THIS MONTH

ACCOUNTING CHANGES

Given that we are now two-thirds of the way through the year, it is a good time to check the status of our New Year's resolutions made many months ago, often in the spirit of optimism. For those that are still outstanding, there is fortunately still time. Nevertheless, time is running out to make tax elections for those UK companies adopting FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. For more, see the article below.

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{ IN DEPTH }

FRS 102: TAX IMPLICATIONS FOR DERIVATIVES

From 1 January 2015, UK companies will need to make the transition from UK GAAP to one of the new accounting standards. Many will choose to adopt FRS 101, *Reduced Disclosure Framework*, or FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

FRS 101 introduces the recognition and measurement requirements of International Accounting Standards subject to some adjustments, for example, alignment with the UK Companies Act. FRS 102 introduces new accounting requirements that are closely aligned to IFRS.

Companies that have not previously adopted FRS 26, *Financial Instruments: Recognition and Measurement*, are likely to see the greatest changes from adopting FRS 102.

Current GAAP (where FRS 26 has not been adopted) requires derivatives entered into for hedging to be accounted for on a historic cost basis matching the accounting of the underlying hedged item. FRS 102 typically requires all derivatives to be accounted for at fair value. Hedge accounting under FRS 102 is only permitted when certain conditions are met and where the company designates there to be a hedging relationship.

The Financial Reporting Council has issued an exposure draft (FRED 51), which proposes limited amendments to FRS 102 in respect of hedge accounting, and provides less onerous conditions. This article does not consider the accounting or tax implications of FRED 51.

Without special rules, hedge relationships would not typically be effective for tax purposes. The 'Disregard Regulations' (SI 2004/3256) were introduced to address this issue.

Broadly speaking, where a derivative is part of a hedging relationship, the rules restore the current UK GAAP position. There are specific regulations for derivatives dealing with currencies, commodities, debt and interest rates. The rules contain particular elections that may be made. Guidance is available in HMRC's *Corporate Finance Manual*, CFM13270 onwards. The current time limits for making these elections are very short, often requiring elections to be made before the start of the accounting period in which fair value accounting is first used. The government is considering whether to make limited amendments in respect of the time limits and complexity of these elections.

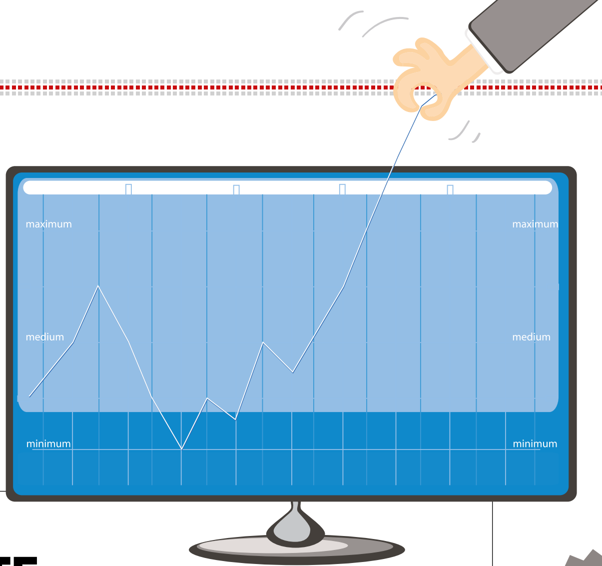
Where a company has a loan or a derivative hedging the exchange risk on an investment in shares, the Disregard Regulations would typically mean that the exchange gain or loss on the loan or derivative would be 'disregarded' for tax. Potentially, an adjustment would be made to any chargeable gain calculation where the shares are subsequently disposed of. Further details on net investment hedging are available in HMRC's guidance, CFM 62000 onwards.

Net investment hedging in respect of a shareholding in a subsidiary company often just takes place at consolidation level. Consolidated accounts don't affect corporation tax, however. The way that the instrument is accounted for in the solo company that holds it will impact that company's tax. This might lead to the derivative being taxed. The accounting and tax implications for that company will therefore need to be carefully considered.

The change to the new valuation bases in FRS will often involve transitional adjustments in the accounts. In some cases, the effect of valuation changes on loan relationships and financial instruments will be postponed for tax and spread over a 10-year period. Companies will need to consider whether these transitional tax rules apply to them, and how they will affect their tax position.

For more on FRS 101 and FRS 102, see page 48

The FSB report outlines its proposals for the reform of interest reference rates



{ INTERNATIONAL }

RATES UPDATE

Following the recent cases of attempted market manipulation and false reporting of global reference rates, the G20 asked the Financial Standards Board (FSB) to undertake a review of major interest rate benchmarks. In July, the FSB published its report, *Reforming Major Interest Rate Benchmarks*, which outlines its proposals, plans and timelines for the reform and strengthening of existing major interest reference rates (such as Libor and Euribor) and the introduction of alternative benchmarks.

While each currency area faces particular conditions that influence the specific recommendations, the following general principles have been agreed to guide the reform and transition to alternative benchmarks:

- Strengthening existing 'IBORs' (interbank offered rates) and other potential reference rates based on unsecured bank funding costs by underpinning them to the greatest extent possible with transaction data (these enhanced rates would be referred to as 'IBOR+'); and
- Developing alternative, nearly risk-free reference rates that could be based on better-suited financial transactions such as derivative transactions.

The UK's Financial Conduct Authority (FCA) and Bank of England have recommended developing and maintaining at least two categories of interest reference rates: a rate with bank credit risk developed from Libor (ie Libor+) and a nearly risk-free rate (RFR), which would be more suitable for most derivative products. In order to implement these recommendations, the FCA will ask the Libor administrator to work towards implementing an expanded Libor definition that will strengthen the anchoring in transactions. Market participants will be asked to collect more data on sterling wholesale funding transactions across the various maturities and it will be assessed whether maturities greater than six months should be discontinued.

For RFRs, a group established by the Bank of England will determine whether the market as a whole would be prepared to develop markets in the Bank of England bank rate and, if not, whether there are measures that could support transactions underlying the sterling overnight interbank average lending rate.

For more, see www.financialstabilityboard.org/publications/r_140722.htm

NEW ON THE WEB

View the following technical updates and policy submissions at www.treasurers.org/technical

ACT responds to ESMA on MiFID II implementation

Supplement to The ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers

ACT responds to ESMA on margins on non-cleared derivatives

John Grout's blog on US money-fund rules (see www.treasurers.org/node/10339)

{ TECHNICAL ROUND-UP }

FINANCIAL INSTRUMENTS, FATCA AND FSB

In July, the final version of IFRS 9, *Financial Instruments*, was published. This replaces earlier versions of IFRS 9 that introduced the new classification and measurement requirements in 2009 and 2010, and substantially revised the hedge accounting model in 2013. IFRS 9 is effective for annual periods beginning on or after 1 January 2018. For more, see page 52.

The Foreign Account Tax Compliance Act finally took effect in July. Corporate treasurers have had to determine whether their group companies are defined as foreign financial institutions or non-exempt non-financial foreign entities and, if so, register with the US Inland Revenue Service. www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-FATCA

The Financial Stability Board Plenary has filed papers with the Swiss authorities to establish the Global Legal Entity Identifier Foundation (GLEIF) as a Swiss not-for-profit foundation. The Global LEI system has the objective of providing unique identification of parties to financial transactions across the globe. The GLEIF will support the maintenance of a centralised database of identifiers with local operational units (such as the China Financial Standardization Technical Committee or London Stock Exchange) and act as the primary interface for registrants.

The People's Bank of China has announced on its website that it will ease restrictions on cross-border yuan operations for multinational companies nationwide. This expands on the operations already allowed in pilot areas such as the Shanghai free-trade zone. The detailed rules and timing for regulating cross-border cash operations in other parts of the country have not yet been finalised.

Mark Carney, the governor of the Bank of England, has declared that the bank would be available to lend to certain shadow banking operations in cases of tight liquidity. This is another small increase in the scope of the bank's potential operations and it is consistent with the bank's recognition of its role as market maker of last resort for corporate bonds and other obligations. See Paul Fisher's 2010 paper to the ACT at http://tinyurl.com/qybrlpr

{ WATCH THIS SPACE }

IMPACT OF SANCTIONS ON CONTRACTS

Both the EU and US have recently increased their sanctions on Russia. As previously noted, the International Swaps and Derivatives Association master agreement allows for a trade to be terminated under a *force majeure* clause if it becomes unlawful for one of the parties to continue honouring the contract. The ACT's Policy and Technical Committee has made several observations. It has been easier for corporates to push back on impossible-to-observe bribery clauses than on sanctions clauses in loan documentation. If sanctions are breached, this may result in a draw-stop (a creditor denying a draw-down on facilities) and also leave the corporate open to civil remedies. Grace periods are needed for acquisitions.