



Financial Reporting Council  
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14 February 2014

Dear Sir/Madam,

**FRED 51 - Draft Amendments to FRS 102: Hedge Accounting**

We are pleased to respond to the invitation by the FRC to comment on FRED 51 on behalf of PricewaterhouseCoopers LLP.

We welcome the approach to hedge accounting taken by the FRC which will provide users with accounting that appropriately reflects a wider range of risk management activities than is available under FRS102 at present. We also expect that many preparers will be attracted by both the consistency with, and simplifications from, IFRS.

While supporting the approach taken by the FRC, we provide a number of recommendations which we consider are important for the successful application of the standard.

*Significance of ineffectiveness*

We support the requirement in the FRED for entities to specify how they will identify and measure ineffectiveness. However, we are concerned that reporters may underestimate the sources and impact of ineffectiveness unless further guidance is provided.

The only requirement for a hedging relationship to be established between an item and an instrument is that an economic relationship exists. This will permit hedge accounting for some relationships for the first time which will be welcome in many instances. However, robust measurement of any ineffectiveness is vital to ensure that the accounting produces reliable and useful outcomes that show the extent to which the hedge was not effective.

Ineffectiveness is an inherent aspect of hedging strategies rather than necessarily indicating the unsuitability of a relationship or a failure of strategy. This should be highlighted in the examples that should show for some common hedging strategies the sources of ineffectiveness and their measurement.

*Consistency with, and departures from, IFRS 9*

FRED 51 introduces an approach to hedge accounting which is highly similar to IFRS 9 in many respects but with the potential for several significant differences. As well as the specific differences highlighted in paragraph 12 of the Advice Letter we also note the wider scope for differences raised in paragraph 11 of that letter arising from the exclusion of some of the specific requirements and guidance contain in IFRS 9.

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The implication is that the FRC does not require that users should necessarily apply the additional guidance in IFRS 9 if an interpretation or application of FRED51 would result in an alternative treatment. We consider this the appropriate approach; however, it would be helpful for both reporters and users if intended consistency with IFRS 9 is made clear where possible by using the same terminology.

In particular, the terms “portion” and “proportion” are used differently in FRED51 than in IFRS 9. These terms are fundamental to establishing what hedge accounting relationships are permitted, and in turn affect the amount of ineffectiveness reported. Specifically, FRED 51 allows portions of instruments to be designated as hedging instruments (as opposed to proportions under IFRS 9). Whereas proportions are understood to be similar to each other in all but size, portions may have different attributes to each other. Similarly, FRED51 12.17 allows a hedged item to be a “portion” of an eligible item whereas IFRS 9 6.3.1 allows for “components”. Unless the FRC intends these to be differences from IFRS 9, in which case further clarification is needed, we suggest the FRC uses consistent terminology that is consistent with IFRS 9. We also recommend that any portion should be separately identifiable and measurable as required by IFRS9, as this is an important safeguard for appropriate application of hedge accounting.

Without further guidance some entities may seek to apply a broader interpretation of “portions”, e.g. to apply hedge accounting to time portions or risk portions of derivatives. Such a broad interpretation risks hedge accounting being used purely to achieve an accounting result (rather than to reflect actual risk management strategies) and departs from IFRS. Unless the FRC intends such a broader interpretation to be permitted (in which case further guidance is needed), we suggest the same guidance as in IFRS 9 be added to FRED51.

The FRC should also consider whether separation of the forward element and spot element of a forward contract and separation of currency basis spread should be permitted or whether this introduces undue complexity. In either case, the standard should be clear.

Also, the guidance in the Accounting Council’s Advice accompanying FRED51 on whether there is an economic relationship and the need for systematic offset uses slightly different wording than IFRS 9 B6.4.4. Whether there is an economic relationship is critical to determining whether hedge accounting can be applied. IFRS 9 does not provide guidance for the interpretation of “systematic”, but different wording in FRED51 suggests that a different meaning is intended although this is not further defined. We can see no need or reason for a difference from IFRS 9 in this area and hence recommend that this wording is amended to be consistent with IFRS 9.

#### *Useful features in IFRS 9 missing from FRED51*

The condensing of the principles of IFRS 9 into FRED51 has omitted certain features which we consider are consistent with the objective of improving the application of hedge accounting. These are:

Rebalancing - Rebalancing under IFRS 9 can be a useful way to keep hedge accounting consistent with an entity’s risk management activities whilst not requiring de and re-designation of a hedge. However, we also recognise that importing this element of IFRS 9 in full could be a distraction for many entities. We recommend that the FRC considers whether the ability to rebalance and



maintain the same hedge for accounting purposes could be straightforwardly brought into FRED51. For example, adding after 25.25:

“An entity that has rebalanced an existing hedging relationship as part of its risk management activities (i.e. has changed the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting) may similarly rebalance the relationship for hedge accounting purposes without discontinuation”.

- Groups of items - Specific guidance equivalent to IFRS 9 6.3.1 to allow groups of items to be designated as hedged items would be a useful clarification for entities which commonly manage risk in this way.
- Intragroup - Without a specific exception, FRED 51 does not permit the hedging of the foreign currency risk of intragroup monetary items or highly probable internal transactions which are available under IFRS9. We recommend that an exemption similar to IFRS9 6.3.6 is included.

#### *Discontinuation*

FRED 51 provides discretion for an entity to revoke designation of hedging relationships. This is may provide useful flexibility to report their risk management activities appropriately as they evolve over time. However, to avoid the risk of revocation with the benefit of hindsight we recommend that a requirement is added to only permit discontinuation prospectively from the date the discontinuation is documented.

#### *Documentation*

We note that paragraph 19 of the Accounting Council’s Advice to FRC states that the economic relationship, risk management strategy and ineffectiveness testing must be documented. However this is not a requirement of the standard. We believe that 12.16 should introduce this requirement.

If you have any questions, please do not hesitate to contact Sandra Thompson, Accounting Consulting Services Financial Instruments Leader (020 7212 5697) or Paul Houghton, Accounting Consulting Services Director (020 7213 5951).

Yours Sincerely

PricewaterhouseCoopers



## **Appendix 1: Responses to consultation 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?*

We support the three hedge accounting models and believe the consistency with IFRS is helpful.

### *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 agree that this is an important principle for both users and preparers of accounts. We also recognise that “straightforwardness” needs to be viewed in context of the other concepts and pervasive principles of FRS102 in order to produce useful treatments for users, and any hedging standard is unlikely to be truly simple.

As noted above, we believe the standard could be usefully improved by clarifying the guidance on hedges of groups of items; rebalancing; intragroup items; and requirements for “portions” to be made consistent with IFRS 9.

### *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 agree with requiring an economic relationship as a requirement to establish whether a hedge accounting is permitted. In the absence of other requirements, this becomes the central test for whether a permitted hedging relationship exists and therefore it is important the term is understood.

In common with IFRS 9, there is limited guidance on what constitutes an economic relationship but it would be an improvement if there were no implied differences between FRED51 and IFRS 9. We recommend that any accompanying guidance to the standard includes the wording of IFRS 9 B6.4.4 rather than the current drafting in paragraph 17 of the Advice Letter.



#### 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. The binary assessment may bear little resemblance to how an entity approaches risk management and can result in very different accounting between entities with similar risk management strategies and accounting policies due to a small mathematical difference. This approach will allow entities to continue to reflect the effectiveness of more of their risk management activities and provide more relevant information to users.

It is important however that hedge accounting is properly applied if it is to provide relevant information. In particular, without the binary test entities may continue to apply hedge accounting to relationships with greater ineffectiveness than has been possible under FRS26. We recommend that the illustrative examples be amended to demonstrate sources of ineffectiveness and the resulting measurement of ineffectiveness so that this is understood as a core feature of applying hedge accounting. Examples of common, straightforward strategies demonstrating ineffectiveness and the accounting entries required would be helpful (for example, a cashflow hedge of variable rate debt with an interest rate swap where counterparty credit risk moves in the same or opposite direction to the change in market interest rates).

#### 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 that the proposals are a sensible approach and are consistent with the treatment of the net investment itself.

#### 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 that these changes are consistent with the overall principle to allow hedge accounting to be applied to more hedging relationships within an entity's risk management strategy. These may provide useful flexibility for some entities to better reflect the effectiveness of their strategies to users.



#### 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 provision of examples is helpful in demonstrating the impact of hedge accounting. However, we recommend that the examples should be expanded to include sources and measurement of ineffectiveness, and to show all relevant journal entries, to assist those who have never experienced FRS26 hedge accounting.

#### 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.*

The transitional arrangements are an important feature of the standard. The proposed arrangements contain some helpful features however there are areas where clarification or change would be helpful:

**Documentation**                      The FRC has issued guidance that documentation may retrospectively be completed for hedging relationships at the date of transition. Due to the timing of the completion of the standard we support the pragmatic approach but recommend that the period in which documentation should be completed is restricted to, say, 3 months after completion of the standard to limit the possibility of abuse with the benefit of hindsight. The transitional relief must be clearly set out in the standard.

**Clarity of 35.9(b)**                      The proposed drafting for paragraph 35.9(b) is generally unclear and different interpretations would be permitted. The FRC may consider being more prescriptive:

It is unclear whether 35.9(b)(i) is applicable to all hedging relationships, those which do not meet the criteria of Section 12, or only those which would meet the criteria of Section 12 but are not designated as hedging relationships. To the extent any of the above are excluded from the scope of 35.9(b)(i), further guidance is required.

The ability to apply discontinued hedge accounting could have significant impact on the distributable reserves position of an entity. It would therefore be helpful for the FRC to clarify their position. Whatever approach the board takes, care should be taken to ensure



that it is written in a manner which is clear to less sophisticated users. It may be useful to add a further illustrative example to cover this situation.

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.

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.