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Dear Ms Shah

## **FRED 51 Draft Amendments to FRS 102 – Hedge Accounting**

### **Introduction**

Ernst & Young LLP welcomes the opportunity to comment on FRED 51 Draft Amendments to FRS 102 – Hedge Accounting ('the exposure draft') issued by the Financial Reporting Council ('the FRC').

### **Overall comments**

Overall, we agree with the proposals to update the hedge accounting requirements in FRS 102 to allow entities to apply hedge accounting when this reflects their economic and risk management strategies, without onerous conditions and to use concepts and language that are, as far as possible, consistent with those included in IFRS 9 – *Financial Instruments*. We believe that the proposals in the exposure draft are an improvement on the existing hedge accounting rules in Section 12 of FRS 102.

Whilst we agree the original transitional exception should be amended, we have a number of reservations about the proposed approach. In our response to Question 8, we propose an alternative approach, the objective of which would (a) require continuity of previous hedge accounting to be reflected in the opening statement of financial position to the extent the hedging relationship was of a type permitted by FRS 102 and (b) allow a continuity of hedge accounting thereafter. Suggested wording for implementing this approach has been included in a separate Appendix. Additionally, we believe that the clarification posted on the FRC's website which states that "hedge accounting is not precluded from the date of transition, if the documentation and designation of the hedging relationship is completed after transition" should be incorporated into FRS 102 since this clarification conflicts with paragraph 12.16 of the exposure draft.

If you have any matters arising concerning the content of our response, please do not hesitate to contact me.

Yours sincerely



Tony Clifford  
Partner, Financial Reporting Group

## Responses to FRC 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 adoption of the three hedge accounting models which are based on the models in IFRS 9. We believe this is an improvement on the existing requirements of Section 12 of FRS 102.

However, we have some minor drafting points as follows:

- Paragraph 12.16(a) refers to “the hedged item and the hedging instrument or portion thereof”. We believe that the reference to “portion” of a hedged item is intended to capture both a designated risk component of a hedged item (see 12.18A and 12.19) and a proportion of a hedged item. However, we believe that the reference here to a “portion” of a hedging instrument is intended to capture a proportion of a hedging instrument (as in the Glossary definition of a hedging instrument – see our comments on paragraph 12.18(b) below).

Therefore, we believe paragraph 12.16(a) should be amended to “(a) the entity designates and documents the hedging relationship so that the risk being hedged, the hedged item (***or portion thereof***) and the hedging instrument (***or proportion thereof***) are clearly identified and the risk in the hedged item is the risk being hedged with the hedging instrument”.

The Glossary definition of a “hedged item” should also clarify the definition, as follows: ...’or a portion (***i.e. designated risk component or proportion***) of any such item”.

The Glossary definition of a “hedging instrument”, as currently drafted, would exclude hedging instruments meeting the requirements of paragraph 12.18A. Therefore, the Glossary definition needs to be amended to clarify that: “The foreign currency component of a non-derivative financial asset or financial liability may be designated as a hedging instrument for a hedge of foreign currency risk.”

- Paragraph 12.17(b) should be amended to read “In consolidated financial statements the hedged item must be an asset, liability, firm commitment or highly probably forecast transaction with a party ***not consolidated*** by the reporting entity. This means that hedge accounting can be applied to transactions between entities ***consolidated*** by the same group only in the individual or separate financial statements of those entities”.

This will permit hedge accounting in the consolidated financial statements of subsidiaries excluded from consolidation under paragraph 9.9 of FRS 102 (equivalent to the investment entity exception in paragraph 6.3.5 of IFRS 9). The same amendment is required in the Glossary.



- Paragraph 12.18(b) as in the Glossary definition of a hedged item should use “*proportion*” instead of “portion”, as for paragraph 12.16 (a).
- Paragraph 12.26, second sentence, should be amended as follows “For financial instruments in the scope of this section *held at fair value* that are not held as part of a trading portfolio...”.

**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 with the overarching principle described above.

**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 an approach that requires an economic relationship between the hedging instrument and the hedged item.

**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 the 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 removal of the requirement to make a binary assessment at the beginning of a hedging relationship that defines a hedge as effective or ineffective.

**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 and losses on hedging instruments be permitted regardless of the mismatch with the foreign currency movements?

We agree with the proposal to not reclassify amounts deferred in equity to profit and loss when a net investment hedging relationship is discontinued.

**Question 6**

The draft requirements 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 with the proposed changes that broaden of the range of instruments that may be designated at fair value through profit and loss.

**Question 7**

Included as non-monetary 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 believe that the examples are helpful application guidance. However, we have the following comments:

- Example 1's 'Alternative – Including ineffectiveness' example (paragraph 12A.3) is not an example of ineffectiveness. It is an example in which only a proportion of a hedging instrument has been designated as a hedged relationship. Either the heading of this example should be altered or a new example demonstrating hedge ineffectiveness should be illustrated.
- Example 2 should be expanded to include the interest flows on the debt and swap and to illustrate paragraph 12.22 or explain why its application is not necessary.
- Example 3 implies that the net assets of the subsidiary are revalued through OCI only to the extent that they are hedged. Paragraph 30.18 of FRS 102 states that all resulting exchange differences arising from the translation of a subsidiary's functional currency to the group's presentational currency shall be recognised in OCI. Therefore, as we are told that the net assets of the subsidiary have increased since acquisition date, we would *not* normally expect the amount debited/credited to OCI on retranslation of the net assets to equal the amount credited to OCI in respect of the hedging instrument. We believe that the example should be reworded to avoid confusion on this matter.



**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 meaning of the original transitional exception, particularly as it applies to hedging relationships that exist at the date of transition, is in our view extremely unclear. Retaining the original exception could therefore result in diversity in practice and lead to what some would consider counter-intuitive accounting outcomes, especially for entities transitioning to FRS 102 from “old” UK GAAP (i.e. those not applying FRS 26 and associated standards). For example, it is unclear whether and to what extent the effects of a cash flow hedge could or should be recognised in the opening statement of financial position. Nor is it clear to us that the effects of a fair value hedge could always be reflected in that statement without contravening other parts of Section 35. Consequently, whilst we support your efforts to improve these transitional provisions, we have a number of reservations about the proposed approach, particularly as it provides entities with a free choice of applying two different requirements, one of which is unclear. Included within our comments below are suggestions as to how we believe the proposals could be improved further.

We agree with retaining the exception for hedging relationships that no longer exist at the date of transition. This avoids the need for companies to reverse hedge accounting adjustments included in the carrying amount of non-financial items such as inventories or property, plant and equipment, for example:

- by recording the purchase of an asset at the rate specified in a forward contract in accordance with paragraph 46 of SSAP 20; or
- by way of a “basis adjustment” in accordance with paragraph 98(b) of FRS 26 or IAS 39.

The FRC’s proposed addition in sub-paragraph (ii) to paragraph 35.9(b) introduces clearer and superior principles than the original, but as noted above we do not support keeping an option to apply the original transitional exception. We would prefer a consistent approach applied to all hedging relationships at the date of transition that addresses separately (a) the effects of prior hedge accounting in the opening statement of financial position and (b) accounting for hedges prospectively from the date of transition.

For hedging relationships that exist at the date of transition, we would advocate an approach that reflects in the transition balance sheet the effect of all hedge accounting applied under previous GAAP to the extent the hedging relationship is of a type that could have qualified for hedge accounting under FRS 102, irrespective of whether the entity chooses to apply hedge accounting prospectively. We would also extend this approach to hedging relationships terminated prior to the date of transition where the hedged item still exists or is still expected to occur and gains or losses on the hedging instrument were deferred and accounted for as if they were liabilities or assets. This should provide simple, clear and objective requirements for those entities transitioning from old UK GAAP and minimal disruption to those entities that previously applied FRS 26 or IAS 39. It is also broadly consistent with the way IFRS 1 is, and we believe should be, applied.

Thereafter the entity would follow the requirements of FRS 102, including the requirements for discontinuing hedge accounting for those hedging relationships that do not meet the necessary conditions in Section 12. In this context, we would encourage you to incorporate into FRS 102 the clarification posted to the FRC website that “hedge accounting is not precluded from the date of transition, if the documentation and designation of the hedging relationship is completed after transition, provided designation and documentation apply as at the date of transition.” We are also unclear whether this concession was intended to apply only to hedging relationships that exist at the date of transition or if it could be extended to, say, hedging relationships entered into between the date of transition and the first FRS 102 reporting date. Without further clarification we expect the wider interpretation will be applied.

We agree with the proposal that companies choosing to apply IAS 39 or IFRS 9 and IAS 39 should apply the relevant parts of IFRS 1, although for the avoidance of doubt we would suggest the text also refers to paragraphs IG60 to IG60B of IFRS 1.

In an appendix to this letter we have drafted a version of paragraph 35.9(b) that incorporates our suggestions, above.



### Appendix – proposed wording for paragraph 35.9(b)

To reflect the suggestions set out in our response to Question 8, we recommend that paragraph 35.9(b) is written as follows:

An entity shall not change its hedge accounting before the date of transition to this FRS for hedging relationships that no longer exist at the date of transition. For hedging relationships that exist at the date of transition, the entity shall:

- (i) reflect in its opening statement of financial position the effects of previous hedge accounting to the extent the hedging relationship is of a type that could have qualified for hedge accounting under FRS 102. The entity shall apply the measurement requirements of Section 11 or 12 to the hedging instruments and, where appropriate, hedged items as follows:
  - gains or losses arising in respect of fair value hedges on the hedging instrument and hedged item should be accounted for in accordance with paragraph 35.8; and
  - gains or losses arising in respect of a hedging instrument in a cash flow hedge and net investment hedge should be recorded in equity (in respect of cash flow hedges in the cash flow hedge reserve).
- (ii) apply the requirements of Section 12, including the requirements for discontinuing hedge accounting for hedging relationships that do not meet the conditions in Section 12, from the date of transition. Hedge accounting is not precluded from the date of transition if the documentation and designation of the hedging relationship is completed after transition, provided designation and documentation apply as at the date of transition.

If an entity had terminated a hedging relationship prior to the date of transition and gains or losses on the hedging instrument were previously deferred as if liabilities or assets, these deferred gains or losses are eliminated at the date of transition. To the extent the hedging relationship was of a type that could have qualified for hedge accounting under FRS 102, associated gains or losses shall be reflected in the opening statement of financial position in accordance with (i) above and, from the date of transition, in accordance with the requirements for discontinuing hedge accounting for hedging relationships in Section 12.

If an entity has made the accounting policy choice under paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) to apply the recognition and measurement provisions of IAS 39 or IFRS 9 and IAS 39, it shall apply the transition requirements in IFRS 1 paragraphs B4-B6 and IG60-IG60B.