Quoted Companies Alliance

6 Kinghorn Street
London EC1A 7HW

T +44 (0)20 7600 3745
F +44 (0)20 7600 8288
mail@theqca.com

www.theqca.com

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

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

Introduction

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The Quoted Companies Alliance Financial Reporting Expert Group has examined your proposals and advised on this response. A list of members of the Expert Group is at Appendix A.

Response

We welcome the opportunity to respond to this consultation.

We would prefer a solution that addresses the causes of the problem, rather than the symptoms. In our analysis the causes are twofold:

- There is a requirement to value items being hedged and the instruments being used to hedge in different ways; and
- There is either a requirement or an option to account for changes in value of the item being hedged that does not match the required treatment of changes in value of the instrument being used to hedge.

We think that the issue of hedging can be most efficiently and effectively addressed by reducing the number of financial instruments that are required to be carried at fair value, and by adopting a general approach that hedging instruments should be accounted for in the same manner as the items being hedged.

We believe that such an approach, accompanied by clearer disclosures, would be the best way to satisfy the information requirements of users of accounts, and would meet the Financial Reporting Council's (FRC) objective of high quality financial information (with quality being judged according to how well the approach meets the needs of users, rather than a more theoretical standard).

We are concerned that the proposals in FRED 51 require the publication of amounts that in some cases do not reflect either entry or exit cash flows, and therefore have limited, if any, informational content for users of accounts.

Our responses to the detailed questions below assume that more extensive changes are not made, and set out the areas where we believe greater clarification or guidance would be of further assistance.

Responses to specific questions

Q1 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 agree with the three hedge accounting models proposed which are consistent with IFRS. Given that hedge accounting will be new for many companies, the language used needs to be clearer (e.g. many people will not understand what a "net written option" is). We also recommend that the FRC gives greater guidance, through the examples, on the difference between each of the three hedge accounting models. To assist in highlighting the distinction, Example 2 should clearly explain why this is a fair value and not a cash flow hedge, as we do not believe this will be clear to many preparers who are considering using hedge accounting for the first time.

Q2 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. Further work needs to be done to ensure that the information which users require is identified and clearly presented in a manner that is most straightforward to prepare.

Q3 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 are not clear on what is meant by 'economic relationship', and suggest that more readily understandable wording is used. We presume that this means that the hedging instrument must clearly hedge against a specific risk inherent in the hedged item. In addition, the point at which the economic relationship should be designated should also be clarified; for example, should such an economic relationship exist at the time a financial instrument is acquired to enable it to be used for hedge accounting?

Q4 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 this approach. However, we suggest that each of the examples include additional guidance on hedge ineffectiveness. This is currently only provided for the cash flow hedging example. To reduce the cost of compliance, the FRC needs to restrict any requirement to individually document up front that a specific transaction is a hedging transaction to situations where the transaction is not in accordance with the hedging policy of the entity.

Q5 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?

The principle must be that the accounting treatment of gains and losses on hedging instruments matches gains and losses on items being hedged. For stewardship purposes, when an item ceases to be recognised in the statement of financial position, all profits or losses relating to that item, which have been deferred in equity, need to be reclassified to profit or loss. Concerns about potential for abuse should be countered by clear disclosure requirements, rather than by additional rules which may in turn create potential for further abuse. The FRC should make any consequential changes necessary to paragraphs 9.18A and 30.13.

Q6 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?

Yes, we agree with the proposed changes.

Q7 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.

Further examples should be provided to ensure that preparers unfamiliar with hedge accounting at present can have the greatest possible guidance. As noted above, Example 2 needs further explanation as to why it is classified as a fair value hedge. Including an example of an interest rate swap with the aim of fixing the interest rate on a variable rate loan would also be of benefit and would be a much more common example. Without this example, we are concerned that preparers will view Example 2 as guidance that interest rate swaps should always be accounted for as fair value hedges when in fact they are more likely to be cash flow hedges.

Q8 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.

In general, we agree with the transitional exemptions. However, further thought should be given to the timing of the documentation of the hedging relationship, as the transition date will have passed for many entities. We do not believe it is the intention of the FRC to prohibit the use of hedge accounting in these circumstances, but this point should be clarified.

If you would like to discuss any of the responses in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward

Chief Executive

APPENDIX A

Quoted Companies Alliance Financial Reporting Expert Group

Matthew Stallabrass (Chairman)	Crowe Clark Whitehill LLP
Joseph Archer	Crowe Clark Whitehill LLP
Edward Beale	Western Selection Plc
Anthony Carey	Mazars LLP
Jack Easton	UHY Hacker Young
Bill Farren	Deloitte LLP
David Gray	DHG Management
Matthew Howells	Smith & Williamson Limited
Andy Ka/Chris Smith	Grant Thornton UK LLP
Shalini Kashyap	EY
Jonathan Lowe/Paul Watts/Nick Winters	Baker Tilly
Niraj Patel	Saffery Champness
Nigel Smethers	One Media IP Group plc
Ian Smith	Deloitte LLP