it becomes a firm commitment to which fair value hedge accounting applies—the entity removes the amount from the cash flow hedge reserve and adds it to the initial cost or carrying amount of the asset or liability.

Otherwise this amount is reclassified from the cash flow hedge reserve to profit or loss in the same period(s) as the expected future cash flows affect profit or loss. However, if a loss is not expected to be recovered it is reclassified to profit or loss immediately.

The effect of applying hedge accounting is that the gain or loss on the hedged item is recognised in profit or loss in the same period as the corresponding loss or gain on the hedging instrument. Hence volatility in earnings is reduced.
**Example: floating to fixed rate swap**

On 1 January 20X5, an entity issues a three year £10m debenture. Interest is variable at LIBOR with semi-annual interest payments.

On the same day, in order to hedge against variability of future cash flows, the entity enters into an interest rate swap to pay 3.75% fixed and receive LIBOR. The swap terms include a £10m notional principal, three year term and semi-annual variable rate reset.

The entity will effectively be paying a fixed rate on the debt rather than LIBOR.

The LIBOR rate that applies for the six months ending 30 June 20X5 is 3%.

Dealer quotes give the swap a fair value before settlement of minus £200,000 at 30 June 20X5.

---

**At 1 January 20X5 – issue the debenture**

Record the issuance of the debenture:

<table>
<thead>
<tr>
<th>Dr Cash</th>
<th>£10,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Debenture</td>
<td>£10,000,000</td>
</tr>
</tbody>
</table>

---

**At 30 June 20X5 – period-end**

Recognise change in fair value of swap:

<table>
<thead>
<tr>
<th>Dr Cash flow hedge reserve</th>
<th>£200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Derivative liability</td>
<td>£200,000</td>
</tr>
</tbody>
</table>

---

Record cash payments on period-end settlement of swap (pay £10m x 0.75% x 6/12):

| Dr Derivative liability    | £37,500   |
| Cr Cash                   |           |

---

Record interest paid at applicable LIBOR rate (pay £10m x 3% x 6/12):

| Dr Interest expense        | £150,000  |
| Cr Cash                   |           |

---

Release loss from equity to reflect the matching impact of the hedge:

| Dr Interest expense        | £37,500  |
| Cr Cash flow hedge reserve | £37,500  |

The overall impact is that interest expense of £187,500 is recorded in profit or loss, reflecting the fixed rate of 3.75%. This has been achieved by recognising the loss on the hedging instrument in a cash flow hedge reserve until such time as the related cash flows on the hedged item affect profit or loss. A balance of £125,000 remains in the cash flow hedge reserve at the period end.
Example: highly probable forecast transaction

On 1 January 20X5, an entity has a forecast sale of 500 tonnes of benchmark quality wheat that is expected to occur on or about 31 December 20X5.

On 4 January 20X5, the entity enters into a cash settled forward contract to sell 500 tonnes of benchmark quality wheat at £1.1 million on 31 December 20X5.

The wheat has a cost of £1 million.

On 31 December 20X5, the forward contract has a fair value of £25,000 and is closed out.

On 1 January 20X6 the entity sells the wheat for £1,075,000. The ineffectiveness caused by the delay in the sale has been ignored for illustrative purposes.

At 4 January 20X5 — enter into forward contract

At the transaction date the forward contract will have a fair value of zero.

At 31 December 20X5 — year-end

Recognise change in fair value of forward contract:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Derivative asset</td>
<td>£25,000</td>
</tr>
<tr>
<td>Cr Other comprehensive income</td>
<td>£25,000</td>
</tr>
</tbody>
</table>

Settle forward contract:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cash</td>
<td>£25,000</td>
</tr>
<tr>
<td>Cr Derivative asset</td>
<td>£25,000</td>
</tr>
</tbody>
</table>

At 1 January 20X6 — sale of wheat

Recognise sale:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cash</td>
<td>£1,075,000</td>
</tr>
<tr>
<td>Cr Stock</td>
<td>£1,000,000</td>
</tr>
<tr>
<td>Cr Profit or loss</td>
<td>£75,000</td>
</tr>
</tbody>
</table>

Release gain from equity to reflect the matching impact of the hedge:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Other comprehensive income</td>
<td>£25,000</td>
</tr>
<tr>
<td>Cr Profit or loss</td>
<td>£25,000</td>
</tr>
</tbody>
</table>

The overall effect is that the whole gain of £100,000 is recognised in the year in which the wheat is sold. At the year end, the gain on the hedging instrument remains in a cash flow hedge reserve as the forecast sale has yet to take place. As soon as it does, this gain is transferred to profit or loss.

Hedges of a net investment in a foreign operation

Hedges of a net investment in a foreign operation are accounted for in a manner similar to cash flow hedges i.e., the effective portion of the gain or loss on the hedging instrument is recognised in other comprehensive income and the ineffective portion is recognised in profit or loss.

The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in equity is not reclassified to profit or loss on disposal or partial disposal of the foreign operation.
Discontinuing hedge accounting
An entity can discontinue hedge accounting whenever it wishes provided it has documented its election to do so. Hedge accounting must, however, be discontinued if the hedging instrument has expired or is sold, terminated or exercised or if the qualifying conditions for hedge accounting are no longer met. In all cases, hedge accounting is discontinued prospectively ie, it does not alter the treatment of past gains or losses.

Disclosures
Entities using hedge accounting are required to make additional disclosures.

For each type of hedging relationship, they must disclose:

• a description of the hedge;
• a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and
• the nature of the risks being hedged, including a description of the hedged item.

There are also additional disclosures required about each of fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation.

Qualifying entities that are not financial institutions are exempt from these disclosures provided equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated. The exemptions available to such entities were amended in 2015 to take into account the fact that company law requires certain disclosures to be made in relation to financial instruments. The disclosures required for all FRS 102 reporters are similar to those required by law.

Small entities applying the small entities regime should refer to Section 1A of FRS 102 for the minimum disclosures required by company law. Further disclosures may be necessary in order to ensure that the accounts give a true and fair view.
Section 8
Transition

Introduction
Section 35 Transition to FRS 102 provides guidance to entities adopting FRS 102 for the first time. While full retrospective application is the norm, there are certain exceptions to this rule, including a general exemption in any case when this would be impracticable. There are also certain exemptions that can be applied when preparing a first set of financial statements under FRS 102.

Derecognition of financial assets and financial liabilities
One of the exceptions to full retrospective application relates to derecognising financial assets and financial liabilities. This means that:
• Financial instruments derecognised under an entity’s previous GAAP before the date of transition are not allowed to be recognised on adoption of FRS 102.
• Financial instruments that were not derecognised under an entity’s previous GAAP in a transaction that took place before the date of transition, but that would have been derecognised under FRS 102, may either be derecognised on adoption of FRS 102 or kept on the balance sheet until they are disposed of or settled.

Designating debt instruments at fair value
Provided certain criteria are met, FRS 102 permits financial instruments to be designated on initial recognition as financial assets and financial liabilities measured at fair value through profit or loss. The transitional arrangements also allow entities to designate financial instruments as such as at their date of transition provided the relevant criteria are met at that date i.e., an entity applying the standard for the first time for the year ending 31 December 2016 could, when preparing its 2016 financial statements, designate instruments at fair value through profit or loss as at 1 January 2015.

Hedging relationships
A first-time adopter can choose to apply hedge accounting to an eligible hedging relationship which exists on the date of transition provided the first three of the five qualifying conditions outlined on page 20 of this factsheet are met on the date of transition and the remaining two conditions are met no later than the date the first financial statements that comply with FRS 102 are authorised for issue. Significantly, hedging documentation does not have to be in place at the date of transition.

A similar exemption is available on transition for hedging relationships that commence after the date of transition. In such cases, hedge accounting can be applied from the date when those same three conditions are met, so long as the remaining two conditions are again met no later than the date on which the first financial statements that comply with FRS 102 are authorised for issue.

Practical tip: hedge documentation
To meet the hedge accounting requirements for hedging arrangements existing at the transition date, FRS 102 as originally issued was sometimes interpreted as requiring that the hedging relationship must be designated and documented by the transition date. Moreover, there were no specific exemptions to the standard’s transition requirements.

However, the amendments made to the standard in July 2014 introduced a new exemption that allows entities to apply hedge accounting to such arrangements provided that the documentation is in place by no later than the date the first financial statements that comply with FRS 102 are authorised for issue. The same timeframe applies to documenting hedging relationships that commenced after the date of transition.

This means that entities will now have up to 33 months after their transition date to create their hedge documentation.

Further faculty factsheets
The factsheets Preparing to Transition to FRS 102 and From FRSE to FRS 102 provide a more detailed explanation of the issues arising on transition to FRS 102.
A first-time adopter may also elect not to adjust the carrying amount of an asset or liability for previous GAAP accounting effects of a hedging relationship that has ceased to exist before the date of transition because the hedging instrument has expired, was sold, terminated or exercised prior to the date of transition.

Additional exemptions for small entities
A small entity that first adopts FRS 102 for an accounting period that commences before 1 January 2017 need not restate comparative information to comply with:

- fair value measurement requirements of Sections 11 and 12, unless those financial instruments were measured at fair value in accordance with the small entity’s previous accounting framework;
- requirements relating to financing transactions involving related parties such as intragroup and directors’ loans.

In both instances, relevant instruments will still need to be measured at fair value at the beginning of the first reporting period in which FRS 102 is applied, so the exemption offers only a temporary respite.

Practical tip: who can benefit from these additional exemptions?
These additional exemptions are available only to small entities adopting the September 2015 version of FRS 102. They are available to all qualifying small entities irrespective of whether they choose to adopt the small entities regime.

Practical tip: small entities and related party balances
Under the FRSSE related party balances would have been recognised initially at cost, whereas FRS 102 requires initial recognition at the present value of the future payments discounted at the market rate of interest for a similar debt instrument. The above exemption means that comparative information will not have to be restated; however, the balance will need to be adjusted to present value at the start of the first reporting period under the new regime. This adjustment can be based on the present value of the financial asset or liability at the start of that first reporting period using the facts and circumstances at that date, rather than when the arrangement was entered into. This is helpful, as in some cases it will avoid entities having to estimate a market rate of interest from many years ago. Many small entities will no doubt want to take advantage of this exemption.

Practical tip: wider implications
A number of the changes relating to financial instruments introduced by FRS 102 will affect tax payable and distributable profits.

Guidance on the impact on distributable profits is available in Tech 05/16 Exposure draft of updated guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006.

Guidance on the tax implications of FRS 102 is available on the HMRC website.
Contacts and further help

Factsheets for faculty members
This factsheet is part of a series designed to provide practical help for Financial Reporting Faculty members in exercising their professional judgement.

The faculty cannot offer interpretations of standards or give views on the application of standards to particular companies or transactions.

The faculty’s standards trackers
To double-check for current standards and recent amendments go to the faculty’s standards trackers at: icaew.com/frfstandardstracker.

Factsheets
Topics covered by other factsheets include:
• An introduction to FRS 102
• Preparing to Transition to FRS 102
• UK Regulation for Company Accounts – 2016

A complete list of factsheets can be found here:
icaew.com/frffactsheets

Factsheet comments and suggestions
To comment on factsheets, or to suggest topics that you’d like to see covered by factsheets, email us at frfac@icaew.com

The faculty website (icaew.com/frf)
Our website contains details of recent developments, faculty publications, and all the current topics of debate.

Use the faculty’s online community
The faculty’s online community gives members the opportunity to discuss financial reporting issues with their peers, ask questions, and find answers. You can use the blogging facility to ask questions on a specific issue, or search to see if the same topic is already under discussion.

The Financial Reporting Faculty
The faculty aims to help members keep up to date with the implications of new standards, regulations and practice in financial reporting.

Our international community of financial reporting professionals also contribute to ICAEW’s work in influencing the development of financial reporting concepts, standards and regulation.

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