

Case Study: Circle Housing Meets the FRS 102 Compliance Challenge

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When the Circle Housing group was confronted with the complex new demands of reporting under FRS 102, the treasury team decided to research, select and implement a new technology solution, as the best approach for achieving compliance. A policy decision was taken to adopt hedge accounting, to minimise any profit and loss (P&L) volatility resulting from the group's derivative operations. This case study describes how the ensuing project was organised and executed, to facilitate FRS 102 compliance, in an automated end-to-end workflow relating to hedge accounting processing, analysis, reporting and interfacing.

Financial Reporting Standard (FRS) 102 is a new accounting standard generally known as the new UK and Irish Generally Accepted Accounting Principles (GAAP) and under which Circle Housing group will have to report for its financial accounts on and after 1 January 2015.

This standard radically changes the statutory reporting requirements and hence the underlying accounting treatment for smaller UK companies and for housing associations. Under existing accounting regulatory regime of UK GAAP, Circle is not presently required to include any financial derivatives disclosures in its accounts. Accordingly the conversion of reporting standards to an IFRS compliant standard presented Circle with both a new challenge and opportunity.

Circle Housing's Treasury Organisation and Operations

The Circle group has a large federal organisational structure. It has a consolidated debt portfolio of approximately £1.7bn, which is managed by a centralised treasury team. As head of treasury, I am responsible for managing all Circle Housing's treasury operations, reporting to Paul Rickard, the group finance director (corporate).

Circle's business, which is conducted through a group of nine UK housing association partners, revolves around the provision of affordable housing. Circle is, accordingly, an ethical sector organisation and its treasury operation is organised and managed in much the same ways as are found in profit generating commercial corporations. The group regards this as the optimum business approach to deliver cost-effective results in the management of cash and treasury risk, in fulfilling its ethical mission.

Circle's debt portfolio is comprised of a combination of loans, which are drawn-down as needed from bank lending facilities, and the group has also issued corporate bonds. The priority mission of the treasury team is to manage Circle's exposure to financial risks; meaning both the risks resulting from interest rate market fluctuations and through inflation. In order to hedge these risks, the group makes

use of interest rate and inflation rate swaps to manage the exposures. The ultimate business purpose of this hedging activity is to provide budgetary and cash flow certainty for Circle's operations.

Historically the group has traded long-term (30 year maturity) interest and inflation rate derivative structures, and has additionally made use of option hedging structures to reduce the net effect of periodic interest coupon payments on some deals.

The Circle group currently has 30 outstanding derivative trades which were transacted with external counterparties through the group funding special purpose vehicle (SPV). These trades were then 'back-to-backed' with Circle's internal entities in order to apply the hedges where they are required; this in-house dealing activity created an additional 120 internal derivative trades. Together, 150 derivative trades form a significant and complex array of financial instrument positions in terms of the required interest administration, accounting, risk management and management reporting operations.

Establishment of the FRS 102 Project

Following the adoption of FRS 102, Circle will have to report these derivative trades through its financial accounts for the first time. Given the volatile nature of interest rate markets and the impact of reporting the changes in the fair value of the derivative trades through the income and expenditure accounts (P&L), such reporting tends to show sharp fluctuations, with unpredictable impacts on the balance sheet. Circle decided to minimise the impact of these changes by adopting hedge accounting.

The team concluded that it needed to select and implement a system to meet the complex information management, calculation, analysis and reporting requirements for an efficient hedge accounting practice. The new system would store information about the debt portfolio and its matching hedges, and report prospectively and retrospectively on the effectiveness of the hedging programme; additionally it would generate appropriate accounting journals for the group's derivative transaction and hedging relationships. The aim was for an intuitive, easy-to-use system that would provide a complete, end-to-end workflow management solution for automating treasury workflows, including processing, risk management, accounting and hedge accounting.

The project team for selecting and implementing the solution consisted of finance team members representing treasury, management accounts, financial reporting and the consolidation teams. In addition this team was supported as required by Circle's business change, procurement and information systems and technology (IS&T) teams. An IT project manager was appointed and I served as project owner.

System Evaluation and Selection

The team conducted a rigorous evaluation and tendering process. Four vendors, including our incumbent treasury management system provider, were invited to participate and to submit solution proposals. We researched each prospective supplier and discussed our ultimate vendor of choice's practical performance and service delivery quality through conversations with reference clients.

The team eventually selected Reval's treasury and risk management (TRM) system as the best fit for our new solution, based on system demonstrations, solution presentations and the responses to our questions. In a close contest, the team felt that this system offered the most intuitive, easy-to-use way forward. It provided a close fit for our automation requirements for a solid end-to-end treasury process, running through from initial deal entry to the ultimate generation of accounting journal entries. An additional factor was this vendor's established position as global provider of hedge accounting solutions and their involvement in thought leadership and debate around areas that affect the regulatory reporting of operations and positions in financial instruments.

Implementation

The implementation team consisted of the business change project manager, three members of the treasury team (assistant director corporate finance (treasury); the treasury operations manager and a treasury officer) and two members from the wider finance team (a management accountant - finance and a senior finance manager - projects and consolidation). The vendor provided one consulting manager. Circle anticipates that additional vendor expert resources will be made available as and when required in the future.

As a separate piece of work, the group also contracted the same vendor to provide consultancy advice on how to interpret the new guidance for compliance, and for assistance with setting up the documentation, which is being used to update our risk and accounting policies. This work is being provided by a separate consulting manager. The treasury team continues to test and roll-out the system, with the next target to generate comparative figures for 31 March 2014.

The TRM system operates technically as a software as a service (SaaS) solution, which provides the cost and efficiency benefits of centralised hosting, implementation, operation and management of the software.

Benefit Summary

Strategically, the high level objectives of the project are the putting in place an IRS 102 solution that generates compliant reporting, objectively demonstrates the effectiveness of the implemented hedging and valuation methodologies, provides enhanced decision support tools for the treasury team, and which automatically generates the accounting journals, for all the affected businesses, for uploading into the group's financial accounting system. The system streamlines and secures treasury processing, supports the group's accounting objectives, and provides a platform for dependable finance operations and management reporting.

Future Potential

In future, treasury will research the impact and value of extending the TRM implementation to provide solutions for further risk and general treasury management requirements, ahead of the periodic reviews conducted on the potential suitability of all treasury systems for adding value for Circle.

Recommendations

Based on our experience, I recommend to others evaluating or planning a similar type of treasury process automation exercise the following considerations:

- Ensure you know what your board/stakeholders are expecting, so that treasury's developments are aligned with key peoples' understanding of the project's objectives.
- Effectively define your strategy, so the selection and implementation processes are clearly mapped out, and can be effectively measured, monitored and managed as needed.
- Ensure that you have allowed for enough time/resource to deliver the project. Whatever amount you originally think of, double it!
- Make sure that the accounting team are fully bought into the project and understand the treasury rationale for the hedging strategies executed. Accountants will be key users of the new system, and treasury and accounting will need to collaborate closely in planning, implementation and the live operations.
- Ensure you have all your hedging records (confirmations) available (ideally scanned) for sharing and review, so essential information for setting up and proving the new system is properly organised. This will help to keep up speed in implementation and in proving the accuracy of new system's results.

Housing Associations

Housing associations are UK non-profit-making organisations, which provide affordable housing to those who require it and a wide range of property-related services to their customers. They are incorporated in several different ways, most commonly as 'industrial and provident societies'. Housing associations are regulated by a range of government bodies in the various countries that comprise the UK.

There has been a consolidation trend in the housing association sector in recent years, as has occurred with the evolution of the Circle Housing group, with several resulting benefits. For example, the component associations can take advantage of the group's creditworthiness and borrowing powers to assure enhanced liquidity at competitive rates. Consolidation can also generate a range of cost efficiencies and operational risk reductions that may be gained from structured centralisation, in areas such as finance, treasury human resources management (HR) and IT.

http://www.gtnews.com/Articles/2013/Case_Study_Circle_Housing_Meets_the_FRS_102_Compliance_Challenge.html