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Dear Susanne

FRED 51 – Hedge accounting

In the appendix to this letter we set out the response of Smith & Williamson to the FRC's exposure draft of proposed amendments to FRS 102 in respect of hedge accounting. In providing our response we are aware that it is also proposed that there will be further clarification in respect of the classification of financial instruments in section 11.9 of FRS 102. We assume that any effect of those amendments will be reflected within the hedge accounting requirements to the extent required.

If you require any clarification of our response please contact Jonathan Pryor.

Yours sincerely



Smith & Williamson

Smith & Williamson LLP

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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?

We are in agreement with the three hedge accounting models proposed in the FRED.

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?

We are supportive of the overarching principle of making the hedge accounting requirements as straightforward as possible. These are however principles that will be new to many preparers and their advisers and as a consequence more detailed guidance and clarity of language may be required to ensure the principles are understood and applied consistently.

A number of entities within the scope of FRS 102 are significant undertakings that have developed sophisticated hedging strategies commensurate with the complexities of their underlying business models. We are aware of a number of such entities that are experiencing some difficulty in understanding how the simple and relatively brief principles set out in the exposure draft can be applied to their circumstances.

Two specific examples of matters that we consider should be addressed are set out below.

Highly probable forecast transactions

UK entities that make regular purchases or sales in foreign currencies will often take out one or more forward contracts to cover their exposure across multiple individual sale or purchase contracts. We believe that the principles set out in FRED 51 make it possible to apply hedge accounting in such circumstances but this is, in our opinion unclear from the drafting. 12.17 refers only to transaction in the singular and the example provided in the Appendix again refers to a single contract. If the intention is that, so long as the economic relationship exists, hedge accounting can be applied; in our opinion further guidance on this matter is needed to ensure that varying practice does not develop.

Commodity contracts

A number of entities applying FRS 102 are exposed to commodity price changes and take out forward contracts to manage potential volatility. The standard and FRED 51 are silent on the treatment of commodity contracts and it is unclear therefore whether the principles of FRED 51 might be applied. Guidance in this area would therefore again help ensure consistency of application.

In addition to the above, we consider that there may need to be some clarification in paragraph 12.22 addressing the amortisation of adjustments arising on fair value hedging. The wording "Amortisation **may** (our emphasis) begin as soon as" will in our opinion be difficult for preparers to interpret in practice as it implies a level of permissiveness not usually seen in accounting standards. We assume that the intention

is to emphasise the latest date from which amortisation must be applied and it may be better to rephrase this part of 12.22 to make this clearer.

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?

We consider that this is an appropriate way of determining whether a hedging relationship exists.

Clarity of the requirements as regards the timing of identification of the economic relationship may however be needed to assist preparers in applying the new principles. We are aware that there is some uncertainty as to whether the designation of a hedging relationship must be at the same time as the associated instruments are first recognised or whether it is possible to make the designation at a later date. It may be possible to extend one of the examples in the Appendix to illustrate the requirements as regards timing.

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.

We agree with this approach.

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?

We agree with this proposal.

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 and loss, with the effect of allowing, in some cases, economic hedging. Do you agree with these changes? If not, why not?

We agree with these changes.

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.

The examples provided in the Appendix may go some way to explaining the principles as applied to the very simplest of circumstances. However, we consider that the examples are however too simple to enable preparers and their advisers to apply the principles to the wide range of hedging arrangements entered into by reporting entities.

We would suggest therefore that for the examples addressing cash flow and fair value hedges, two examples be provided. One simple and one more complex.

For possible examples please see our response to question 2.

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.

We consider that the exemptions should facilitate the application of hedge accounting. However, given the timing of the exposure draft we think that further clarification might be required as regards the application of paragraph 12.16, in particular the timing of documentation of the hedging relationship. The amendment will not be finalised until some time after many entities' transition date and it is not therefore practical that they have the documentation in place by the transition date.

The standard should therefore clarify whether hedge accounting may be applied from transition date in circumstances where the relationship was in place at that date but the documentation is only prepared once the amendment to the standard is finalised.