Example 1: floating to fixed interest rate swap (designated cash flow hedge)

Background

Financial Reporting Standard (FRS) 101 and FRS 102 both introduce significant changes in the accounting for financial instruments compared to Old UK Generally Accepted Accounting Practice (GAAP) (where FRS 26 is not applied). Consequently, for many users of FRS 101 or FRS 102, the interaction of the accounting and the tax in respect of financial instruments may be unfamiliar.

The purpose of this paper is to provide a brief introduction, using a worked example, to the Corporation Tax treatment for a designated cash flow hedge. The example goes through the:

- assumed facts
- ongoing position
- transitional position

Scope

The paper assumes the following fact pattern:

- a company within the charge to Corporation Tax
- applying the hedge accounting requirements contained in section 12 of FRS 102
- transitioning from Old UK GAAP without the application of FRS 26
- applying fair value accounting for the first time in 2015

It does not specifically deal with the requirements of FRS 26, FRS 101, International Accounting Standard (IAS) 39 or International Financial Reporting Standard (IFRS) 9. The mechanics of hedge accounting in those standards are similar to the requirements of section 12 of FRS 102 and companies applying those standards may also find this paper helpful. However, differences do exist between the standards which potentially affect the accounting and tax analysis.

The paper reflects amendments made to the Disregard Regulations (SI 2004/3256) in December 2014. The paper assumes that the company is applying fair value accounting for the first time in a period of account commencing on or after 1 January 2015. For companies which applied fair value accounting before this time, regulations 7, 8 and 9 applied by default.

This paper is concerned with the Corporation Tax rules, and therefore only applies to companies that are within the charge of Corporation Tax. It also assumes that the hedging instrument falls to be a derivative contract within part 7 of CTA 2009. Because of the specific nature of the tax rules, the commentary is unlikely to be of wider application.

The commentary provided in the paper is of a general nature. Companies should not rely on the commentary in isolation and it is not intended as a substitute for referring to the accounting standards and tax law. Hedge accounting can be a complex area and companies may wish to consider discussing the implications of hedging arrangements with their advisers and/or consult the detailed guidance in the HM Revenue and Customs (HMRC) manuals and in particular the Corporate Finance Manual.

It remains the responsibility of the company to ensure that it prepares accounts in accordance with relevant GAAP and submits a self-assessment in line with UK tax law. Where HMRC considers that there is, or may have been, avoidance of tax the analysis as presented will not necessarily apply.

Assumed facts

Hedged item

On 1 January 20X4, XYZ Ltd borrows £100 million under a 3 year loan which accrues interest at a floating rate of the London Interbank Offered Rate (LIBOR) plus 5%.

XYZ Ltd has a loan payable which bears interest at a floating rate. The cash flows payable under the loan will therefore fluctuate as interest rates change. This variability introduces uncertainty and potential volatility into the cash flows of the company. If LIBOR increases then the company will have to find additional funds to service the debt.

The table below illustrates how a change in LIBOR impacts on the cash outflows.

£m		**20X4**	**20X5**	**20X6**
LIBOR		1.00%	3.00%	5.00%
Interest payable on loan	L+5%	6.0	8.0	10.0

Hedging instrument

At the same time, the company also entered into an interest rate swap with the following terms:

- notional principal £100 million
- period 3 years
- fixed interest payable on notional principal at 7%
- floating interest receivable on notional principal at LIBOR plus 5%

XYZ Ltd has hedged this interest rate exposure by entering into an interest rate swap. This swaps the overall interest rate profile from a floating rate to a fixed rate.

Cashflows				
Loan principal		100.0		(100.0)
Interest on loan	L+5%	(6.0)	(8.0)	(10.0)
Receivable leg on swap	L+5%	6.0	*8.0*	*10.0*
Payable leg on swap	7%	(7.0)	(7.0)	(7.0)
Net (payment) / receipt under swap		(1.0)	1.0	3.0
Net cash payable		**(7.0)**	**(7.0)**	**(7.0)**

Hedging relationship

It is assumed that XYZ Ltd meets the conditions for hedge accounting as set out in section 12 of FRS 102 and designates the interest rate swap as a cash flow hedge of the forecast interest rate payments on the £100 million loan.

The ongoing position

Accounting treatment

The ongoing accounting treatment where FRS 102 is applied is as follows:

The loan (the hedged item)
This is measured on amortised cost basis (it is assumed that the loan will be accounted for as a basic financial instrument under section 11).

The swap (the hedging instrument)
This is measured at fair value. Movements on the effective portion of the hedging instrument are recognised directly in Other Comprehensive Income (OCI). Movements on the ineffective portion of the hedging instrument are recognised in the income statement (being the FRS 102 term used for the profit and loss account).

The accounting is summarised below:

Accounting treatment	**20X4**	**20X5**	**20X6**
Income statement			
Interest payable on loan (including net payment on swap)	7.0	7.0	7.0
Fair value movement on swap (ineffective component)	(0.3)	0.1	0.2
Loss before tax	6.7	7.1	7.2
OCI (cashflow hedging reserve)			
Fair value movement on swap (effective component)	(2.7)	2.0	0.7
Balance sheet position			
Loan payable	(100.0)	(100.0)	-
Derivative	3.0	0.9	-

A company is only required to recognise ineffectiveness in profit or loss to the extent that the cumulative fair value movement in the derivative is greater than the cumulative change in fair value on the hedged item.

The effective/ineffective element and the fair values assigned to the swap have been assumed for the purposes of this example. Where the expected cash flows of the hedging instrument match those of the hedged item, there should be no hedge ineffectiveness. The hedge ineffectiveness in this case could be caused, for example, by differences in the payment dates between the swap and the loan.

In practice the fair value of the swaps would most likely be obtained from a finance house or bank.

Tax treatment: default position

If the company has not elected into regulation 9 then regulation 9A will have effect given there is a designated cash flow hedge. As a result for tax purposes, XYZ Ltd would simply follow the amounts recognised in the income statement. The amounts recognised to OCI are not brought into account (unless and until these amounts are transferred to the income statement).

The tax result would be as follows:

Tax treatment: default position	**20X4**	**20X5**	**20X6**
Interest payable on loan (including net payment on swap)	7.0	7.0	7.0
Fair value movement on swap (ineffective component)	(0.3)	0.1	0.2
Total tax deduction	6.7	7.1	7.2

This is close to the position that would have arisen under Old UK GAAP (assuming FRS 26 had not applied). There is likely to be some fluctuations over time to the extent of any hedge ineffectiveness.

Tax treatment: XYZ Ltd has elected into Regulation 9 (SI 2004/3256)

If XYZ Ltd has elected into regulation 9, then this regulation will have effect because:

- there is a hedging relationship between the swap and the loan
- the loan would not be taxed on a fair value basis

As a result, the fair value movements taken to the income statement and to OCI are disregarded. Amounts under the swap are brought into account in line with an appropriate accruals basis. So the tax computation will include an accrual of the payments and receipts under the swap for the period in question. Depending on the precise accountancy treatment adopted, this may well be (or close to) the amount of any swap payment that is recycled from OCI to the income statement for the period (or alternatively, the amounts may possibly have been included directly with the interest payable figure for the period).

Tax treatment: election made into regulation 9	**20X4**	**20X5**	**20X6**
Interest payable on loan (including net payment on swap)	7.0	7.0	7.0
Fair value movement on swap (P&L / OCI) - disregarded	-	-	-
Total tax deduction	7.0	7.0	7.0
B/f	*-*	*(3.0)*	*(0.9)*
Current period fair value movement disregarded	*(3.0)*	*2.1*	*0.9*
C/f	*(3.0)*	*(0.9)*	*-*

All amounts that are disregarded under regulation 9 should at some point either reverse or be brought back into account. It can therefore be helpful to keep track of the cumulative position.

The result is in line with Old UK GAAP (where FRS 26 is not applied) and should not in theory have any fair value fluctuations over time. However, the company would be required to make computational adjustments to remove any fair value movements recognised in the income statement for hedge ineffectiveness.

Transitional position

Accounting treatment

If you now assume that XYZ Ltd previously applied Old UK GAAP without the application of FRS 26 and adopts FRS 102 for the first time in 20X5. For accounting purposes the adoption of FRS 102 is applied retrospectively and therefore it restates its 20X4 figures (including in particular its balance sheet figures as at 31 December 20X4).

The figure will therefore be as follows (no change to the ongoing position):

Accounting treatment	20X4 (restated)	20X5	20X6
Income statement			
Interest payable on loan (including net payment on swap)	7.0	7.0	7.0
Fair value movement on swap (ineffective component)	(0.3)	0.1	0.2
Loss before tax	6.7	7.1	7.2
OCI (cashflow hedging reserve)			
Fair value movement on swap (effective component)	(2.7)	2.0	0.7
Balance sheet position			
Loan payable	(100.0)	(100.0)	
Derivative	3.0	0.9	-

Tax treatment: default position

If the company has not elected into regulation 9 then regulation 9A will have effect given there is a designated cash flow hedge. Going forwards, therefore, it will simply follow the income statement. However, it may be necessary to bring a transitional adjustment into account under the 10-year spreading rules as per the Change of Accounting Practice (COAP) Regulations (SI 2004/3271). No Spreading is available if the loan (the hedged item) falls to be repaid within the accounting period of the transition. In such cases the transitional adjustment is brought into tax in that period in full.

Overall there is a credit of £3 million under Section 614 CTA 2009 as a result of the accounts recognising the fair value of the derivative of £3 million when previously it was not recognised. Typically on first time adoption of New UK GAAP the prior period comparative will be restated and, as such, there will be no 'prior period adjustment' recognised in the period. As a result, it is likely that the £3 million will be taxable under section 614 CTA 2009 rather than section 597(2) CTA 2009.

This transitional adjustment is dealt with as follows:

- No 10-year spreading is needed for the part of the transitional adjustment that relates to the cash flow risk (assumed in this example to be £2.7 million) as this amount is excluded under regulation 3C(2)(e) of the COAP Regulations. This will be the cumulative amount that is reflected in the cash flow hedging reserve as at 31 December 20X4.
  (This amount represents the amounts that would have been recognised to OCI under the new accounting treatment. Nothing has changes as regards this £2.7 million. It was not taxed before because it was not there under Old GAAP applied and would not have been taxed now because regulation 9A excludes the amounts recognised to the cash flow hedging reserve.)

- The part of the transitional adjustment relating to hedge ineffectiveness (assumed in this example to be £300,000) is brought into account over 10 years starting in 20X5.

The tax position will therefore be as follows:

Tax treatment: default position	20X5	20X6
Interest payable on loan (including net payment on swap)	7.00	7.00
Fair value movement on swap (ineffective component)	0.10	0.20
Loss before tax	7.10	7.20
COAP Regs - 10 year spreading	(0.03)	(0.03)
Total tax deduction	7.07	7.17
Transitional adjustment	*(0.30)*	*(0.27)*
10 year spreading	*0.03*	*0.03*
C/f	*(0.27)*	*(0.24)*

It can be essential to keep a track of the remaining balance of the transitional adjustment that is being spread over the 10 years.

Tax treatment: XYZ Ltd has elected into regulation 9 (SI 2004/3256)

Regulation 9 will apply to the swap. No 10-year spreading is needed in respect of the transitional adjustment of £3 million. (This amount is excluded under regulation 3C(2)(c) of the COAP Regulations.) This transitional adjustment is effectively disregarded and will be dealt with under the Disregard Regulations.

The tax position will therefore be as follows:

Tax treatment: election made into regulation 9	20X5	20X6
Interest payable on loan (including net payment on swap)	7.00	7.00
Fair value movement on swap (P&L / OCI) - disregarded	-	-
Total tax deduction	7.00	7.00
Transitional adjustment disregarded / b/f	*(3.00)*	*(0.90)*
Current period fair value movement disregarded	*2.10*	*0.90*
C/f	*(0.90)*	-

The result is in line with Old UK GAAP (where FRS 26 is not applied) and should not in theory have any fair value fluctuations over time.

All amounts that are disregarded under regulation 9 should at some point either reverse or be brought back into account. It can be essential to keep track of the cumulative position. This should include the transitional credit that was not brought into account under the 10-year spreading.