July 2014

Amendments to FRS 102
The Financial Reporting Standard applicable in the UK and Republic of Ireland
Basic financial instruments and Hedge accounting

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Amendments to FRS 102
The Financial Reporting Standard applicable in the UK and Republic of Ireland
Basic financial instruments and Hedge accounting
Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Basic financial instruments and Hedge accounting is issued by the Financial Reporting Council in respect of its application in the United Kingdom and promulgated by the Institute of Chartered Accountants in Ireland in respect of its application in the Republic of Ireland.
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Summary

(i) In 2012, 2013 and 2014 the Financial Reporting Council (FRC) revised financial reporting standards in the United Kingdom and Republic of Ireland. The revisions fundamentally reformed financial reporting, replacing the extant standards with four Financial Reporting Standards:

(a) FRS 100 Application of Financial Reporting Requirements;
(b) FRS 101 Reduced Disclosure Framework;
(c) FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland; and
(d) FRS 103 Insurance Contracts.

(ii) The FRC has now made limited amendments to FRS 102 in respect of the classification conditions for basic debt instruments and hedge accounting. The amendments come into effect for financial years beginning on or after 1 January 2015, the same date FRS 102 becomes effective.

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

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

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

Basic financial instruments

(v) After the publication of FRS 102 in March 2013 entities and their advisers considered the effects of implementing the requirements of FRS 102 in more detail. In the process they discovered that the conditions attached to the classification of basic debt instruments may have unintended accounting consequences. These potential problems had not been identified during the consultations preceding the issue of FRS 102.

(vi) The conditions, as set out in FRS 102, were considered by constituents as overly and unnecessarily restrictive, with the consequence that in practice some common and relatively simple financial assets and liabilities would be measured at fair value. In the view of constituents measurement of these financial instruments at fair value would be unnecessary, since a measurement at amortised cost would capture the risks associated with these instruments adequately. It was also highlighted that IFRS permits the measurement of these instruments at amortised cost.

(vii) Under these amendments prescriptive conditions apply to determine the classification of debt instruments accounted for in accordance with Section 11 Basic Financial
Instruments. However, the conditions have been made more permissive, and thereby the scope of permissible contractual terms has been broadened. The amendments have the following intended effects:

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

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

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

**Hedge accounting**

(viii) These amendments to FRS 102 are issued in accordance with the FRC’s previously stated plans to update the requirements for hedge accounting in FRS 102 once the IASB had finalised the new hedge accounting requirements in IFRS 9.

(ix) The hedge accounting requirements in FRS 102 defined a narrow set of permitted arrangements that may qualify for hedge accounting. The amendments remove these restrictions by adopting hedge accounting models that are similar to those of IFRS 9. The amendments are intended to achieve the following:

(a) to allow entities to apply hedge accounting when this reflects their economic and risk management strategies;

(b) to use concepts and language that are, as far as possible, consistent with those included in IFRS 9; and

(c) to introduce hedge accounting requirements that are as straightforward to apply as possible, without onerous conditions.

**Footnote numbering**

(x) The amendments to FRS 102 include an insertion of a footnote. When these amendments are incorporated into FRS 102, the footnote numbering in FRS 102 will be updated sequentially.
Amendments to Financial Reporting Standard FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

**Basic financial instruments and Hedge accounting**

1. The following sections set out the amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (deleted text is struck through, inserted text is underlined).
Amendments to Section 1

Scope

2 Paragraph 1.12(c) is amended as follows:

(c) The requirements of Section 11 paragraphs 11.39 to 11.48A and Section 12 paragraphs 12.26 to 12.29A providing the equivalent disclosures required by this FRS are included in the consolidated financial statements of the group in which the entity is consolidated.

3 Paragraphs 1.14A and 1.14B are inserted below paragraph 1.14:

1.14A This FRS permits a financial instrument (provided it meets certain criteria) to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss. Entities that have applied this FRS in financial statements authorised for issue prior to 1 August 2014 are permitted in their first financial statements authorised for issue on or after 1 August 2014 to designate, as at the date of transition to this FRS, any financial asset or financial liability at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 11.14(b) at that date. Entities that have applied this FRS in financial statements authorised for issue prior to 1 August 2014 are permitted in their first financial statements authorised for issue on or after 1 August 2014 to de-designate any financial asset or financial liability previously designated at fair value through profit or loss and classify and measure the financial instrument in accordance with Section 11.

1.14B This FRS permits entities to apply hedge accounting, provided certain qualifying conditions are met. Entities that have applied this FRS in financial statements authorised for issue prior to 1 August 2014 are permitted to apply hedge accounting to a hedging relationship existing on or before 31 July 2014 as set out in Section 12 of this FRS from a date no earlier than the conditions of paragraphs 12.18(a) to (c) are met, provided the conditions of paragraphs 12.18(d) and (e) are met no later than the date the first financial statements issued on or after 1 August 2014 are authorised for issue. This choice applies to each hedging relationship existing on or before 31 July 2014. This choice only applies in respect of the first financial statements that comply with this FRS that are authorised for issue on or after 1 August 2014.

In a fair value hedge the cumulative hedging gain or loss on the hedged item from the date hedge accounting commenced, shall be recorded in retained earnings (or if appropriate, another category of equity). In a cash flow hedge and net investment hedge, the lower of the following (in absolute amounts) shall be recorded in equity (in respect of cash flow hedges in the cash flow hedge reserve):

(a) the cumulative gain or loss on the hedging instrument from the date hedge accounting commenced to the reporting date of the last financial statements authorised for issue prior to 1 August 2014; and

(b) the cumulative change in fair value (ie the present value of the cumulative change of expected future cash flows) on the hedged item from the date hedge accounting commenced to the reporting date of the last financial statements authorised for issue prior to 1 August 2014.
Amendments to Section 11  
*Basic Financial Instruments*

4  Paragraph 11.6(c) is amended as follows:

   (c) financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in Section 12; and

5  Paragraph 11.8(b) is amended as follows:

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

6  Paragraph 11.9 is amended as follows:

   A debt instrument that satisfies all of the conditions in accordance with paragraph 11.8(b) is accounted for in accordance with Section 11:

   (a) The contractual returns to the holder (the lender), assessed in the currency in which the debt instrument is denominated, are as follows:

      (i) a fixed amount;

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

      (iii) variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR) or [not used]

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

   (aA) The contract may provide for repayments of the principal or the return to the holder to be linked to a single relevant observable index of general price inflation of the currency in which the debt instrument is denominated, provided such links are not leveraged.

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

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

         (1) a change of a contractual variable rate;

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

         (3) changes in levies applied by a central bank or arising from changes in relevant taxation or law; or

      (ii) the new rate is a market rate of interest and satisfies condition (a).
Contractual terms that give the lender the unilateral option to change the terms of the contract are not determinable for this purpose.

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

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

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

(ii) the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law.

The inclusion of contractual terms that, as a result of the early termination, require the issuer to compensate the holder for the early termination does not, in itself, constitute a breach of this condition.

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

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

7 A footnote is inserted as indicated in paragraph 11.9(a)(ii) as follows:

[Footnote 11]

11 A variable rate for this purpose is 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.

8 The following examples are inserted below paragraph 11.9:

<table>
<thead>
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<th>Examples – Debt instruments</th>
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<tr>
<td>1 A zero-coupon loan</td>
</tr>
<tr>
<td>For a zero-coupon loan, the holder’s return is the difference between the nominal value of the loan and the issue price. The holder (lender) receives a fixed amount when the loan matures and the issuer ( borrower) repays the loan. The return to the holder meets the condition of paragraph 11.9(a)(i).</td>
</tr>
<tr>
<td>2 A fixed interest rate loan with an initial tie-in period which reverts to the bank’s standard variable interest rate after the tie-in period</td>
</tr>
<tr>
<td>The initial fixed rate is a return permitted by paragraph 11.9(a)(ii). A bank’s standard variable interest rate is an observable interest rate and, in accordance with the definition of a variable rate, is a permissible link. In accordance with paragraph 11.9(a)(ii) the variable rate should be a positive rate.</td>
</tr>
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8 Amendments to FRS 102: Basic financial instruments and Hedge accounting (July 2014)
The variation of the interest rate after the tie-in period is non-contingent and since the new rate (ie the bank’s standard variable rate) meets the condition of paragraph 11.9(a), paragraph 11.9(aB)(i) is met.

3 A loan with interest payable at the bank’s standard variable rate plus 1 per cent throughout the life of the loan

As discussed under Example 2 above, a bank’s standard variable rate is a permitted variable rate in accordance with the definition of variable rate. The combination of a positive fixed rate (ie plus 1 per cent) and a positive variable rate is a permitted return under paragraph 11.9(a)(iv). The combination of a bank’s standard variable rate plus a fixed interest rate of 1 per cent therefore meets the condition in paragraph 11.9(a)(iv).

4 A loan with interest payable at the bank’s standard variable rate less 1 per cent throughout the life of the loan, with the condition that the interest rate can never fall below 2 per cent

Paragraph 11.9(aB)(i)(a) permits variation of a return to a holder (lender) that is contingent on a change of a contractual variable rate. In this example the contractual variable rate is the bank’s standard variable rate. The variation of the return to the holder is between the bank’s standard variable rate less 1 and 2 per cent, depending on the bank’s standard variable rate. For example, if the bank’s standard variable rate is less than 3 per cent, the return to the holder is fixed at 2 per cent; if the bank’s standard variable rate is higher than 3 per cent, the return to the holder is the bank’s standard variable rate less 1 per cent. The contractual variation meets the condition of paragraph 11.9(aB)(i)(1).

The holder is protected against the risk of losing the principal amount of the loan via the interest rate floor of 2 per cent. The requirement of paragraph 11.9(b) is therefore also met.

5 Interest on a loan is referenced to 2 times the bank’s standard variable rate

In accordance with the definition of a variable rate, the contractual interest rate payable can be linked to a single observable interest rate. A bank’s standard variable rate is an observable rate and meets the definition of a variable rate, but the rate in this example is 2 times the bank’s standard variable rate and the link to the observable interest rate is leveraged. Therefore, the rate in this example is not a variable rate as described in paragraph 11.9(a). The instrument is measured at fair value in accordance with Section 12.

6 Interest on a loan is charged at 10 per cent less 6-month LIBOR over the life of the loan

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

Under paragraph 11.9(a)(iv) the combination of positive or negative fixed rate and positive variable rate is a permitted return. The variable rate (6-month LIBOR) meets the definition of a variable rate, as the rate is a quoted interest rate. However, since the variable rate is negative (minus 6-month LIBOR), the rate is in breach of paragraph 11.9(a)(iv). The instrument is measured at fair value in accordance with Section 12.
Interest on a GBP denominated mortgage is linked to the UK Land Registry House Price Index (HPI) plus 3 per cent.

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

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

Paragraphs 11.11(a), 11.11(b) and 11.11(c) are amended as follows:

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

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

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

Paragraph 11.14(b) is amended as follows:

(b) Debt instruments that meet the conditions in paragraph 11.8(b) and commitments to receive a loan and to make a loan to another entity that meet the conditions in paragraph 11.8(c) may upon their initial recognition be designated by the entity as at fair value through profit or loss (paragraphs 11.27 to 11.32 provide guidance on fair value) provided doing so results in more relevant information, because either:
Amendments to Section 12
Other Financial Instruments Issues

11 Paragraphs 12.8(a), 12.8(b) and 12.8(c) are amended as follows:

(a) investments in equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment; and

(b) hedging instruments hedging instruments in a designated hedging relationship accounted for in accordance with paragraph 12.23; and

(c) financial instruments that are not permitted by the Regulations or the LLP Regulations to be measured at fair value through profit or loss shall be measured at amortised cost in accordance with paragraphs 11.15 to 11.20.


Hedge accounting

12.15 If specified criteria are met, an entity may designate a hedging relationship between a hedging instrument and a hedged item in such a way as to qualify for hedge accounting. A hedging relationship consists of a hedging instrument and a hedged item. Provided the qualifying conditions in paragraph 12.18 are met, an entity may apply hedge accounting.

Hedged items

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

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

(b) the hedged risk is one of the risks specified in paragraph 12.17;

(c) the hedging instrument is as specified in paragraph 12.18; and

(d) the entity expects the hedging instrument to be highly effective in offsetting the designated hedged risk. The effectiveness of a hedge is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation, or a component of any such item, provided the item is reliably measurable.
For hedge accounting purposes, only assets, liabilities, firm commitments or a highly probable forecast transaction with a party external to the reporting entity can be a hedged item. Hedge accounting can be applied to transactions between entities in the same group only in the individual financial statements of those entities, except for:

(a) transactions with subsidiaries, where the subsidiaries are not consolidated in the consolidated financial statements;

(b) the foreign currency risk of intragroup monetary items that result in an exposure to foreign exchange gains or losses that are not fully eliminated on consolidation in accordance with Section 30 Foreign Currency Translation; and

(c) the foreign currency risk of highly probable forecast intragroup transactions, provided the transactions are denominated in a currency other than the functional currency of the entity entering into the transactions and the foreign currency risk affects consolidated profit or loss.

A group of items, including components of items, can be an eligible hedged item provided that all of the following conditions are met:

(a) it consists of items that are individually eligible hedged items;
(b) the items in the group share the same risk;
(c) the items in the group are managed together on a group basis for risk management purposes; and
(d) it does not include items with offsetting risk positions.

A component of an item comprises less than the entire fair value change or cash flow variability of an item. The following components of an item (including combinations thereof) may be a hedged item:

(a) changes in the cash flows or fair value attributable to a separately identifiable and reliably measureable specific risk or risks, including cash flow and fair value changes above or below a specified price or other variable;

(b) one or more selected contractual cash flows; or

(c) a specified part of the nominal amount of an item.

Hedging instruments

This FRS permits hedge accounting only for the following risks:

(a) interest rate risk and foreign exchange risk of a debt instrument measured at amortised cost;

(b) foreign exchange and interest rate risk in a firm commitment or a highly probable forecast transaction;

(c) price risk of a commodity that the entity holds or price risk in a firm commitment or highly probable forecast transaction to purchase or sell a commodity; and

(d) foreign exchange risk in a net investment in a foreign operation.

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

(a) it is a financial instrument measured at fair value through profit or loss;

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

(c) it is not a written option, except as described in paragraph 12.17C.
An instrument (or a combination of such instruments) meeting the conditions of paragraph 12.17, may only be a hedging instrument:
(a) in its entirety; or
(b) a proportion of such an instrument or a proportion of a combination of such instruments, eg 50 per cent of the nominal amount of the instrument.

For a hedge of foreign currency risk, the foreign currency risk component of a financial instrument, provided that it is not a financial instrument as described in paragraph 11.6(b), may be a hedging instrument.

A written option is not a hedging instrument unless the written option is an offset to or is combined with a purchased option and the effect of the offset or combination is not a net written option. An example of a combination of a written and a purchased option that is not a net written option is a zero cost interest rate collar.

Conditions for hedge accounting

This FRS permits hedge accounting only if the hedging instrument meets all of the following terms and conditions:
(a) it is an interest rate swap, a foreign currency swap, a cross currency interest rate swap, a forward or future foreign currency exchange contract, a forward or future commodity exchange contract, or any financial instrument used to hedge foreign exchange risk in a foreign operation, provided it is expected to be highly effective in offsetting the designated hedged risk(s) as identified in paragraph 12.17;
(b) it involves a party external to the reporting entity (ie external to the group, segment or individual entity being reported on);
(e) its **notional amount** is equal to the designated amount of the principal or notional amount of the hedged item;
(d) it has a specified maturity date not later than:
   (i) the maturity of the financial instrument being hedged;
   (ii) the expected settlement of the commodity purchase or sale commitment; or
   (iii) the later of the occurrence and settlement of the highly probable forecast foreign currency or commodity transaction being hedged; and
(e) it has no prepayment, early termination or extension features other than at fair value.

An entity may apply hedge accounting to a hedging relationship from the date all of the following conditions are met:
(a) the hedging relationship consists only of a hedging instrument and a hedged item as described in paragraphs 12.16 to 12.17C;
(b) the hedging relationship is consistent with the entity’s risk management objectives for undertaking hedges;
(c) there is an economic relationship between the hedged item and the hedging instrument;
(d) the entity has documented the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified; and
(e) the entity has determined and documented causes of hedge ineffectiveness.
12.18A An economic relationship between a hedged item and hedging instrument exists when the entity expects that the values of the hedged item and hedging instrument will typically move in opposite directions in response to movements in the same risk, which is the hedged risk.

Hedge of fixed interest rate risk or foreign exchange risk of a recognised financial instrument or commodity price risk in a firm commitment or of a commodity held

Accounting for qualifying hedging relationships

12.19 If the conditions in paragraph 12.16 are met and the hedged risk is the exposure to a fixed interest rate risk or foreign exchange risk of a debt instrument measured at amortised cost or the commodity price risk of a commodity that it holds or has a firm commitment, the entity shall:

(a) recognise the hedging instrument as an asset or liability and the change in the fair value of the hedging instrument in profit or loss; and
(b) recognise the change in the fair value of the hedged item related to the hedged risk in profit or loss and as an adjustment to the carrying amount of the hedged item.

There are three types of hedging relationships:

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

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

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

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

Fair value hedges

12.20 If the hedged risk is the fixed interest rate risk of a debt instrument measured at amortised cost, the entity shall recognise the periodic net cash settlements on the interest rate swap that is the hedging instrument in profit or loss in the period in which the net settlements accrue.

A fair value hedge shall be accounted for as follows from the date the conditions in paragraph 12.18 are met:

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

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

12.21 The entity shall discontinue the hedge accounting specified in paragraph 12.19 if:

(a) the hedging instrument expires or is sold or terminated;
(b) the hedge no longer meets the conditions for hedge accounting specified in paragraph 12.16; or

e) the entity revokes the designation.

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

12.22 If hedge accounting is discontinued and the hedged item is an asset or liability carried at amortised cost that has not been derecognised, any gains or losses recognised as adjustments to the carrying amount of the hedged item are amortised into profit or loss using the effective interest method over the remaining life of the hedged instrument.

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

Hedge of variable interest rate risk or foreign exchange risk of a recognised financial instrument, foreign exchange risk or interest rate risk in a firm commitment or highly probable forecast transaction or commodity price risk in a highly probable forecast transaction, or foreign exchange risk in a net investment in a foreign operation

Cash flow hedges

12.23 If the conditions in paragraph 12.16 are met and the hedged risk is:

(a) the variable interest rate risk or foreign exchange risk in a debt instrument measured at amortised cost;

(b) the foreign exchange risk or interest rate risk in a firm commitment or a highly probable forecast transaction;

(c) the commodity price risk in a highly probable forecast transaction; or

(d) the foreign exchange risk in a net investment in a foreign operation;

the entity shall recognise in other comprehensive income the portion of the change in the fair value of the hedging instrument that was effective in offsetting the change in the fair value or expected cash flows of the hedged item. The entity shall recognise in profit or loss any excess (in absolute terms) of the cumulative change in fair value of the hedging instrument since inception of the hedge over the cumulative change in the fair value of the expected cash flows of the hedged item since inception of the hedge (sometimes called hedge ineffectiveness). The hedging gain or loss recognised in other comprehensive income shall be reclassified to profit or loss when the hedged item is recognised in profit or loss or when the hedging relationship ends. However, the cumulative amount of any exchange differences that relate to a hedge of a net investment in a foreign operation recognised in other comprehensive income shall not be reclassified to profit or loss on disposal or partial disposal of the foreign operation.

A cash flow hedge shall be accounted for as follows from the date the conditions in paragraph 12.18 are met:

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

(i) the cumulative gain or loss on the hedging instrument from the date the conditions of paragraph 12.18 are met; and
(ii) the cumulative change in fair value on the hedged item (ie the present value of the cumulative change of expected future cash flows) from the date the conditions of paragraph 12.18 are met;

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

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

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

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

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

(iii) if the amount is a loss, and all or part of that loss is not expected to be recovered, the amount of the loss not expected to be recovered shall be reclassified to profit or loss immediately.

Hedges of a net investment in a foreign operation

12.24 If the hedged risk is the variable interest rate risk in a debt instrument measured at amortised cost, the entity shall subsequently recognise in profit or loss the periodic net cash settlements from the interest rate swap that is the hedging instrument in the period in which the net settlements accrue.

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see Section 30), shall be accounted for similarly to cash flow hedges from the date the conditions of paragraph 12.18 are met:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income (see paragraphs 12.23(a) and (b)); and

(b) the ineffective portion shall be 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 shall not be reclassified from equity to profit or loss on disposal or partial disposal of the foreign operation.

Discontinuing hedge accounting

12.25 The entity shall discontinue the hedge accounting specified in paragraph 12.23 if:

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

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

16 Amendments to FRS 102: Basic financial instruments and Hedge accounting (July 2014)
(c) in a hedge of a forecast transaction, the forecast transaction is no longer highly probable; or
(d) the entity revokes the designation.

If the forecast transaction is no longer expected to take place or if the hedged debt instrument measured at amortised cost is derecognised, any gain or loss on the hedging instrument that was recognised in other comprehensive income shall be reclassified from other comprehensive income to profit or loss.

The entity may discontinue hedge accounting provided the entity has documented its election.

The entity shall discontinue hedge accounting when:
(a) the hedging instrument has expired, is sold, terminated or exercised; or
(b) the conditions for hedge accounting in paragraph 12.18 are no longer met.

In all cases, hedge accounting shall be discontinued prospectively.

12.25A In a fair value hedge, any adjustment arising from paragraph 12.20(b) is dealt with in accordance with paragraph 12.22.

In a cash flow hedge, if the hedged future cash flows are no longer expected to occur, the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 12.23(a) shall be reclassified from the cash flow hedge reserve to profit or loss immediately. If the hedged future cash flows are still expected to occur (for example a future cash flow that is no longer highly probable may still be expected to occur), the cumulative gain or loss in the cash flow hedge reserve is dealt with in accordance with paragraph 12.23(d).

In a net investment hedge, in accordance with paragraph 12.24, the amount that has been accumulated in equity is not reclassified to profit or loss.

Presentation

12.25AB A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:
(a) currently has a legally enforceable right to set off the recognised amounts; and
(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Disclosures

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

12.27 An entity shall disclose the following separately for hedges of each of the four types of risks hedging relationship described in paragraph 12.179:
(a) a description of the hedge;
(b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and

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

12.28 If an entity uses hedge accounting for a hedge as described in paragraphs 12.19 to 12.22 it shall disclose the following:

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

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

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

12.29 If an entity uses hedge accounting for a hedge as described in paragraphs 12.23 to 12.25 it shall disclose the following:

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

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

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

(c) the amount of the change in fair value of the hedging instrument that was recognised in other comprehensive income during the period (paragraph 12.23);

(d) the amount, if any, that was reclassified from other comprehensive income to profit or loss for the period (paragraphs 12.23 and 12.25); and

(e) the amount, if any, of any excess of the fair value of the hedging instrument over the change in the fair value of the expected cash flows that was recognised in profit or loss for the period (paragraph 12.24).

12.29A If an entity uses hedge accounting for a net investment in a foreign operation it shall disclose separately the amounts recognised in other comprehensive income in accordance with paragraph 12.24(a) and the amounts recognised in profit or loss in accordance with paragraph 12.24(b).
Appendix to Section 12

Examples of hedge accounting

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

Example 1

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

In accordance with paragraph 12.19A, a hedge of the foreign currency risk of an unrecognised firm commitment may be accounted for as a cash flow or fair value hedge. This example illustrates fair value hedge accounting.

12A.1 On 9 June 20X5 an entity enters into a purchase agreement with a third party over a non-financial asset in a foreign currency (FC) for FC515,000. On the same day, the entity enters into a forward currency contract to buy FC500,000 for CU1,000,000. Under the purchase agreement, the non-financial asset will be delivered and paid for on 30 March 20X6, the same day the forward currency contract is required to be settled.

In this example the hedged item is the total of the commitment of FC515,000 and the hedging instrument is the forward contract to buy FC500,000. Since the nominal amounts of the two contracts do not match, hedge ineffectiveness arises. It should be noted that in practice an entity could avoid ineffectiveness arising for this reason by identifying an amount of FC500,000 of the total commitment as the hedged item in accordance with paragraph 12.16C.

For simplification, this example disregards other sources of ineffectiveness, eg counter party credit risk associated with the forward currency contract.

The entity's financial year ends on 31 December.

This example assumes that the qualifying conditions for hedge accounting in paragraph 12.18 are met from 9 June 20X5.

The table below sets out the applicable forward exchange rates, the fair value of the forward currency contract (the hedging instrument) and the hedging gains/losses on the purchase commitment (the hedged item) on the relevant dates. This example ignores the effects of discounting.
<table>
<thead>
<tr>
<th></th>
<th>9 Jun 20X5</th>
<th>31 Dec 20X5</th>
<th>30 Mar 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward exchange</td>
<td>2:1</td>
<td>2.2:1</td>
<td>2.16:1</td>
</tr>
<tr>
<td>rate (CU:FC)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Forward currency</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>contract (hedging instrument)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value</td>
<td>nil</td>
<td>FC500,000 ×</td>
<td>FC500,000 ×</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU0.2:FC =</td>
<td>CU0.16:FC =</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU100,000</td>
<td>CU80,000</td>
</tr>
<tr>
<td>Fair value change</td>
<td>nil</td>
<td>CU100,000 – 0 =</td>
<td>CU80,000 –</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>CU100,000 =</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(CU20,000)</td>
</tr>
<tr>
<td><strong>Purchase commitment (hedged item)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cumulative</td>
<td>nil</td>
<td>(FC515,000) ×</td>
<td>(FC515,000) ×</td>
</tr>
<tr>
<td>hedging (loss)‡</td>
<td></td>
<td>CU0.2:FC =</td>
<td>CU0.16:FC =</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(CU103,000)</td>
<td>(CU82,400)</td>
</tr>
<tr>
<td>Hedging (loss)/gain</td>
<td>nil</td>
<td>(CU103,000) – 0 =</td>
<td>(CU82,400) –</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(CU103,000) =</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(CU20,600)</td>
</tr>
</tbody>
</table>

Key to table:

‡: This is the fair value of the contract prior to settlement.
‡: In accordance with paragraph 12.20(b), the commitment is fair valued only for the hedged risk, which in this example is the forward exchange rate risk.

12A.2 Hedge accounting:

Note that there are no hedge accounting entries on 9 June 20X5.

31 December 20X5

(1) In accordance with paragraph 12.20(a) the fair value gain of CU100,000 on the forward currency contract is recognised in profit or loss.

(2) In accordance with paragraph 12.20(b) the cumulative hedging loss of CU103,000 on the commitment is recorded as a liability with a corresponding loss recognised in profit or loss.

**Accounting entries:**

<table>
<thead>
<tr>
<th>Ref</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Forward currency contract</td>
<td>CU100,000</td>
</tr>
<tr>
<td></td>
<td>Profit or loss</td>
<td>CU100,000</td>
</tr>
<tr>
<td>(2)</td>
<td>Profit or loss</td>
<td>CU103,000</td>
</tr>
<tr>
<td></td>
<td>Hedged item (commitment)</td>
<td>CU103,000</td>
</tr>
</tbody>
</table>
30 March 20X6

(1) In accordance with paragraph 12.20(a) the fair value loss of CU20,000 on the forward currency contract is recognised in profit or loss.

(2) In accordance with paragraph 12.20(b) the hedging gain on the commitment of CU20,600 is recognised in profit or loss with a corresponding adjustment to the recognised liability from CU103,000 to CU82,400.

(3) In accordance with paragraph 12.21 the non-financial asset’s carrying amount is adjusted to include the cumulative hedging loss on the hedged item of CU82,400.

Note A: For illustrative purposes the accounting entry in respect of the settlement of the forward currency contract in cash for CU80,000 is shown below.

Note B: For illustrative purposes the accounting entry for the purchase of the non-financial asset at the applicable spot rate of FC2.16:CU for CU1,080,000 (settled in cash) is shown below.

**Accounting entries:**

<table>
<thead>
<tr>
<th>Ref</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Profit or loss</td>
<td>CU20,000</td>
</tr>
<tr>
<td></td>
<td>Forward currency contract</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU20,000</td>
</tr>
<tr>
<td>(2)</td>
<td>Hedged item (commitment)</td>
<td>CU20,600</td>
</tr>
<tr>
<td></td>
<td>Profit or loss</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU20,600</td>
</tr>
<tr>
<td>(3)</td>
<td>Hedged item (commitment)</td>
<td>CU82,400</td>
</tr>
<tr>
<td></td>
<td>Property, plant and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>equipment (PP&amp;E)</td>
<td>CU82,400</td>
</tr>
<tr>
<td>(A)</td>
<td>Cash</td>
<td>CU80,000</td>
</tr>
<tr>
<td></td>
<td>Forward currency contract</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU80,000</td>
</tr>
<tr>
<td>(B)</td>
<td>Property, plant and</td>
<td>CU10,080,000</td>
</tr>
<tr>
<td></td>
<td>equipment (PP&amp;E)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>CU10,080,000</td>
</tr>
</tbody>
</table>
Example 2

Cash flow hedge accounting – Hedge of variability in cash flows in a floating rate loan due to interest rate risk

This example illustrates the accounting for a cash flow hedge of interest rate risk associated with a floating rate loan. The entity borrows money at a floating rate and enters into an interest rate swap with the effect of paying a fixed rate overall.

12A.3 On 1 January 20X5, an entity borrows CU10,000,000 from a bank at a floating rate of 3-month LIBOR plus 2.5 per cent. The interest is payable annually in arrears on 31 December. The loan is repayable on 31 December 20X7.

On 1 January 20X5 the entity also enters into an interest rate swap with a third party, under which it receives 6-month LIBOR and pays a fixed rate of interest of 4.5 per cent. The notional amount of the swap is CU10,000,000. The swap is settled annually in arrears on 31 December and expires on 31 December 20X7.

The LIBOR rates on the loan and the interest rate swap are reset and fixed annually in advance on 31 December based on the expected LIBOR rates applicable at that time. Note that in practice the loan and swap interest rates would be reset more frequently than assumed for the purpose of simplification in this example.

The entity hedges the variability of the interest rate payments on the bank loan based on 3-month LIBOR. It should be noted that because the entity receives interest based on 6-month LIBOR under the interest rate swap, ineffectiveness will arise because the expected cash flows of the hedged item and the hedging instrument differ. The fair value of the interest rate swap may be affected by other factors that cause ineffectiveness, for example counter party credit risk, but these have been disregarded in this example.

There are no transaction costs.

The entity's financial year ends on 31 December.

This example assumes that the qualifying conditions for hedge accounting in paragraph 12.18 are met from 1 January 20X5.

The table in paragraph 12A.5 summarises the impact of hedge accounting on the interest rate swap, profit or loss and other comprehensive income.

The table below sets out the applicable LIBOR rates, interest payments and swap settlements. The fair values of the interest rate swap and the hedged item shown in the table are shown for illustrative purposes only.

Note that in practice, when forecasted variable interest rate payments are the hedged item, the fair value of a hypothetical swap, that would be expected to perfectly offset the hedged cash flows, is used as a proxy of the fair value of the hedged item. The hypothetical derivative in this scenario is a fixed to floating interest rate swap with terms that match those of the loan and a fixed rate of 4.3 per cent, which for the purpose of this example, is the interest rate where the fair value of the hypothetical swap is nil at the inception of the hedging relationship.
<table>
<thead>
<tr>
<th></th>
<th>1 Jan 20X5</th>
<th>31 Dec 20X5</th>
<th>31 Dec 20X6</th>
<th>31 Dec 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual 3-month LIBOR</td>
<td>4.3%</td>
<td>5%</td>
<td>3%</td>
<td>n/a</td>
</tr>
<tr>
<td>Actual 6-month LIBOR</td>
<td>4.5%</td>
<td>4.9%</td>
<td>3.2%</td>
<td>n/a</td>
</tr>
<tr>
<td>Interest payments based on 3-month LIBOR</td>
<td>n/a</td>
<td>CU10m × (4.3% + 2.5%) = CU680,000</td>
<td>CU10m × (5% + 2.5%) = CU750,000</td>
<td>CU10m × (3% + 2.5%) = CU550,000</td>
</tr>
<tr>
<td>Interest rate swap (hedging instrument)</td>
<td>Fair value</td>
<td>nil</td>
<td>CU78,000</td>
<td>(CU89,000)²</td>
</tr>
<tr>
<td></td>
<td>Fair value change</td>
<td>nil</td>
<td>CU78,000 – 0 = CU78,000</td>
<td>(CU89,000) – CU78,000 = (CU167,000)</td>
</tr>
<tr>
<td></td>
<td>Swap settlement receipts/ (payments) based on 6-month LIBOR</td>
<td>n/a</td>
<td>CU10m × (4.5% – 4.5%) = 0</td>
<td>CU10m × (4.9% – 4.5%) = CU40,000</td>
</tr>
<tr>
<td>Hedged item</td>
<td>Fair value</td>
<td>nil</td>
<td>(CU137,000)</td>
<td>CU59,000</td>
</tr>
</tbody>
</table>

Key to table:

¹: This valuation is determined before the receipt of the cash settlement of CU40,000 due on 31 December 20X6.

²: This valuation is determined before the payment of the cash settlement of CU130,000 due on 31 December 20X7.

³: CU40,000 is the settlement of the interest rate swap as at 31 December 20X6 which affects the fair value of the swap, but is not included in the fair value of the swap at 31 December 20X6 of CU89,000.

12A.4 Hedge accounting:

31 December 20X5

(1) In accordance with paragraph 12.23(a), the cash flow hedge reserve is adjusted to the lower of (in absolute amounts) the cumulative gain on the hedging instrument (ie the interest rate swap), which equals its fair value, of CU78,000 and the cumulative change in fair value of the hedged item, which equals its fair value of (CU137,000).

In accordance with paragraph 12.23(b), the gain of CU78,000 on the interest rate swap is recognised in other comprehensive income.

(2) The fixed interest element on the hypothetical swap is CU430,000, the same amount as the variable rate component. The variability of the 3-month LIBOR did therefore not affect profit or loss during the period. The reclassification
adjustment in accordance with paragraph 12.23(d)(ii) is nil. (Note that no accounting entry is shown below.)

Note A: For illustrative purposes the accounting entry for interest payments is shown below. Note that in practice the accrual and payment of interest may be recorded in separate accounting entries.

**Accounting entries:**

Note that the accounting entries shown are only those relevant to demonstrate the effects of hedge accounting. In practice other accounting entries would be required, eg an entry to recognise the loan liability.

<table>
<thead>
<tr>
<th>Ref</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Interest rate swap</td>
<td>CU78,000</td>
</tr>
<tr>
<td></td>
<td>Other comprehensive income</td>
<td></td>
</tr>
<tr>
<td>(A)</td>
<td>Profit or loss</td>
<td>CU680,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
</tr>
</tbody>
</table>

31 December 20X6

(1) In accordance with paragraph 12.23(a), the cash flow hedge reserve is adjusted to the lower of (in absolute amounts) the cumulative loss on the hedging instrument (ie the interest rate swap) which equals its fair value of (CU89,000) and the cumulative change in fair value of the hedged item, which equals its fair value of CU59,000. The cash flow hedge reserve moves from CU78,000 to (CU59,000), a change of (CU137,000).

In accordance with paragraph 12.23(b), a loss of CU137,000 on the interest rate swap is recognised in other comprehensive income, as this part of the loss is fully off-set by the change in the cash flow hedge reserve. The remainder of the loss on the interest rate swap of CU30,000 is recognised in profit or loss, as required by paragraph 12.23(c).

(2) The fixed interest element on the hypothetical swap is CU430,000, whilst the variable rate component is CU500,000. The variability of the 3-month LIBOR affects profit or loss during the period by CU70,000. Accordingly, the reclassification adjustment in accordance with paragraph 12.23(d)(ii) is CU70,000.

Note A: For illustrative purposes the accounting entry for interest payments is shown below. Note that in practice the accrual and payment of interest may be recorded in separate accounting entries.

Note B: For illustrative purposes the accounting entry for the settlement of the swap is shown below.
Accounting entries:

<table>
<thead>
<tr>
<th>Ref</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Other comprehensive income</td>
<td>CU137,000</td>
</tr>
<tr>
<td></td>
<td>Profit or loss</td>
<td>CU30,000</td>
</tr>
<tr>
<td></td>
<td>Interest rate swap</td>
<td>CU167,000</td>
</tr>
<tr>
<td>(2)</td>
<td>Other comprehensive income</td>
<td>CU70,000</td>
</tr>
<tr>
<td></td>
<td>Profit or loss</td>
<td>CU70,000</td>
</tr>
<tr>
<td>(A)</td>
<td>Profit or loss</td>
<td>CU750,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>CU750,000</td>
</tr>
<tr>
<td>(B)</td>
<td>Cash</td>
<td>CU40,000</td>
</tr>
<tr>
<td></td>
<td>Interest rate swap</td>
<td>CU40,000</td>
</tr>
</tbody>
</table>

31 December 20X7

(1) In accordance with paragraph 12.23(a), the cash flow hedge reserve is adjusted to the lower of (in absolute amounts) the cumulative loss on the hedging instrument (ie the interest rate swap) which equals the fair value of (CU130,000) and the cumulative change in fair value of the hedged item, which equals its fair value of CU130,000.

The cash flow hedge reserve moves from (CU129,000) to (CU130,000), a change of (CU1,000). In accordance with paragraph 12.23(b), the loss of CU1,000 on the interest rate swap is recognised in other comprehensive income.

(2) The fixed interest element on the hypothetical swap is CU430,000, whilst the variable rate component is CU300,000. The variability of the 3-month LIBOR affects profit or loss during the period by (CU130,000). Accordingly, the reclassification adjustment in accordance with paragraph 12.23(d)(ii) is (CU130,000).

Note A: For illustrative purposes the accounting entry for interest payments is shown below. Note that in practice the accrual and payment of interest may be recorded in separate accounting entries.

Note B: For illustrative purposes the accounting entry for the settlement of the swap is shown below.
### Accounting entries:

<table>
<thead>
<tr>
<th>Ref</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Other comprehensive income</td>
<td>CU1,000</td>
</tr>
<tr>
<td></td>
<td>Interest rate swap</td>
<td>CU1,000</td>
</tr>
<tr>
<td>(2)</td>
<td>Profit or loss</td>
<td>CU130,000</td>
</tr>
<tr>
<td></td>
<td>Other comprehensive income</td>
<td></td>
</tr>
<tr>
<td>(A)</td>
<td>Profit or loss</td>
<td>CU550,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>CU550,000</td>
</tr>
<tr>
<td>(B)</td>
<td>Interest rate swap</td>
<td>CU130,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>CU130,000</td>
</tr>
</tbody>
</table>

12A.5 The table below summarises the effects of the accounting entries shown in paragraph 12A.4 on the interest rate swap, profit or loss and other comprehensive income.

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest rate swap</th>
<th>Other comprehensive income</th>
<th>Profit or loss</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>31 December 20X5</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening balance</td>
<td>nil</td>
<td>nil</td>
<td>–</td>
</tr>
<tr>
<td>Interest on the loan</td>
<td></td>
<td></td>
<td>CU680,000</td>
</tr>
<tr>
<td>Interest rate swap fair value movement</td>
<td>CU78,000</td>
<td>(CU78,000)</td>
<td>–</td>
</tr>
<tr>
<td>Closing balance</td>
<td>CU78,000</td>
<td>(CU78,000)</td>
<td>–</td>
</tr>
<tr>
<td><strong>31 December 20X6</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening balance</td>
<td>CU78,000</td>
<td>(CU78,000)</td>
<td>–</td>
</tr>
<tr>
<td>Interest on the loan</td>
<td></td>
<td></td>
<td>CU500,000</td>
</tr>
<tr>
<td>Interest rate swap fair value movement</td>
<td>(CU167,000)</td>
<td>CU137,000</td>
<td>CU30,000</td>
</tr>
<tr>
<td>Settlement receipt interest rate swap</td>
<td>(40,000)</td>
<td></td>
<td>–</td>
</tr>
<tr>
<td>Reclassification from cash flow hedge reserve</td>
<td></td>
<td></td>
<td>CU70,000</td>
</tr>
<tr>
<td>Closing balance</td>
<td>(CU129,000)</td>
<td>CU129,000</td>
<td>–</td>
</tr>
</tbody>
</table>

26 Amendments to FRS 102: Basic financial instruments and Hedge accounting (July 2014)
<table>
<thead>
<tr>
<th>Description</th>
<th>Interest rate swap</th>
<th>Other comprehensive income</th>
<th>Profit or loss</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>31 December 20X7</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening balance</td>
<td>(CU129,000)</td>
<td>CU129,000†</td>
<td>=</td>
</tr>
<tr>
<td>Interest on the loan</td>
<td></td>
<td></td>
<td>CU550,000</td>
</tr>
<tr>
<td>Interest rate swap movement</td>
<td>(1,000)</td>
<td>1,000</td>
<td>=</td>
</tr>
<tr>
<td>Settlement payment interest rate swap</td>
<td>CU130,000</td>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td>Reclassification from cash flow hedge reserve</td>
<td>=</td>
<td>(CU130,000)</td>
<td>CU130,000</td>
</tr>
<tr>
<td><strong>Closing balance</strong></td>
<td>nil</td>
<td>nil†</td>
<td>=</td>
</tr>
</tbody>
</table>

Key to table:

†: This is the balance of the cash flow hedge reserve.
Example 3

Hedge accounting: Net investment in a foreign operation

*This example illustrates the accounting for a net investment hedge in the consolidated financial statements. The entity has a foreign operation and hedges its exposure to foreign currency risk in the foreign operation by the use of a foreign currency loan.*

12A.6 On 1 April 20X5 an entity with functional currency CU acquires an investment in an overseas subsidiary (with functional currency FC) at a cost of FC1,200,000. On the same day the entity takes out a loan with a third party of FC1,200,000 to finance the investment. This example disregards the effects of interest or other transaction costs associated with the loan.

This example assumes that the carrying amount of the investment denominated in FC is impaired below FC1,200,000 as presented in the table below, which causes ineffectiveness.

The entity’s financial year ends on 31 December.

This example assumes that the qualifying conditions for hedge accounting in paragraph 12.18 are met from 1 April 20X5.

The table below sets out the applicable exchange rates, the carrying amount of the loan and the foreign exchange gains and losses on the loan as determined in accordance with Section 30, as well as the retranslation differences on the foreign investment recognised in other comprehensive income in accordance with Section 30.

<table>
<thead>
<tr>
<th>Date</th>
<th>Spot exchange rate CU:FC</th>
<th>Loan (hedging instrument)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1 Apr 20X5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(FC1,200,000) × CU0.35:FC=</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(CU420,000)</td>
</tr>
<tr>
<td>Carrying amount under Section 30</td>
<td>nil</td>
<td></td>
</tr>
<tr>
<td>Cumulative gain/loss</td>
<td>nil</td>
<td>(CU360,000) – (CU420,000) = CU60,000</td>
</tr>
<tr>
<td>Gain/(loss)</td>
<td>nil</td>
<td>(CU360,000) – (CU420,000) = CU60,000</td>
</tr>
</tbody>
</table>
### Investment in foreign operation (hedged item)

<table>
<thead>
<tr>
<th></th>
<th>1 Apr 20X5</th>
<th>31 Dec 20X5</th>
<th>31 Dec 20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retranslation difference in accordance with Section 30</td>
<td>nil</td>
<td>(CU55,000)†</td>
<td>CU157,500‡</td>
</tr>
<tr>
<td>Cumulative retranslation differences</td>
<td>nil</td>
<td>(CU55,000) – 0 = (CU55,000)</td>
<td>CU157,500 + (CU55,000) = CU102,500</td>
</tr>
</tbody>
</table>

**Key to table:**

†: This is the exchange difference referred to in paragraph 30.20 which is recognised in other comprehensive income. The amount under paragraph 30.20(a) is CU5,000 and under paragraph 30.20(b) (CU60,000). The calculation is based on the translation of the FC200,000 loss at the average rate of 0.325CU:FC.

‡: This is the exchange difference referred to in paragraph 30.20 which is recognised in other comprehensive income. The amount under paragraph 30.20(a) is CU7,500 and under paragraph 30.20(b) CU150,000. The calculation is based on the translation of the FC100,000 profit at the average rate of 0.375CU:FC.

### 12A.7 Hedge accounting:

#### 31 December 20X5

A component of equity is adjusted to the lower of (in absolute amounts) the cumulative exchange gain on the loan of CU60,000 and the cumulative retranslation difference on the net investment of (CU55,000).

In accordance with paragraph 12.24(a), a gain of CU55,000 on the loan is recognised in other comprehensive income. The remainder of the gain of CU5,000 is recognised in profit or loss, as required by paragraph 12.24(b).

**Accounting entry:**

Note that only the accounting entry in relation to hedge accounting as described in paragraph 12.24 is shown. Other accounting entries in relation to the loan and the investment in the foreign operation would be required in practice.
31 December 20X6

A component of equity is adjusted to the lower of (in absolute amounts) the cumulative exchange loss on the loan of CU120,000 and the cumulative exchange difference on the net investment of CU102,500.

The amount recorded in equity changes from CU55,000 to (CU102,500), a change of (CU157,500). In accordance with paragraph 12.24(a) a loss of CU157,500 on the loan is recognised in other comprehensive income. The remainder of the loss of CU22,500 is recorded in profit or loss, as required by paragraph 12.24(b).

**Accounting entry:**

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other comprehensive income</td>
<td>CU157,500</td>
<td></td>
</tr>
<tr>
<td>Profit or loss</td>
<td>CU22,500</td>
<td></td>
</tr>
<tr>
<td>Loan</td>
<td></td>
<td>CU180,000</td>
</tr>
</tbody>
</table>
Amendments to Section 13
Inventories

13 Paragraph 13.12 is amended as follows:

13.12 Paragraph 12.19(b) provides that, in some circumstances, the change in the fair value of the hedging instrument in a hedge of fixed interest rate risk or commodity price risk of a commodity held adjusts the carrying amount of the commodity. [not used]
Amendments to Section 35

Transition to this FRS

14 Paragraph 35.9(b) is amended as follows:

(b) **Hedge accounting:**
An entity shall not change its hedge accounting before the date of transition to this FRS for hedging relationships that no longer exist at the date of transition. For hedging relationships that exist at the date of transition, the entity shall follow the hedge accounting requirements of Section 12 Other Financial Instruments Issues, including the requirements for discontinuing hedge accounting for hedging relationships that do not meet the conditions of Section 12. [not used]

15 Paragraph 35.10(s) is amended and paragraph 35.10(t) is inserted below paragraph 35.10(s) as follows:

(s) **Designation of previously recognised financial instruments**
This FRS permits a financial instrument (provided it meets certain criteria) to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss. Despite this an entity is permitted to designate, as at the date of transition to this FRS, any financial asset or financial liability at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 11.14 (b) at that date.

(t) **Hedge accounting**

(i) **A hedging relationship existing on the date of transition**
A first-time adopter may choose to apply hedge accounting to a hedging relationship of a type described in paragraph 12.19 which exists on the date of transition between a **hedging instrument** and a **hedged item**, provided the conditions of paragraphs 12.18(a) to (c) are met on the date of transition to this FRS and the conditions of paragraphs 12.18(d) and (e) are met no later than the date the first financial statements that comply with this FRS are authorised for issue. This choice applies to each hedging relationship existing on the date of transition.

Hedge accounting as set out in Section 12 Other Financial Instruments Issues of this FRS may commence from a date no earlier than the conditions of paragraphs 12.18(a) to (c) are met. In a fair value hedge the cumulative **hedging gain or loss** on the hedged item from the date hedge accounting commenced to the date of transition, shall be recorded in retained earnings (or if appropriate, another category of equity). In a cash flow hedge and net investment hedge, the lower of the following (in absolute amounts) shall be recorded in equity (in respect of cash flow hedges in the cash flow hedge reserve):

(a) the cumulative gain or loss on the hedging instrument from the date hedge accounting commenced to the date of transition; and

(b) the cumulative change in fair value (ie the present value of the cumulative change of expected future cash flows) on the hedged item from the date hedge accounting commenced to the date of transition.

(ii) **A hedging relationship that 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**
A first-time adopter may 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.
A first-time adopter may elect to account for amounts deferred in equity in a cash flow hedge under a previous GAAP, as described in paragraph 12.23(d) from the date of transition. Any amounts deferred in equity in relation to a hedge of a net investment in a foreign operation under a previous GAAP shall not be reclassified to profit or loss on disposal or partial disposal of the foreign operation.

(iii) **A hedging relationship that commenced after the date of transition**

A first-time adopter may elect to apply hedge accounting to a hedging relationship of a type described in paragraph 12.19 that commenced after the date of transition between a hedging instrument and a hedged item, starting from the date the conditions of paragraphs 12.18(a) to (c) are met, provided that the conditions of paragraphs 12.18(d) and (e) are met no later than the date the first financial statements that comply with this FRS are authorised for issue.

The choice applies to each hedging relationship that commenced after the date of transition.

(iv) **Entities taking the accounting policy choice under paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) to apply IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments**

A first-time adopter adopting an accounting policy set out in paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) shall not apply the transitional provisions of paragraphs (i) to (iii) above. Such a first-time adopter shall apply the transitional requirements applicable to hedge accounting in IFRS 1 *First–time adoption of International Financial Reporting Standards*, paragraphs B4-B6, except that the designation and documentation of a hedging relationship may be completed after the date of transition, and no later than the date the first financial statements that comply with this FRS are authorised for issue, if the hedging relationship is to qualify for hedge accounting from the date of transition.

A first-time adopter adopting an accounting policy set out in paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) that has entered into a hedging relationship as described in IAS 39 or IFRS 9 in the period between the date of transition and the reporting date for the first financial statements that comply with this FRS may elect to apply hedge accounting prospectively from the date all qualifying conditions for hedge accounting in IAS 39 or IFRS 9 are met, except that an entity shall complete the formal designation and documentation of a hedging relationship no later than the date the first financial statements that comply with this FRS are authorised for issue.
Amendments to Appendix I: Glossary

16 The following glossary terms and definitions are deleted:

<table>
<thead>
<tr>
<th>effectiveness of a hedge</th>
<th>The degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.</th>
</tr>
</thead>
<tbody>
<tr>
<td>hedged item</td>
<td>For the purpose of special hedge accounting under Section 12 of this FRS, a hedged item is:</td>
</tr>
<tr>
<td></td>
<td>(a) interest rate risk of a debt instrument measured at amortised cost;</td>
</tr>
<tr>
<td></td>
<td>(b) foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction;</td>
</tr>
<tr>
<td></td>
<td>(c) price risk of a commodity that the entity holds or price risk in a firm commitment or highly probable forecast transaction to purchase or sell a commodity; or</td>
</tr>
<tr>
<td></td>
<td>(d) foreign exchange risk in a net investment in a foreign operation.</td>
</tr>
<tr>
<td>hedging instrument</td>
<td>For the purpose of special hedge accounting under Section 12 of this FRS, a hedging instrument is a financial instrument that meets all of the following terms and conditions:</td>
</tr>
<tr>
<td></td>
<td>(a) it is an interest rate swap, a foreign currency swap, a cross currency interest rate swap, a forward or future foreign currency exchange contract, a forward or future commodity exchange contract, or any financial instrument used to hedge foreign exchange risk in a net investment in a foreign operation; provided it is expected to be highly effective in offsetting the designated hedged risk(s) identified in paragraph 12.17.</td>
</tr>
<tr>
<td></td>
<td>(b) it involves a party external to the reporting entity (ie external to the group, segment or individual entity being reported on).</td>
</tr>
<tr>
<td></td>
<td>(c) its notional amount is equal to the designated amount of the principal or notional amount of the hedged item.</td>
</tr>
<tr>
<td></td>
<td>(d) it has a specified maturity date not later than (i) the maturity of the financial instrument being hedged, (ii) the expected settlement of the commodity purchase or sale commitment, or (iii) the later of the occurrence and settlement of the highly probable forecast foreign currency or commodity transaction being hedged.</td>
</tr>
</tbody>
</table>
(e) it has no prepayment, early termination or extension features other than at fair value.

An entity that chooses to apply IAS 39 *Financial Instruments: Recognition and Measurement* (as adopted in the EU) in accounting for financial instruments shall apply the definition of a hedging instrument in that standard rather than this definition.

17 The following glossary term and definition are inserted below “group reconstruction”.

| hedging gain or loss | The change in fair value of a hedged item that is attributable to the hedged risk. |
Amendments to Appendix II: Significant Differences Between FRS 102 and the IFRS for SMEs

18 The following amendments are made to the table:

<table>
<thead>
<tr>
<th>Section</th>
<th>Changes to the IFRS for SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Scope of this FRS</td>
<td>This section of the IFRS for SMEs has been replaced. The IFRS for SMEs applies to small and medium sized entities that do not have public accountability and publish general purpose financial statements. FRS 100 <em>Application of Financial Reporting Requirements</em> sets out the scope of entities applying this FRS. Paragraphs 1.14A and 1.14B are added to provide transitional provisions in respect of the designation of financial instruments at fair value and hedge accounting which are available to entities that have authorised for issue financial statements compliant with this FRS prior to 1 August 2014.</td>
</tr>
<tr>
<td>11 Basic Financial Instruments</td>
<td>The scope of §Section 11 is amended to clarify that certain financial instruments are not within its scope. Paragraph 11.8(b) is amended to clarify that instruments as described in paragraph 11.6(b) are not debt instruments accounted for under Section 11. Paragraph 11.9(a) is amended to clarify the permissible contractual returns to the lender. Paragraph 11.9(aA) is added to include some contractual provisions that provide for a linkage of repayments and/or returns to the lender based on inflation. Paragraph 11.9(aB) is added to permit certain variations of the return to the holder during the life of the instrument. Paragraph 11.9(c) is amended to clarify that contractual prepayment provisions which are contingent future events exclude those which protect the holder from credit deterioration, changes in central bank levies or tax changes and to clarify when compensation payments do not breach the condition. The text of paragraph 11.9(d) is deleted as it is no longer needed. Paragraph 11.9(e) is added to permit certain contractual extension options. Examples are inserted after paragraph 11.9 to illustrate the application of paragraph 11.9. Paragraphs 11.11(b) and (c) are deleted as the instruments shown as examples are excluded from debt instruments within the scope of Section 11 under paragraph 11.8(b). Paragraph 11.14(b) is inserted to clarify that entities may choose to designate debt instruments and loan...</td>
</tr>
<tr>
<td>Section</td>
<td>Changes to the IFRS for SMEs</td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td></td>
<td>commitments as fair value through profit or loss under certain circumstances.</td>
</tr>
<tr>
<td></td>
<td>Paragraph 11.38A is inserted to allow offsetting of certain financial assets and financial liabilities in the statement of financial position.</td>
</tr>
<tr>
<td></td>
<td>Paragraph 11.48A is inserted to provide disclosures required in accordance with the Regulations for financial instruments that are not held as part of a trading portfolio and are not derivatives.</td>
</tr>
<tr>
<td></td>
<td>Paragraphs 11.48B and 11.48C require additional disclosures for financial institutions.</td>
</tr>
<tr>
<td>12</td>
<td>Other Financial Instruments Issues</td>
</tr>
<tr>
<td></td>
<td>The scope of Section 12 is amended to exclude financial instruments issued by an entity with a discretionary participation feature, reimbursement assets and financial guarantee contracts.</td>
</tr>
<tr>
<td></td>
<td>Paragraph 12.8(c) is added to clarify when financial instruments within the scope of Section 12 should not be measured at amortised cost.</td>
</tr>
<tr>
<td></td>
<td>Paragraphs 12.15 to 12.29 are deleted and replaced with paragraphs 12.15 to 12.29A to include revised hedge accounting requirements which have the following effect:</td>
</tr>
<tr>
<td></td>
<td>(a) the scope of permissible hedged items and hedging instruments is expanded;</td>
</tr>
<tr>
<td></td>
<td>(b) the hedge accounting conditions are revised and simplified;</td>
</tr>
<tr>
<td></td>
<td>(c) it determines three hedge accounting models, ie cash flow, fair value and net investment hedges;</td>
</tr>
<tr>
<td></td>
<td>(d) it clarifies that the cumulative amount of foreign exchange differences relating to a hedge of a net investment in a foreign operation is not reclassified to profit or loss on disposal or partial disposal; and</td>
</tr>
<tr>
<td></td>
<td>(e) it introduces a documentation requirement in cases of voluntary hedge accounting discontinuation.</td>
</tr>
<tr>
<td></td>
<td>Paragraph 12.23 clarifies that the cumulative amount of foreign exchange differences relating to a hedge of a net investment in a foreign operation are not reclassified to profit or loss on disposal or partial disposal.</td>
</tr>
<tr>
<td></td>
<td>Paragraph 12.25AB is inserted to allow offsetting of certain financial assets and financial liabilities in the statement of financial position.</td>
</tr>
<tr>
<td></td>
<td>Paragraph 12.26 is amended to comply with requirements set out in the Act.</td>
</tr>
<tr>
<td>Section</td>
<td>Changes to the IFRS for SMEs</td>
</tr>
<tr>
<td>---------</td>
<td>----------------------------</td>
</tr>
<tr>
<td></td>
<td>The Appendix to Section 12 is inserted to illustrate by way of example the application of the hedge accounting requirements.</td>
</tr>
<tr>
<td>13</td>
<td>Paragraphs 13.4A and 13.20A are inserted to provide guidance on inventories held for distribution at no or nominal consideration. Paragraph 13.5A is inserted to provide guidance on inventory acquired through non-exchange transactions. Paragraph 13.8A is inserted to clarify the treatment for provisions made against dismantling and restoration costs (of PPE) in the cost of inventory. Paragraph 13.12 is deleted because of the revisions to the hedge accounting requirements. Paragraph 13.15 is amended to allow for the inclusion of a cost model for agricultural produce in Section 34 Specialised Activities.</td>
</tr>
</tbody>
</table>
Amendments to Appendix IV: Note on Legal Requirements

19 Paragraph A4.12A is inserted below paragraph A4.12 and paragraph A4.13 is amended as follows:

A4.12A In limited circumstances, an entity applying this FRS to its financial instruments that are classified as non-basic in accordance with Section 11 *Basic Financial Instruments* may be prohibited, by paragraph 36 of Schedule 1 to the Regulations, to measure those financial instruments at fair value through profit or loss in accordance with the requirements of this FRS. The Regulations prohibit the measurement of certain financial instruments at fair value through profit or loss, unless the instruments could be designated for such measurement under EU-adopted IFRS. EU-adopted IFRS permits designation at fair value through profit or loss upon initial recognition for financial instruments where: doing so eliminates or reduces a measurement or recognition inconsistency; or a group of financial instruments is managed and their performance evaluated on a fair value basis; or for a hybrid financial instruments which contains a component that, if recognised separately, would meet the definition of a derivative. Paragraph 12.8(c) of this FRS is applicable to the measurement of financial instruments prohibited under the Regulations to be measured at fair value through profit or loss and requires them to be measured at amortised cost.

A4.13 ...Section 11 *Basic Financial Instruments* or...
**Amendments to Appendix VI: Republic of Ireland (RoI) Legal References**

20 The table below paragraph A6.16 is amended as follows:

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>UK References</th>
<th>Role References</th>
</tr>
</thead>
<tbody>
<tr>
<td>A4.12 and A4.12A</td>
<td>Paragraph 36 of Schedule 1 to the Regulations</td>
<td>Paragraphs 22A and 22AA of Part IIIA of the Schedule</td>
</tr>
</tbody>
</table>
Approval by the FRC

Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Basic financial instruments and Hedge accounting was approved for issue by the Financial Reporting Council on 2 July 2014, following its consideration of the Accounting Council’s Advice.
The Accounting Council's Advice to the FRC to issue Amendments to FRS 102 – Basic financial instruments and Hedge accounting

Introduction

1 This report provides an overview of the main issues that have been considered by the Accounting Council in advising the Financial Reporting Council (FRC) to issue Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Basic financial instruments and Hedge accounting.

2 The FRC, in accordance with the Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012 (SI 2012/1741), is a prescribed body for issuing accounting standards in the UK. The Foreword to Accounting Standards sets out the application of accounting standards in the Republic of Ireland.

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

   (a) it is apparent that a significant group of stakeholders has not been adequately consulted;

   (b) the necessary assessment of the impact of the proposal has not been completed, including an analysis of costs and benefits;

   (c) insufficient consideration has been given to the timing or cost of implementation; or

   (d) the cumulative impact of a number of proposals would make the adoption of an otherwise satisfactory proposal inappropriate.

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

Advice

5 The Accounting Council is advising the FRC to issue Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Basic financial instruments and Hedge accounting to:

   (a) remove the unintended accounting consequences arising for the classification of certain financial instruments. It believes these changes will result in a reduction in the cost of compliance for entities within the scope of the standard; and

   (b) to make the application of the hedge accounting requirements easier and more cost effective to apply for entities that choose to take advantage of this option.

6 The Accounting Council's Advice to the FRC in FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland is supplemented by the inclusion of its advice on these amendments.

Background

7 The FRC issued FRS 102 in March 2013, which is effective for accounting periods beginning on or after 1 January 2015.

8 After the publication of FRS 102, feedback from constituents indicated that the implementation of the accounting requirements of FRS 102 for loans with common contractual features could have unintended consequences for many entities. The amendments to Section 11 Basic Financial Instruments address the issues identified...
and take into account responses to FRED 54 Draft Amendments to FRS 102 Financial Reporting Standard applicable in the UK and Ireland – Basic financial instruments.

9 At the time of issue of FRS 102, the Accounting Council and the FRC were of the view that the standard should reflect up-to-date thinking on hedge accounting, but the IASB had not yet finalised the hedge accounting requirements in IFRS 9 Financial Instruments. The Accounting Council advised the FRC at that time that amending the hedge accounting requirements in FRS 102 prior to the IASB finalising the hedge accounting requirements in IFRS 9, would risk implementing hedge accounting requirements in FRS 102 that were inconsistent with IFRS.

10 The hedge accounting amendments to FRS 102 were developed based on the hedge accounting requirements in IFRS 9 and take into account the responses to FRED 51 Draft Amendments to FRS 102 Financial Reporting Standard applicable in the UK and Ireland – Hedge Accounting.

Objective

11 The FRC gives careful consideration to its objective and the intended effects when developing new accounting standards or requirements for the UK and Republic of Ireland. In developing accounting standards, including FRS 102, the overriding objective of the FRC is:

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

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

(a) have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;

(b) reflect up-to-date thinking and developments in the way businesses operate and the transactions they undertake;

(c) balance consistent principles for accounting by all UK and Republic of Ireland entities with practical solutions, based on size, complexity, public interest and users’ information needs;

(d) promote efficiency within groups; and

(e) are cost-effective to apply.

Basic financial instruments

Rules vs principles-based solution

13 The classification of financial instruments as “basic” or “other” in FRS 102 is dependent on a list of prescriptive conditions. The Accounting Council considered whether a principles-based solution to relaxing the conditions, based on the principle articulated in IFRS 9 in respect of the classification of financial assets, would be more effective, but advises retaining the rules-based conditions of FRS 102 instead, for the following reasons:

(a) the IFRS 9 principle is yet untested in practice and, at the time of giving the advice, the IASB is currently debating possible amendments to IFRS 9; and

(b) the IFRS 9 principle in relation to the classification of financial instruments only applies to financial assets. The classification conditions in FRS 102, however, apply equally to debt instruments that are assets or liabilities.
Interaction with Regulations or LLP Regulations on measurement of certain financial instruments

14 Subsequent to receiving the responses to FRED 54, the Accounting Council was made aware of an additional issue in relation to a conflict between the Regulations and LLP Regulations and the requirements in FRS 102, as originally issued, on measurement of some financial liabilities. The original text of FRS 102 could have resulted in the standard requiring certain financial liabilities to be measured at fair value where such measurement may be prohibited by the Regulations. The Regulations prohibit the measurement of financial liabilities at fair value, except for those held as part of a trading portfolio, that are derivatives or where permitted by EU-adopted IFRS.

15 For example, the original text of FRS 102 would have required certain financial liabilities, where the cash outflows are linked to non-financial variables specific to one party to the contract, to be classified as non-basic and measured at fair value. Fair value measurement is not permitted for such liabilities under EU-adopted IFRS and so would be prohibited by the Regulations.

16 Such liabilities commonly arise in insurance contracts where the amount an insurer is liable to pay depends on the occurrence of insured events specific to the insured party and its activities.

17 The Accounting Council is aware that there are divergent views on what constitutes a “non-financial variable” in other cases. For example, there is no clear consensus as to whether measures of performance such as turnover, profits or EBITDA are “non-financial variables...specific to a party to the contract”. The Accounting Council is unable to resolve this divergence as to do so would involve interpreting EU-adopted IFRS on an issue that the IFRS Interpretations Committee has so far not reached a definitive conclusion.

18 Similarly, FRS 102 would have required that financial assets which are similarly linked to non-financial variables specific to one party to the contract, be classified as non-basic and measured at fair value through profit or loss. Although Regulations permit financial assets to be classified at fair value, this classification is only available as permitted by EU-adopted IFRS, which in some cases is restricted to fair value through other comprehensive income.

19 The Accounting Council also notes that there may be other non-basic financial assets and liabilities that EU-adopted IFRS, and hence the Regulations, would not permit to be measured at fair value through profit or loss although it expected that such instruments would be rare in practice.

20 As a result, the Accounting Council advises the inclusion of an exception in Section 12 in respect of non-basic financial instruments where the Regulations would not permit the use of fair value through profit or loss, instead requiring them to be measured at amortised cost. In advising this, the Accounting Council is conscious that this exception would be applicable to a small number of entities under a narrow set of circumstances.

Loans in the social housing sector

21 In response to FRED 54, a number of respondents from the social housing sector raised concerns about the classification of certain lending arrangements common within that sector. It was noted that a number of these arrangements were structured in different ways but often to achieve the same economic outcome. After detailed consideration the Accounting Council advises that a loan cannot be classified as basic if it includes contractual terms giving the lender the unilateral option to change the terms of that loan, for example from a pre-determined fixed rate to a variable rate or to a different fixed rate chosen by the lender, even if the holder can avoid it by repaying the loan.
Structured financial instruments

22 In response to FRED 54, a number of respondents raised questions about the classification of certain financial instruments that were structured in a complex way and requested that the final amendment clarify their classification in accordance with FRS 102. The Accounting Council noted that such structured financial instruments are not based on contracts that are standardised across an industry. As a result, the repayment of principal and interest on such loans can be impacted in a complex way by a number of different variables defined in the contractual terms. The Accounting Council noted that it was not possible to conclude on the classification of such financial instruments without a close reading of the individual contracts and an understanding of the detailed clauses. Therefore, the Accounting Council advises that the reporting entity’s directors should apply their judgement to determine whether the contractual terms enable a financial instrument to be classified as basic in accordance with the requirements in FRS 102.

Classification subsequent to initial recognition

23 The Accounting Council noted that the initial classification assessment of a financial instrument should take into account the relevant clauses dealing with the returns and any subsequent contractual variations relating to returns, prepayments and extensions of terms etc. Once the classification of a financial instrument is determined at initial recognition, no re-assessment is required at subsequent dates unless there is a modification of contractual terms.

Hedge accounting

24 The previous hedge accounting requirements in FRS 102 narrowly defined the types of permitted arrangements that may qualify for hedge accounting, which was not necessarily representative of an entity’s risk management objectives and hedging practices.

25 The Accounting Council’s aim was to develop new hedge accounting requirements that allow for a reflection of an entity’s hedging activities in the financial statements that is consistent with the entity’s risk management objectives and are, as far as appropriate for constituents of FRS 102, consistent with IFRS.

26 These amendments to FRS 102 have been developed on the basis of IFRS, and substantively adopt the terminology and hedge accounting requirements in IFRS 9, with notable exceptions described in more detail below. The Accounting Council has been mindful that the requirements in IFRS 9 deal with hedging transactions that can be far more complex than those typically entered into by entities applying FRS 102. The departures from the requirements in IFRS 9 are therefore intended to simplify the application of hedge accounting.

Eligible hedged items

27 The Accounting Council was requested to reconsider the exclusion of explicit macro-hedging provisions in FRS 102, similar to those in IAS 39 Financial Instruments: Recognition and Measurement. After consideration of the specific concerns of entities that raised this as an issue, the Accounting Council concluded that in the interest of developing straight-forward hedge accounting requirements that are relevant for a majority of entities, it retains its previous advice stated in FRED 51. Entities wishing to apply the IFRS macro-hedging provisions are able to apply the accounting policy choice in FRS 102 to apply IAS 39 and/or IFRS 9 instead.
Qualifying hedge accounting conditions

28 The qualifying hedge accounting conditions in FRS 102 have been simplified compared to the criteria set out in IFRS 9, with the aim of making hedge accounting easier to apply.

29 Under the amended hedge accounting requirements it is not necessary to achieve a prescribed level of effectiveness in a hedging relationship in order to qualify for hedge accounting, but an economic relationship between the hedged item and the hedging instrument has to exist. In response to feedback on FRED 51, an explanation has been added of when an economic relationship between a hedged item and a hedging instrument exists, which is in line with IFRS 9.

30 The Accounting Council notes that although a quantitative assessment of hedge effectiveness is not required, it is nevertheless important for entities to identify the different factors that affect the valuation of the hedging instrument and hedged item, including factors that may be a source of hedge ineffectiveness. Entities are therefore required to identify and document causes of hedge ineffectiveness before they commence hedge accounting, to ensure that ineffectiveness is properly captured in profit or loss.

31 Entities are required to document a hedging relationship, to avoid hedge accounting being misused. The hedge documentation requirements are, however, relatively informal and undemanding and should not be an administrative burden for entities in practice.

Discontinuing hedge accounting

32 These amendments permit entities to discontinue hedge accounting voluntarily. This is a departure from IFRS 9. The Accounting Council considered that the restrictions in IFRS 9 on discontinuance are unnecessarily onerous, and instead has retained the existing option of voluntary discontinuation. An entity must document the election to discontinue hedge accounting, which is consistent with the requirement for documentation at the start of hedge accounting.

Disclosure

33 These amendments retain substantially the disclosure requirements of FRS 102. The disclosure requirements in relation to the hedge accounting requirements in IFRS 9, contained in IFRS 7 Financial Instruments: Disclosure focus on risks and risk mitigation through hedging. The Accounting Council notes that risk disclosures are not generally required in FRS 102, except for financial institutions.

Transitional provisions for first-time adopters of FRS 102

34 The Accounting Council’s aim was to develop transitional provisions that are consistent with the permissive hedge accounting regime of FRS 102 and give entities a choice over whether to commence, continue or end hedge accounting on transition to FRS 102. Some respondents to FRED 51 were concerned that this flexibility may be abused, as it allows entities to apply a degree of hindsight. The Accounting Council is mindful of this possible exploitation of the transitional provisions. Nevertheless, on balance it believes that in the interests of the majority of entities, especially entities that have not applied hedge accounting before, flexibility should take precedence over restrictions aimed at preventing abuse.

35 The Accounting Council is conscious that entities may have applied diverse hedge accounting practices before the adoption of FRS 102. Entities may have applied the hedge accounting requirements in accordance with FRS 26 (IAS 39) Financial Instruments: Recognition and Measurement or may have applied synthetic accounting practices permitted under SSAP 20 Foreign currency translation. Accommodating these different accounting practices introduces complexity that the transitional provisions need to
address. Under the transitional provisions, regardless of what accounting practices were applied previously, entities have the choice to continue hedge accounting in accordance with FRS 102, provided the conditions for hedge accounting are met. Entities that elect not to apply the FRS 102 hedge accounting requirements, have to comply with the applicable measurement requirements for assets and liabilities set out elsewhere in FRS 102 from the date of transition.

36 The amendments are issued after the date of transition to FRS 102 for many entities. The transitional provisions take this into account by providing an extended deadline for hedge documentation on first-time adoption.

**Alternative reporting of economic hedges**

37 The Accounting Council advises modifying the provision in Section 11 to allow the designation of loan commitments at fair value through profit or loss (in addition to the designation of debt instruments at fair value through profit or loss). This will have the effect of allowing economic hedge accounting where an entity balances the risks from a first instrument by taking out a second which is measured at fair value: it will be able to choose to measure the first at fair value too, thus matching the movements in profit and reflecting, in financial reporting, the combined economic effect of the instruments.

**Impairment provisions**

38 Originally it was planned to amend FRS 102 prior to its effective date in respect of the requirements relating to hedge accounting and the impairment of financial assets. The IASB’s project on the new IFRS impairment model is delayed and the FRC’s consultation on introducing equivalent requirements in FRS 102 has therefore been deferred. Respondents to FRED 51 requested the exemption of certain entities from the requirement to adopt the impairment accounting requirements in FRS 102 until the new impairment requirements in FRS 102 are finalised.

39 The Accounting Council deliberated on the likely impact of the adoption of the impairment accounting requirements in FRS 102. It concluded that the incurred loss impairment model in FRS 102 is consistent with UK GAAP, as applicable prior to the introduction of FRS 102. The Accounting Council considers that it is therefore unnecessary to provide a temporary relief from the impairment accounting requirements in FRS 102.

**Effective date**

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

**Approval of this advice**

41 This advice to the FRC was approved by the Accounting Council on 19 June 2014.
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Amendments to FRS 102

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