The Association of Corporate Treasurers

Comments in response to

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

Financial Reporting Council,

November 2013

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The Association of Corporate Treasurers (ACT)

Incorporated by Royal Charter, the ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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The ACT believes the Financial Reporting Council's principle based approach to hedge accounting is a step in the right direction for entities reporting under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland.* We recognise and appreciate that it is designed to reflect risk management more closely and as a result more hedge relationships are expected to be eligible for hedge accounting under the new model.

Response to 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?

The ACT supports the adoption of the three accounting models, fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. These models are consistent with those in international accounting standard IFRS 9 which achieves the first objective of the FRC.

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?

The ACT welcomes the high level principles based approach that the FRC have adopted in this accounting standard. The majority of companies adopting FRS 102 will have relatively straightforward financial risks and as you point out undertake relatively simple economic steps to manage these risks. For these companies we would also expect relatively simple or ‘vanilla’ derivative products to be used as distinct from highly complex structured or ‘exotic’ products.

Having said that we would classify a plain vanilla call or put option as a simple derivative and it is a perfectly reasonable hedging instrument when there is uncertainty as to whether the exposure will arise or not. An example of this is hedging foreign exchange exposures when tendering for a contract, or selling off price list that will rule for a season or a year. The foreign exchange exposures are not certain until the contract has been won, or the sale made. However the company may need to protect their profit margin by buying foreign currency options whether the exposure arises on the revenue or cost side or both. We would argue that *buying* a straightforward foreign currency option should be included within the “relatively simple economic steps to manage risk”.

We understand that FRED 51 would not prohibit designating a purchased option as a hedge of “one-sided” risk. We also understand that the model of hedged risk (known in IFRS as the “hypothetical derivative”) could be documented as an option under FRED 51 - in line with widespread practice that existed in IFRS prior to the amendment to IAS 39 that prohibited such designation (note that such practice continues to exist in US GAAP in accordance with Statement 133 Implementation Issue DIG No G20).

We would like to ensure that practical accounting for a bought option results in as little profit and loss volatility under FRS102 as under IFRS 9. This is especially important in the context of relatively small size of the majority of entities that will be applying FRS 102 for the first time and that may not be familiar with the concept of the hypothetical derivative. Instead of introducing new guidance specific to options within the body of FRS 102 we therefore ask FRC to add some practical examples in the appendix illustrating a highly effective hedge with a purchased option where the hedged risk is itself documented as an option and as a result full fair value of the actual option is deferred in equity (and not just intrinsic value for example). For more on this and other examples that we would like to be added we refer to the answer to Question 7 below.

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?

FRED 51 proposes to remove the requirement that an entity must expect the hedging instrument to be highly effective in offsetting the hedged risk in order to apply hedge accounting. Instead, FRED 51 would require there to be “an economic relationship between the hedged item and the hedging instrument”. We agree with this amendment as it brings FRED 51 in line with IFRS 9, however FRED 51 does not include any guidance on how the existence of an economic relationship between the hedged item and hedging instrument should be assessed. For the majority of hedging relationships it will be apparent that an economic relationship exists, for example hedging a forecast foreign exchange cashflow with a forward FX contract in the same currency. There are also some common situations where the underlying in the exposure (i.e. in the hedged item) and the hedging instrument are not the same. For example it is common practice to use Brent crude oil as a benchmark index for hedging other grades of oil worldwide. We would recommend that some guidance along the lines of IFRS 9 paragraphs B6.4.4 and B6.4.5 are provided.

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.

In principle we agree with the amendment as the resultant ineffectiveness on all hedges is booked to the profit and loss account.

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 the proposal that on disposal of an investment in an overseas subsidiary the accumulated foreign exchange gain or loss in equity is not recycled.

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?

We agree with the amendments as they provide more flexibility.

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 three examples provided are very helpful in explaining to a first time user the accounting implications of hedge accounting. They cover fairly typical corporate transactions i.e. hedging a committed foreign currency transaction with a forward foreign exchange contract; borrowing with a fixed rate loan and swapping to floating rate; and hedging the purchase of an overseas subsidiary by denominating the loan taken out to finance the acquisition in the same currency as the subsidiary. However these examples do not provide adequate guidance for applying the requirements to real life scenarios. For example foreign denominated purchases don't always take place on the planned date and hence there is usually a timing difference between the maturity date of the forward foreign exchange contract and the receipt of goods and invoice; in example two the interest rate swap may not be taken out on the same day as the borrowing; and in example three the cost of the acquisition does not always equal the fair value of the net assets.

Additionally there isn't an example covering the use of an option as a hedging instrument in the fair value and cash flow hedge examples. As noted in 2 above the use of options is not an uncommon hedging practice.

We would suggest that in addition to the simple examples that the appendix is expanded to include more realistic examples to assist users with implementing hedge accounting under FRS 102.

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 found the additional text added to the transitional paragraph 35.9 (b) a little confusing and possibly insufficient. We welcome the exemption that will allow entities to designate the hedges on the date of transition. After all transition to FRS 102 would be a one – off event that is unlikely to be recurring.

In our example in Q2 above the key to subsequent effectiveness of the hedges is the date from which the hypothetical derivative is set up. If the hypothetical derivative is set up from the date of transition even perfectly good and very closely matched hedge relationships could result in large amounts of ineffectiveness reported in profit or loss after transition to FRS 102. We think that a sentence should be added for example after the first sentence in paragraph 35.9 (b) that could be “For the hedge relationships that meet requirements of Section 12 for which an entity applied hedge accounting in accordance with previous UK GAAP, the model of hedged risk (“the hypothetical derivative”) should be set up from inception of such hedge relationship.” The vast majority of entities that use derivatives state in their financial statements or in their other books and records that they do not speculate, which by implication means that they apply a form of hedge accounting (typical UK GAAP off-balance sheet treatment for derivatives is one such form of hedge accounting). Such verifiable evidence would help to avoid entities “cherry-picking” gains on derivatives on transition to FRS 102.

The Association of Corporate Treasurers

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