HMRC - CFM27015 - Hedging: Development Of Hedge Accounting

Before the introduction of IFRS in 2005, there was limited guidance on hedge accounting. SSAP 20 provided guidance on contract rate accounting and hedging of foreign currency investments. However, in general no other formal guidance existed. In practice, entities would typically either apply accruals accounting (e.g. to contracts with periodic cashflows, such as interest rate swaps), or accounting for derivatives when the hedged transaction actually took place.

IFRS in contrast set out detailed requirements for the accounting of all financial instruments (contained in IAS 39). This provided a strict set of criteria that must be met before hedge accounting can be used. Hedge accounting enables companies to modify the normal basis for recognising gains or losses on associated hedging instruments and hedged items. This provides the company with the opportunity to reduce income statement volatility that would otherwise occur if the hedged items and hedging instruments were accounted for separately without regard to the business purposes of the hedge.

Under Old UK GAAP, FRS 26 provided the same requirements as IAS 39. However, not all companies were required to adopt FRS 26. Therefore many companies continued with the treatment that had existed before 2005.

A similar approach, with certain differences, has now also been taken in FRS 102 and IFRS 9.

The result is that from 2015 all UK companies will have to measure derivative financial instruments at fair value and will only be permitted to apply hedge accounting where the relevant conditions are satisfied. The only exception is for companies which apply the FRSSE or micro accounting.

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