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Dear Sir or Madam

We welcome the opportunity to comment on the FRC's Exposure Draft, FRED 51 "Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland Hedge Accounting* ("FRED 51")".

We acknowledge that it was always the FRC's intention to amend FRS 102 once the IASB had completed its hedge accounting and impairment projects. However, FRED 51 has been issued prior to the completion of the impairment project and based on principles in IFRS 9 which currently has no mandatory effective date and has not yet been endorsed by the EU. This means that UK private companies will be applying the principles of IFRS 9 earlier than UK listed entities which, based on historical experience, may be amended before its eventual mandatory effective date or endorsement by the EU.

In addition, if a mandatory effective date of 1 January 2015 is implemented for the changes to FRS 102, this will not give entities time to adequately prepare for the implementation of the proposals given that the transition date for December year-ends has already passed. Our concerns mirror those expressed by the IASB's chairman on 19 November 2013 that; "*the mandatory effective date [1 January 2015] for IFRS 9 provided insufficient time for companies to adequately prepare*". Entities will also encounter practical difficulties in applying the requirement to document the hedging relationship, despite the transitional exemption.

We understand that the proposals will enable a wider range of preparers to apply the hedge accounting principles to an increased number of hedging relationships than is currently possible under FRS 102. We are supportive of these principles in the longer term but, in our opinion, a wholesale revision of Section 11 and Section 12 of FRS 102 should be undertaken as part of the three year amendment cycle once IFRS 9 has been completed and endorsed by the EU. Until then, we would like to see a stable platform with no, or minimal, amendments to Section 11 and Section 12 or other sections within FRS 102.



Given our concerns outlined above, we see an alternative short-term means of enabling a wider range of preparers to apply the hedge accounting principles to an increased number of hedging relationships. Our recommendation is that FRS 102 is amended to permit limited scope application of IAS 39 or IFRS 9 recognition and measurement provisions for hedge accounting. We realise this suggestion does not meet the aim of simplified hedge documentation and hedge effectiveness requirements but consider a short-term divergence to be acceptable for entities that wish to apply hedge accounting to arrangements where FRS 102 would not permit hedge accounting.

Should the FRC continue with the current proposals in FRED 51, we have set out in Appendix 1 our responses to the questions raised. In addition, we have detailed typographical and terminology points in Appendix 2.

If you would like to discuss any aspect of this response please do not hesitate to contact me.

Yours faithfully

A handwritten signature in blue ink that reads "D Wilcox".

**Donna Wilcox**  
**Technical Senior Manager**  
**Baker Tilly UK Audit LLP**



*Subject to our concerns, as set out in the covering letter to this response, should the FRC continue with the current proposals in FRED 51, we have set out below our responses to the questions raised followed by other comments on the proposals.*

### **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?*

Given our suggested short-term solution to include in FRS 102 a permitted limited scope application of the hedge accounting requirements of IAS 39 or IFRS 9, and as the definitions of the three hedge accounting models are consistent with those in IAS 39 and IFRS 9, we are supportive of the proposal.

### **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?*

In our experience, due to the cost of managing risk it has become more common for entities to enter into more complicated and sophisticated financial contracts which manage the exposure to interest rate risk and foreign exchange risk to a certain extent. These contracts often expose the entity to a degree of risk which the entity is prepared to accept for a more beneficial rate within the contract. Consequently, we believe the overarching principle should be to set requirements that can be straightforwardly applied to all hedging transactions, both relatively simple economic steps to manage risk and more complex hedging arrangements.

The proposals, as currently drafted, would be easier to apply if they included guidance on, and a definition of, “economic relationship”. This would reduce potential practical difficulties in application of the requirement to hedging transactions that are not relatively simple. For example, where the values of the hedging instrument and the hedged item move in the same direction but there is an economic relationship between them. Practical difficulties in application could result in divergent practices.

### **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?*



In our view, widening the ability to hedge account to economic hedges in principle is a positive step forward. However, the term “economic relationship” is undefined in FRS 102. The application guidance in IFRS 9 could be applied but it is unclear as to whether this was the intention of the FRC. It is, therefore, our suggestion that “economic relationship” is defined in the glossary and accompanied by implementation guidance.

#### 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 that aligning the ability to hedge account with the risk management objectives and strategies for undertaking hedges and assessing the economic relationship between the hedged item and the hedging instrument is sufficient. A binary assessment of hedge effectiveness at inception adds an unnecessary level of complication as effectiveness is unlikely to be considered in this degree of detail in the entity’s risk management strategy.

In addition, there may be situations where an economic hedge would not meet a “bright line” test but would nevertheless be the most appropriate and effective means of managing the hedged risk. The proposed approach allows hedge accounting to be used in such situations.

#### 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 proposals.

#### 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 have no significant concerns with regard to this amendment given that it aligns with the requirements of IAS 39 and IFRS 9.

### **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.*

In our view, the examples are a useful demonstration of the accounting entries. Expanding the examples to include the documentation, designation, assessment of effectiveness and fair value measurement would be even more useful in demonstrating how the requirements will apply in practice.

Our suggestion would be that the firm commitment is used to demonstrate a fair value hedge as well as a cash flow hedge. In our experience, interest rate swaps to fix interest rates are more common than a swap of a fixed rate for a variable rate.

Example 1 ignores; “*ineffectiveness that may arise relating to the interest rate differential between the two currencies involved*”. This example would be more useful if it did consider ineffectiveness to demonstrate the limit on the cash flow hedge reserve set out in paragraph 12.23(a).

We also consider the statement that ineffectiveness is ignored could be misinterpreted to mean the spot rate in a forward contract can be designated in isolation (as permitted by IFRS 9). However, FRS 102 does not appear to permit this as paragraph 12.18(b) states that a derivative may only be designated as a hedging instrument in a hedging relationship if it is designated in its entirety or a portion of its nominal amount is designated.

Similarly, Example 2 would be more useful as an aid to practical application of the requirements if it included (rather than excluded) interest charges and cash payments.

### **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 anticipate that these exemptions facilitate application of hedge accounting to arrangements already in place at transition? If you have any reservations, please tell us why and provide details of alternative transitional arrangements.*

We have three key recommendations:

1. Clarification of the proposed transitional exemptions for hedging relationships in place at transition;



Appendix 1

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2. Extending the transitional exemption to hedging relationships entered into after 1 January 2014;
3. Establishing a grace period during which entities can complete the documentation and designation of the hedging relationship.

*Clarification of the proposed transitional exemptions for hedging relationships in place at transition*

In our view the transitional exemptions, as currently drafted, will not facilitate hedge accounting for arrangements in place at the date of transition.

The FRC’s website confirms; “*hedge accounting is not precluded from the date of transition, if the documentation and designation of the hedging relationship is completed after transition*”, and this clarification is needed in FRS 102 as to when the conditions in paragraph 12.16 (including the documentation and designation requirements) must be met.

*Extending the transitional exemption to hedging relationships entered into after 1 January 2014*

For many entities the proposals in FRED 51 will be finalised after the date of transition to FRS 102. Consequently, they may be unable to comply with the conditions for hedge accounting. This may not reflect their risk management strategy, will reduce comparability and create volatility in profit or loss. For this reason, the transitional exemptions should also apply to hedging relationships entered into for a period after 1 January 2014 (i.e. the earliest mandatory transition date). This period should extend to a reasonable timeframe after proposals in FRED 51 have been issued in final form.

*Establishing a grace period during which entities can complete the documentation and designation of the hedging relationship*

We suggest the transitional provisions proposed above include a period of grace to complete the documentation and designation of the hedging relationship. This period should allow sufficient time for entities to become familiar with the proposals and their consequential effects.

It is still unclear how long “after transition” an entity has to finalise the documentation and designation of the hedging relationship. We also request that the FRC consider extending the transition provisions to hedging relationships entered into for a period after transition.

**Other Comments**

***Qualifying Conditions***

We note that the conditions in 12.16 must be complied with “at the inception of the hedge”. A definition of “at the inception of the hedge” would be useful to preparers with limited



exposure to International Accounting Standards to clarify that it means inception of the hedge accounting rather than commencement of the commercial hedge.

### ***Designation of Hedging Instruments***

We believe that the exceptions permitted in IFRS 9 (paragraph 6.2.4) should be incorporated into the proposed amendments to FRS 102 to add additional flexibility to the calculation of effectiveness for hedge accounting purposes, particularly for cash flow hedges to clarify that it means inception of the hedging relationship between the hedged item and hedging instrument for hedge accounting purposes.

### ***Fair Value Hedges***

In our view, the requirements of 12.22 will result in differing practices and presentation in profit or loss. We do not see the benefit of this choice or the added complexity this creates.

### ***Additional Guidance***

In addition to our comments above on the “economic relationship”, we would ask the FRC to consider further guidance on written options. It would be helpful if that guidance included examples of written options that may, and net written options that may not, be designated as a hedging instrument, and clarification whether hedge accounting can be applied to derivative contracts that contain a net written option.

### ***Disclosures***

We would recommend the following additional disclosures given the impact of the entity’s economic decision-making on its ability to apply hedge accounting, the level of effectiveness and consequentially the impact on the financial statements;

- The entity’s risk management objective and its strategy for undertaking hedges
- How the entity will identify and measure hedge ineffectiveness or effectiveness
- Gains or losses arising from the discontinuation of hedge accounting



Appendix 2

We note the following typographical and terminology points for consideration by the FRC.

Paragraph	Typographical or Terminology Point
12.23(a)(ii)	The closing bracket is after “present value” but should be after “on the hedged item” in-line with IFRS 9.
12.25 – Final paragraph	<p>Suggest clarification is added that “any cumulative gain or loss on the hedging instrument <i>previously recognised in other comprehensive income</i> shall be reclassified ...”</p> <p>As (per 12.23(b)) it is only the effective portion of the gain or loss on the hedging instrument that is taken to other comprehensive income.</p>
Example 2	<p>Notes in the second paragraph of 12A.4 that the economic relationship is; “<i>by virtue of having the same underlying (its fair value fluctuates with the base rate, as does the fair value of the loan)</i>”.</p> <p>However, the variable element of the interest rate swap is linked to LIBOR not base rate.</p>