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Dear Susanne

FRED 51 Hedge Accounting

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) consultation 'FRED 51 Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland Hedge Accounting'.

Overall approach of FRED 51

We support strongly the overall objectives and approach of FRED 51. In particular, we support the goal of aligning hedge accounting towards the more principles based approach of IFRS 9 in contrast to the rules based IAS 39 approach. This will allow hedge accounting to provide more meaningful information to users and is less burdensome on preparers as compared to either the IAS 39 approach or the existing hedge accounting models within FRS 102. By making hedge accounting more easily available in a manner consistent with risk management objectives, many businesses will be able to apply hedge accounting to allow the profit and loss account to more fairly reflect its underlying profitability when it uses derivative hedging instruments for economically based hedging activities. This aids businesses in unlocking their potential for growth.

We agree with the approach of consistency with IFRS 9 in summarised format, while making simplifications where appropriate. The simplifications reflect a balance between avoiding undue complexity while retaining features to allow FRS 102 users to apply hedge accounting in common hedging relationships. Preparers who wish to utilise more sophisticated strategies have available the accounting policy choice of applying IFRS 9 or IAS 39 instead of sections 11 and 12 of FRS 102.

The proposals have most of the necessary safeguards to ensure that hedge accounting is only applied to valid hedging activities consistent with risk management objectives. However, the importance of assessing the level of ineffectiveness and making clear the associated accounting entries should not be understated. For this reason we suggest the finalised standard give some additional emphasis to this aspect.

We have made some suggestions for improvements. These include:

- permitting hedged items to be defined in the contexts of groups of similar transactions as opposed to singular transactions. For example, in cash flow hedges as in our experience it is much more common for forecast transactions to involve a group of similar transactions as opposed to a single transaction

- incorporating the approach of IFRS 9 relating to the time value of options as hedging instruments. This amortises the time value as a cost of hedging reducing volatility. We consider the benefit worthwhile due to the popularity of some option based derivatives, such as zero cost collars, although it adds some additional complexity.

Transitional provisions

Although we support the overall approach to hedging within FRED 51, we have major concerns regarding the transitional provisions, as currently drafted.

A common feature of hedge accounting designations is that the hedging relationship must be evidenced by hedge accounting documentation, which cannot be backdated. Given that the finalised standard will be issued after the transition date for many entities will have past, it is essential that some scope for backdating documentation is allowed initially. We welcome the recent announcement by the FRC, which clarifies that such backdating is to be permitted, however we are concerned as to the lack of clarity over the deadline by which time this 'backdated' hedge accounting documentation must be prepared. In order to avoid earnings management manipulation it is crucial that the deadline for preparation of such hedging documentation is clearly specified. It is also important that the finalised deadline gives suitable time for businesses to assess whether they wish to apply hedge accounting and to prepare the necessary documentation.

We understand that although the FRC currently intend to allow the documentation to be backdated where FRS 102 sections 11 and 12 are applied, the proposals do not permit a similar approach where, within FRS 102, the policy choice is taken to apply IFRS 9 or IAS 39. We recommend strongly that this extension in time is also afforded to those entities that may wish to take these policy choices. In particular, many entities are not yet in a position to make their assessment as to which policy choice to take, as the standard has not yet been finalised. We consider that in such circumstances the extension of the deadline by which documentation must be in place should be available for all entities that use FRS 102. In addition, the transitional provisions are unclear as to the required entries in the opening transitional balance sheet where an entity has in place existing hedging relationships that meet the criteria for hedge accounting under FRS 102 (including the IAS 39 or IFRS 9 policy choices) but chooses not to hedge account following transition. This is particularly relevant for those entities that did not apply FRS 26, with derivatives off balance sheet but where the approach adopted reflects the profit and loss impact of the derivative in a similar way to a hedge, for example when the interest charged to P&L on a variable to fixed rate swap is simply the fixed rate interest charge.

We have outlined two potential interpretations below for a simple cash flow hedge:

1 When bringing the derivative on balance sheet the other side of the entry is to profit and loss reserves.

2 The arrangement is treated as if hedge accounting had applied before transition and then discontinued at that date. This results in the other side of the transitional date entry being to a cash flow hedging reserve rather than profit and loss reserves. The hedging reserve is then recycled to profit and loss in post transition date periods over the remaining life of the hedged item.

Our recommendation is that there must be clarity in the final standard as to which approach entities should take. Our understanding is that, based on the ICAEW distributable profits guidance Tech 02/10, the two approaches can have significantly different impact on the distributable profit position. This is due to the large number of 'out of the money' derivatives such as interest swaps, which reflect the low levels of interest rates in recent years. This consequential impact on the legally distributable reserves means that it is highly desirable to have no diversity in practice. To aid clarity we also suggest that the finalised proposals have illustrative guidance relating to the transition date balance sheet entries. It is important that the finalised standard is written with clear guidance to avoid future disputes relating to an entities distributable profits and its associated legality of dividend payments.

In terms of which approach is taken, on balance, our preference is for the second approach. We note that this is more complex than the first approach. However the second approach has the following key advantages:

1 At the date of transition, the distributable profit position would typically be neutral, irrespective of whether hedge accounting is followed going forward. In contrast, in the first approach there would be an immediate entry to profit and loss reserves when an entity chooses not to follow hedge accounting after transition, which would immediately impact distributable profits.

2 The second approach is consistent with the common interpretation of IFRS 1.

3 The second approach also avoids some earnings management issues which might otherwise arise.

We set out our detailed responses to each of the questions raised in the attached Appendix.

If you have any questions on our response, or wish us to amplify our comments, please contact Alan Chapman (telephone :0131 6598509, email alan.chapman@uk.gt.com). or Joyce Grant (telephone: 0207 7282073, email joyce.grant@uk.gt.com).

Yours sincerely

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Response 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?

Yes. The three models of cash flow hedge accounting, fair value hedge accounting and hedge of a net investment in foreign operations are consistent with both IFRS 9 and IAS 39. It is helpful to have general models that are consistent with those standards, while providing useful practical simplifications in their application.

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?

Yes we agree with the overarching principle. We agree with the approach based on the IFRS 9 more principles based approach compared to the more rules based approach of IAS 39, while setting the requirements out in a more summarised form.

However, we have concerns that in a small number of areas, the proposals may be more restrictive than IFRS 9, in areas which are relevant to the users of FRS 102. We appreciate that FRS 102 paragraph 11.2 allows a user as a policy choice to instead apply IFRS 9 or IAS 39. We also understand that it is helpful for sections 11 &12 to be as simplified as far as possible. Nevertheless, in order to allow sections 11 & 12 to have wider application, we suggest the following areas are considered.

Extension of the definition of hedged items to incorporate "groups" of similar items

At present, FRED 51 defines a hedged item in singular form. It does not appear to contemplate "groups" of items. If not addressed in the final standard, this would be a substantial restriction on many entities eligibility to apply hedge accounting. For example, in a foreign currency hedge of a highly probable forecast transaction, it is very common for the hedged item to be a group of transactions rather than a single transaction. Indeed in our experience in cash flow hedges over foreign exchange risk on sales or purchases, the hedge is typically in respect of a group of similar transactions. For example, a typical hedged item might be designated as "the first $10M of sales in the month of July 2015".

We recommend strongly that the definition of a hedged item is extended to include groups of similar items, in a similar way to IFRS 9. In particular, we consider the key criteria should be:

- all items within the group are individually eligible items
- the items are managed together on a group basis
- all of the items in the group share similar risks

We note that IFRS 9 allows hedge of net positions, however this adds complexity to that standard and we consider that it would be unnecessarily complex to incorporate the net position designations within FRS 102 sections 11 & 12.

Incorporation of the IFRS 9 approach relating to the time value of options

We recommend that the proposals should incorporate the IFRS 9 approach of allowing the time value of options to be separately amortised through other comprehensive income as a cost of hedging.

When a hedging instrument is option related and the entire instrument is designated as the hedging instrument, the movement in the option's time value can cause significant ineffectiveness and volatility. IFRS 9 allows an approach whereby:

a only the intrinsic value is designated as the hedging instrument
b the movement in time value is amortised to the profit and loss as a cost of hedging. In the context of a cash flow hedge the time value is initially taken to other comprehensive income and then amortised through profit and loss.

This approach increases the usefulness of hedge accounting for option based instruments. Although some option based instruments are in our experience less common within typical UK GAAP preparers, there are some notable exceptions, in particular interest rate collars.

As currently drafted, if an entity had an interest rate collar that is designated as a hedging instrument, applying FRED 51 may result in significant profit volatility. As such the IFRS 9 approach may be much more attractive in this regard. For this reason we would welcome the incorporation of the IFRS 9 approach in relation to components of option based hedging instruments within sections 11 & 12 of FRS 102.

We note that in addition to the approach on options, IFRS 9 also permits the forward element of forward contracts and foreign currency basis spreads to be separated from the hedging instrument and treated as a cost of hedging. In our view, the cost/benefit balance is less compelling for those elements.

Restrictions relating to cash flow hedges over foreign currency risk in a group situation
In common with IFRS 9 and IAS 39, FRED 51 requires that the hedged item must relate to an external transaction, which we support. However, there is a specific, but relatively common scenario where this can be unduly restrictive. Consider a situation where parent P has GBP functional currency, and subsidiary S has US dollars functional currency. It is common for the group to enter into foreign currency forward contracts to hedge the foreign exchange exposure on the US dollar sales. If applying FRED 51 as currently drafted, in the group accounts the USD external sales do not give rise to foreign exchange risk and so are not a valid hedged item and so cash flow hedge accounting in the group accounts would be precluded.

IFRS 9 and IAS 39 both permit hedge accounting in this scenario, by allowing the hedged item to be defined in the context of the intra-group transactions, subject to stated criteria. Although this would increase complexity, in order to allow for hedge accounting in this common situation, we recommend that the approach in IFRS 9 paragraph B6.3.5 is incorporated within sections 11 and 12.

Incorporation of some aspects of the IFRS 9 approach in permitting hedges of risk components
It is relatively common in some sectors for entities to hedge risk components. For example in the aviation sector it is common for crude oil derivatives to be used to hedge the cost of jet fuel purchases. FRED 51 is currently silent on the hedge of risk components, although the definition of a hedged item does refer to "portions". We recommend this is made clearer in the final standard. If risk components are intended to be allowed as a hedge accounting designation, it would be helpful for the criteria to be made more explicit. In particular we note that IFRS 9 requires such components to be "separately identifiable and reliably measureable".

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?

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. However it would be helpful for further guidance on the meaning of an economic relationship to be defined within the body of the standard in a similar way to IFRS 9 paragraphs B 6.4.4 to B6.4.6.

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 the absence of a binary assessment at the beginning of a hedge relationship. The establishment of the requirement for there to be an economic relationship, the requirement for the designation to be consistent with risk management strategy and the requirement for actual ineffectiveness to be in profit or loss should ensure robust accounting reflecting the economic substance of the hedging arrangements.

However, the complexities of measuring ineffectiveness in some instances should not be underestimated. For instance even in "perfect" hedges ineffectiveness can arise through credit risk associated with the derivative counterparty. In this context it may be helpful to provide additional illustrative examples to demonstrate the sources of hedge ineffectiveness.

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. The absence of recycling in relation to a hedge over a net investment should be consistent with the general approach on foreign currency on the disposal of foreign operations in paragraphs 30.13 and 9.18A.

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.

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.

We consider these examples are helpful illustrations of the basic accounting entries within the three hedge accounting models. The examples given are of simplistic situations which might lead the user to underestimate the potential complexity which might arise. We appreciate that the FRC needs to strike a balance between providing helpful guidance versus providing burdensome detail. However on balance we consider that it may be helpful to provide some additional examples, in particular

1 an example demonstrating potential ineffectiveness
2 examples demonstrating the application of the transitional rules (see question 8).

Question 8 -The draft amendments propose a transitional exemption which will allow certain of 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.

In order to reduce complexity and provide more meaningful information for those entities that are moving from non-FRS 26 UK GAAP to FRS 102, we consider that the transitional relief that appears to be set out in paragraph 35.9(b)(ii) is essential. This is because it permits hedge relationships that are in place at date of transition to be accounted for as if they were "zero starting".

The term "zero starting" refers to a situation which is the same as if hedge accounting had been historically applied in the past, with hedge accounting commencing at a time when the derivative hedging instrument had zero value. By contrast a "non-zero starting" relationship is one which commences later when the derivative hedging instrument has a non-zero value.

A crucial aspect of this in the context of cash flow hedge accounting is the creation of a cash flow hedge reserve via the transition adjustments. This is what is proposed by 35.9(b)(ii). An opening transition date cash flow hedge reserve equal to the fair value of the derivative hedging instrument is an essential feature of this. Without this relief, the accounting for a non-zero starting designation is considerably more complex and less easily understood by a user. We therefore support this transitional relief.

However we have major concerns in respect of the drafting of the transitional provisions. These relate to:

1 the lack of clarity over the deadlines by which entities are required to prepare hedge accounting designation documentation in order to qualify for the transitional provisions

2 application of transitional provisions where an entity opts to apply IFRS 9 or IAS 39 instead of sections 11 and 12

3 lack of clarity as to the accounting entries where an entity has existing hedge relationships that qualify for hedge accounting but chooses not to hedge account following transition

The extent of the lack of clarity relating to the transitional provisions is such that we suggest that a significant redraft of this section is required. We describe in detail below the key features which appear to be problematic or unclear in the existing draft.

Timescales for preparation of hedge accounting designation documentation in order to qualify for the transitional relief

FRED 51 paragraph 35.9(b)(ii) has not been clearly drafted to state when hedge designation documentation is required to be prepared in order for the transitional relief to apply. We note that IFRS 1 requires designation documentation to be in place by date of transition in order to be treated as a continuing zero starting hedge. There are normally good reasons for this, as it is important that entities cannot backdate documentation for hedge accounting purposes or this can result in earnings management manipulation. However, for entities first applying FRS 102 for 31 December 2015 ends, transition date will be 1 January 2014. Given the timing of the issue of the final standard, it would not be practical to expect entities to have hedge designation documentation in place by the date of transition. Therefore as an exception it is necessary in the initial application of FRS 102 to allow an element of backdating of hedge documentation, contrary to normal hedge accounting principles.

We understand from recent announcements by the FRC that the intention is to allow entities a period of time beyond the date of transition to prepare hedge documentation, such that it is treated as if the relationship had been formally designated as at date of transition.

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. In our view this 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 an entity applying the FRSSE may have little notice that it is required to move away from the FRSSE, for example if it is acquired on the last day of its financial year, 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.

A similar issue arises when 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. In this case (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 its date of transition or three months after the standard has been finalised.

Transitional adjustments where hedge accounting is NOT designated

Due to low interest rates it is common for many entities to have substantially "out of the money" derivatives such as interest swaps. This is particularly relevant to businesses that entered into long term interest swaps connected with long term debt. Based on guidance in Tech 02/10, for a cash flow hedge, we understand that any fair value loss on a derivative which is a hedging instrument in a cash flow hedge is not considered to be a realised loss until it is recycled to the profit and loss account (para 5.7 of Tech 02/10). Therefore cash flow hedge accounting impacts on the distributable profit position. This is particularly relevant to a limited company, which is not subject to the plc net assets test in section 831 of the Companies Act.

Where an entity chooses to apply cash flow hedge accounting from date of transition, FRED 51 would appear to be clear on its impact, although as noted above lacks clarity on the timescale for preparing the necessary documentation. However, the situation is less clear when hedge accounting is not chosen from date of transition when an entity had relationships in place at the date of transition that would have met the relevant hedge accounting criteria. Based on the current wording in FRED 51, it is possible to arrive at two different views.

FRED 51, para 35.9(b) states that for "hedging relationships that exist at date of transition", if an entity does not designate hedge accounting, that entity shall "follow the hedge accounting requirements of section 12 Other Financial Instruments Issues, including the requirements for discontinuing hedge accounting for hedging relationships that do not meet the conditions of sections 12"; This would appear to provide the relevant criteria where an entity chooses not to apply hedge accounting. However we consider that the application lacks clarity.

Two potential interpretations are

View 1 – In the context of non-FRS 26 UK GAAP there was no concept of hedging relationships or hedge accounting. Therefore, as such relationships were not defined under previous GAAP the hedge accounting transition rules might not be viewed as relevant. As such, on transition, the other side of any adjustment on bringing the derivative on balance sheet should be to profit and loss reserves.

View 2 – The term "hedging relationship" should be considered in a broad sense in the context of non-FRS 26 UK GAAP. When derivatives are accounted for as economic hedges such that any fair value movements are not recognised until date of settlement, then these would be considered as having been accounted for as a "hedge". For instance, an interest rate swap when swap payments were recognised in a manner to match the related interest payments on a related loan. When an entity at date of transition has a derivative which meets the definition of a hedging instrument and another item meeting the definition of a hedged item such that it could opt to apply hedge accounting in accordance with para 12.16 (except for the absence of designation in para 12.6(a)) then it should account for the hedging relationship as if it had applied hedge accounting up to date of transition and then derecognise the hedging relationship from that date. Following this approach, the other side of the transition entry would be to create a hedging reserve. Although hedge accounting is discontinued on transition, this hedging reserve would then be recycled post transition over the remaining life of the hedged item.

Which approach is taken has a significant impact on:

1 distributable reserves as at transition date for the purpose of declaring dividends
2 future profits.

Depending on which approach is taken, there could be a major difference to an entity's distributable reserves. This is particularly important at the current time as due to the low interest rates many interest rate swaps taken out some time ago may now represent substantial liability positions. Under view 1, for derivative liabilities there is an immediate restriction on distributable reserves but the same may not be the case for view 2. View 1 could therefore lead to a significant dividend trap and a large transition date difference in terms of distributable reserves depending on whether that entity decides to make the relevant hedge accounting designations.

We note that in the context of IFRS, IFRS 1.B6 might be similarly difficult to interpret, but the GAAP texts of the major firms generally prescribe view 2 based on IFRS 1.IG60B. The rationale behind this is to ensure logical consistency with the transitional relief where hedges are designated and also to avoid earnings management issues. However, in the absence of very clear direction, less sophisticated entities may intuitively be minded to view 1.

Overall we consider that due to the link with distributable profits, it would not be acceptable to have significant diversity in practice in this area. The approach should therefore be clear and mandated.

In terms of which approach should be mandated, we summarise on the advantages of the respective approaches as follows:

	View 1	**View 2**
Complexity of accounting entries where hedge accounting not wished to be used	Straightforward.	• More complex due to unwinding of transitional entries against future profits. • This might be less intuitive to a less sophisticated user.
Impact on distributable reserves in the context of out of the money derivatives (common at current time on interest swaps)	• Will immediately impact on distributable reserves in contrast to where hedge accounting is applied. • Could act as an immediate block on ability to pay dividends	• Initial entry is to cash flow hedge reserve. • Following tech 02/10, does not impact on distributable profits until recycled in later years. • Distributable profits position at transition date is the same compared to where hedge accounting is designated.
Earnings management issues	Potentially a sophisticated user could manage earnings through deliberately designating at a later date.	Avoids earnings management issues
Consistency with IFRS 1 approach	Not consistent	Consistent

Therefore we suggest that:

1 explicit direction is given in a manner which can be understood by non-sophisticated users

2 in the context of non-FRS 26 UK GAAP, guidance is given as to what is meant by a "hedging relationship"

3 this is supplemented by illustrative examples. This should contrast between an entity which pre transition (a) applied FRS 4/SSAP 20 UK GAAP versus (b) applied FRS 26 UK GAAP/FRS 101 or IFRS – see below.

Transition adjustments – what if an entity applied FRS 26, FRS 101 or IFRS before transition?

IFRS, FRS 101 and FRS 26 UK GAAP require derivatives to be recognised on the balance sheet at fair value together with a form of hedge accounting to manage profit volatility arising in valid and designated hedging relationships. If the entity moved from such an accounting framework to FRS 102, we would expect transitional arrangements which allowed previously designated hedging relationships to continue. However, where such entities had chosen not to designate a hedge accounting relationship under that previous framework, we consider that special transitional relief would not be necessary.

Consider a situation where an entity applied FRS 26 but chose to avoid hedge accounting and so carries the derivative at fair value through profit or loss, then on transition to FRS 102 elects to use hedge accounting.

In this situation para 35.9(b) would appear to result in the transition relief being fully available on conversion to FRS 102 (in a similar way to a non-FRS 26 entity). We note that for entities already within FRS 26, this could lead to earnings manipulation opportunities despite those entities already accounting for derivatives at fair value through profit or loss in existing GAAP. We consider this could give rise to unsatisfactory outcomes.

In our view, where an entity moves to FRS 102 having earlier applied FRS 101, IFRS or FRS 26:

1 when a derivative was already accounted for at fair value through profit or loss and no hedge accounting designation had been made relating to that derivative then no transitional relief should be available.

2 when hedge accounting relationships had been designated under the previous GAAP and the previously designated relationship also meets the hedge accounting criteria within FRS 102, then we consider the hedge relationship should continue for that relationship

3 when hedge accounting relationships had been designated under the previous GAAP, but the relationship does not meet the criteria in FRS 102, then on transition this would be treated as a discontinued hedge. We consider that this situation would be rare.