FINANCIAL
REPORTING
FACULTY

FAQ

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HEDGE ACCOUNTING UNDER FRS 102

The Financial Reporting Faculty answers your initial questions on hedge accounting under the new UK GAAP regime

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 of the UK standards it replaces. Section 12 of the standard allows reporting entities to apply hedge accounting if certain criteria are met.

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1. 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 and using interest rate swaps to manage exposures to interest rate movements, although some entities will be involved in more complex hedging transactions.

When an entity enters into a hedging transaction, it uses a hedging instrument (which is typically a derivative instrument) to manage an exposure arising from a 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.

2. What is hedge accounting?

Under FRS 102's normal accounting rules, the 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. 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.

3. What criteria do I have to meet to qualify for hedge accounting?

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 ie, 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;
- 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.

4. What is a hedged item?

A hedged item is something that exposes an entity to a 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 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.

5. What is a hedging instrument?

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.

While most hedging instruments are derivatives, it is possible to use non-derivatives to hedge foreign exchange risk (eg, in a net investment hedge).

6. What types of hedging relationships does FRS 102 cover?

The standard describes three types of hedging relationship, namely:

- fair value hedges;
- cash flow hedges; and
- hedges of a net investment in a foreign operation.

It also explains how each type of hedge is accounted for when an entity meets the above criteria and elects to apply hedge accounting.

7. Can I pick and choose when to apply hedge accounting?

Yes. Hedge accounting is optional. Moreover, an entity can choose to apply hedge accounting on a hedge by hedge basis.

8. Does the standard include any numerical examples?

Yes. An appendix to Section 12 includes a number of useful numerical examples of hedge accounting.

9. Can I still record foreign currency debtors and creditors using a contract rate?

No. SSAP 20 allows entities to use the rate in a matching forward contract to translate a matched transaction but this option is not permitted under the new regime. Instead, the debtor or creditor will have to be recorded at the spot rate. The matching forward contract will also be recognised on-balance sheet and will be measured at fair value through profit or loss. This may result in gains and losses being recorded in different accounting periods than under previous UK GAAP. It may also have tax implications.

10. How and when do I discontinue 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.

11. What disclosures are required?

Entities using hedge accounting are required to make a number of 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.

12. What transitional requirements are there?

A first-time adopter can choose to apply hedge accounting to an eligible hedging relationship which exists on the date of transition to FRS 102 provided the first three of the five qualifying conditions listed above 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.

13. Are FRS 102's requirements the same as those of IFRS 9 *Financial Instruments*?

No. Although the requirements are based on the hedge accounting requirements of IFRS 9, they have been simplified with the aim of making hedge accounting easier to apply. There are some important differences between the two standards, for example the qualifying conditions are much simpler under FRS 102 as no quantitative assessment of hedge effectiveness is required.

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