CL 137E

Paul Ebling
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
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14 October, 2002

Dear Mr Ebling

RE: proposed new UK Financial Reporting Standards on financial instruments

On behalf of BT Group plc, I am writing to comment on the Exposure Drafts numbers 23 and 30, dealing with hedge accounting and financial instruments. In our view, these proposed standards need to be assessed together. Comments on specific questions raised by the ASB are included in the Appendix.

Hedge accounting

On the whole, the introduction of improved reporting on hedge accounting in the UK is to be welcomed as this is an area that has not kept up with commercial 'developments. The implementation of the proposed International Accounting Standards on financial instruments and hedge accounting is, however, likely to require major work from companies in reviewing their hedging strategies for each individual hedge, preparing the requisite documentation and ensuring their treasury and accounting systems are able to assess the hedge effectiveness of each hedge and report accordingly. It is therefore important that companies start preparing for this work now and review the likely impact that the International Accounting Standards ("IAS") will have from an operational and financial reporting perspective.

However, as the ASB accepts, the final content of the IAS is still being decided and there are certain areas, such as recycling of profits or losses on a transaction, which may change between now and the introduction of the IAS in 2005. In addition, the adoption of the IAS will require

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changes to the UK Companies Act, which are also not yet finalised. The introduction of FRED 23 and FRED 30 at this time therefore does not assist this review process. A new FRS based on FRED 23 might be brought in sometime in 2003, and the ASB accepts that this standard would be less restrictive than IAS 39 and so may well permit hedge accounting in some areas where IAS 39 would not. FRED 30 makes certain changes and omissions to IAS 39 which may then be introduced under IAS 39 in 2005. It appears possible that we will have slightly different rules for hedge accounting every year for the next three years.

Certain areas of the FRED are preferable to IAS 39, in particular FRED 30's approach to recycling and the accounting treatment of cash flow hedges. However, it would be preferable for the IAS to be amended in these regards rather than have two different accounting treatments in two consecutive years.

Practical issues with IAS 39

The ASB has stated that the IASB will not be undertaking a fundamental review of IAS 39 at this stage. This is disappointing, given that the current international standards do not allow for enough emphasis to be placed on the substance of an underlying commercial transaction with regards to hedge accounting. The prescriptive nature of the international standard may well lead to a gap between the economic substance of a transaction and the permitted accounting treatment. In practice, some treasurers are likely to take out hedges as before but not wish to fulfil all the onerous documentation and effectiveness assessment requirements and so simply not claim hedge accounting. Others may be affected by the gap between the economic substance of a transaction and its permitted accounting treatment and hold back from hedging when this may be good commercial judgement. There is some evidence that this has already occurred in the US under FAS 133. This will lead to a lack of comparability and understandability in different sets of accounts.

Corporates can certainly work within the proposed rules on hedge accounting for smaller size transactions. However larger transactions which, due to the potential impact of their size need more certainty and therefore significantly more prehedging activity, will not always fit the stricter interpretation of hedge accounting. This leads us to the conundrum whereby corporates, in trying to achieve transaction certainty, create via accounting standards mark to market exposure in the profit and loss account.

The following is an example of the situation which large corporates may face:
BT's expansion into Europe, Asia and 3G technology required significant funding in the bond market. However, the timing of issuing bonds is always subject to market conditions (e.g. too many other significant issuers, sector sentiment, market unease etc.) and the ability to make detailed statements about the company. In August 2000 we were unable to go to the bond market as a result of due diligence issues. We therefore locked in the fixed interest rates applicable at the time by transacting £10bn of interest rate swaps with around 20 counterparties with maturities of 5,10,20 and 30 years. Initially we funded the company's plans by issuing short term, mainly dollar denominated, commercial paper which was swapped into sterling by spot purchase! forward sell foreign exchange contracts to give synthetic floating sterling interest rate borrowing. When the interest rate swaps were taken into account we effectively had short-term borrowing with fixed 5,10,20 and 30 year interest rates. Commercial paper that matured was refinanced with further commercial paper issues until we were able to go to the bond market in December 2000. The amount of finding required forced BT to look outside the domestic market. The dollar and euro

bond markets were therefore tapped and this required £1 3bn of currency swaps to be transacted to turn the bond proceeds into sterling. Such significant currency activity could not be undertaken on the same day as the bonds were issued without seriously moving the market against us. The hedges were therefore put in place over a period of time. The maturity of the bonds we issued were subject to market appetite and this varies with time e.g. investors might take S3bn of 30 year debt in December but by March would only take 10 year debt. The maturity of the bonds we eventually issued did not completely match the maturity of our interest rate swaps. It would have been pure luck if they had matched.

As can be seen above we were able to finance BT's significant funding requirement without exposing the company to interest rate hikes which would have seriously weakened BT. However, this was achieved without having perfectly matched hedges to underlying debt transactions.

Transition arrangements

It is also not apparent how existing hedges should be treated under these proposed new UK standards— it is clear that their effectiveness as hedges could not have been continuously assessed since inception under the guidelines of FRED 23 (one criteria set down in FRED 23 in order to qualify for hedge accounting). Are all hedges to be assessed at the onset of FRED 23 and the gains or losses on hedges then deemed ineffective to be taken to the profit and loss account in that year? How does this fit in with the requirement in FRED 30 to restate comparative figures as if that standard had always applied, if one chooses to adopt the fair value accounting rules in 2004? And will this change in 2005 when applying the transition to international accounting standards? This is a key question from a practical perspective, and needs much greater clarity in the proposed standards.

Conclusion

At a time when UK companies are already addressing the issues around the introduction of IAS 32 and 39 in 2005, we believe that introducing intermediate UK standards in 2003 and 2004 would be extremely counterproductive and accordingly their adoption before 2005 should be on a voluntary basis. The potential need for companies to explain restatements of restatements may further undermine investor confidence in UK financial reporting. This may also result in a lack of comparability and understanding.

Kind regards

Yours sincerely

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APPENDIX

FRED 23

1. Do you agree that a UK standard on hedge accounting is needed at this time to improve UK accounting and to prevent a gap appearing in UK accounting literature on hedges of net investments in foreign operations?

The gap is only appearing in UK accounting literature due to the introduction of FRED 24 as a precursor to IAS 21. We believe that it is better not to introduce UK accounting standards piecemeal in advance of the IAS being finalised so as to ensure that there are not inconsistencies in financial statements appearing over the next 3 years as a result of conflicting treatments.

An improved standard on hedge accounting would be welcomed, but given the short period of time before IASs are mandatory in the UK, it seems unhelpful to introduce an intermediate UK standard now. BT supports the introduction of a fit for purpose IAS 39 rather than piecemeal intermediate UK FRSs.

2. The ASB has taken the view that, in order to start the process of bringing UK practice on hedge accounting into line with the practice adopted internationally, the proposed UK standard's restrictions on the use of hedge accounting should be based on the main principle that underlies the hedge accounting restrictions in IAS 39: that hedge accounting should be permitted only if the hedging relationship is pre-designated and meets certain effectiveness criteria.

(a) Do you agree that UK standard should be based on the principles underlying IAS 39 as set out in the FRED?
(b) Does the principle need to be supplemented by any other principles?

Any UK standard should be based on the principles underlying IAS 39, to the extent that these are not expected to change. This principle should however be reinforced by the substance of any hedging transaction being undertaken - more emphasis should be placed on the economic substance of any hedging decision and related transactions and not just whether it complies with a set of prescribed rules. The box-ticking approach did not prevent Enron and other perceived accounting abuses in the US and was a key driver in the introduction of FRS 5 "Reporting the substance of transactions."

3. The ASB has taken the view that the UK standard should contain those detailed restrictions in IAS 39 that appear to it to be necessary to implement the aforementioned principle, but should not at this stage include any other restrictions on the use of hedge accounting.
(a) Do you agree that the FRED's proposed restrictions on the use of hedge accounting are all necessary to implement the aforementioned principle?
(b) Do you agree that the FRED should not contain any other restrictions on the use of hedge accounting? If not, what should those other restrictions be?

We agree with the approach taken by the ASB in emphasising the principle of IAS 39 and not setting out too many specific restrictions - what should be important is the substance of the underlying transaction.

4. Do you agree with the material in the FRED in measuring hedge effectiveness? If you do not, what if any changes would you make to the material?

The information provided by the FRED is limited. More illustrative examples would be more useful to preparers of accounts.

5. The ASB has taken the view that, in the main, the proposed FRED should not prescribe how hedge accounting should be done. Do you agree with this approach?

Yes. This should also be adopted in the International Accounting Standards to ensure that hedge accounting does not become a tick-box exercise bearing little relation to the economic substance of a transaction. However, further examples of the accounting treatment for specific transactions would be welcomed to provide clarity for preparers.

6. The ASB has nevertheless decided that the FRED should propose some minimum requirements on the use of hedge accounting techniques to be used. Do you agree with the FRED's proposals on:

(a) the treatment of hedges of net investments in foreign operations?
(b) The treatment of the ineffective portion of a gain or loss on a hedge that is not a hedge of a net investment in a foreign operation
(c) The treatment of hedging instruments that cease to qualify for hedge accounting?

Yes.

7. The ASB is proposing that the standard should come into effect for reporting periods ending on or after a certain date in early 2003, although it is also proposing certain transitional requirements. Do you agree with this approach?

No. As noted above, whilst BT agrees that companies need to focus on preparing for the introduction of international accounting standards, adopting parts of these on a piecemeal basis into the UK over the next two years is an unnecessary and burdensome distraction.

FRED 30

1. The ASB has concluded that it is best to view the requirements in LAS 32 and 39 as a single package of requirements that should, as far as is practicable, be implemented in the UK at a single point in time. Do you agree with this approach?

Yes.

2. The ASB is proposing to implement, at a single point in time, some parts of the standards in mandatory form, some in non-mandatory form and some not at all for the time being. At the same time, it is proposing to withdraw FRSs 4 and 13 (and related UITF abstracts) and keep in place most parts of FRS 5. Do you believe that, in the ‘circumstances, this represents the best possible approach of implementing in the UK the international requirements in this area?

No. Given that the implementation of IASs for listed UK entities is just over 2 years away, a piecemeal approach to adopting international requirements will be confusing to investors and shareholders alike, as well as increasing the unnecessary administration for companies in ensuring compliance with UK GAAP at each point in time.

3. The FRED proposes that the proposed new IAS 39 approach to recognition and derecognition should not be implemented in the UK at the present time. Instead, when the direction of international convergence on this subject becomes clearer, a further consultation document will be issued. Do you agree with this approach?

Yes.

4. The ASB is proposing that, prior to 2005, companies should be required to adopt IAS 39’s measurement requirements only if they choose to adopt the fair value accounting rules that will be set out in companies legislation. Entities that do not choose to adopt those rules will not initially be required by UK standards to adopt the measurement requirements at all.
(a) Do you agree with this approach?
(b) Do you agree that the recycling requirements of IAS 39 should not be implemented in the UK pending completion on the project on reporting financial performance and do you agree with the alternative treatment proposed in the FRED?

It is not clear how this statement ties in with FRED 23, which sets out certain hedge accounting criteria, based on IAS 39, for all UK entities other than small companies. These criteria already cover the most onerous areas of IAS 39.

It is sensible that the recycling requirements of IAS 39 are not included in the UK standard yet. Whilst the UK proposal for recycling appears more reasonable, this should only be included if the IAS is likely to change here too.

5. The ASB is proposing a similar approach to IAS 32’s hedge accounting requirements as to its measurement requirements.
(a) Do you agree with this approach?

Yes.

(b) Do you agree with the approach being proposed in place of recycling?

Yes the approach adopted in the FRED, i.e. not recycling gains and losses through the p&l if they have already gone through the statement of total recognised gains and losses, is sensible. However, we would again prefer that the UK and international accounting standards are the same here rather than two different treatments being introduced over the next two years.

6. (a) The FRED proposes that, prior to 2005, entities should be required to comply with IAS 39's measurement and hedge accounting provisions in certain circumstances only. That will change in 2005 for the consolidated financial statements of listed entities, but as the FRED suggests, not for other entities or other types of financial statements. Thus, from 2005, listed entities that do not prepare consolidated financial statements and unlisted entities will not be required to adopt IAS 39's measurements and hedge accounting provisions unless they choose to adopt the fair value accounting provisions set out in the Companies Act 1985. Similarly, listed entities that prepare consolidated financial statements will not be required to adopt IAS 39's measurement and hedge accounting provisions unless they adopt the fair value accounting rules in those financial statements. Do you agree with this approach?

Yes.

(b)FRS 13's disclosure requirements apply only to entities, other than insurance entities, that are listed or have publicly-traded securities and all banks. The ASB is proposing to revise the disclosure requirements on 1 January 2004 and to apply those new requirements to all listed entities, all other entities that have publicly-traded securities and all banks. Do you agree with this approach, or do you believe that, from 2004, the requirements should apply to all other entities (for example unlisted insurance companies) or, alternatively, to a narrower range of entities?

Yes.

(c) FRS 13's disclosure requirements apply both to consolidated financial statements and to individual financial statements, except that they do not need to be applied in the individual financial statements of entities that are preparing FRS 13- compliant consolidated financial statements. The FRED proposes to retain a similar exemption. Do you agree with this approach?

Yes.