

22 May 2017

Ms. Mei Ashelford
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS
By email: ukfrs@frc.org.uk

Re: File Reference Number FRED 67, Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Triennial review 2017 Incremental improvements and clarifications

Dear Ms. Ashelford,


Chatham Financial ("Chatham") is pleased to comment on the Financial Reporting Council ("FRC") FRED 67, Draft amendments to FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (the "Exposure Draft" or "proposal"). Chatham serves as a hedging advisor to over 1,800 companies globally in many different industries. More than 500 of our clients apply the hedge accounting provisions of either FRS 102, International Accounting Standard ("IAS") 39 or International Financial Reporting Standard ("IFRS") 9 and Accounting Standards Codification ("ASC") 815. We assist these companies with the application of hedge accounting on thousands of derivative transactions, which includes preparing hedge designation memos, effectiveness testing, derivative valuations, journal entries and disclosures for a variety of hedging relationships in many different industries.

We support the FRC's stated objective to setting accounting standards to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

Given the nature of our business and our client base, we understand the impact of FRS 102 on a broad spectrum of derivative end users in the UK and the Republic of Ireland. Whilst the proposed amendments within FRED 67 focus on important areas within FRS 102, we feel the FRC should broaden these amendments to include improvements in relation to the accounting and valuation of derivative financial instruments. Although we have not provided responses on the invitation to comment questions, we have included in the Appendix to this letter some suggested areas of improvement in relation to the accounting and valuation of derivatives having a significant impact on both the understandability and comparability of financial statements under FRS 102.

Our principal comments are as follows:

- We believe the FRC should harmonise the definition of "fair value" in Section 2.34(b) to IFRS in order to clarify whether an adjustment for credit or non-performance risk is required in the fair value of derivatives under FRS 102.
- We suggest that the FRC provide guidance on the presentation of derivative gains or losses in the income statement for entities that are not applying hedge accounting. This would avoid entities presenting hedge accounting-like results without applying the hedge accounting models within FRS 102.
- We believe that the current guidance under FRS 102 makes the application of cash flow hedge accounting for option-based products (such as interest rate caps and foreign exchange options) less attractive as changes in the time value of options flows through profit or loss as hedge ineffectiveness. This results in profit or loss



volatility irrespective of whether or not hedge accounting is applied. We suggest that the FRC adopt a “cost of hedging” approach similar to IFRS 9 which results in the inception time value being accounted for similar to an insurance premium and recognised in profit or loss in the same period as the hedge item.

We expand on these comments in the Appendix below.

We thank the FRC for its consideration of our comments and would be pleased to discuss these issues in more detail with the FRC or staff at your convenience. Please do not hesitate to contact me at +44 207 766 5729 or at zsacho@chathamfinancial.eu.

Yours sincerely,

Zwi Sacho
Director, European Accounting Advisory
Chatham Financial

Appendix:

Clarification of whether FRS 102 requires entities to incorporate credit risk into the valuation of derivative contracts


The definition of “fair value” contained in Section 2.34(b) of FRS 102 reflects the old definition of fair value that existed under IAS 39, namely that the fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction. This definition of fair value implies an asymmetrical position for financial assets and financial liabilities in that assets are measured based on a transfer value whereas liabilities are to be held at a settlement value. The “transfer value” of a financial instrument assumes that the instrument is transferred to a credit equivalent entity and that it continues after the transaction and is not settled. By contrast, the “settlement value” of a financial instrument is the amount that would be received or paid to settle or extinguish the instrument. Because derivatives are bilateral contracts which can switch between being assets or liabilities at any given point in time, it was unclear whether the IAS 39 definition of fair value when applied to derivatives, required companies to compute fair value based on a transfer value or a settlement value. For this reason, the IASB clarified in IFRS 13 – *Fair Value Measurement* that derivative fair values should be based on a **transfer price** and incorporate non-performance risk in fair value measurements.

Given that FRS 102 uses the old IAS 39 definition of fair value for derivatives, we have seen a lack of clarity and consistency in the requirement to incorporate non-performance risk (known as “credit/debit valuation adjustments (CVA/DVA)”) in the valuations of derivatives under the Standard. This is because the current definition neither explicitly requires nor prohibits the incorporation of such adjustments resulting in accounting policy choice for preparers which can materially impact the valuation of derivatives. We appreciate that the determination of a credit risk adjustment for derivatives in particular is complex for a number of reasons. Firstly, unlike the exposure of a vanilla receivable or payable which remains relatively constant over time, the bilateral nature of derivative contracts means that the exposure not only varies over time based on changes in the underlying variables of the contract but also may switch from being positive (a derivative asset) or negative (a derivative liability) at different points in time. Secondly, aside from the modelling challenges associated with the bilateral future exposure of derivatives, there can also be data challenges to determine the appropriate credit spread to be applied for both the entity and its counterparty(ies) in determining the CVA/DVA. However, we note that in our experience, failure to incorporate a CVA/DVA into derivative valuations could potentially portray a misleading view of the fair value of derivatives, particularly when there are long-dated instruments, there is volatility in the underlying hedged risk and/or counterparties are less than creditworthy.

We believe that the FRC should clarify the point of CVA/DVA in relation to derivatives as part of its triennial review of FRS 102. In particular, we feel that the definition of “fair value” in FRS 102 should be consistent with IFRS 13 to avoid any doubt of whether or not to include CVA/DVA into the valuations of derivatives. In doing so, this would remove the inconsistency of application of CVA/DVA under FRS 102 as well as removing a GAAP difference that might exist currently between FRS 102 and IFRS. We appreciate that some preparers have argued against incorporating this change into FRS 102 due to the cost and complexity of incorporating CVA/DVA in derivative valuations. However, we believe that these concerns would be better addressed by reinforcing the basic principle that CVA/DVA adjustments need only be made where material (i.e. for credit intensive instruments such as interest rate swaps and cross-currency swaps) as such an approach would mitigate concerns around undue cost and effort for large groups of users whilst ensuring that there is not significant variety in practice in this important area.

Presentation of derivatives used as economic hedges but are not designated in hedge accounting relationships under FRS 102

FRS 102 requires all derivatives to be measured at fair value with changes in fair value being recorded for through profit or loss with exception of derivatives that qualify as effective cash flow hedges or net investment hedges. There is limited guidance in the Standard on the presentation of gains or losses on derivatives that are not designated as



effective hedges. Without such guidance, practices have emerged for a presentation that splits the components of a derivative's gains or losses into different line items on the income statement or that reclassifies realised gains or losses of a derivative out of the line item that included unrealised gains and losses of the same derivative. For example, a company may have executed a derivative under its risk management policy without designating the derivative for hedge accounting. Because this hedge is an economic hedge, the company might decide to present unrealised gains or losses of the derivative in a single line item of the income statement and reclassify realised gains or losses (i.e. the periodic or final cash settlements from this economic hedge) in the period into the revenue or expense line item associated with the related exposure. Applying such synthetic accounting achieves the same presentation outcome as hedge accounting in that unrealised derivative gains or losses are warehoused to a separate line item in profit or loss and the realised gains or losses are recognised in the same line item as the underlying hedged risk. This practice allows companies to achieve the benefits of hedge accounting whilst circumventing the specific hedge accounting requirements of FRS 102.

We believe that the intention of FRS 102 to allow the fair value adjustment of a derivative to be split into various components applies only within the context of applying specific hedge accounting models. Reclassifying realised gains and losses, as described, essentially presents hedge accounting-like results for some income statement captions, without the company necessarily applying the rigors of hedge accounting.


While FRS 102 is essentially "silent on geography," we recommend that the FRC consider providing specific guidance that the presentation of both realised and unrealised gains or losses on derivatives that are not designated in hedge accounting relationships, be shown in a single line item or as a component of "other income or expense." We refer the FRC to Section 3 of the U.S. Security and Exchange Commission (SEC) 2006 Staff Paper in which the SEC expressed its views against synthetic or so-called "pseudo hedge accounting" under US GAAP.

Accounting for the time value of purchased options in cash flow hedge relationships under FRS 102

Unlike IAS 39 or IFRS 9, FRS 102 does not permit entities to separate the time value of an option derivative and designate as the hedging instrument only the intrinsic value element. For example, a company might be hedging interest rate payments on its floating rate GBP debt with an interest rate cap with an upfront cash premium. In this instance, the interest rate cap is hedging a one-sided risk of a highly probable future transaction (i.e. interest rate risk above the cap strike rate) but the hedged risk would not include the time value component of the cap as time value is not a component of the forecast transaction that affects profit or loss. Only changes in the intrinsic value of the option can therefore be included in the hedging relationship and changes in the time value component will run through profit or loss as hedge ineffectiveness. In many cases, the time value of an option comprises most of the option's total fair value. Requiring fair value changes in time value to flow through profit or loss makes hedge accounting for option products under FRS 102 less attractive as most of the volatility of the option is still being recognised in profit or loss.

To address this issue, we suggest that the FRC consider applying a cost of hedging approach similar to IFRS 9 when applying cash flow hedge accounting with option products. This approach reflects the view that the inception option premium (which typically is comprised entirely of time value) is akin to an insurance premium which is paid to the counterparty to compensate it for assuming the inverse asymmetrical position. Accordingly, entities would exclude the time value of the option from the hedge designation and designate only the option's intrinsic value as the hedging instrument. Periodic changes in the fair value of the time value of the option, to the extent that they relate to the hedged item, are first recognised in other comprehensive income (OCI). The inception time value, which is a known cost and included in the inception option premium, is reclassified to profit or loss in the period in which the underlying hedged item impacts profit loss. This treatment reduces profit or loss volatility and makes cash flow hedge accounting for option products more beneficial for companies to apply.

We believe that allowing companies to separate the time value and intrinsic value of an option product and apply a cost of hedging approach would not introduce additional costs and complexities in the application of hedge accounting for a number of reasons. Firstly, the computation of intrinsic value is generally straightforward in that the forward rate



of the underlying index is compared to the option's fixed strike rate to determine any "moneyness". Companies would then compute the time value of the option as the difference between the option's total fair value and its intrinsic value. Secondly, the application of the cost of hedging approach should be relatively straightforward as the option premium is known at inception of the hedging relationship. For simplicity, we suggest that the FRC allow the **total** time value of the option at inception of the hedging relationship to be accounted for as a cost of hedging without the need to compute the "aligned time value" as required by IFRS 9 para. B6.5.32. This would make the application of hedge accounting for option products more palatable for users of FRS 102.