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Dear Susanne

RESPONSE OF THE ACCOUNTING COMMITTEE OF CHARTERED ACCOUNTANTS IRELAND

FRED 51: Draft Amendments to FRS 102 – Hedge Accounting

The Accounting Committee (AC) of Chartered Accountants Ireland welcomes the opportunity to comment on the Financial Reporting Exposure Draft (FRED) on the proposed amendments to the FRS 102 in relation to hedging.

The responses to the individual questions posed in the ED are included in the appendices to this letter.

AC is generally supportive of the proposed changes to FRS 102, but has some specific comments in response to question 3 which AC considers should be addressed in the final standard to ensure some common hedge arrangements are within scope.

Effective date

The FRED itself contains no provisions with regard to an effective date. AC notes that for an entity planning to apply FRS 102 in 2015, the effective date would be for accounting periods beginning on or after 1 January 2015, i.e. such entities would presumably be required to apply the finalised FRED when dealing with hedging instead of what is currently included in FRS 102. However, it is less clear as to how early adopters of FRS 102 might deal with the hedging revisions. Such entities appear to break down into two groups:

- (i) Those entities that have already issued, or will have issued, their financial statements prior to the FRED itself being finalised, i.e. applying the current FRS 102 hedging requirements. For example this would relate to financial statements for 31 December 2012 and 2013 year ends. Consideration is needed to determine the effective date and transitional provisions that should be applied by them in moving to the finalised FRED and, in particular whether the revisions should be accounted for prospectively or retrospectively; and

- (ii) Entities that are planning to apply FRS 102 in 2014, with those financial statements being issued after the finalisation of the FRED. The question here is whether these entities should be allowed to or (for simplicity) be required to apply the finalised FRED in their 2014 financial statements, thereby avoiding dealing with further revisions in relation to hedging in the following year. If these entities are permitted or required to use the current FRS 102 in their 2014 financial statements, then, as in the case of (i) above consideration is needed to providing transitional rule guidance for them.

AC would welcome clarifications on these matters.

Non-mandatory guidance

As discussed in the response to question 7, AC considers the examples with regard to the three proposed hedge accounting models to be helpful. AC notes, however, that the FRC has also released staff education notes on various topics on its website, which are also non-mandatory and serve a similar function. AC suggests that it would be helpful to collate all such non-mandatory material, with regard to FRS 102, in a single source.

Should you wish to discuss any of the views expressed, please feel free to contact me.

Yours sincerely



Mark Kenny
Secretary to the Accounting Committee



Appendix

Question 1

Do you support the adoption in FRS 102 of the three hedge accounting models as set out in this FRED? If not, why not?

AC supports the adoption in FRS 102 of the three hedge accounting models as set out in this FRED. These models have become well established (through IFRS and US GAAP) and, therefore, there is a benefit to using similar models in FRS 102.

Question 2

Do you agree with the overarching principle of setting the requirements for hedge accounting in a way that can be straightforwardly applied by entities undertaking relatively simple economic steps to manage risk? If not, why not?

AC supports the overarching principle as set out above.

Question 3

The draft amendments to FRS 102 require an economic relationship between the hedging instrument and hedged item. Do you agree with this approach to establishing whether a hedging relationship exists? If not, why not?

AC is supportive of this overall approach. However, AC has a number of specific comments relating to the definitions of what can be considered a hedged item and a hedging instrument, which are set out below.

3.1 Relating to hedged items

General

FRED 51, paragraph 12.17 states that:

'A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation, or a portion of such an item, with the following conditions:

- (a) the hedged item must be reliably measurable; and*
- (b) in consolidated financial statements the hedged item must be an asset, liability, firm commitment or highly probable forecast transaction with a party external to the reporting entity. This means that hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities.'*

AC notes that the above definition of qualifying items is more restrictive than both current IAS 39 and the new IFRS 9, both of which permit exceptions in relation to (1) certain intragroup arrangements and (2) highly probable forecast transactions. Details on these two areas of concerns are set out below.

(1) Certain intragroup arrangements

AC notes that IFRS 9, paragraph 6.3.5 (and IAS 39.80) includes a similar requirement to that included in the FRED. The paragraph has, however, two important exceptions that, therefore, allow hedging in a broader range of situations that commonly arise:

- a) A foreign currency risk of an intragroup monetary item (e.g. payable/receivable) between two subsidiaries may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IAS 21.
- b) A foreign currency risk of a highly probable forecast transaction between two group entities may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

AC is of the view that it would be important to include these exceptions in FRS 102's revised hedging section, to allow companies the flexibility that exists in current IFRS and is set to continue in the upcoming IFRS 9.

(2) Highly probable forecast transactions

Paragraph 12.17 refers to the qualifying hedged item being a highly probable forecast transaction; it does not refer to groups of such transactions being eligible. IFRS 9, paragraph 6.6.1 (and IAS 39.78) permits groups of such items to be eligible. AC is of the view that, in practice, it would be common for a group of highly probable forecast sales or a group of purchases of inventory to be hedged with a single derivative. For this reason, AC would favour the expansion of the FRED's scope to address this situation.

3.2 Relating to hedging instruments

Paragraph 12.18 states that:

'A derivative or non-derivative instrument measured at fair value through profit or loss may be designated as a hedging instrument, ...'

AC notes that the 'instrument' above is not described as a '**financial** instrument' (similar to the wording in relation to permitted hedging instruments as set out in IFRS

9, paragraph 6.2.1 and 6.2.2). Was this intended? If so, AC considers that an explanation should be provided of what types of non-financial instruments might be involved.

Question 4

The draft amendments have the effect of removing the requirement to make a binary assessment at the beginning of a hedging relationship that defines that hedge as effective or ineffective. The effect of this would be to allow hedge accounting to be used for the effective portion of any relationship meeting the qualifying conditions. Do you agree with this approach? If not, why not? If you envisage practical application difficulties, please provide an illustration of these.

AC is supportive of the approach as set out in the FRED. AC agrees that the existence of an economic relationship between the hedging instrument and hedged item should be required for hedge accounting to be applied. However, AC believes further guidance on when such a relationship exists is necessary to avoid differing interpretations in practice. In particular, it would be useful to echo the requirements of IFRS 9 by stating that:

- For an economic relationship to exist the hedging instrument and the hedged item have values that will generally (but not necessarily always) move in the opposite direction because of the same risk; and
- The assessment of whether an economic relationship exists includes an analysis of the possible behaviour of the hedging relationship during its term. The mere existence of a statistical correlation between two variables does not, by itself, support the conclusion that an economic relationship exists (i.e. two variables could be correlated but not economically related).

Question 5

The draft requirements for net investment hedges state that when a hedging relationship is discontinued, amounts deferred in equity may not be reclassified to profit or loss. This is to achieve consistency with paragraphs 9.18A and 30.13 of FRS 102. Do you agree with this proposal, or should recycling of gains or losses on hedging instruments be permitted regardless of the mismatch with the foreign currency movements?

For consistency, AC is supportive of the approach as set out in the FRED.

Separately, AC notes that paragraph 12.25 sets out the circumstances when hedge accounting should be discontinued. AC would welcome clarification as to how paragraph 12.25 is to be interpreted in relation to the date from which hedging should cease. Consider the following fact pattern, as an example.

Assume that an entity reviews its cash flow hedging arrangements (and net investment hedging) semi-annually, and that it finds, during its end of year review, that a foreign currency forecast transaction that it previously considered was highly probable is no longer so, i.e. it is now only probable. Is that entity required to:

- (i) record fair value movements on the related hedging derivative in other comprehensive income up to the year-end date and only cease hedge accounting prospectively? or
- (ii) cease hedge accounting back to the last review date (i.e. at the half year, as this is the last date at which the transaction was determined to be highly probable) and, thus, take fair value movements on the hedging derivative through profit or loss in relation to the second half of the year? or
- (iii) cease hedge accounting when the probability changes (perhaps often impracticable)?

Clarification on this point would be welcome.

Question 6

The draft amendments propose an alteration to Section 11 of FRS 102 to broaden the range of instruments that may be designated at fair value through profit or loss, with the effect of allowing, in some cases, economic hedging. Do you agree with these changes? If not, why not?

AC supports these revisions. However AC notes that the change does not appear to be that significant. The current FRS 102, paragraph 11.14(b) permits an entity that has 'debt instruments', as defined in paragraph 11.8(b), that would otherwise be measured at amortised cost to instead be designated to be at fair value through profit or loss (FVTPL). The proposed revision to paragraph 11.14(b), which now permits 'financial assets and financial liabilities to be designated at FVTPL, appears to AC to extend the designation out to cash and to commitments to make or receive a loan from another party, these being the only other items that are otherwise permitted in section 11 of FRS 102 to be carried at amortised cost. All other financial instruments in scope of section 11 and section 12 of FRS 102 are already at FVTPL. It would in, AC's view, be helpful if the nature of the change in scope was clarified in the revision when it is finalised, for example in the Accounting Council's Advice note to the FRC that will accompany the revision.

Separately, AC would like to suggest a revision in the wording in paragraph 11.14(b)(ii). This paragraph currently permits the designation at FVTPL where:

'a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis....'

In practice, a group of financial assets on their own might be managed on a fair value basis (without any related financial liabilities), funded by the issuance of investor shares/units. This would be particularly common in the investment funds sector. Therefore, AC would suggest the wording be revised to instead permit designation at FVTPL where:

'a group of (i) financial assets, (ii) financial liabilities, or (iii) a group of financial assets and liabilities is managed and its performance is evaluated on a fair value basis...'

Question 7

Included as non-mandatory guidance in the draft amendments are examples of the three proposed hedge accounting models (Appendix to Section 12). In your view, are these examples helpful application guidance of the requirements of paragraphs 12.15 to 12.25? If not, please provide examples of hedges that could be more usefully included.

AC is of the view that the examples included are helpful. However, AC has three suggestions that it thinks would provide additional assistance, namely:

- (i) The inclusion of an example of a cash flow hedge of a variable rate loan liability being hedged with a floating to fixed interest rate swap (IRS). This would be a very common hedging scenario for general corporates, i.e. much more common than fair value hedging of fixed rate loan liabilities. While AC notes the cash flow hedge example in relation to a foreign currency purchase, in that case the reclassification from other comprehensive income (OCI) occurs at a single point in time. The accounting entries for a cash flow hedge of a loan with an IRS involve periodic reclassifications from OCI and it would be helpful to set these out.
- (ii) On the topic of 'effectiveness', AC is of the view that an example of a cash flow hedge of a highly probable forecast sale would be helpful, to include the entries that arise if, during the hedging period, the expected sale date is delayed. This would be helpful, as it would deal with a situation that arises in practice and would demonstrate the manner in which ineffectiveness is dealt with in profit or loss.
- (iii) In relation to the foreign currency purchase example, paragraph 12A.3 is headed '*Alternative – including ineffectiveness*' and deals with when one might use a portion of a derivative to set up a hedge relationship as the derivative's notional amount is higher than the highly probable forecast purchase amount. AC is not clear that the excess element of the derivative is in fact 'ineffectiveness'; instead it would appear that the designated hedging instrument is, at the outset, merely 5/6^{ths} of the total derivative, with the 1/6th portion then being measured in the normal way as a derivative at FVTPL. AC would suggest that the heading be revised to instead refer to '*Hedging with a portion of a derivative*'.

AC's comments requesting additional examples, in (i) and (ii) above, are intended to deal with situations that commonly arise in practice for companies and, therefore, the extra illustrative examples would be valuable.

Question 8

The draft amendments propose a transitional exemption which will allow certain one off remeasurements of hedging instruments and hedged items at the transition date. Do you believe that these exemptions facilitate application of hedge accounting to arrangements in place at transition? If you have reservations, please tell us why and provide details of alternative transitional arrangements.

AC considers that the transitional arrangements do not have adequate regard to the transition from current UK GAAP, and its flexibility, to FRS 102.

AC understands the relief afforded in relation to cash flow and net investment hedges in paragraph 35.9(b)(ii). However, AC would point out that the relief on transition in the final sentence of the 'lower of' test from paragraph 12.23(a), when setting up cash flow hedge reserves, means that the amount included in that reserve could include an amount of ineffectiveness. At the next measurement date, this ineffectiveness will be recorded through profit or loss. AC's view is that this does not seem appropriate and would instead support the application of the 'lower of' test in paragraph 12.23(a) being applicable at the transition date.

Paragraph 35.9(b) notes that:

'An entity shall not change its hedge accounting before the date of transition to this FRS for hedging relationships that no longer exist at the date of transition.'

It would be helpful if the Appendix in the final standard was to elaborate as to where that might be relevant and what its implications are. AC considers this might cover deferred gains or losses that arose on the early termination of a hedging derivative prior to the related hedged item affecting profit or loss. Clarification on this would be helpful to preparers and users of financial statements.

As regards pre-existing hedging arrangements that are in place at transition, AC observes that it would be helpful if the final standard was clear that even if hedge accounting is not being applied prospectively, it is necessary to set up the hedging arrangements in line with the transitional provisions. Specifically, for example, if there is, at the transition date, an arrangement that is a cash flow hedge in nature (even though it was not formally documented as such under old UK GAAP), the derivative's fair value is required to be recorded in the cash flow hedge reserve at transition, i.e. it cannot be recorded in retained earnings. This appears to be the requirement, *regardless* of whether the entity intends to opt into hedging prospectively.

AC notes that the FRC website states that the required hedge documentation need not be in place at the date of transition, due presumably to the FRED not being finalised to facilitate that. AC presumes this relief will form part of the final revision to section 35, when it is issued.