



HM TREASURY

Financial Reporting Advisory Board Paper

FINANCIAL REPORTING STANDARD FRS 25 (IAS 32) – FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION

FINANCIAL REPORTING STANDARD FRS 26 (IAS 39) – FINANCIAL INSTRUMENTS: MEASUREMENT

Issue:	Strategy for implementation of FRSs 25 and 26
Impact on guidance:	The FReM will reflect the application of the FRSs in 2006-07
UK GAAP adaptation?	Yes; implementation of FRS 25's presentation requirements is delayed by a year
IAS/IFRS compliant?	No; implementation of FRS 25's presentation requirements is delayed by a year, and FRS 26 has not implemented IAS 39's derecognition requirements
IPSAS compliant?	No, including that IPSASs do not reflect many significant revisions to IASs
Impact on budgetary regime	N/A for 2005-06
Recommendation:	That the FRAB approves the proposed implementation strategy for the two FRSs
Timing:	2006-07 for both FRSs

DETAIL

Background

1. FRS 25 (IAS 32) *Financial Instruments: Disclosure and Presentation*, and FRS 26 (IAS 39) *Financial Instruments: Measurement* were issued on 2 December 2004. They have the effect of implementing IAS 32 and part of IAS 39 for entities not preparing their accounts in accordance with

IASs as adopted in Europe. FRS 25 implements IAS 32's requirements for the presentation of, and disclosures relating to, financial instruments. FRS 26 implements IAS 39's requirements for the classification and measurement of financial instruments but not those relating to the derecognition of financial instruments. At the current time, this aspect of UK accounting remains governed by FRS 5.

2. FRS 25's objective is to enhance users of financial statements' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows. Its presentation requirements cover the classification of issued debt and equity financial instruments and the implications of that classification for dividends and interest expense. Its disclosure requirements require a range of mainly risk-based qualitative and quantitative disclosures to be given about financial instruments held or issued.

3. FRS 26's objective is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial ones. It requires the use of specific measurement bases for financial instruments and for the use of hedge accounting.

4. FRS 26 applies to listed entities still following UK standards for accounting periods beginning on or after 1 January 2005, and to entities preparing accounts in accordance with the fair value accounting rules set out in the Companies Act 1985 for accounting periods beginning on or after 1 January 2006 but such entities may voluntarily apply it for accounting periods beginning on or after 1 January 2005.

5. FRS 25's disclosure requirements apply to entities that apply FRS 26 and in any case to all entities from 2007. Its presentation requirements apply to all entities for accounting periods beginning on or after 1 January 2005.

6. Comparatives need not be restated at all by entities that first adopt both standards fully for accounting periods beginning before 1 January 2006. They need not be restated for FRS 26 and for the disclosure requirements of FRS 25 where these are both adopted before 1 January 2007.

7. Summaries of both FRSs are given in the appendix to this paper, together with indications of some of the implications of implementation.

Implementation strategy

8. The proposed is to implement the two FRSs in 2006-07. This aligns with the FRS's timetable requirements other than in delaying the implementation of FRS 25's presentation requirements by a year.

FRS 26

9. Application of FRS 26 in 2006-07 would meet the FRS's requirements. It would not represent the normally expected alignment generally of requirements for departments, NDPBs and trading funds with best practice as represented in that for listed companies, which would imply application in 2005-06. However:

- a. FRS 26 has the effect of requiring the application of recognition criteria to provisions that relate to financial instruments that differ significantly from the recognition criteria in FRS 12, '*Provisions, contingent liabilities and contingent assets*'. In essence, FRS 12's probability recognition threshold is removed, and probability is instead reflected in the initial measurement of the liability at fair value. In addition, though financial instruments that are

insurance contracts (including financial guarantees) are scoped out of FRS 26, FRS 12 is amended so that these are also measured initially at fair value, though subsequently these may require re-measurement rather than simply being carried at amortised cost;

- b. The IASB is planning to issue an ED quite soon to amend IAS 37, '*Provisions, Contingent Liabilities and Contingent Assets*', to change its recognition and measurement requirements, effectively bringing those in to line with IAS 39's. The ASB is currently considering the implications for FRS 12, and it seems likely to issue a FRED at the same time as the IASB consults through its ED, to propose either revisions to FRS 12 or a new FRS. The effect of these changes would be not only to bring on balance sheet more obligations that haven't reached FRS 12's probability threshold but also to remove the obligations that are not unconditional that nevertheless are required to be recognised under FRS 12;
- c. Changes are to be made by the IASB and the ASB to IAS 39 and FRS 26 in the first half of 2005 in the light of the IASB's ED on '*Financial Guarantee Contracts and Credit Insurance*', including to make clearer the rather difficult-to-follow relationships between FRS 12 and FRS 26, particularly in relation to financial guarantee contracts;
- d. Implementation of FRS 26 in 2005-06 would entail distinguishing between those provisions and contingent liabilities to be accounted for under FRS 12 as hitherto, those to be accounted for under FRS 12 as insurance contracts, and those to be accounted for under FRS 26 as financial instruments. Then, most likely in 2006-07, assuming that is when FRS 12 is amended, those different treatments would be substantially aligned and so further changes would be made;
- e. Central government especially has very many provisions and contingent liabilities, as disclosed in its resource accounts. These include those that are statutorily based or are constructive in nature in such a way as not to fall within the scope of FRS 26, those that are contractual and would fall under FRS 26, and many that are likely to comprise a mixture of the two. The exercise of distinguishing these categories would be onerous, as recent discussions with departments has confirmed. It would be necessary only for 2005-06, as after that substantially the same recognition and initial measurement criteria would be applied to all provisions and contingent liabilities from 2006-07. In addition, the requirements for financial guarantee contracts, which are also quite numerous in central government, would be clearer and easier to apply; and
- f. It is considered that the extra cost of carrying out this additional work is outweighed by any benefits that early adoption might bring.

FRS 25 - disclosure

10. Application of FRS 25's disclosure requirements in 2006-07 would meet the FRS's requirements. It would not represent the normally expected alignment generally of requirements for departments, NDPBs and trading funds with best practice as represented in that for listed companies, which would imply application in 2005-06. However:

- a. It is not possible to apply FRS 25's disclosure requirements without also applying FRS 26. It is, however, not proposed to apply FRS 26 until 2006-07;

- b. The IASB has reviewed IAS 32's requirements, and those of IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, and has issued an ED, IFRS ED 7, proposing significant amendments simplifying the disclosures required for concentrations of risk, liquidity risk and market risk. The ASB also proposes in FRED 33 to amend FRS 25's requirements accordingly, with effect from 1 January 2007 with early adoption permitted. Application in 2006-07 would allow the revised requirements to be met without having to make changes in successive years, and would also allow comparatives not to be restated.

FRS 25 - presentation

11. Although implementation of FRS 25's presentation requirements in 2005-06 would ensure compliance with the FRS, there are operational reasons why it should be delayed until 2006-07 when its disclosure requirements, and FRS 26 as a whole, will also be implemented. These reasons include:

- a. the need to consider further the appropriate treatment of public dividend capital (PDC) and 'dividends' payable thereon so as to reach a conclusion on the application of FRS21 and FRS26 in respect of PDC, which will need to go through due process. The Board has previously debated FRS21 (FRAB (69) 2) and will recall that no definitive answer on the classification of PDC was reached; and
- b. the continued need to manage the convergence process in a way that minimises burdens across government and is transparent in its effect. The Treasury view is that it is clearer for accounts preparers and accounts users to use FRS4 and FRS13 for 2005-06 and switch to FRS25 and FRS26 in 2006-07 (with the consequential implementation of FRSs 21, 23 and 24), rather than having a mixture of standards in force for one year.

FRS 23 and FRS 24

12. A consequential effect of implementing FRS 26 in 2006-07 is that FRS 23 (IAS 21), *The effects of Changes in Foreign Exchange Rates* and FRS 24 (IAS 29) *Financial Reporting in Hyperinflationary Economies* would also be implemented in 2006-07. This is consistent with the requirements of both FRSs. Separate FRAB papers consider FRS 23 and FRS 24.

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28 January 2005

Implications of FRSs 25 & 26

Generally

1. FRS 25 supersedes both FRS 4 *Capital Instruments* (other than, in certain respects, for entities not applying FRS 26) and FRS 13 *Derivatives and other Financial Instruments: Disclosures* (other than for entities not applying FRS 25). FRS 26 is new to UK GAAP, as the ASB has not until now issued an accounting standard on the measurement of financial instruments.
2. Both FRSs have a number of scope exemptions. For example, they apply to all kinds of financial instruments except those that are covered by other FRSs – eg interests in subsidiaries, associates and joint ventures that are accounted for under FRSs 2, 5 and 9; and employers' rights and obligations under employee benefit plans to which FRS 17 apply.
3. From a review of current FRS 13 disclosures, it appears that for most departments FRS 25 is not likely to change current practices significantly, other than in having to make new credit risk disclosures. The impact of FRS 26 may be greater, as entities will be required to evaluate all their financial instruments, including those not previously on balance sheet, as the standard sets out many requirements that are new to UK GAAP. At this stage, it appears that some departments may be affected significantly, but many others less so.

FRS 25

Summary

4. FRS 25's definition of a financial instrument underlies FRS 26 as well, and does not differ significantly from that of FRS 13. FRS 25 classifies financial instruments, from the perspective of the issuer's balance sheet, as financial assets, financial liabilities and equity instruments. Financial instruments are contracts that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity. A financial asset is, mainly, an asset that is either cash, or an equity instrument of another entity, or a contractual right to receive cash or another financial asset from another entity. A financial liability is a liability that is, mainly, a contractual obligation to deliver cash to another entity or to exchange financial assets or liabilities on unfavourable terms. Investments, loans, debtors, creditors, provisions that are subject to contracts, and cash are all examples of financial instruments.
5. FRS 25 also defines an equity instrument, as a contract evidencing a residual interest in the assets of an entity after deducting all of its liabilities, and fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Both of which definitions are very close to those in FRS 13.
6. Compound financial instruments may contain both a liability and an equity component. Offset of assets and liabilities is permitted only where there is a legally enforceable right to set off and an intention to settle on a net basis.
7. FRS 25 requires interest, dividends, losses and gains relating to financial liabilities to be recognised as income or expense in profit or loss, whereas distributions to holders of equity instruments are debited directly to equity.

8. Disclosure is required about the factors that affect the amount, timing and certainty of the entity's future cash flows relating to financial instruments and the accounting policies applied to those instruments. FRS 25 also requires disclosures about the nature and extent of an entity's use of financial instruments, the business purposes they serve, and management's policies for controlling those risks.

Changes from existing standards - presentation

9. FRS 25's presentation requirements differ from those of FRS 4 in taking a substance approach and in not being bound by Companies Act definitions of shares. Under FRS 25, a financial instrument is an equity instrument only if there is no contractual obligation or economic compulsion to deliver cash or another financial asset to the holder of the instrument. Preference shares that would be classified under FRS 4 as shares and presented in non-equity shareholders' funds may be required by FRS 25 to be presented as financial liabilities, and related dividends would be presented as interest payments.

10. In addition, currently under the Companies Act, dividends on equity instruments are debited to the profit and loss account. However, under FRS 25, such dividends will be required to be debited directly to equity.

11. Lastly, FRS 25's rules on the offset of financial assets and liabilities, where these are brought together as a single net payable or receivable, differ from those in FRS 5. For example, it may be enough under FRS 5 to have a master netting agreement to show net positions, but, under FRS 25, there would also need to be an intention to offset.

Impact on departments and NDPBs – presentation

12. The RAM and the guidance for NDPBs and trading funds currently do not adapt FRS 4, adding that it applies if given situations arise. Neither departments nor NDPBs are likely to be affected by FRS 25's presentation requirements.

Impact on trading funds – presentation

13. FRS 25 will have a significant impact on trading funds' accounts. This is for two reasons: firstly, because long term loans are currently presented as part of a trading fund's financing, along with its PDC (which is taken as akin to equity, though not an exact match to it – see paragraph 11 above) and reserves, instead of as liabilities as they will have to be under FRS 25; and secondly, because dividends payable in relation to PDC are presented in a trading fund's income and expenditure account rather than debited direct to equity as FRS 25 will require.

14. The result is that there will no longer be as direct a link as before between trading funds' balance sheets and income and expenditure accounts, and their financial targets. Extra disclosure on the return on capital employed will be required to provide this link, giving information on the composition of the return and of capital employed..

Changes from existing standards - disclosure

15. FRS 25's disclosure requirements do not differ substantially overall from those of FRS 13, though the requirements are differently phrased and FRS 25 is less prescriptive than FRS 13. The

focus of both is on the need to provide information to assist users of accounts in assessing the extent of risk relating to financial instruments. Narrative disclosure requirements are similar, including for the entity's financial risk management objectives and policies, including for hedging, and information about the extent and nature of financial instruments used (including their terms and conditions – not required by FRS 13) and the accounting policies and methods adopted.

16. A requirement of FRS 25 that is not directly covered by FRS 13 is for disclosure of exposures to credit risks, including those relating to transactions in which no financial asset is recognised in the balance sheet such as a financial guarantee. Disclosure is of exposure by class of financial asset, and other credit exposures, both on and off balance sheet, including the amount that best represents the entity's maximum exposure at the balance sheet date and any effective concentrations of credit risk.

Impact on central government - disclosure

17. The RAM and the guidance for NDPBs and trading funds currently do not adapt FRS 13's disclosure requirements, although they express an expectation that entities will take advantage of the option in FRS 13 to exclude short-term debtors and creditors from disclosures. They also require the use of NLF rates to calculate fair values of loans. The RAM states that the fair value of PDC can be based on the net assets of the recipient body. The trading fund guidance views PDC as outside the scope of FRS 13 on the basis that it is akin to an equity stake.

18. It is not proposed that FRS 25's disclosure requirements should be adapted for the public sector context. However, many departments, NDPBs and trading funds are likely to have few dealings in financial instruments that give rise to risks for which FRS 25 would require extensive disclosure because of their significance to an understanding of the entity's overall financial position, performance or cash flows. Accordingly, it may be proposed that the FrEM should contain guidance on the application of FRS 25 to the public sector, that draws attention to the need to disclose only what is necessary for that understanding, including in relation to credit risks and gives some assistance on identifying where that disclosure is likely to be necessary.

19. There will be no need for the FrEM to give equivalent guidance to that in the RAM for FRS 13 based disclosures of short-term debtors and creditors. FRS 25 states that no disclosure of fair value is required when the carrying value is a reasonable approximation of fair value. This would normally be the case with short-term debtors and creditors.

20. It may be proposed that application guidance should continue to be given that NLF rates should be used to calculate the fair value of loans, and that PDC is to be treated as akin to equity.

21. FRS 25's fair value disclosure requirements apply to departments' investment interests that would be accounted for under FRS 2, FRS 5 or FRS 9 but for the departmental boundary. However, given the difficulties in estimating fair values for many of these entities, for example because they are carrying out activities that are only carried out by government (eg registering patents), this is likely to preclude fair value disclosures. It may be proposed that, where this applies, the entities' net asset values are to continue to be disclosed instead.

FRS 26

Summary

22. FRS 26 requires financial assets and liabilities to be measured initially at fair value, as defined in FRS 25. In very many cases, this is effectively the transaction value. Subsequent measurement depends on how the financial instrument is categorised, and is normally at fair value or at amortised cost using the effective interest method.

23. The FRS defines the amortised cost of a financial asset or a financial liability as the amount at which the financial asset or financial liability is recognised at initial recognition minus principal repayments, plus the cumulative amortisation using the effective interest rate method of that initial amount and the maturity amount. The effective interest method calculates the amortised cost of a financial asset or liability and allocates the interest income or expense over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash flows over the life of the instrument to its net carrying amount. For assets, further consideration of impairments to the effective interest rate value will of course be required.

24. There are five categories of financial instruments:

- financial assets or liabilities at fair value through profit or loss, those either held for trading or as designated;
- held-to-maturity investment assets, where, eg, the entity has the ability and the intention to hold to maturity (but which cannot be equities);
- loans and receivable assets, with fixed or determinable payments, and not quoted in an active market;
- available-for-sale assets (as designated);
- and other liabilities (ie other than at fair value through profit or loss).

25. Financial assets, including derivatives that are assets, are measured subsequently at fair value through profit or loss except for held-to-maturity investments, and loans and receivables, both of which are measured at amortised cost using the effective interest method unless they are designated either as fair value through profit and loss or as available for sale. Changes in the fair value of available-for-sale assets are taken to the STRGL, except for impairment losses and foreign exchange gains and losses which are taken to profit or loss, until disposal or sale at which time these unrealised movements from prior periods are recognised in profit or loss.

26. Financial liabilities are measured subsequently at amortised cost using the effective interest method except mainly those that are designated as fair value through profit or loss. Financial liabilities that are designated as hedged items are subject to hedge accounting requirements.

27. Hedges are recognised to take two forms that are accounted for differently. Fair value hedges hedge the possibility of changes in fair values. Related fair value movements in both the hedging instrument and the hedged item are recognised in profit or loss. Cash flow hedges hedge the possibility of changes in future cash flows. Related fair value movements in the hedging instrument are recognised in the STRGL until such time as the hedged item affects profit or loss.

28. Embedded derivatives, being derivatives that are embedded in non-derivative contracts, are required to be accounted for separately through profit or loss, unless the economics of the derivative are closely related to those of the host contract. The FRS's aim is to ensure that mark-to-market

through profit or loss cannot be avoided by including , or embedding, a derivative in another contract that is not marked to market through profit or loss. Separate accounting would be required, for example, for most inflation-, equity- or commodity-linked features embedded in a debt instrument. However, it would not be required, for example, for a contract that is to be settled in a foreign currency where the contract is in the currency of either party to the contract or the foreign currency is the only one in which contracts for a particular commodity is priced (such as US\$ for crude oil contracts).

29. FRS 26 relies implicitly on FRS 5's derecognition provisions instead of applying those in IAS 39. The ASB has indicated that it will seek to amend FRSs 5 and 26 in the near future so as apply IAS 39's derecognition provisions to financial instruments.

Changes from existing practices

30. There has been no UK accounting standard on the measurement of financial instruments, and there will be many changes to existing practices. Currently, although banks mark their trading books to fair value through profit or loss, most financial instruments are carried at amortised or un-amortised cost, and, for financial assets such as loans and debtors, net of provisions. FRS 26 will newly require the initial recognition of all financial instruments at fair value and, for subsequent measurement purposes, the application of specific measurement bases to specific categories of financial instruments. As outlined above, the categorisation itself may involve making choices with different accounting consequences.

31. This will result in some financial instruments being on balance sheet for the first time and others being recognised initially, and then carried subsequently at different values than hitherto. Many derivatives, including hedges and embedded derivatives, will be on balance sheet for the first time. Non-trading book assets held for trading, and assets and liabilities designated as fair value through profit or loss, will be held at fair values rather than at cost.

32. The current practice of taking amortisation and impairment provisions to profit and loss will not change compared with existing practice. However, the practice of taking of fair value changes to profit or loss is new to most entities, and the recycling of gains and losses from STRGL to profit and loss on the disposal of available-for-sale assets, is new to UK GAAP.

33. The FRS has many detailed rules, eg on how to determine fair value (including where there are no market prices), on how to calculate impairment provisions, and on where hedge accounting may be applied, which may also change existing practices.

Impact on central government - generally

34. The RAM and the NDPB and trading fund guidance set out requirements for the measurement of a number of categories of financial assets and liabilities, all of which have to be considered separately against the FRS's requirements. The main categories are:

- investments;
- debtors,
- student and other subsidised loans;

- cash;
- creditors and accruals;
- provisions;
- early departure costs;
- commitments;
- government grants payable.

35. In addition, consideration needs to be given to financial instruments that are to be recognised for the first time and which previous guidance has not covered.

36. The potential impacts include:

- fair valuing on initial recognition, particularly where cost may not approximate to amortised cost;
- subsequently measuring on a fair value rather than cost basis;
- taking the effects of changes in fair values (other than for available-for-sale assets) to the operating cost statement or income and expenditure account rather than through the statement of recognised gains and losses to reserves;
- recycling through profit or loss any unrealised gains and losses previously recognised in the SRGL on the disposal of available-for-sale assets;
- eliminating the current practice of taking revaluation changes (other than on impairments) only to the revaluation reserve via the SRGL, and not to operating cost statement;
- bringing more provisions relating to financial instruments (eg guarantees) on balance sheet,
- recognising embedded and other derivatives, including hedges, on balance sheet

Impact on central government - investments

37. The RAM requires investments (PDC, other equity, loans) in entities outside the departmental boundary to be held at historical cost. It is proposed that these treatments should continue for the same reasons as before. This would be an adaptation of FRS 26 because that standard excludes from its scope only subsidiaries, associates and joint ventures that are accounted for under FRSs 2, 5 and 9, but these standards have been adapted by the FreM so as not to apply to entities that are outside the departmental boundary. Such investments by NDPBs and trading funds are beyond the scope of FRS 26 because they are not subject to the same boundary based adaptation of FRSs 2, 5 and 9 as in the RAM.

38. The RAM, and the NDPB and trading fund guidance, require other loans (other than student loans) to be held at cost. The impact of the new FRSs would be for these, as loans and receivables, normally to be held at amortised cost, unless they are designated on initial recognition as at fair value

through profit or loss or as available for sale. Neither of these options is likely to be relevant, and in the interests of consistency of treatment, it is proposed that neither should be available except, and exceptionally so, with Treasury consent.

39. The RAM, and the NDPB and trading fund guidance, require other investments to be included at market value unless this cannot readily be ascertained, in which case the investment should be valued on a basis determined by entity as agreed with the Treasury and the sponsoring department. It may be proposed that this requirement should continue, subject to the determination being to the FRSs' categories of financial assets.

Impact on central government – student loans

40. The RAM requires student loans to be held at their recoverable amount. They are recognised at the original cost and subsequently as indexed for inflation less any provision for bad and doubtful debts. No interest is otherwise payable. The loans carry, in effect, a rate of interest equivalent to the rate of inflation. As loans and receivables, the FRS would require them to be recognised initially at fair value and then measured subsequently at amortised cost using the effective interest method unless they are designated on initial recognition as at fair value for profit or loss or as available-for-sale, or are to be sold in the short term.

41. Neither of these designations is likely to be relevant. The change to an amortised cost basis of initial recognition may be significant in relation to the carrying value of the asset in the balance sheet. However, the impact may be offset in relation to the provisions currently carried to reflect the subsidy element of the loans.

Impact on central government – NDPB subsidised loans

42. The NDPB guidance covers subsidised loans. However, it is not anticipated that NDPBs have subsidised loans of a nature that require specific coverage in FreM

Impact on central government – debtors

43. The RAM requires debtors to be stated at their net realisable value after allowance for bad and doubtful debts. As loans and receivables, FRS 26 would require them to be recognised initially at fair value and then measured subsequently at amortised cost using the effective interest method unless they are designated on initial recognition as at fair value for profit or loss or as available-for-sale, or are to be sold in the short term.

44. Neither of the designation options is likely to be relevant, and in the interests of consistency of treatment, it is proposed that neither should be available except, and exceptionally so, with Treasury consent

Impact on central government – creditors and accruals, and government grants payable

45. The RAM requires creditors and accruals to be recognised at the contractually agreed amounts. The FRS would require them to be recognised initially at fair value (normally this would be at the transaction value), and measured subsequently at amortised cost using the effective interest method, except mainly as designated as fair value through profit or loss.

46. The designation option is not likely to be relevant, and in the interests of consistency of treatment, it may be proposed that it should not be available except, and exceptionally so, with Treasury consent

Impact on central government - provisions

47. The RAM, and the NDPB and trading fund guidance, require provisions to be accounted for on the basis of FRS 12. FRS 12's recognition criteria include an assessment of probability, and for many provisions this will not change. However, provisions relating to financial instruments will need to be accounted for under FRS 26, whose recognition criteria do not depend on a probability test. Initial recognition is always at fair value, so that probability, whether high or low, is reflected instead in the measurement of the obligation, in its fair value. Hence, depending on materiality, a provision may be required to be recognised under FRS 26 that would not have been under FRS 12. A further complication is that provisions that are for financial instruments that are for insurance (and can include financial guarantees) will need nevertheless to be accounted for under FRS 12, except that, for these, there is subsequent re-measurement which may increase the carrying amount above amortised cost.

New to balance sheets - embedded derivatives

48. Departments, NDPBs and trading funds need to consider all their contracts to identify any embedded derivatives, then to identify those whose economics differ from those of their hosts, and to account for these separately where material.

49. Potentially any contract may be a host contract that has embedded within it a derivative financial instrument that would be fall within the scope of FRS 26 and may need to be accounted for separately. The host contract may be itself be a financial instrument that intuitively would normally be likely to be considered under a financial instrument standard, such as a debt or equity instrument. The host contract may also be an instrument that might not so clearly be identified, such as an insurance contract or a sale or purchase contract, and may even be a derivative instrument that itself is scoped out of the financial instruments standards.

50. An embedded derivative is one or more implicit or explicit terms in a contract that affects the cash flows of the contract in a manner similar to a stand-alone derivative instrument. The derivative element of such contracts may be based on a specified interest rate, security price, commodity price, foreign exchange rate, index of prices, or other variable.

51. The FRS does not provide a description or definition of what are closely related economic characteristics and risks, and where the economics may differ significantly, but provides examples of each. What is necessary is to understand the economic characteristics of the host contract and the embedded derivative and their cash flows, and to compare the cash flows of the contract as a whole with those of the host contract alone.

52. Whilst embedded derivatives that are required to be accounted for separately may arise from deliberate financial engineering, which is unlikely in the public sector, others may instead reflect common contracting arrangements. Examples in the public sector may include supplier contracts linked to changes in exchange rates or leases in foreign countries or other contracts where the exposure to interest rate risk may be leveraged in some way or there is significant optionality.

New to balance sheets- hedges

53. Under the RAM, and NDPB and trading fund guidance, in the absence of specific requirements in UK accounting standards, not all hedges might appear on balance sheet, and those that do would likely to be treated on an amortised cost basis to match the accounting treatment of the hedged item. Under FRS 26, all derivatives must be measured at fair value, whether used for hedging or trading purposes.

54. FRS 39 permits special hedge accounting, allowing the recognition of gains and losses on the hedged item in some circumstances. But it imposes strict requirements for hedge designation and effectiveness testing of the hedge relationship.