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Your ref: FRED 52
Our ref: 00/JN/Comment letter
FRED 51

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Dear Susanne

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

We are pleased to have the opportunity to comment on FRED 51. We broadly agree with the FRC's direction of travel enshrined in FRED 51, although make a number of suggestions for improvement and / or clarity in our responses to specific consultation questions below.

One major lacuna in the proposals, however, seems to be catering for those entities that manage exposure to risk through the use of derivatives with purchased optionality (e.g. interest rate caps and collars and forward currency options). Application of FRED 51 would (often) result in the cost of such purchased optionality being unmatched to the hedged transaction giving rise to volatility. As these arrangements are very common in the UK we believe that FRS 102 should also incorporate elements of IFRS 9 enabling the cost to be allocated to periods relevant to the hedged transaction.

Note that we only provide answers to questions for which we have specific observations. We agree with all other questions.

Question 4

We agree with the removal of the binary assessment of effectiveness at the beginning of a hedging relationship. However, on that basis we query why at the start of the hedging relationship the draft proposals require an entity to determine a method for identifying and measuring hedge effectiveness in paragraph 12.16(e). For fair value and cash flow hedges, FRED 51 sets out the method for determining how to account for the hedged item and hedging instrument respectively and, as such, there would appear to be no need to specify at the outset how to assess effectiveness. It would appear that the need to specify at the outset a method of testing hedge effectiveness applies only to net investment hedges. Subject to our comments in relation to question 5, we would therefore suggest that paragraph 12.16(e) refer only to net investment hedges as follows "for net investment hedges, the entity has determined how it will identify and measure hedge effectiveness". If paragraph 12.16(e) is intended to have wider application it should be made clear how specifying a method of testing effectiveness would affect the subsequent accounting for fair value and cash flow hedges.



Question 5

We agree with the proposal not to recycle amounts deferred in equity. However, our major concern with the proposals for net investment hedging is that it states that such hedges should be accounted for similarly to cash flow hedges, but then goes on to describe an accounting that is different to cash flow hedges, namely by referencing back to the method of measuring hedge effectiveness. The approach for cash flow hedges in FRED 51, however, does not involve referencing back to the method of testing hedge effectiveness, rather it sets out explicitly the accounting entries to make.

We believe that the accounting entries for net investment hedging should be as explicit as those for cash flow hedging. Not only would this result in simplicity and consistency, but it would also mean that the requirement in 12.16(e) to determine a method of testing effectiveness could be removed.

Question 7

We do not believe the examples are particularly helpful as they merely reproduce very simplistic circumstances that are unlikely to apply in practice.

With regards to the first example, it would be helpful if the example were extended to indicate how the double entry would work if the cash payment to the supplier took place at a later date than the recognition of the asset. This is because, typically, buyers pay suppliers following a period of credit. The example could be further elucidated by looking at what happens if the hedged cash flow to the supplier takes place on a different date to that on which the forward currency is settled. This is because, typically, the forward contract will be taken out based on the expected point of cash flow, but in practice it may not always crystallise on exactly the same date that payment is ultimately made.

Regarding the "Alternative - including ineffectiveness" part of example 1, it may be worthwhile explaining that the answer would be the same even if the whole derivative were designated as the hedging instrument due to the absence of a binary assessment of hedge effectiveness and the specified accounting entry to make as set out in 12.23.

Following on from our observations in relation to questions 4 and 5 above, it is not clear how example 3 is applying the stated accounting in FRED 51:

- In order to make the specified entry in paragraph 12.24(a) it seems to us that the example would have to set out how the entity determined at the start of the hedging relationship effectiveness would be measured. The example, however, does not do this.
- If, by contrast, net investment hedging is to operate in the same way as a cash flow hedge, then it is not clear why the hedged item needs to be "the first" 1.2m of net assets (referred to in both the facts in 12.A6 and note (b) to the example). The operation of paragraph 12.23 would result in the exchange rate movements on the loan being taken fully to reserves if less than the investee's total net assets. Conversely, if the amount of the loan was greater than the investee's net assets, then the operation of paragraph 12.23 would result in the excess being taken to profit or loss.

We also recommend the following:

- an example of the accounting entries to make for a cash flow hedge of the exposure to variable interest rates should be included; and
- the inclusion of illustrative hedge documentation for each example that includes only the information required to be documented as stated in 12.16(a). We are aware of templates being designed by some advisers for hedge documentation that seem to include facts and figures to be documented that go far beyond the requirements of 12.16(a), with the effect that preparers often believe that the documentation requirements are far more onerous than FRED 51 actually requires.
- A comparison for each example showing how the accounting would work if hedge accounting is not applied. This would assist those for whom hedge accounting is a new concept.

Question 8

We are unclear what is meant by “hedge accounting” and “hedging relationships” at the date of transition in the context of current UK GAAP. If we assume it means synthetic accounting whereby derivatives are off balance sheet with only cash flows accounted for as they arise, then we do not believe it is appropriate to force an entity into the hedge cessation regime if they do not wish to hedge account on adoption of FRS 102. Instead, we believe that an entity should be able (for “hedging relationships” that would be classed as cash flow hedges) to recognise derivatives at transition date by adjusting retained earnings and then to simply fair value the derivative through profit or loss. Requiring entities to apply the cessation rules whereby an element is recognised in a separate cash flow hedge reserve and subsequently reclassified (paragraph 12.25) may lead to a cost that does not justify the benefit. Similarly (for “hedging relationships” that would be classed as fair value hedges) we do not believe that any entity should be required to remeasure the hedged item to include the hedging gain or loss at the date of transition absent a requirement to carry the hedged item at fair value. We believe (rightly or wrongly) this approach was widely used on adoption of full IFRS and is likely, therefore, to be the approach of those entities making use of the option to apply the rules in IAS 39 and IFRS 9.

Other drafting issues

In addition to the above, we would recommend the following drafting changes:

- Including in the first sentence of paragraph 12.24 similar wording to that included in the first sentence of paragraphs 12.20 and 12.23 referring to paragraph 12.16, but in all cases removing the word “basic” so as not to confuse with the notion of basic financial instruments.
- With regards to the need to document hedges in place at the date of transition, we would agree with the sentiment on the FRC website that the documentation need not be in place as at the date of transition, and believe that as long as it is in place by the date of approval of the financial statements then hedge accounting should be permitted. Indeed, we would go further than this and extend this relief to all situations and not only those relationships in place at the date of transition. Although the existence of documentation can be proven, policing or auditing whether it was in place as at the start of a hedge is impractical and therefore do not see how this requirement can be

effectively enforced. Therefore, we believe there is little point including this requirement. Rather than including a transitional rule, it would be more practical to remove the words “at the inception of the hedge” from paragraph 12.16.

- Some entities may have adopted the current version of FRS 102 early (i.e. for periods ending on or after 31 December 2013). The transitional rules should consider how such entities must apply the revised hedge accounting provisions to those transactions for which hedge accounting is being applied under the current version of FRS 102. For example, it needs to be clarified whether they would be able to adopt the transitional rules related to hedging in section 35 even though they are not a first time adopter. Furthermore, there could be hedging relationships for which hedge accounting would be permitted, but which is unavailable under the current version of FRS 102, e.g. the proposals now remove the requirement for a hedge to be highly effective and also widen the population of permissible hedging instruments and hedged items.
- Paragraph 12.16(c) should refer to paragraph 12.18A as well as 12.17 and 12.18.
- The terms “firm commitment” and “highly probable forecast transaction” are currently defined in the FRS 102 glossary and therefore should be in bold type when used in section 12.

Yours sincerely



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For and on behalf of BDO LLP