Commissioners' Advisory Accountant

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Dear Ms Pust Shah

FRED 51
Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*
Hedge Accounting

Thank you for the opportunity to comment on this Financial Reporting Exposure Draft. We would be happy to discuss any of the points raised in this letter if you so wish.

Our perspective

1. HM Revenue & Customs (HMRC) administers and collects tax in the United Kingdom. In doing so, we use the financial statements of most businesses in the UK, and a number of overseas businesses. The managers and owners of those businesses directly use the numbers reported in financial statements as the basis of their corporate or personal tax liabilities. We check those numbers and the tax liabilities based on them, and we use many of the disclosures in financial statements to help us to check those and other tax liabilities.

2. In the UK, it has long been the case that the starting point for most businesses for calculating a business's corporate or income tax liability is its commercial profit. It is now enshrined in UK tax law that the starting point for taxable business profits is the "profit prepared in accordance with Generally Accepted Accounting Practice" (GAAP).

3. HMRC's direct interest is with a reliable measure of commercial profit, or profit before tax, which businesses can use to measure their liability to corporate or income tax. HMRC also uses the information disclosed in financial statements to check entities' returned tax liabilities.

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General comments

4. HMRC welcomes the draft amendments which will more fully align the hedge accounting model in FRS 102 with IFRS 9. In the longer term, this should facilitate greater consistency in the application of hedge accounting by UK entities. However, until such time as IFRS 9 receives EU endorsement, UK entities applying FRS 102 are likely to be applying IFRS 9 principles in advance of other UK counterparts who apply EU adopted IFRS in their consolidated financial statements or individual financial statements (including FRS 101 adopters).

5. As part of our answers to the specific questions below, we have suggested a few areas where clarification of the requirements may be helpful.

Answers to specific questions

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?

6. We agree that the use of the three hedge accounting models make the proposals easier to read (particularly for those accustomed to IFRS terminology) compared to the current version of FRS 102 which uses longer headings based on the permitted types of hedges.

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?

7. We agree with the overarching principle. However, the proposed hedge accounting model remains a complex area (particularly for those who have not previously applied the hedge accounting rules in IAS 39 or FRS 26).

Question 3:
The draft amendments to FRS 102 require an economic relationship between hedging instrument and hedged item. Do you agree with this approach to establishing whether a hedging relationship exists? If not, why not?

8. We agree with the proposed approach. However, 'economic relationship' is not defined within the proposed amendments to FRS 102. Whilst an explanation of the meaning of 'economic relationship' is given in the Accounting Council's Advice to the FRC which accompanies the FRED, in our view, the inclusion of a definition in the body of section 12 of FRS 102 or the glossary to FRS 102 would be helpful.

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.

9. No comment.

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?

10. No comment.

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?

11. No comment.

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.

12. We agree with the inclusion of the examples as an appendix to Section 12.

13. However, as a minor point regarding Example 1, it may be helpful to clarify the wording of the journal entries. As the first two journals refer to 'Other Comprehensive Income', it is not immediately clear how CU80,000 (in total) has been recognised in the cash flow hedge reserve from which to make the basis adjustment in the last journal.

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.

14. In our view, the current proposed wording of para 35.9 (b) (ii) is ambiguous as it refers to the qualifying conditions in para 12.16 which need to be met at the inception of the hedge. We note the statement on the Ongoing Projects page of the FRC website which clarifies that hedge accounting is not precluded from the date of transition, if the designation and documentation is completed after transition, provided the designation and documentation apply as at the date of transition. However, in our view, the current wording of the transitional provision may lead to inconsistent application of the provision in practice and confusion over what documentation is required and when.

15. In addition, it is our understanding that the transitional provision will also allow entities flexibility to choose whether to apply hedge accounting to some, none or all of the hedging relationships that exist at the date of transition. The transitional provision does not specifically prohibit entities which have previously adopted hedge accounting under FRS 26/IAS 39 from reconsidering whether to designate existing hedging relationships on transition to FRS 102. Entities will also be able to make this decision retrospectively and this may be influenced by whether the hedges are 'out of the money' (i.e. standing at a loss) or 'in the money' (i.e. standing at a gain) at the date of transition. There is therefore a risk of manipulation of entities' financial results.

Yours sincerely

Matthew Blake

Matt Blake, FCA
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