

Susanne Pust Shah
Financial Reporting Council
Aldwych House
71-91 Aldwych
London
WC2B 4HN

By email to: ukfrs@frc.org.uk

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Dear Ms Pust Shah

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

Deloitte LLP is pleased to respond to FRED 51: *Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland Hedge Accounting* ("FRED 51"). We have set out our detailed responses to the consultation questions in the Appendix to this letter.

Overall we support the twin aims of FRED 51 to allow entities to apply hedge accounting that reflects their economic and risk management strategies and more closely align the concepts and language used in FRS 102 with those included in IFRS 9: *Financial Instruments*. We believe FRED 51 largely meets these aims but in a number of respects the proposals need amending before they are finalised.

Our two major concerns are the measurement of hedge ineffectiveness and transition.

We believe the measurement of hedge ineffectiveness will be a major difficulty in the practical application of hedge accounting for simple entities and that this complexity has been underestimated. Our experience of IAS 39 and FRS 26 *Financial Instruments: Recognition and Measurement* has shown that hedge ineffectiveness arises in many common and simple hedges even where the critical terms of the hedged item and hedging instrument perfectly match. The same problems will arise with FRED 51 as it uses terms consistent with IAS 39. Measuring and reporting such ineffectiveness will be operationally burdensome and not necessarily useful to the users of the financial statements. We suggest the FRC may wish to consider allowing a 'short cut' method that would allow a sub-group of common hedge relationships to be accounted for as if they were 100 per cent effective. Our proposal is discussed further in our answer to question 4.

We believe the proposed transitional requirements are unclear and open to various interpretations. More

generally, we have concerns about the timing of designation of hedge relationships on transition. We accept that a pragmatic solution is needed to overcome the problem that the hedge accounting requirements will be finalised after the effective date of FRS 102, but as drafted, the proposals could be read as allowing complete flexibility as to the timing of documenting hedge relationships in the period up to the issue of the first financial statements that include these amendments. We consider some discipline should be introduced to reduce the risk that hedges are designated with the benefit of hindsight. Further, because entities will transition from different GAAPs with different eligibility and documentation requirements we believe that the transitional provisions should differ. For entities transitioning from a framework with formal hedge accounting requirements (old UK GAAP including FRS 26, FRS 101 or IFRS) to FRS 102 including the requirements of Sections 11 and 12 in full should differ from those for entities transitioning from a framework with no such requirements (e.g. old UK GAAP excluding FRS 26). Our response to Question 8 includes our detailed proposals for making the transition requirements clearer and the results of applying them more meaningful.

We would be happy to discuss our letter and the draft proposals with you. If you have any questions, please contact Helen Shaw on 0207 303 4658.

Yours sincerely



Veronica Poole
National Head of Accounting and Corporate Reporting
Deloitte LLP

Appendix

Responses to detailed 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. In particular we agree with the use of terminology consistent with IAS 39 and IFRS 9 to describe the models set out in FRED 51. The approach currently taken in Section 12 of FRS 102, of describing types of relationships to which a model should be applied, is no longer practical in combination with the broader eligibility requirements of FRED 51. We do, however, have some concerns about the detailed application of these models which are highlighted in our responses to the questions below.

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 of setting the requirements of hedge accounting to be straightforward and accessible.

We believe that some simplifications compared to IFRS 9 are desirable given the less sophisticated nature of many entities adopting FRS 102 and the option available to entities to apply the recognition and measurement provisions of IFRS 9 in full.

In general we agree with the simplifications to IFRS 9 proposed in FRED 51 but we consider more detailed guidance is needed in the following areas:

- groups of items: It is very common for entities to group similar items together for risk management purposes. For example, sales or purchases in the same foreign currency in the same month are often economically hedged with a single forward contract. It would be impractical, where there is a high volume of transactions, to designate each in a separate hedge relationship with a proportion of the forward. FRED 51 is silent on the designation of groups of items. We would recommend clear guidance setting out when groups of items can be designated in combination; and
- risk components: Although it is clear from the Accounting Council's advice to the FRC in relation to partial term hedges that some risk components can be designated as a hedged item. It remains unclear whether and which risk components more generally can qualify as hedged items. Common examples we believe should be eligible include hedges of the interest rate risk component in debt instruments and the hedges of foreign exchange risk in forecast sales or purchases. We would recommend the inclusion of a requirement for risk components to be separately identifiable and reliably measurable.

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 that the existence of an economic relationship between the hedging instrument and hedged item should be required for hedge accounting to be applied. However, we believe further guidance on

when such a relationship exists is necessary to avoid differing interpretations in practice. In particular it would be useful to echo the requirements of IFRS 9 by stating that:

- for an economic relationship to exist the hedging instrument and the hedged item have values that will generally (but not necessarily always) move in the opposite direction because of the same risk; and
- the assessment of whether an economic relationship exists includes an analysis of the possible behaviour of the hedging relationship during its term. The mere existence of a statistical correlation between two variables does not, by itself, support the conclusion that an economic relationship exists (i.e. two variables could be correlated but not economically related).

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.

Yes, we agree with the relaxations to the eligibility criteria of Section 12 proposed in FRED 51. However, we note some practical difficulties that can arise from measuring hedge ineffectiveness.

We believe the measurement of ineffectiveness will be one of the major difficulties in practical application of the hedge accounting requirements for less sophisticated entities. We further believe that the complexity in this area may have been underestimated. The requirements proposed in FRED 51 are consistent with those of IAS 39 which would show ineffectiveness in many common, simple hedges even where the critical terms of the hedged item and hedging instrument perfectly match. In such cases the hedge ineffectiveness would have to be quantified and recognised in accordance with the model's requirements. For example the following could give rise to ineffectiveness:

- credit risk on the hedging instrument: The effect of credit risk on the valuation of a hedging instrument such as a derivative would not be replicated on the hedged item despite the matching of critical terms. An example of this is when an uncollateralised interest rate swap is used to hedge debt with matching terms;
- foreign currency basis spreads in hedging instruments: For hedges of foreign currency risk, the valuation of the hedging instrument could be affected by changes in the foreign currency basis spread which are not replicated in the hedged item despite the matching of critical terms. An example of this is where a cross-currency interest rate swap is used to hedge interest and foreign currency risk on a foreign currency bond;
- derivative with non-zero fair value designated in a cash flow hedge: The change in value of the "embedded financing" represented by the fair value of the derivative on the designation date would not be replicated in the hedged item, despite the matching of cash flows on the variable leg of the derivative. This would arise, for example where an entity designates late, an interest rate swap with terms that perfectly match the hedged debt;

- forward contract used to hedge an item only impacted by spot risk: The change in value of forward points would impact the forward contract but would not be replicated in the hedged item. An example of this is where a commodity forward is used to hedge inventory held; and
- derivative with a non-benchmark floating leg used in a fair value hedge: The change in value of the hedging instrument in a fair value hedge could be different from the hedged item due to different curves for projecting and discounting cash flows applied on the hedging instrument. An example of this is in a hedge of a fixed rate bond with an interest rate swap with a floating leg based on 3M LIBOR. Ineffectiveness would arise even where the terms of the fixed rate bond match the fixed leg of the swap because in the UK 6M LIBOR is the benchmark rate,

To quantify the hedge ineffectiveness in these cases requires two separate valuations: one of the hedged item and one of the hedging instrument, even where the critical terms match. Such an exercise could be costly and burdensome for less sophisticated entities that rely on external valuations. Also, in many cases reporting the ineffectiveness due to such factors is not necessarily useful to the users of the financial statements. The FRC may therefore wish to consider allowing a 'short cut' method that would allow a sub-group of relationships to be accounted for as if they were 100% effective.

If a short-cut method was permitted, there would need to be strict criteria to avoid it being used inappropriately to mask hedge ineffectiveness that should be recorded. In your consideration of our proposal we would like to draw your attention to the simplified accounting of interest rate hedges introduced by the US Financial Accounting Standards Board (FASB) in its recently issued Accounting Standards Update (ASU) No. 2014-03, *Accounting for Certain Receive-Variable, pay-Fixed Interest Rate Swaps – Simplified Hedge Accounting Approach – a consensus of the Private Company Council*. In this ASU, the FASB allows private companies to assume no hedge ineffectiveness where certain criteria are met. We would recommend allowing a similar approach to be taken for hedges of foreign exchange risk (for any eligible hedged item) in addition to hedges of interest rate risk (for recognised debt instruments only). We would be pleased to work with you to develop specific criteria for when the short-cut method could be used.

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?

Yes, we agree that the treatment of amounts deferred in equity in a net investment hedge should be consistent with the treatment of foreign exchange gains and losses on foreign operations more generally.

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 with these changes, although we note that the impact would be limited in practice as basic loan commitments would seem to be the only type of instrument affected.

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 simple examples are helpful in illustrating the basic mechanics of hedge accounting. We do however recommend the following minor changes:

- Example 1 Cash flow hedge: It would be helpful to include journals to illustrate the alternative including hedge ineffectiveness currently described in 12A.3; and
- Example 2 Fair value hedge: It would be helpful to include journals for the accrual and settlement of interest on the hedged item and hedging instrument.

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.

We agree that specific transitional provisions are needed in order to reflect properly the hedging arrangements that entities have in place at the date of transition, and to simplify the application of hedge accounting to such arrangements following transition. However, the proposal in paragraph 35.9(b) is unclear, and as explained below we believe is open to various interpretations. In addition to the lack of clarity of the requirements themselves we also have concerns in relation to the timing of designation of hedge relationships on transition.

We would recommend a complete redrafting of this paragraph once the approach to transition has been decided. We believe some of the lack of clarity in the current draft is due to incorporating the structure and some of the wording of the IFRS 1 requirements (via the IFRS for SMEs) without the supporting guidance.

We have divided our response to this question into three subsections; the first covering the timing of designations on transition, the second explaining our preferred approach to the transitional arrangements and the third highlighting specific issues in relation to the current drafting that would need to be addressed.

The timing of designations on transition

It is clearly not practical to require entities to have their hedge documentation in place at the date of transition, as the date of transition for many entities will have passed before the revised hedge accounting requirements are finalised. We note that the FRC has addressed this to an extent by issuing a clarification statement stating that designation documentation need not be in place on the date of transition provided it is subsequently documented as at this date.

Retrospective designation of hedge relationships could give rise to manipulation or abuse due to the use of hindsight. In order to minimise the potential for such abuse we believe additional guidance is required if retrospective designation is to be allowed on transition. In particular:

- the wording in paragraph 35.9(b) should be redrafted to make it clear that retrospective designation is being allowed as a specific transitional provision. In the absence of clear guidance, the precedent of retrospective designation on transition may be used to argue that this treatment is also appropriate in other circumstances; and
- an explicit limit should be set for retrospectively designating hedges. It is possible to read the current wording as allowing designation up until the point at which an entity files their first set of FRS 102 financial statements. We would suggest an entity should be required to have all documentation in place by the later of 6 months after the issuance of the amendment and its date of transition.

FRED 51 requires entities that choose to apply the recognition and measurement provisions of IAS 39 or IFRS 9 to apply the transitional provisions of IFRS 1 in relation to their hedging arrangements. IFRS 1 would require hedge documentation to be in place by the date of transition if hedge accounting is to be applied from that date. However, we believe many entities will wait for the revised hedge accounting requirements of Section 12 of FRS 102 before deciding which recognition and measurement provisions to apply. We therefore recommend that any provisions allowing the retrospective designation of hedge relationships under Section 12 is explicitly extended to allow the same treatment for hedge relationships under IAS 39 or IFRS 9.

An alternative solution to the problems caused by the amendments to the hedge accounting being finalised after the date of transition for many entities, would be to allow the grandfathering of an entity's current accounting treatment for financial instruments within the scope of Sections 11 and 12 for the comparative period in an entity's first set of FRS 102 financial statements. This would eliminate the need to allow the retrospective designation of hedge relationships (assuming the final standard is issued swiftly). This was the approach followed for entities required to transition to IFRS in 2005 where IAS 39 did not have to be applied in the comparative period presented. This approach may also be preferable if further changes to Sections 11 & 12 in relation to the classification of financial instruments are made during the current year, as this could give rise to similar issues in relation to the retrospective application of the fair value option.

Approach to the transitional arrangements

We agree with the proposal in FRED 51 that entities choosing to apply the recognition and measurement requirements of IAS 39 or IFRS 9 should apply the requirements of paragraphs B4 to B6 of IFRS 1 rather than those of FRS 102.35.9(b).

We also believe that the transitional provisions for entities transitioning from a framework with formal hedge accounting requirements (old UK GAAP including FRS 26, FRS 101 or IFRS) to FRS 102 including the requirements of Sections 11 and 12 in full should differ from those for entities transitioning from a framework with no such requirements (old UK GAAP excluding FRS 26 or the FRSSE).

Entities transitioning from old UK GAAP including FRS 26, FRS 101 or IFRS should not retrospectively change the accounting that they followed under their previous framework. From the date of transition:

- hedge relationships to which hedge accounting was applied under their previous framework, but that are of a type that would not qualify for hedge accounting under Section 12 should be discontinued and accounted for using the Section 12 rules for discontinuation from the date of transition; and

- hedge relationships to which hedge accounting was applied under their previous framework, and that are of a type that would continue to qualify for hedge accounting under Section 12 should be accounted for as continuing hedges.

For hedge accounting to be applied following the date of transition the conditions in 12.16 would need to be met by the later of 6 months after the issuance of the amendment and the date of transition (as set out above).

For entities transitioning from other frameworks (e.g. old UK GAAP excluding FRS 26), it would be useful to define what is meant by a “hedge relationship that exists at the date of transition”. We would suggest that a hedge relationship exists at the date of transition if:

- the relationship would qualify for hedge accounting under Section 12 if designated; and
- either SSAP 20.51 was applied or the hedged item and hedging instrument were synthetically accounted for immediately prior to transition.

In all other cases a hedge relationship would not exist at transition.

We generally agree that an entity should not amend the accounting for hedge relationships that no longer exist at the date of transition but with the following exceptions:

- where an entity (not transitioning from old UK GAAP including FRS 26, FRS 101 or IFRS) deferred gains or losses on what would have been an eligible cash flow hedge and at the date of transition the hedged cash flow is still expected to occur, the entire gain or loss should be recognised in equity and reclassified to profit or loss in accordance with Section 12 requirements for cash flow hedges; and
- where an entity (not transitioning from old UK GAAP including FRS 26, FRS 101 or IFRS) did not recognise gains or losses on what would have been an eligible fair value hedge and at the date of transition the hedged item still exists and is not measured at fair value, the entity should adjust the carrying amount of the hedged item by the cumulative change in fair value of the hedging instrument that reflects the designated hedged risk that was not recognised.

Where a hedge relationship exists (in an entity not transitioning from old UK GAAP including FRS 26, FRS 101 or IFRS) at the date of transition we believe that these transitional provisions should be applied to that relationship irrespective of whether or not the entity chooses to designate the hedge on a prospective basis. We believe offering a choice in relation to the application of the transitional provisions would be open to manipulation as it would in effect allow entities to choose whether pre-transition gains or losses on hedging instruments will impact post-transition profit or loss.

For simplicity we would suggest that where such a hedge relationship exists on the date of transition that the hedge accounting requirements of Section 12 should be applied retrospectively as if the hedge had always been designated in accordance with paragraph 12.16.

We would also recommend that, if a “short-cut” method introduced as we suggest in response to question 4 that this should be applied retrospectively to eligible relationships, i.e. they would be treated as if they had always been 100% effective.

To be able to continue to apply hedge accounting from the date of transition we would suggest that an entity would need to comply with all the conditions set out in paragraph 12.16(a)-(e) from the date of transition (or a later date where relief is provided) and not from the inception of the hedge. If the requirements are not met from that date (e.g. because the entity chooses not to designate the hedge under FRS 102) the discontinuation rules set out in Section 12 should be applied from the date of transition.

Issues with the current drafting of the transitional arrangements

Although we would favour a complete redraft of this paragraph, we have compiled the following list of specific issues with the requirements as set out in FRED 51:

- it is unclear whether paragraph 35.9(b)i) requires prospective or retrospective application of the requirements of Section 12;
- if paragraph 39.5(b)i) is intended to allow the retrospective application of the requirements of section 12, it would need to offer some kind of relief from meeting the requirements of paragraph 12.16 at inception of a hedge to achieve the desired result;
- if paragraph 39.5(b)i) is not intended to allow the retrospective application of the requirements of Section 12, the reference to the requirements for discontinuing hedge accounting would not be required;
- where in paragraph 39.5(b)ii) it says “providing all the requirements of 12.16 are met”, it would be clearer to say “providing they comply with all of the conditions listed in 12.16 (a) to (e) from the date of designation”. A literal reading of the current wording would suggest that all of the conditions in paragraph 12.16(a)-(e) must have been met at the inception of the hedge as that is what paragraph 12.16 requires;
- as discussed above it is not clear from the drafting the date by which designation is required for the transitional provisions to apply;
- when paragraph 35.9(b)ii) states that “The entity shall apply the measurement requirements of Section 12 to the hedging instruments and hedged items” this would seem to require all hedged items and hedging instruments to be remeasured to fair value which we do not believe is the intention; and
- it is unclear whether the choice between paragraph 35.9(b)i) and paragraph 35.9(b)ii) is an accounting policy choice or a hedge by hedge choice. As noted in the previous section, a choice in relation to whether or not transitional adjustments are made could be open to manipulation.