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For the attention of Susanne Pust Shah

14 February 2014

Dear Sir / Madam

Financial Reporting Exposure Draft 51: Draft Amendments to FRS 102 - Hedge Accounting

We welcome the opportunity to comment on the draft amendments to FRS 102 set out in Financial Reporting Exposure Draft 51 (FRED 51) in respect of hedge accounting.

We broadly support the changes set out in FRED 51 and set out our responses to the specific questions raised in the FRED in Appendix 1 to this letter. In order to seek to make the final standard as clear as possible and to reduce diversity in practice, we have a number of detailed observations on the proposals. We set out our detailed comments within Appendix 2.

If you wish to discuss any of the points raised, please contact Terry Harding on 0207 694 8105, Steve Hubbard on 0207 694 8033 or Muriel Buchanan on 0207 694 8712.

Yours faithfully

KPMG-LLP

KPMG LLP

Enclosures:

Appendix 1: Responses to specific questions raised in FRED 51

Appendix 2: Detailed comments in relation to FRED 51

Appendix 1: Responses to specific questions raised in FRED 51

Q 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?

Yes, we agree with the three hedge accounting models as set out in FRED 51. Please see our comments within Appendix 2 regarding the detailed application of the hedge accounting models.

Q2 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?

Yes, we agree with the 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.

Q3 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?

Yes, we agree that there should be an economic relationship between the hedging instrument and the hedged item to establish whether a hedging relationship exists. We support the approach in the FRED.

Q4 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.

Yes, we agree with the approach in the FRED.

Q5 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?

We agree that amounts deferred in equity should not be reclassified to profit and loss when a hedging relationship is discontinued. We agree with this approach, as it will achieve consistency with the treatment of foreign exchange gains and losses on disposal of a foreign subsidiary under FRS 102.

Q6 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?

Yes, we agree with the proposal to broaden the range of instruments that may be designated at fair value through profit and loss within Section 11 of FRS 102. In Appendix 2, we suggest some amendments to the proposed wording of paragraph 11.14(b).

Q7 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.

Yes, we agree that the examples provided in the Appendix to Section 12 are good examples of hedges that are common in practice. In order to be helpful in demonstrating how an entity might apply the requirements in practice, we suggest that the examples be enhanced in some respects. Please see our comments in Appendix 2 to this letter which set out our observations and suggestions in this respect.

Q8 The draft amendments propose a transitional exemption which will allow certain one-off re-measurements 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.

Whilst we agree that transitional exemptions are needed to allow a practical means for entities to hedge account from the date of transition, it is not sufficiently clear from the current exposure draft what the FRC intends the transition provisions to be, who they can be applied by and when they can be applied.

We have a number of reservations over the proposed transitional guidance. Our key concerns are as follows:

- No distinction is made on the basis of the previous accounting framework used, e.g. IFRS, FRS 101, FRS 26, pre-FRS 26 UK GAAP, FRSSE;
- It is unclear what the phrase 'hedging relationship that existed at the date of transition' means, e.g. economic relationship / risk management strategy or accounted for as a hedge under previous GAAP; and

- We acknowledge the references to documentation on the FRC website. However, there is no time limit stated in the FRED for the latest date by which an entity's hedging documentation needs to be in place.

We note that there is no clarification regarding the effective date of the amendments. We assume that they will be effective from the date of transition to FRS 102 as no statement to the contrary is made in the FRED.

We would suggest that the transitional guidance be redrafted along the following lines:

Entities previously applying FRS 26, IFRS, FRS 101 or current FRS 102

We have not identified circumstances when transition relief would be needed on adoption of the revised hedge accounting guidance by such entities, as these frameworks already include hedge accounting models that are similar to the proposed new rules and the entity will have fully documented existing hedge relationships. Therefore, we believe that these entities should continue to apply hedge accounting in respect of all hedges for which hedge accounting was applied under previous GAAP (to the extent that FRS 102 allows hedge accounting). Entities should be required to follow the normal rules in paragraph 12.15 for any hedges that they wish to discontinue after the date of transition. The FRC may wish to consult further with preparers as to whether they envisage any circumstances in which transition relief would be needed in these cases.

Entities previously applying pre-FRS 26 UK GAAP or the FRSSE

If an entity previously applied pre-FRS 26 UK GAAP or the FRSSE, there may not be clear evidence of previous decisions on whether to apply hedge accounting. In addition, the documentation requirements in FRS 102 will be more rigorous than those under previous GAAP. We believe that the entity should be required to make an accounting policy choice, as at its date of transition to FRS 102, as to whether or not to apply hedge accounting to all existing hedge relationships. We suggest that the latter term be defined as hedge relationships of a type that is permitted under FRS 102 for which hedge accounting has been applied under previous GAAP.

If the entity chooses to apply hedge accounting, then the amendments should be applied retrospectively to all existing hedge relationships. If an entity wanted to apply FRS 102 hedge accounting to only some of its previous hedge relationships, it would make an accounting policy choice not to apply hedge accounting at transition, then designate the relevant FRS 102 hedges and apply the hedging guidance in Section 12 prospectively from the date of transition. We believe that this "all or nothing" approach to retrospective application at transition is necessary to prevent an entity from cherry-picking which hedge accounting balances to establish at its date of transition.



Deadline for preparing FRS 102 compliant hedge documentation

We suggest a deadline be set for when entities first adopting the requirements must have FRS 102 compliant hedging documentation in place for hedge relationships that existed at the date of transition. For simplicity, we suggest that, irrespective of which accounting framework was applied previously, or when an entity first adopts the new hedging requirements, FRS 102 compliant hedge documentation should be in place before the beginning of the first day of the FRS 102 accounting period in which the new rules are applied. This would allow an entity sufficient time after its date of transition but before the beginning of its first FRS 102 reporting period to consider how to apply the transition requirements to its existing hedges and to put the necessary documentation in place. For this purpose we have assumed the FRSSE will soon cease to exist.

Transition to IAS 39 / IFRS 9 hedge accounting rules

We note that the transitional guidance in FRED 51 refers to the transition requirements in IFRS 1 paragraphs B4-B6. Therefore, as currently drafted, no transitional relief appears to be available for entities that choose to apply the recognition and measurement provisions of IAS 39/ IFRS 9 under paragraphs 12.2(b) or (c). We suggest, instead, that these entities be entitled to the same transitional relief arrangements as those entities applying Sections 11 and 12 in full.

Appendix 2: Detailed comments in relation to FRED 51

Section 11 Basic financial instruments

- **11.14(b)(i)** – We suggest that the term ‘debt instruments’ be replaced by ‘financial liabilities’, as this would then be consistent with the changes made in the opening sentence of 11.14(b).
- **11.14(b)(ii)** – We suggest that the first sentence be amended to read ‘a group of financial assets, financial liabilities or both’. As drafted, the current wording would exclude groups of financial assets from designation as at fair value through profit or loss.

Section 12 Other financial instruments

General – There are several references within Section 12 to a ‘portion’, ‘proportion’ and ‘component’. It is unclear what the exact meaning of these terms is, as they are not defined. We suggest the FRC defines any specific terms used to avoid confusion and applies them consistently throughout the amendments. The FRC may wish to consider limiting the terms used to ‘component’ and ‘proportion’, which have specific meaning in IFRS 9, and include examples of each to clarify their meaning.

12.17 (b) – It is unclear why the first sentence refers to ‘consolidated financial statements’, as the requirement for the hedged item to be held with an external party would seem equally applicable in individual financial statements. We would therefore suggest deleting the words ‘in consolidated financial statements’.

12.17(b) – As currently drafted, it is unclear whether groups of similar items (eg. forecast sales or purchases in the same foreign currency expected in the same period) would qualify as a ‘hedged item’, as paragraph 12.17 refers to the singular only. Given that entities frequently group similar items together for risk management purposes, we believe that FRS 102 should specifically allow such designation.

12.18(b) – Consideration should be given to amending the current wording so that it specifically permits a hedging instrument to be designated in its entirety in *one or more* hedging relationships. Further we assume that the current reference to ‘portion’ should be amended to read ‘proportion’ (but see also related comments above).

12.18(b) – The current draft does not address the separating out of the forward element of forward contracts or the time value of options. As a result, the proposals could lead to significant volatility within profit and loss. We suggest that the FRC adopt an approach similar to that in IFRS 9, whereby the forward element of the forward contract or the time value of the option is treated as a cost of hedging and amortised over the relevant period.

12.23(d)(ii) – The amendment does not specify whether a reclassification from the cash flow reserve other than to the initial carrying amount of a non-financial asset or non-financial liability affects other comprehensive income (OCI). We note that the equivalent paragraph in IFRS 9, IFRS 9.6.5.11(d)(ii), clarifies that this reclassification flows through OCI, in contrast to a ‘basis adjustment’ which does not. We believe that having different requirements for ‘basis adjustment’ and ‘no basis adjustment’ would add unnecessary complexity in FRS 102. The ‘basis adjustment’ approach would ultimately lead to two ‘credits’ to ‘total comprehensive income’ on a cumulative basis; firstly, the amounts recognised through OCI during the life of the cash flow hedge and, secondly, through the reduced depreciation charge in P&L, as the PPE has been recognised at a lower cost. We suggest that the FRC consider an alternative approach in which amounts accumulated in the cash flow reserve are always reclassified through OCI. This would also remove the inconsistency between 11(d)(i) and 11(d)(ii).

12.24 – We suggest deletion of the words ‘disposal or partial disposal of the foreign operation’ at the end of the paragraph as they are superfluous. They might also suggest that there are other circumstances in which reclassification to P&L would be appropriate.

12.25 – We suggest the following amendments which will help to clarify the guidance:

- We note that the cross reference to paragraph 30.13 refers only to loans forming part of the net investment. We assume that the cross-reference should instead be to paragraph 9.18A, which addresses more widely the treatment of the cumulative amount of any exchange differences previously recognised in equity on disposal of a foreign subsidiary.
- We believe that ‘hedged item’ in the last sentence should be replaced by ‘hedging instrument’.

12.27 – The FRC may consider clarifying what is meant by “disclosing separate information for the three types of hedges”. It is not clear whether this means separate information for each individual hedge (which could lead to very lengthy disclosures) or aggregated information for each of the three types of hedge, e.g. aggregate information for all cash flow hedges? We would suggest that the FRC include language in 12.26 to clarify that information may be aggregated for similar types of hedges based on the nature of the hedged item.

12.29(a) – the FRC may wish to delete the words ‘if at all’ as these appear to contradict the definition of a cash flow hedge in paragraph 12.19(b).

Appendix to Section 12 – Examples of hedge accounting under the principles in Section 12

As a general comment, it would be useful if the examples could illustrate how the entity might define the hedged item and the hedged risk and measure hedge ineffectiveness under each scenario. Given the apparent latitude granted by paragraph 12.16(e), we believe that entities would welcome further guidance on how the documentation requirements could be applied in practice.

Example 1 – Cash flow hedge

We suggest the following amendments:

Defining the hedged risk within the example, e.g. the change in forward rates (as this would explain why no ineffectiveness is expected).

In order to be more specific about how the hedged item/hedged risk needs to be documented, we suggest the following amendment: ‘The whole of the derivative is designated as hedging the ~~future purchase~~ variability in cash flows in the purchase price due to changes in the exchange rate between FC and CU’.

We suggest the following amendment: ‘At the inception of the hedge, the fair value of the forward contract is zero (it reflects the ~~expected~~ forward exchange rate on 29 March 20X6). This reflects the common understanding that a forward exchange rate is simply a function of the spot rate and interest rate curves. It does not require an estimate of what a future spot rate is expected to be.

The example states that ‘no ineffectiveness has been observed’. We would recommend that the FRC expand on the reasons for this. We expect that hedge ineffectiveness would be measured by comparing, on one hand, the effect of the changes in the forward rate on the future foreign currency cash outflow required to purchase the item of plant and, on the other hand, the change in fair value of the derivative. Ineffectiveness would be expected to arise to the extent that the fair value of the derivative changes because of other factors such as deterioration in credit quality of the counterparty to the derivative. Including such language would explain why, in this case, no such ineffectiveness has been observed.

No clarification is provided as to whether anything should be recognised within OCI on recognition of the PPE (please see also comments above on paragraph 12.23(d)).

The ‘Alternative – including ineffectiveness’ does not actually provide an example of ineffectiveness. It illustrates a case where one sixth of the derivative is excluded from the hedge. We suggest deleting the alternative which does not seem likely to occur in practice.

Example 2 – Fair value hedge

We suggest the following amendments:

We suggest that the FRC clarify the references to LIBOR e.g. 6 month LIBOR. This would be consistent with the level of detail required in hedging documentation.

We note that the hedged item is a fixed rate loan paying interest of 9% and the hedging instrument is an interest rate swap under which the entity will pay a floating rate and receive 7%. We suggest clarifying that the hedged item would usually be designated to include a 7% component of the 9% fixed rate.

The fair value of the swap will also be affected by credit risk and this cannot be separated. The example should acknowledge that this is a common source of ineffectiveness in practice.

The current journals exclude the entries for interest charges and cash payments. It would be beneficial to illustrate these entries given the purpose of the hedge to swap a fixed interest expense into a floating rate in profit or loss. We suggest the example is expanded to show these journals.

Example 3 – Net investment hedge

We suggest the following amendments:

Delete ‘fair value caused by foreign exchange movements’ and replace with ‘carrying amount of the loan arising from retranslation under Section 30’.

The increase in the subsidiary’s net assets at the end of the first year has not been reflected within the accounting entries. Footnote (a) suggests that the increase in net assets during the period would not be retranslated, which is clearly incorrect.

Insert the wording ‘opening’ within the following sentence: ‘First, the opening net assets are retranslated into CU...’.

Glossary

We suggest that the definition of a *hedged item* be updated to ‘net investments in foreign operations in consolidated financial statements or financial statements that incorporate the net assets of a foreign branch’. We also suggest that the definition of *hedging instruments* be updated to include ‘non-derivatives measured at amortised cost’ (for hedges of foreign currency risk).