From:	Edward Beale
To:	UKFRS
Subject:	Hedge Accounting
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Dear Susanne

Please see below my comments on FRED 51 from the background of a regular professional user of financial accounts for investment selection and appraisal, and for credit control purposes.

If you have any queries or would like to discuss any of these points further, please do not hesitate to contact me.

Kind regards
Edward Beale

Approach to hedge accounting

Rather than look at the approach taken by the IASB and then try to tame down their excesses, the FRC should approach standard setting by identifying the information that is relevant to users of accounts and then codifying an approach to presenting that relevant information in a clear manner without introducing clutter.

There is no fundamental distinction between commitments to purchase at a future date: goods, services, foreign currency, an interest cash flow, or a fixed asset. There should be no difference in approach to accounting for such commitments.

Users need to know an entity's policy in respect of such commitments (or if there is not a standard policy that a material commitment has been entered into), that the commitments in place conform to this policy, and any material cash flows (amount and timing) resulting. e.g. "The entity has committed to acquire FCX at an exchange rate of [rate] costing £Y on [date] from [bank name]. The value of FC X at the period end date was £Z." or "The entity has entered into an interest rate swap with [bank name] fixing the interest cost on £Am of loan from [base + B%] for the period from [date] to [date] to C%p.a.. This has been accounted for as a hedge since variable rate borrowings over the period [date] to [date] are expected to exceed £Am."

In addition, the information that is relevant for stewardship and valuation purposes is:

Where the amount of the item that the business is committed to purchase exceeds the amount that will be used in the business within a reasonable time of the purchase, the value of this excess commitment, if material, and when payments will need to be made. This is probably best shown as an asset (or expense) and liability in the statement of financial position, with description in the notes. e.g. "The entity has committed to acquire X tonnes of [raw material] over the period to [date] at a cost of £Y with payment 30 days from delivery. Recent production volumes indicate that usage in this period may only be Z tonnes. An expense and a liability have been recognised for £A, the difference between the cost of [X-Z] tonnes and its market value at the period end date." or "The entity has committed to acquire X tonnes of [raw material] over the period to [date] at a cost of £Y with payment 30 days from delivery. Recent production volumes indicate that usage in this period may only be Z tonnes. At the period end date there was an unrealised gain on this excess commitment of [X-Z] tonnes of £A."

Whereas consistency over time is relevant, comparability of commitments between entities in numerical terms in the statement of financial position is of little relevance due to the extreme difficulty that would be encountered in attempting to achieve clear presentation of this information. Comparability is best achieved through disclosure.

Applying these principles to the examples presented by the FRC clearly show that they are not focussed on clear presentation of relevant information.

Example 1

The FRC needs to ask itself who is going to use the numbers proposed for inclusion at the balance sheet date of 31/12/20X5? The information that is relevant to users at that date is that:

- The amount and timing of the material future cash flow in a foreign currency
- The fixed local currency amount that this foreign currency cash flow has been hedged to
- That there is a counterparty risk associated with the hedging instrument

All of this information can be provided in the notes and there is no need for any entries in the statement of financial position.

Putting a number on how far in/out of the money the hedging instrument is at a period end date is not relevant information, but is clutter. Even if this number might be of interest to a small sub-set of users, it is likely to be immaterial.

Example 2

The structure of this example demonstrates how out of touch with reality the FRC is. The vast majority of potential preparers using FRS 102 will be completely unable to borrow money at a fixed rate, other than from related parties. The obvious example should have been an entity borrowing at a floating rate and entering into a swap to fix the rate relating to some or all of this borrowing.

Taking the FRC's example the information that is relevant is:

- the entity has entered into a swap between fixed and floating rates covering a certain amount of principal, and confirmation that this amount of principal is less than anticipated borrowings at a fixed rate over the period of the swap
- the fixed and floating rates involved
- the duration of the swap
- That there is a counterparty risk associated with the hedging instrument

The example given is not a fair value hedge but a cash flow hedge (12.19(b)). It is hedging the cash flow cost of the loan, not any variability in the principal. A better example might be using index options to hedge an investment portfolio.

Example 3

This examples needs to include a disclosure requirement of the value of FC loan treated as a hedging instrument. E.g. Included in [type of loan] in the statement of financial position is a foreign current loan from [bank name] of FC1.2m (£364,000) designated as a hedge against [some] of the net assets of a subsidiary whose functional currency is FC. The loan carries interest at [rate] and is repayable [when].

<u>Upfront designation of a hedging transaction</u>

There is no need to identify a transaction as a hedging transaction upfront if there is a hedging policy in place and the transaction is in accordance with this policy.

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Anti-abuse rules

Anti-abuse rules add complexity and make understanding accounts more difficult. Transparency is a better deterrent than complex rules. Rather than put conditions on hedges there should be a requirement to disclose (i) changes in hedging policy, and (ii) the impact on profit of(a) closing out hedges in a period different to that of the cessation of the exposure being hedged and (b) hedges becoming ineffective (e.g. reduction in net assets of foreign subsidiary, early repayment of variable rate loan whose interest cost has been hedged).

Question responses:

1 No. See above for preferred solution

2 Yes, but the FRC's proposals can be significantly improved as highlighted above.

3 This question is not readily understandable and will discourage consultation responses from those not cogniscant of technical accounting terminology. You do not explain what you mean by "economic relationship". If the question is whether a hedging instrument will effectively hedge an identified risk, then, yes, this must be a precondition for identifying a transaction as hedging.

4 Yes. It should not be necessary to document the intention to create a hedge at inception. While this intention is clear in the section on "advice to the FRC", it could be made clearer in 12.18 (b) and 11.14(b)

5 Treatment of gains and losses on hedging should mirror treatment of gains or losses on the items being hedged. The full extent of any profit or loss on investment in a subsidiary should be recognised in the income statement to meet stewardship concerns over identifying the success or failure of an investment.

6 Yes. However it should be clarified that "initial recognition" does not mean "inception", so that the intention referred to in Qu. 4 above is achieved.

7 No. See comments above.

8 No. The applicability of the first sentence of 35.9(b) is unclear. Does it means that hedging arrangements that were allowed under old GAAP but are not allowed under new GAAP should be identified when reconciling between old & new GAAP? If not what does it mean?

Other Comments

The draft paragraphs for insertion into FRS 102 have obviously been written by a financial instruments expert, and need to be translated into plain English in order to facilitate their adoption.

"Net written option" is not defined. There may be other terms not defined.

There is no justification for the requirement to use a separate "cash flow hedge reserve".

The Accounting Council needs to clarify that in the overriding objective in paragraph 9 of its advice to the FRC "high quality financial reporting" is information "proportionate to the size and complexity of the entity and users' information needs", and does not relate to some technical or theoretical quality standard. Alternatively if it does relate to some technical or theoretical quality standard, then this should be explained and justified.

The FRC needs to take more care in drafting consultation questions so that it does not deter consultation responses from people who have valuable experience to contribute but who may be concerned that their responses might highlight that they did not fully understand the questions.