12 February 2014

Our ref: ICAEW Rep 29/14

Your ref: FRED 51

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Dear Susanne

FRED 51 *Hedge Accounting*

ICAEW is pleased to respond to your request for comments on FRED 51 *Hedge Accounting.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

FRED 51 HEDGE ACCOUNTING

Memorandum of comment submitted in February 2014 by ICAEW, in response to FRC's exposure draft FRED 51 *Hedge Accounting* published in November 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft FRED 51 *Hedge Accounting* published by the FRC on 15 November 2013, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

Incorporating IFRS 9's approach to hedging into UK GAAP makes sense

5. By replacing IAS 39's rules-based approach with IFRS 9's more principles-based approach, the IASB has better aligned its hedge accounting model with entities' risk management activities. This new approach will, we believe, facilitate more meaningful and understandable accounting and disclosure.

6. It clearly makes sense to incorporate these principles into UK GAAP as soon as possible. We therefore welcome the publication of the exposure draft and its proposals to broadly align the hedging requirements of FRS 102 with those of IFRS 9. Many entities will find FRS 102 a more attractive framework when the proposed amendments are implemented.

Departures from IFRS 9 should be kept to a minimum

7. While we supported the IASB's efforts to improve its hedge accounting model, we did not agree with every detail of its proposals and made a number of suggestions as to how they could be improved. However, now that IFRS 9's hedge accounting requirements have been finalised, the FRC should seek to minimise differences between the IASB's model and the requirements incorporated into its own standard.

8. Some simplifications to IFRS 9 are desirable given the less sophisticated nature of many of the entities adopting FRS 102 (particularly as the 'fall-back' option of applying the recognition and measurement provisions of IFRS 9 in full is also available).

9. We agree with the exposure draft's simplified approach to the initial assessment of hedge effectiveness, the option to discontinue hedge accounting voluntarily and the prohibition of recycling of gains and losses initially recognised in equity in a net investment hedge. We are, however, pleased to note that – on the whole – the FRC's proposals retain the principles set out in the international standard.

Some common risk management strategies may not qualify for hedge accounting

10. We are concerned that some of the proposed simplifications to the IFRS 9 model may inadvertently result in accounting outcomes that are different from those that would have arisen had IFRS 9 been applied and that in some instances this may prevent common risk management strategies from qualifying for hedge accounting under UK GAAP.

11. For example, it would appear that groups of items (including groups of items that constitute a net position) would not be eligible hedged items under the proposals and it remains unclear whether and which risk components can qualify as hedged items. These – and other similar concerns – are discussed further in our answer to question 2 below.

12. It may be that only a small number of entities will be affected by some of these issues. The FRC may therefore wish to undertake some research into how often these differences will result in identical transactions being accounted for differently under the proposals and IFRS 9 before deciding on the best way forward.

The transition guidance is unclear

13. We agree that transitional exemptions are needed for those moving to FRS 102 in order to allow hedging relationships that exist at the date of transition to benefit from hedge accounting. However, it is not sufficiently clear from the current drafting what the FRC intends the transition provisions to be or when and by which entities they can be applied. It is important that the transition guidance is clear and that the latitude for manipulating post-transition earnings is kept to a minimum. Our answer to question 8 suggests some improvements that we believe would make the transition guidance clearer.

14. We also have a concern in relation to the timescale for the preparation of hedge documentation as there appears to be scope for entities to selectively designate or de-designate hedging relationships with the benefit of hindsight up to the point when their first set of FRS 102 financial statements are filed (some 33 months after the date of transition). This clearly is unsatisfactory and could be open to manipulation and abuse. We suggest that for transition dates before 31 December 2014, a limit is set for retrospectively designating and documenting pre-existing hedging relationships. We suggest that, in such cases, an entity should have all documentation in place by the later of 12 months after its date of transition or three months after the standard has been finalised. This is discussed further in our answer to question 8 below.

15. We also have other significant concerns about the transitional guidance, including the lack of guidance on accounting for pre-existing hedging relationships where an entity elects not to apply hedge accounting at its date of transition. These concerns are discussed further in our answer to question 8 below.

RESPONSES 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?

16. Yes. We believe that consistency with IFRS 9 is helpful and therefore we support the adoption of the three hedge accounting models as set out in the exposure draft. We do, however, have some concerns about the detailed application of these models in the context of section 12 of FRS 102 which are highlighted in our responses to the questions below.

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?

17. Yes, we agree with the overarching principle of keeping FRS 102's hedge accounting requirements relatively simple and accessible. Some simplifications to IFRS 9 are desirable given the less sophisticated nature of many of the entities adopting FRS 102 (particularly as the 'fall-back' option of applying the recognition and measurement provisions of IFRS 9 in full is also available).

18. We agree with the exposure draft's simplified approach to the initial assessment of hedge effectiveness, the option to discontinue hedge accounting voluntarily and the prohibition of recycling of gains and losses initially recognised in equity in a net investment hedge. We are, however, pleased to note that – on the whole – the FRC's proposals retain the principles set out in the international standard.

19. However, we are concerned that some of the proposed simplifications to the IFRS 9 model may inadvertently result in accounting outcomes that are different from those that would have arisen had IFRS 9 been applied and that in some instances this may prevent common risk management strategies from qualifying for hedge accounting under UK GAAP.

20. We therefore encourage the board to provide clarification on the following issues in order to avoid confusion and potential diversity in practice.

a) Groups of items and net positions

21. It is very common for entities to group similar items – such as sales or purchases in the same foreign currency in the same month – together for risk management purposes and hedge the net exposure. IFRS 9 specifically states that a hedged item can be a single item or group of items, which explicitly includes groups of items that constitute a net position. In contrast, the definition of a hedged item that would be added to FRS 102 under the proposals makes no mention of groups of items. It would be a disappointing outcome if such hedges were not able to qualify for hedge accounting under FRS 102.

b) Risk components

22. It is also common in some sectors for entities to hedge risk components. For example, in the aviation sector, airlines often hedge their exposure to jet fuel price movements by using crude oil futures. This can be an effective risk management strategy as the latter is clearly a significant risk component of the former. IFRS 9 specifically states that a risk component can qualify as a hedged item. The definition of a hedged item that would be added to FRS 102 under the proposals makes no specific mention of risk components. The reference to hedging the risk associated with only a portion of a hedged item may, arguably, cover risk components but we feel that this could be made clearer to avoid any confusion or doubt about what does

and does not qualify for hedge accounting. Moreover, we recommend that the board echoes the requirement in IFRS 9 that states that a risk component can qualify as a hedged item only where it is 'separately identifiable and reliably measureable'.

c) The time value of options

23. It is also common for entities to enter into zero cost interest rate collars in order to hedge the interest payments on variable rate loans. The approach taken in the exposure draft would still result in substantial profit volatility due to the option's time value. The approach taken by IFRS 9 is to treat the movement in time value as a cost of hedging and amortise this over the relevant period. This may significantly reduce profit volatility. While we appreciate that some may think that this is over complicating matters, we nonetheless recommend that the FRC carefully considers whether it would be appropriate to adopt a similar approach here in the UK.

d) Foreign currency risk of intragroup monetary items

24. Consistent with IFRS 9, the exposure draft requires that in the consolidated financial statements the hedged item must be an asset, liability, firm commitment or highly probable forecast transaction with a party external to the reporting entity. However, paragraph 6.3.6 of IFRS 9 provides an exception to this rule for the foreign currency risk of an intragroup monetary item and highly probable forecast transactions – such as a payable or receivable between two subsidiaries or highly probable intragroup sales or purchases – which may qualify as hedged items in the consolidated financial statements if they result in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. We note that this exception has not been included in the exposure draft. While we appreciate that it may have been deliberately excluded in order to simplify things, we believe – on balance – that it should be retained as omitting it may again result in effective risk management strategies that qualify for hedge accounting under IFRS 9 being excluded from it under UK GAAP.

e) Cash flow hedges

25. Paragraph 12.23(d)(i) of the exposure draft states that 'the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability'. The equivalent paragraph – namely 6.5.11(d) – of IFRS 9 explicitly states that this is not a reclassification adjustment and does not affect other comprehensive income. It is unclear whether the additional wording has simply been left out in order to abridge the text or whether its exclusion means that the FRC disagrees with the IASB's analysis and instead believes that this adjustment should affect other comprehensive income. The board needs to be clear on what its intentions are.

26. We also note that paragraph 6.5.11(d)(iii) of IFRS 9 has not been included in the exposure draft. This sub-paragraph includes some useful guidance on impairments that the FRC may wish to add to FRS 102.

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?

27. Yes. We agree that there should be an economic relationship between the hedging instrument and the hedging item if an entity is to qualify for hedge accounting.

28. The existence or otherwise of such an economic relationship is, however, a judgemental area. While the Accounting Council's Advice to the FRC that accompanies the exposure draft provides some further guidance, it would be helpful if the wording could be the same as – or more similar to – that used in paragraphs B6.4.4 to B6.4.6 of IFRS 9. Failure to more closely

align this guidance may result in the FRC's words being interpreted differently from those of the IASB and inconsistencies arising in practice.

29. In particular, it would be useful to echo IFRS 9 by stating that for a hedging relationship to exist, the hedging instrument and the hedged item will have values that will generally – but not always – move in the opposite direction because of the same risk and that the mere existence of a statistical correlation between two variables does not, in itself, support the conclusion that an economic relationship exists.

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.

30. Yes, we agree with the proposed approach as the remaining qualification criteria appear robust enough to ensure that the economic substance is reflected in the financial statements.

31. Removing the requirement to make a 'binary assessment' of hedge effectiveness at the beginning of a hedging relationship will remove some of the cost and effort that may otherwise have deterred some entities from considering hedge accounting. Hence, it will allow an entity's risk management strategies to be reflected in its financial statements in more instances.

32. However, the complexities of measuring ineffectiveness in some instances should not be underestimated. Moreover, some entities may not appreciate that hedge ineffectiveness may even arise in relation to what appear to be 'perfect' hedges. For example, changes in the credit risk associated with a derivative counterparty will affect the value of the hedging instrument but not that of the hedged item meaning there will be some ineffectiveness even where the critical terms of the hedging instrument perfectly match the exposure.

33. Similar ineffectiveness on apparently 'perfect' hedges can also arise on – among others – cross-currency hedges and cash flow hedges where the hedging instrument is a derivative with a non-zero fair value on day one.

34. Additional illustrative examples demonstrating sources of hedge ineffectiveness would be welcomed as this would not only highlight the importance of these requirements but also reinforce that they are a core feature that needs to be considered by anyone considering applying hedge accounting. These examples might helpfully indicate that sometimes it will be clear from a simple qualitative assessment that any ineffectiveness will be immaterial.

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?

35. Yes. We agree with the proposed approach to net investment hedges and the absence of recycling.

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?

36. Yes. We agree with broadening the range of instruments that may be designated at fair value through profit or loss as this will allow, in some cases, economic hedging.

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.

37. While the three examples included are simple, they will no doubt be useful to those not familiar with the mechanics of hedge accounting. We therefore think that they are helpful application guidance.

38. We do, however, suggest the following minor changes:

- Example 1 Cash flow hedge – it would be helpful if the 'alternative' described in paragraph 12A.3 was extended so that the relevant journal entries (including the effect of the hedge ineffectiveness) are included.

- Example 2 Fair value hedge – it would be helpful to include journals for the accrual and settlement of interest on the hedged item and hedging instrument.

39. Straightforward examples such as those provided can be helpful if the simplifying assumptions are clearly stated. Nonetheless, some will always call for more complex examples. However, their inclusion risks confusion in relation to the basics. How many and how detailed any illustrative examples should be is always a difficult judgement call. Such is the standard-setter's dilemma.

40. On balance, we think that it would be helpful to include some further examples in this instance. As noted above, additional examples demonstrating sources of hedge ineffectiveness would be welcomed. Similarly, examples demonstrating the impact of transitional adjustments would be helpful.

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.

41. We agree that transitional exemptions are needed for those moving to FRS 102 in order to allow hedging relationships that exist at the date of transition to benefit from hedge accounting. However, it is not sufficiently clear from the current drafting what the FRC intends the transition provisions to be or when and by which entities they can be applied. It is important that the transition guidance is clear and that the latitude for manipulating post-transition earnings is kept to a minimum.

42. Transitional relief should be available for all entities – with the possible exemption of those entities that have previously adopted FRS 26 or EU-adopted IFRS – when moving to FRS 102 when the new UK GAAP regime first becomes effective. However, in later periods the same transitional relief would not be necessary for those moving from EU-adopted IFRS or FRS 101 as these standards include sophisticated hedge accounting requirements which will usually meet the FRS 102 requirements. If an entity hedge accounted under EU-adopted IFRS or FRS 101 then we believe that it should, if permitted by FRS 102, continue to hedge account under FRS 102 from its transition date. For entities transitioning from the FRSSE on-going transitional relief will be required.

43. In addition to the above, we have a concern in relation to the timescale for the preparation of hedge documentation. Although paragraph 35.9(b)(ii) suggests that designation must be made and documentation must be in place at the date of transition, we note that the FRC has issued a clarification statement stating that this need not be the case provided that it is subsequently documented as at that date.

44. We appreciate that the relaxation of these requirements is, for those adopting it when the new UK GAAP regime first applies, necessary given the timing of the publication of the exposure draft. However, without further guidance there appears to be scope for entities to selectively designate or de-designate hedging relationships with the benefit of hindsight up to the point when their first set of FRS 102 financial statements are filed (some 33 months after the date of transition). This clearly is unsatisfactory and could be open to manipulation and abuse. We suggest that for transition dates before 31 December 2014, a limit is set for retrospectively designating and documenting pre-existing hedging relationships. We suggest that, in such cases, an entity should have all documentation in place by the later of 12 months after its date of transition or three months after the standard has been finalised. As noted above, this transitional relief should only be available when the new UK GAAP regime first applies. However, as a FRSSE entity may have little notice that it is required to move away from the FRSSE – eg, if it is acquired on the last day of its financial year – the transitional relief should remain for this specific scenario and a longer date of, say, three months after the entity ceases to be eligible to adopt the FRSSE would be merited in order to give the entity time to decide whether to hedge account, and if so, to prepare documentation.

45. A similar issue arises where an entity takes the option of applying the recognition and measurement requirements of either IAS 39 or IFRS 9 instead of the equivalent provisions of sections 11 and 12 of FRS 102. Again (and with the same cut-off of 31 December 2014 as suggested above) we would suggest that such entities should have all documentation in place by the later of 12 months after their date of transition or three months after the standard has been finalised.

46. The proposed drafting for paragraph 35.9(b) is generally unclear and open to multiple possible interpretations. We have noted a number of areas where the existing drafting is unclear or where further precision is needed and these are detailed below. However, the best way to achieve the desired clarity over when and how the transitional adjustments are applied may be a complete redraft of this paragraph rather than by making targeted amendments to it.

47. It is unclear what is meant by ‘hedging relationships that exist at the date of transition’ and there is no guidance on accounting for such relationships where an entity elects not to apply hedge accounting at its date of transition.

48. For instance, we note that due to the reduction in interest rates over recent years, many entities will at date of transition be substantially ‘out of the money’ on derivatives such as interest rate swaps that have been used for economic hedging. Under FRS 4, these are commonly combined with a variable rate loan and accounted for as a synthetic fixed rate loan. If the entity elects not to apply hedge accounting under FRS 102, it is not currently clear whether:

- The pre-transition arrangement should be accounted for as a discontinued cash flow hedge. If this is the case, the other side of the double entry on date of transition would create a cash flow hedge reserve. This would then be unwound against future profits to match the hedged item; or

- The pre-transition arrangement should be accounted for at fair value through profit or loss with the other side of the double entry on the date of transition resulting in an immediate impact on profit or loss reserves.

49. This could have a significant impact on the distributable reserves position depending on the approach taken. It would therefore be helpful for the FRC to clarify its intention. It may be useful to add further illustrative examples to cover this situation.

50. It is also unclear whether paragraph 35.9(b)(i) is intended to require retrospective or prospective application of section 12 and, hence, whether transitional adjustments are required under this option. Similarly it is unclear whether paragraph 35.9(b)(ii) is intended to approximate the retrospective application of section 12 to continuing hedges.

51. Lastly, it is also unclear whether the choice between paragraphs 35.9(b)(i) and 35.9(b)(ii) is an accounting policy choice or a hedge by hedge choice. If it is the latter, it would offer entities a choice over whether the historical gain or loss on the hedging instrument is recognised in profit or loss. This could clearly be open to manipulation. For example, an entity could decide not to hedge account for an arrangement that was out of the money (the debit would be taken to reserves on transition) whilst hedge accounting for an arrangement that was in the money (the credit would be taken to cash flow hedge reserve and subsequently released over time to the income statement). Entities should not be able to pick and choose which hedges are accounted for retrospectively, especially if they did not previously hedge account.

52. Neither paragraph 35.9(b)(i) nor 35.9(b)(ii) allows clear relief from the requirement in paragraph 12.16 to have documentation in place at the inception of the hedge. This could be problematic if retrospective application was intended.

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