FRS 13 – getting the story right

The disclosures are right here, right now. Nigel Dealy of PricewaterhouseCoopers looks at the lessons to be learned from telling a good story.

You've put it off… but no longer! A few of the brave adopted FRS 13 early on, though since last March there has been no choice in the matter, primarily for listed companies and all banks. So, as you take the plunge, what can you learn from those who have gone before?

Many found the requirements of FRS 13 extremely challenging. Explanations of the use of financial instruments and, in particular, the policies and strategies on hedging, seem incomplete. Of the numerical disclosures, the most misunderstood appear to be currency risk and the gains and losses on hedging instruments. This article therefore focuses on these areas.

Lesson 1: take a closer look

Check that all financial instruments evident from the accounts have been included in all relevant disclosures. Some companies' failings were no doubt due to a misunderstanding of the 'short-term debtors and creditors' exclusion. Short-term financing liabilities such as overdrafts, bills of exchange, commercial paper and finance leases had been inappropriately omitted. Others had overlooked preference shares (deemed to be financial instruments) and provisions for onerous contracts that meet the definition of a financial liability.

Lesson 2: identify and explain

FRS 13 does not define hedging or hedge accounting but many companies assumed that both terms were understood. Only a few, correctly, gave a full description of what they hedged, the period of time involved, the instruments used and how they were accounted for, together with their objectives and strategies. Perhaps hedging of net foreign investments with borrowings is relatively common but, nevertheless, an explanation of the strategy would be useful when the hedge is an amortising loan and thus the initial level of cover is declining.

Lesson 3: narratives policies

Don't be shy. The most common risks identified were interest rate, currency and liquidity. However, the quality of the discussion about objectives, policies and strategies in managing these risks in many cases appeared to be incomplete. Descriptions of policies were given but many companies were reticent about how these were achieved. For example, the preferred mix of fixed and floating rate debt was not quantified and it was left to the reader to guess whether the mix had been achieved through borrowing directly in the desired ratio or through the use of, say, interest rate swaps.

A fairly common failing was the lack of required explanation as to whether the year-end numerical disclosures reflected the policies, objectives and strategies. Conversely, where such comment was made it was often not put into context. Taking the debt example, was the year-end mix of fixed to floating rate representative of the position throughout the year or had it been achieved gradually over the year? Oh, and if you're cash-rich, remember that cash is a financial asset so you'll need to give all the required disclosures explaining this luxury.

Don't over look your accounting policies. A careful crafting by reference to the 'checklist' for financial instruments in the standard should avoid accusations of non-compliance with SSAP 2 'Disclosure of accounting policies'. Detail should include:

- the methods chosen to account for particular derivatives;
- the recognition and measurement of income and expenses and other gains and losses;
- the basis for recognising, measuring and ceasing to recognise financial assets and financial liabilities;
- policies on offsetting; and
- a full description of all the features of your hedge accounting.

Foreign currency translation policies have often contained policies on hedging; hence it is worthwhile revisiting these policies to eliminate duplicates or contradictions of your newly crafted financial instruments policy.

Lesson 4: currency risk disclosures

A 'bottom-up' approach. The group profit and loss account may show minimal net exchange differences, but if this arises from compensating exposures in different locations an analysis of the relevant net foreign currency monetary assets or liabilities is required. Unless hedging is undertaken at operating unit level, this disclosure should be common for companies with overseas operations. It isn't helpful that it is not always apparent why the disclosure is not given.

In preparing the analysis, remember:

- foreign currency intercompany balances should be included in an operating unit's foreign currency net monetary assets since they give rise to translation differences in its profit and loss account that do not eliminate on consolidation; and
- compensating exposures created centrally to protect the group position should not be allocated. Every single operating unit's foreign currency net

assets/liabilities are properly presented 'gross' showing where they are located even if the group's overall exposure may be minimal due to the central hedging programme.

Lesson 5: hedging gains & losses

Debate has revolved around whether the disclosure captures the gains and losses on both the hedged item and the hedging instrument or just the latter. If the first interpretation were to apply, a perfect hedge would mean nil disclosure. This may explain some companies' lack of disclosure despite the fact that they were clearly involved in hedging activities. However, this is not the interpretation intended by the ASB.

The disclosure should be 'gross', that is, the aggregate gains and losses on the hedging instruments and they should reconcile to the total fair value of the hedging derivatives shown in the fair value table. To construct the disclosure, companies' systems must be able to track individual hedging instruments and to differentiate between gains and losses unrecognised at the year-end and those that are carried forward on the balance sheet.

Many found the requirements of FRS 13 extremely challenging. Explanations of the use of financial instruments and the policies and strategies on hedging, seem incomplete

The latter arise, for example, where the accounting policy is to translate items covered by forward currency contracts at the contracted rates. The derivative gain or loss is included in the year-end carrying value of stocks, debtors or creditors. It may be that this finesse has eluded many, since there is often little disclosure of such deferred gains and losses.

Listen and learn…

The trailblazers have painted clear signs to the problem areas. Learn from the lessons. In my view, the biggest task is to raise the quality of the narrative disclosures. Be clear and precise. Fuzzy narrative will at best suggest that risks are inadequately managed or at worst that there is something to hide. It all depends on how the story is told! ■

Nigel Dealy is director, UK accounting, in the UK accounting technical department at PricewaterhouseCoopers. He is a contributing author to PwC's Manual of Accounting *and wrote the firm's accounting guide to FRS 13.*