FILLING THE GAAP

AS WE MOVE TOWARDS 2014, THERE ARE A NUMBER OF KEY ACCOUNTING DEVELOPMENTS OF WHICH CORPORATE TREASURERS SHOULD BE AWARE. STANISLAV VARKALOV OUTLINES THE IMPACT THEY MAY HAVE

In August 2009, the UK's Accounting Standards Board – the predecessor to the Accounting Council of the Financial Reporting Council (FRC) – announced proposals to replace the current UK GAAP with a new comprehensive standard that came to be known as FRS 102. FRS 102 was finally published in March 2013. It is the new Financial Reporting Standard applicable in the UK and Republic of Ireland, with effect from 1 January 2015, with earlier adoption permitted for periods ending on or after 31 December 2012.

Based on the IFRS for SMEs, amended for use in the UK, FRS 102 may have a significant impact on the preparation of financial statements by any individual entity currently using UK GAAP. This may require treasurers to think through the impact on group structures, tax and distributable reserves, for example (see the 'What you could do now' box on page 33 for further information).

FRS 102 looks and feels in many ways like IFRS, which publicly listed groups in the UK and the rest of the EU should have been compliant with since 2005. Now, as then, it may lead to a number of significant areas of change compared with existing UK accounting. First and foremost is the impact on the measurement of financial instruments. Under FRS 102, derivative financial instruments will be brought on balance sheet at fair value with changes recorded, in many cases, through the profit and loss (P&L) account. Under current UK GAAP, derivatives are typically held off balance sheet, with only those changes reported in P&L that are offsetting the gains and losses in the underlying exposures when these are themselves recognised. This major shift will potentially gross up the balance sheet, is likely to impact net earnings and may increase volatility of both P&L and total assets and liabilities.

The new standard has stricter (compared with full IFRS) rules on hedge accounting, however. While hedge accounting is permitted within sections 11 (*Basic Financial Instruments*) and 12 (*Other Financial Instrument Issues*) of FRS 102, this is only true for certain specified and relatively straightforward types of hedges.[1] Nevertheless, companies will also have the alternative of adopting the recognition and measurement criteria of IAS 39, *Financial Instruments: Recognition and Measurement* (or IFRS 9, *Financial Instruments* – when it is implemented by the FRC), with the disclosures as specified in FRS 102. Note that after some repeated delays, IFRS 9 is essentially still a work in progress and it is currently expected to be issued in final form by 2015.

Under FRS 102, derivative financial instruments will be brought on balance sheet at fair value with changes recorded, in many cases, through the P&L account

FRS 102 vs IAS 39/IFRS 9

Although adopting full IFRS for financial instruments may seem, on the surface, to be complex – and it may require the treasurer to do some additional reading – it is likely to ultimately give the company greater flexibility. Under IAS 39/IFRS 9, more risk management strategies will qualify for hedge accounting than under sections 11 and 12 of FRS 102 (as it currently stands), which could potentially be too much of a straitjacket.

Inflation-linked debt, for example, would not have to be fair-valued under IFRS 9, whereas under sections 11 and 12 of FRS 102 there is some uncertainty. The question mark arises because under FRS 102 the definition of what constitutes a simple coupon vs a complex coupon (the latter triggers fair value treatment)

again, you cannot apply hedge accounting using FRS 102. If IAS 39/IFRS 9 was adopted, P&L volatility from these hedges could be significantly reduced as it would typically allow full or partial hedge accounting in both cases.

Treasurers should therefore take the time to consider whether adopting the full IAS 39/IFRS 9 standard for financial instruments will be more beneficial for the company than opting for the 'simpler' FRS 102 approach.

FRS 102: WHAT YOU COULD DO NOW

◆ **Outline the timeline to transition for your group and prepare a project plan. How many entities need to transition in total? Can systems be easily upgraded? What training will staff require? All of these are important considerations for determining a transition plan.**

◆ Assess the impact on tax. FRS 102 is likely to cause corporate treasurers to think about possible impacts from financial instruments in entirely new terms. All individual entity accounts from which tax returns are generated will fall under FRS 102. HMRC has also been consulting on modernising taxation of derivatives since June 2013. Might restructuring be appropriate/beneficial?

◆ **Ensure sufficient dialogue with stakeholders. The impact of the changes should be clearly communicated – including the entire spectrum from shareholders to lenders and staff.**

◆ Ask your bank. Some swaps achieve hedge accounting more easily than others. Many could be embedded in, for example, debt that is generally accrual accounted. It will be important to consider and future-proof the accounting impacts of any risk management strategies and your bank may be able to help.

◆ **Ask an accounting expert. As this article highlights, accounting changes can be complex. To ensure your company is getting the best accounting treatment possible, expert advice and an early conversation with your auditor will be invaluable.**

could be subject to different interpretation. If the interest is fixed or if the coupon interest is linked to an interest index such as Libor, then these would be types of a simple coupon in accordance with FRS 102. But is inflation deemed to be an interest index or not? If not, then the whole inflation-linked debt would be carried at fair value through P&L.

To use another example, FRS 102 would not allow options to receive hedge accounting. If the treasurer wanted to execute a cap or collar on interest rates – which is, after all, a fairly common risk management strategy for our clients – that would not qualify for hedge accounting under sections 11 and 12 of FRS 102 – probably because it was deemed too complex for an SME. FRS 102 also contains relatively strict rules about the matched timing and notional amounts of the derivative transactions and hedged exposures. If a 10-year swap matures a couple of days after the underlying debt, then, once

Pending final provisions

While full IFRS for financial instruments is arguably more flexible than FRS 102, IAS 39 itself has been widely criticised over the years within the treasury community for being too restrictive. Responding, among other things, to repeated requests from the G20, the International Accounting Standards Board (IASB) decided to replace IAS 39 with IFRS 9 in a project that has been repeatedly delayed. The FRC says that it plans to issue exposure drafts amending FRS 102 in relation to hedge accounting and impairment of financial assets when the IASB finalises IFRS 9 (expected by 2015).

Hence, another slight spanner in the works is that the world is still waiting for the full wording of the final IFRS 9 provisions. The final version of the hedge accounting part of IFRS 9 is expected by the end of 2013. This should be just in the nick of time for individual UK entities to start implementing it (the comparative year for the first FRS 102 numbers begins on 1 January 2014, since UK GAAP is being replaced for accounting periods starting 1 January 2015).

That said, for listed corporates to be able to use IFRS 9 in their group accounts, not only does the IASB have to finish the standard, but the EU will also have to endorse it. This endorsement period typically takes six to eight months, but with IFRS 9 being such a political 'hot potato', the EU has been looking reluctant to adopt the standard quickly, if at all.[2]

What is interesting here is that unlisted companies in the UK are not subject to the EU IAS Directive, but to UK company law and related UK accounting requirements. Therefore, an individual entity of a UK-listed company applying FRS 102 under the UK Companies Act could legitimately use IFRS 9, once finalised and embedded in FRS 102 as outlined above. In theory, this means that a small group entity may be able to apply more favourable hedge accounting rules earlier than the consolidated parent. Two sets of hedge documentation could be required in this case.

Time is of the essence

As with all new accounting standards, there are a number of technical and practical loose ends still to be tied up. Still, there is no need to delay action while these creases are ironed out. Indeed, the introduction of the new UK GAAP is a potentially disruptive change that treasurers should put at the top of their agenda sooner rather than later.

1 The FRC indicated that it may relax FRS 102 hedge accounting rules and bring them closer to the draft requirements of IFRS 9. At the time of writing, the exposure draft for these changes has not yet been formally issued.
2 Note that the G20 at its September 2013 meeting in St Petersburg called on the IASB and the US standard setter, the Financial Accounting Standards Board, to finalise the asset impairment part of IFRS 9.

Stanislav Varkalov is director, accounting and regulatory advisory, Lloyds Bank Commercial Banking

LLOYDS BANK