



April 25, 2011

Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 2011-175, Invitation to Comment, Selected Issues about Hedge Accounting (Including IASB Exposure Draft, *Hedge Accounting*)

Dear Ms. Cospers:

PwC appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB or the Board) Discussion Paper, *Selected Issues about Hedge Accounting* (the Discussion Paper). We support the Board's objective of working with the International Accounting Standards Board (IASB) to develop converged standards, including on hedge accounting.

In view of the difficulties that practice has experienced in applying hedge accounting, we support the FASB and IASB's overall efforts to simplify accounting for hedging activities and to improve transparency for users of financial statements. We are supportive of many of the proposed amendments to hedge accounting in the FASB's proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, issued in May 2010 (the Financial Instruments Exposure Draft). We expect that several of the FASB's proposed amendments will help reduce the complexity of qualifying for hedge accounting and improve the consistency and comparability of financial reporting. In our response letter dated September 1, 2010, we expressed concerns about certain of the proposed amendments related to hedge accounting. We recommend that the FASB refer to those concerns when redeliberating this project.

We are also supportive of many of the amendments to hedge accounting proposed by the IASB, some of which were not specifically addressed in the FASB's Financial Instruments Exposure Draft. We encourage the FASB to continue to work with the IASB to collectively redeliberate hedge accounting.

Convergence of derivative and hedge accounting

The IASB has proposed more broad-based changes to its hedge accounting model than the FASB has in its Financial Instruments Exposure Draft. We recommend the FASB consider a similar, broader based reconsideration of hedge accounting, including for items such as nonfinancial hedged items and hedging portfolios of dissimilar items. However, as described in our response to the IASB (attached as Appendix B), we believe there are areas where changes or clarifications to the IASB's proposed standard should be considered. These include areas such as the meaning of a risk management strategy in the context of hedge accounting, certain aspects of the proposed new hedge effectiveness assessment criteria to qualify for hedge accounting (such as the requirement for hedging relationships to produce unbiased results), and the requirement to continually rebalance hedging relationships. The risk of creating significant new



differences between IFRS and U.S. GAAP should be minimized as the FASB works with the IASB to develop converged guidance.

In setting a path to convergence, we recommend considering the existing differences between IFRS and U.S. GAAP. While the underlying concepts in hedge accounting under both frameworks are consistent, there are a number of differences in the accounting itself. Furthermore, there are several differences in the basic model for derivative accounting, including the definition of a derivative and exceptions to derivative accounting. Therefore, in seeking to converge the hedge accounting guidance, we recommend that the FASB consider addressing certain existing differences in both derivative and hedge accounting. We believe that it would be difficult to integrate some of the changes proposed by the IASB into the U.S. GAAP hedge accounting model and arrive at a consistent result when the starting point is different.

Macro hedging

The IASB decided not to address in its Exposure Draft the hedging of open portfolios, such as enterprise asset and liability duration management (commonly referred to as “macro hedging”). Instead, it will address that topic separately in a second exposure draft later in 2011. Today, macro hedging is not part of hedge accounting guidance under U.S. GAAP. However, the ability to hedge open portfolios and hedge on a macro basis is a critical component of many entities’ risk management strategies.

We believe the ability to obtain hedge accounting for such activities is important and will provide a clearer picture of an entity’s risk management strategies and the results of those strategies to users of financial statements. We understand that efforts to adapt these strategies to comply with the current hedge accounting model is a source of significant complexity. As such, we recommend that the FASB address macro hedging as part of its reconsideration of the hedge accounting model and work with the IASB as it begins the next phase of its hedge accounting project.

Attached to this letter are two appendices: Appendix A contains our responses to the specific questions raised in the Discussion Paper; Appendix B contains the full response letter, from the PwC network of firms to the IASB in response to its Exposure Draft: Hedge Accounting, for your reference.

If you have any questions, please contact Paul Kepple at 973-236-5293, Donald Doran at 973-236-5280, or Chip Currie at 973-236-5331.

Sincerely,

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

PricewaterhouseCoopers LLP



Appendix A

PricewaterhouseCoopers LLP's responses to specific questions in the FASB's Invitation to Comment: Discussion Paper – Selected Issues about Hedge Accounting

Question 1:

When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity's risk management objectives?

We agree with the IASB's proposed objective of hedge accounting (i.e., to allow the financial statements to more appropriately reflect the effects of an entity's risk management activities when financial instruments are used to manage exposures arising from particular risks). We believe a closer alignment of hedge accounting to an entity's risk management activities should make financial statements more reflective of the economics of these activities and therefore more understandable for users. Thus, achieving this objective would be responsive to concerns that have been raised by many constituents about hedge accounting.

We understand, however, that the guidance proposed by the IASB only pertains to the application of hedge accounting in specified contexts that are a subset of risk management activities. Extending the objective of hedge accounting and related guidance to activities beyond this subset would require a broader project to address risk management activities, which is beyond the scope of the IASB's project. Economic hedges will continue to exist in instances such as macro hedging, nonderivative hedging, or for hedge relationships that are more complex or for which ineffectiveness is difficult to measure. Further, depending on the final conclusions reached by the FASB and IASB on de-designation of hedging relationships, companies may not want to designate economic hedges in hedge accounting relationships where they would be limited in their ability to de-designate.

An entity's use of derivatives in economic hedging relationships is disclosed to users of the financial statements. Under existing disclosure requirements, the entity must provide information about its use of derivatives, including those not designated in hedge accounting relationships (as required under Topic 815, *Derivatives and Hedging* (Topic 815)).

Question 2:

Do you believe that the proposed guidance and illustrative examples included in the IASB's Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

It is not clear what the IASB means by a "risk management objective and strategy" in the IASB's Exposure Draft. We recommend that the nature and level of the risk management objective and strategy



be specified in sufficient detail so that it is possible to determine whether a particular hedge transaction is linked to an objective and a qualifying strategy. It is unclear at what level of granularity an entity would need to define its risk management strategies for purposes of designating and maintaining a hedging relationship. Our understanding is that the proposal to link hedge accounting with risk management is transaction-based (i.e., the goal is not for a hedging strategy to manage exposures at the enterprise level, but to manage the specific risk identified as part of an identified transaction, future event, or group of transactions or events). Clarification of that objective would be helpful and should include consideration of the decisions reached in the IASB's macro hedging project.

We believe additional clarity is needed on how changes in an entity's risk management policies will impact when a rebalancing of the hedging relationship should be required or permitted, and how this interacts with the concept of discontinuing hedge accounting. For example, although we disagree conceptually with prohibiting the discontinuance of hedge accounting, it is not clear whether this is a significant issue. Under the proposed guidance, a hedging relationship can be discontinued if the "risk management objective" for a hedging relationship has changed. If the risk management objective is considered broadly across multiple hedging relationships, then this is potentially a significant issue. However, if the risk management objective is viewed narrowly, say at the individual hedge transaction level, then de-designation can be achieved by simply changing the risk management objective for the hedging relationship in question. This is likely to be much less of an issue, as the conditions giving rise to an entity wanting to de-designate a hedging relationship would generally result from a change in the risk management strategy for the individual hedged transaction. Regardless of what the FASB and IASB decide to do on the issue of de-designations, we believe the granularity of the "risk management objective" should be clarified.

Requiring hedging relationships to produce unbiased results, minimize expected ineffectiveness and to be continually rebalanced is overly complex and adds an "accounting only" exercise that may lead to a different designation of the hedge relationship than is done for risk management purposes. These new requirements surrounding "unbiased" hedge relationships appear to be principally anti-abuse provisions, and we believe the desired effect can be achieved without forcing the complexities of the "unbiased" hedge requirement on the preparers. We believe requiring that (1) there is an appropriate economic relationship between the hedging instrument and the hedged item that meets the risk management objective, (2) hedge ineffectiveness be reliably measurable and recognised in profit or loss, and (3) all designations and de-designations be made prospectively, are sufficient safeguards.

We note that if the hedging strategy includes determining the optimal hedging ratio, then rebalancing would be undertaken whether or not the accounting standard requires it. Permitting entities to rebalance thus enables entities to reflect the effect of the risk management activity in the financial statements. We believe that the ability (as opposed to a requirement) to rebalance would be an improvement to current guidance that must be applied in dynamic hedging strategies (e.g., delta hedging) whereby hedges must be de-designated and re-designated. For dynamic hedging strategies that explicitly consider rebalancing, rebalancing hedging ratios without having to re-designate hedging relationships would reduce complexity and be more aligned with risk management strategies. We also believe that it will be important to consider these issues as part of a project on open portfolio, or macro hedging, which we believe is an important risk management strategy.



Question 3:

Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?

We do not anticipate any significant change in how entities would determine, document, or oversee their risk management objectives as a result of the proposed guidance. However, we believe that removing the 80-125 % effectiveness threshold to qualify for hedge accounting and allowing an entity, where appropriate, to qualitatively evaluate hedge effectiveness are significant improvements. We believe that removing this bright line threshold will eliminate a major stumbling block to qualifying for and applying hedge accounting and ease the administrative burden on preparers. In our view, it will likely result in more transactions qualifying for hedge accounting. It will also avoid undue income statement volatility, where a hedging transaction qualifies for hedge accounting in one period but not in another, therefore resulting in only true ineffectiveness being reported in income. We welcome that change.

With respect to documentation, companies generally prepare their risk management documentation at the strategy level and specific transaction-level hedge documentation refers to the strategy documentation. We expect that this practice would continue under the proposed guidance. The elimination of the ongoing quantitative analysis of effectiveness should reduce the complexity in the documentation and application of hedge accounting.

Companies generally have appropriate controls in place over derivative and hedging activities that permit only transactions with valid risk management purposes to be entered into. Because the IASB's proposed guidance links hedge accounting with risk management objectives, we believe that significant difficulties would not be encountered in establishing or updating the controls necessary to comply.

Question 4:

Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity's risk management strategies measurable and objective? Could the inclusion of an entity's risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of an entity's risk management objectives?

When applying hedge accounting under IFRS and U.S. GAAP today, formal documentation of the hedging relationship, including the entity's risk management objective and strategy for undertaking the hedge, is required. Audit procedures for hedge accounting address whether the hedging strategy is valid for the hedge relationship in accordance with the accounting guidance. The audit opinion does not address the adequacy, sufficiency or appropriateness of the risk management objective itself. Furthermore, the audit opinion is not based on an evaluation of risk reduction, since the accounting guidance does not require enterprise risk reduction or risk reduction generally; something that would increase the difficulty of auditing, if explicitly required. Therefore, we believe that the inclusion of an



entity's risk management strategy in the context of a hedge accounting relationship does not change what is expected to be covered by the audit and should not result in new auditing challenges.

From a disclosure perspective, the nature of and rationale for how and why derivatives are used are required to be disclosed today. The existing required disclosures pertaining to risk management activities are limited to those that involve derivative and hedging transactions executed and disclosed by the entity and do not extend to other risk management activities. We believe disclosure requirements are an essential part of enhancing the usefulness of the financial statements when applying hedge accounting and many of the disclosures in the IASB's Exposure Draft are appropriate. However, we are concerned that certain of the proposed disclosures appear excessive and that the IASB's Exposure Draft does not strike the right balance between the needs of users and the burden of providing the information. We are particularly concerned with the requirements in paragraph 46 of the IASB's Exposure Draft. We understand that information about total forecast exposures may be useful for some users, but many preparers may find this information to be commercially sensitive. If these exposures are not hedged, it is unclear why disclosure of these risks should be required as part of a hedge accounting standard. We also note that requiring forecast information in financial statements may result in increased audit costs given its nature and subjectivity.

Question 5:

Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, *Financial Instruments*, and IAS 21, *The Effects of Changes in Foreign Exchange Rates*)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?

We agree that non-derivative financial instruments measured at fair value through profit or loss should be eligible as hedging instruments if they are a part of the entity's risk management strategy. We believe that the form of the instrument used to mitigate risk (i.e., derivative versus non-derivative) is an artificial distinction. We believe that the eligibility of these financial instruments as hedging instruments would better align with the classification model of IFRS 9 and therefore make the hedge accounting model better able to address hedging strategies that could evolve in the future. We do not believe the ability to designate cash instruments as hedging instruments will present operational concerns.

Question 6:

Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated)? If not, what additional guidance should be provided?



We agree that an aggregated position that is a combination of another exposure and a derivative should be eligible for hedge accounting. For example, it is not uncommon for an entity to manage the foreign exchange risk and interest rate risk associated with a foreign currency denominated financial instrument separately and to establish those hedging relationships at different points in time. Allowing aggregated positions that include a derivative as part of the hedged item better aligns hedge accounting with the entity's risk management activities.

We believe however, that it may be necessary to further clarify the application of hedge accounting to an aggregated exposure that includes a derivative instrument to ensure consistency in practice. Allowing a derivative to be designated as a hedged item may need to be limited to only those situations where the derivative is presently designated in a hedging relationship. Absent such a limitation, it will likely be challenging to determine the amounts to be reclassified from other comprehensive income (in the case of cash flow hedges). In addition, we believe that when hedging an aggregated position, the hedged derivative must be included in its entirety. It may not be appropriate to designate only selected cash flows of a derivative as the hedged item.

Question 7:

Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.

We support the extension of the ability to hedge component risks in transactions involving non-financial items beyond the current ability to hedge foreign currency risk. This would represent a significant change to Topic 815 and we would welcome that change. We believe that allowing risk components of non-financial items to be identified as the hedged item better reflects common risk management strategies which are often to hedge only one or more components rather than the entire item. Allowing the designation of a risk component for hedge accounting purposes also provides more useful information to users on the degree of effectiveness of hedges, as the effect of components that were not part of the risk management strategy will not be reported as ineffectiveness. Furthermore, extending risk components to non-financial hedged items removes an arbitrary distinction between financial and non-financial items that has not helped users understand risk management activities.

We agree with the IASB's proposal that entities should be able to apply hedge accounting to risk components provided that the component is separately identifiable and reliably measurable. This concept exists today within the IFRS hedge accounting guidance for financial instruments and has worked well.

However, we are concerned that the proposed guidance, as drafted, is not sufficiently clear to ensure consistent application in practice. Specifically, we are concerned about situations where the risk components are "implicit" in the total fair value or cash flows of the hedged item. For example, where there is a known cost component for a product, is the mere physical presence of that component and the



logical belief that it would in some way influence the pricing of a product be sufficient to support eligibility for hedge accounting?

We believe that it may be helpful to further clarify the guidance for non-contractually specified risk components. One way would be to state that a known cost component of an item can be eligible for designation as a risk component, if knowledgeable and willing buyers and sellers would be expected to explicitly consider it in determining the fair value or transaction price of the total product. This will typically be the case, for example, when prices are determined using a building block approach.

Question 8:

Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?

No. We believe that “separately identifiable” should not be limited to those risk components that are contractually specified. Such limitations are not required for the current model of hedging components in financial instruments under U.S. GAAP or IFRS. Such lack of contractual specificity does not seem to be an issue when knowledgeable market participants understand what to consider in determining the fair value of a transaction or price of a product. However, refer to our response to Question 7 where we describe our concerns about potential complexities associated with risk components that are not contractually specified.

Question 9 – not used.

Question 10:

Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?

We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item since identifying a layer of the nominal amount for either a single item or a group is a common risk management strategy. Designating a percentage component of a nominal amount can give rise to a different accounting outcome compared with designating a layer component of a nominal amount. Therefore, if hedge accounting is not aligned with the risk management strategy, the result in profit or loss may be misleading or provide less useful information to users. We believe that the ability to hedge layers makes identifying the hedged item and measuring it simpler in many circumstances. However, we believe that the “sufficiently specific” test should be retained (i.e., when a transaction occurs, it should be clear whether or not it is part of the hedged layer). For example, a layer should not be defined as the last 10,000 widgets to be sold during a specified period.

In regards to prepayment options within layers, we agree, when considered in isolation, that when a prepayment option gives the holder the right to prepay a financial instrument at par it would not be



appropriate to use a layer to isolate the effects of the prepayment option. However, there are situations, especially in the case of mortgages, where there may exist compensation mechanisms (e.g., a make whole provision) that substantially mitigate, but do not fully eliminate the effect of the hedged risk. In these situations, we believe it may still be appropriate to designate a layer even though there may still be some relatively small impact on the prepayment option attributable to the hedged risk (i.e., interest rate risk).

We encourage the FASB to consider the issues involving prepayment options, similar to what may be considered by the IASB as part of its separate project on macro hedging. The solution that is appropriate for macro hedging may also be appropriate when hedging a single transaction.

Question 11:

Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them?

As discussed in our response to Question 6, we agree that an aggregated position that is a combination of another exposure and a derivative should be eligible for hedge accounting. We also support the IASB's proposal to allow hedging of dissimilar items as a single group. We believe that the IASB's proposed changes to the eligibility for groups to be designated as hedged items will more closely align the hedge accounting model with risk management practices.

Operationally, considerations will exist any time there are portfolio level adjustments that are required to be calculated and allocated among the individual items in the portfolio. However, we believe that similar to other instances where allocations must be performed (e.g., a credit risk adjustment when measuring the fair value for a portfolio of derivatives) there are reasonable and rational methodologies available to allocate the impact of hedge accounting to individual hedged items.

One example where we believe an allocation is necessary and can be performed is for the presentation in the income statement of the effects of hedging transactions within a group. In such a strategy, many entities regard all items in the group as being hedged. We believe that in such circumstances all items in the hedged group should be reflected at the hedged rate, as that best reflects the risk management strategy. This will give a consistent accounting whether or not a hedged item is part of a micro, gross, or net group hedge. It will also faithfully portray what the entity considers to be the full impact of its hedging strategy, and therefore, be consistent with the focus on risk management strategies in the IASB's Exposure Draft.

As noted in our cover letter, we are supportive of the FASB undertaking a similar project to that contemplated by the IASB to permit more "macro hedging" strategies to achieve hedge accounting.



Question 12:

Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity's use of derivatives? Why or why not?

We believe that allowing the hedging of aggregated (and in some cases net offsetting) exposures will provide more transparent information about an entity's use of derivatives. One commonly used risk management strategy is to aggregate exposures of a group including offsetting items, as this reduces the number of external derivative transactions entered into and thus mitigates the cost of hedging. The proposed changes better align accounting with the risk management activities undertaken. We believe being able to represent the hedging of groups that includes offsetting positions (net hedging) is important and should be addressed. We also believe that when hedging a net position, the overall group of items that make up the net position should be identified as the hedged item.

However, we disagree with the proposed requirements that the cash flows of the offsetting hedged items in a cash flow hedge must affect profit or loss in the same interim period. The hedging gain or loss is determined when the hedged transaction occurs, not when it is reported in profit or loss. The cut-off points will create arbitrary outcomes that will reduce the comparability between entities and over time. This restriction also adds unnecessary complexity, as similar strategies may be eligible or not depending only on timing of the transactions. We believe that requiring that offsetting cash flows or transactions occur or affect profit or loss in the same reporting period will not align the accounting with the risk management practices and thus undermines the purpose of allowing hedges of net positions.

As further discussed in our response to Question 11, we also do not agree that the results of hedging a net position should be presented in a separate line item in the income statement. We believe allocating the results of hedging net positions to the relevant line items in the income statement impacted by the hedged item is more transparent, provides better information to users, and more closely aligns the accounting with the risk management strategy.

Question 13:

Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?

We support allowing designation of net positions of closed groups as hedged items as these strategies are commonly undertaken as risk management strategies. We agree that all items in a group should individually be eligible hedged items and be managed on a group basis to be eligible as a group of items for hedge accounting. We also believe that when hedging a net position, the overall group of items that make up the net position should be identified as the hedged item.

As discussed in our response to Question 12, we do not agree with the IASB's proposal that to qualify, the hedged items must impact earnings in the same period. This is not consistent with risk management



strategies which focus on cash flows. In addition, as discussed in our response to Questions 11 and 12, we do not agree that the results of hedging a net position should be presented in a separate line item in the income statement. We believe allocating the results of hedging net positions to the relevant line items in the income statement impacted by the hedged item is more transparent, provides better information to users, and more closely aligns the accounting with the risk management strategy.

Question 14:

Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them?

We believe that removing the 80-125 % effectiveness threshold to qualify for hedge accounting and allowing an entity, where appropriate, to qualitatively evaluate hedge effectiveness are significant improvements. We note that this shift in the assessment of effectiveness testing from a strict quantitative analysis to a qualitative analysis is similar to the FASB's proposal. We also agree with the concept of more closely aligning the hedge accounting model with risk management activities. As further discussed in our response to Question 2, we believe that additional clarity regarding the granularity of the "risk management objective" is needed. Nonetheless, we believe that the concept of having "other-than-accidental-offset" is broadly consistent with a valid risk management strategy and is a concept that is appropriately included in the qualification criteria for hedge accounting.

However, consistent with our September 2010 response to the FASB's proposed revisions to hedge accounting within its Financial Instruments Exposure Draft, we disagree with the proposal to prohibit an entity from discontinuing hedge accounting for a hedging relationship that still meets the risk management strategy and that continues to meet all other qualifying criteria. As further discussed in our response to Question 2, this may or may not be a significant issue, depending on further clarification regarding the risk management objective.

Question 15:

Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

As discussed in our response to Question 7, we believe that it may be helpful to further clarify the guidance for identifying non-contractually specified risk components that are eligible to be hedged for non-financial hedged items. However, we do not believe that any additional guidance should provide proscriptive requirements on how to measure a hedged risk as we believe there are several reasonable and rational ways one can measure separately identifiable risks.



Question 16:

Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity's risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them?

We disagree with the proposal to prohibit an entity from discontinuing hedge accounting for a hedging relationship that still meets the risk management strategy and that continues to meet all other qualifying criteria. De-designating hedge accounting is an important tool in any dynamic hedging strategy. This is allowed under U.S. GAAP and IFRS today, and we are not aware of problems that have arisen in practice. It is a voluntary choice to apply hedge accounting, and therefore, we believe stopping hedge accounting on a prospective basis should also be discretionary.

As further discussed below in Question 17, the rebalancing concept for hedge relationships that are expected to be static introduces unnecessary complexity. The requirements surrounding unbiased hedge relationships and required rebalancing appear to be principally anti-abuse provisions and there are less operationally complex manners in which these concerns can be addressed. However, we do support rebalancing (without de-designation and re-designation) for dynamic hedge strategies (e.g., delta hedging). In these circumstances, the risk management strategy contemplates such rebalancing.

In considering the nature of a change in an entity's risk management objective, we would not expect risk management activities to change from period to period. The objective is revisited on a regular basis but typically remains generally consistent. Changes that do occur are driven by significant factors such as changes in decision makers and overall business strategy changes. However, as discussed in our response to Question 2, we believe that clarity is needed regarding what is meant by a "risk management objective and strategy" and whether de-designations can be effected through changes to the risk management objective.

Question 17:

Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?

Requiring entities to continuously monitor the optimal hedging ratio when rebalancing is not an inherent component of the risk management strategy introduces significant complexities and burdens on preparers. Furthermore, the benefits to users are limited, because any additional ineffectiveness that results from a non-optimal hedge ratio will be reported in profit or loss. The requirement to rebalance a hedging relationship will require entities to determine a different hedging ratio for accounting purposes than they are using for risk management purposes.



We note that if the hedging strategy includes determining the optimal hedging ratio then rebalancing would be undertaken whether or not the accounting standard requires it. Permitting entities to rebalance thus enables entities to reflect the effect of the risk management activity in the financial statements. We believe that the ability (as opposed to a requirement) to rebalance would be an improvement to current guidance that must be applied in dynamic hedging strategies (e.g., delta hedging) whereby hedges must be de-designated and re-designated. For dynamic hedging strategies that explicitly consider rebalancing, rebalancing hedging ratios without having to re-designate hedging relationships would reduce complexity and be more aligned with risk management strategies. In these circumstances, the risk management strategy contemplates rebalancing; the complexity exists due to the complexity of the risk management strategy itself, not because of the accounting. In contrast, rebalancing in a hedge relationship designed to be static in nature would likely be rare as it would take a significant change in the market, with long term impacts, to require an adjustment to the hedge ratio.

Question 18:

Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity's statement of financial position? Why or why not?

We agree that when options are used for hedging, the initial time value of the option is a cost associated with the hedging relationship and should be part of hedge accounting. We believe that the ability to defer changes in the fair value of an option by recognizing those changes in other comprehensive income under current U.S. GAAP for cash flow hedges has improved transparency in financial reporting. In these cases, volatility due to the cost of a hedge that is not expected to be monetized is not reported in current earnings. We therefore agree with the IASB's proposal to defer changes in the time value of options in other comprehensive income. This is a reasonable approach to equalize the use of options with futures, forwards, and swaps, and provides a reasonable outcome. We also support extending this treatment to include fair value hedges.

To reduce complexity, we believe that the two different recognition methods described (i.e., transaction related and time period related) could be replaced with a broader principle. For example, the cost should affect profit or loss in a manner consistent with how the hedged item affects profit or loss. Such a principle is well understood in practice, consistent with current treatment under U.S. GAAP, and would eliminate the need to provide rules distinguishing "transaction related" and "time period related" strategies.

Question 19:

Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not?

We understand that users want to have greater insight into the fair value changes of the hedging instrument and the hedged item, as well as the amount of ineffectiveness that is reported. However, we



believe that it would be preferable to retain the FASB's current model of reporting all effects of changes in fair value of the hedging instrument and changes in fair value of the hedged risk in the income statement. Presenting the effective and ineffective portions of the hedging relationship gross in other comprehensive income and then transferring the ineffectiveness to the income statement would add three compulsory line items to the statement of comprehensive income that simply net to zero. Given this information will most likely be presented on an aggregate basis for all of the entity's fair value hedges, it will provide only marginal information to users. A requirement to place all hedging disclosures in one note on a disaggregated basis provides users with more information, makes it easier for users to locate and assess the impact of the entity's fair value hedges and does not clutter the face of the financial statements.

Question 20:

Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity's hedging activities? Why or why not?

We agree that it is useful to provide users with information about the original accounting basis for the hedged item separately from the fair value adjustment, because it retains the information content of the (amortized) cost measurement and gives a clear understanding of the effect of fair value hedge accounting. The unit of account, however, should be maintained on the face of the statement of financial position. We believe splitting the hedged asset or liability into two line items is inconsistent with the unit of account. It may also significantly increase the number of lines in the financial statement of certain entities, such as financial institutions, that likely have fair value hedges affecting multiple balance sheet line items.

We believe that disclosing the hedge accounting adjustment and the amortized cost in the notes to the financial statements provides users with relevant information they desire without burdening the statement of financial position with excessive detail.

Question 21:

Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?

We believe the question of whether or not a linked presentation should be required in the financial statements is not only limited to hedge accounting. It could for example also be applicable for derecognition issues, pension accounting, subleasing, etc. and should be considered in a broader context. We therefore suggest that the issue of linked presentation be considered either within the financial statement presentation project or the conceptual framework project.

In addition, as discussed in our response to Questions 11 and 12, we do not agree that the results of hedging a net position should be presented in a separate line item in the income statement. We believe allocating the results of hedging net positions to the relevant line items in the income statement



impacted by the hedged item is more transparent, provides better information to users, and more closely aligns the accounting with the risk management strategy.

Question 22:

Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

We believe disclosure requirements are an essential part of enhancing the usefulness of the financial statements when applying hedge accounting and many of the proposed disclosures are appropriate. However, we are concerned about the requirement in paragraph 46 of the IASB's Exposure Draft that would require information to be provided about exposures and forecasts for each subsequent period by risk exposure type. We understand that information about total forecast exposures may be useful for some users, but many preparers may find this information to be commercially sensitive. If these exposures are not hedged, it is unclear why disclosure of unhedged risk should be required as part of a hedge accounting standard. We also note that requiring forecast information may result in increased audit costs given its nature and subjectivity.

However, as further discussed in our response to Question 4, the audit opinion does not address the adequacy, sufficiency or appropriateness of the risk management objective itself. Furthermore, the audit opinion is not based on an evaluation of risk reduction, since the accounting guidance does not require enterprise risk reduction or risk reduction generally; something that may increase the difficulty of auditing, if required. Therefore, we believe that the inclusion of an entity's risk management strategy in the context of a hedge accounting relationship does not change what is expected to be covered by the audit opinion and should not result in new auditing challenges.

Question 23:

Do you believe that the changes proposed by the IASB provide a superior starting point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB's standards?

As discussed in our cover letter, we believe the IASB has taken a more fundamental look at its hedging model and the FASB may want to consider a similar, broader based reconsideration of hedge accounting guidance, including items such as nonfinancial hedged items and hedging portfolios of dissimilar items. There are many elements of the IASB's proposed model that we believe would be a good starting point for a broader reconsideration of hedge accounting by the FASB. At the same time, as described in our response to the IASB on its proposal (attached as Appendix B) and in our responses to the FASB's questions herein, we believe there are areas where changes or clarifications to the IASB's proposed standard should be considered.



We recommend that the FASB and IASB work together to develop guidance that is converged in order to minimize significant new differences between U.S. GAAP and IFRS. While the underlying concepts in hedge accounting under existing U.S. GAAP and IFRS are consistent, there are a number of differences in the accounting itself. Furthermore, there are several differences in the basic model for derivative accounting, including the definition of a derivative and exceptions to derivative accounting. Therefore, in seeking to converge the hedge accounting guidance, we recommend that the FASB consider addressing certain existing differences in both derivative and hedge accounting. We believe that it would be difficult to integrate some of the changes proposed by the IASB into the U.S. GAAP hedge accounting model and arrive at a consistent result, when the starting point is different.

Finally, we encourage both the FASB and IASB to address hedging of open portfolios, such as enterprise asset and liability duration management (commonly referred to as “macro hedging”). Macro hedging is not part of the existing U.S. hedge accounting guidance yet the ability to hedge open portfolios and hedge on a macro basis is a critical component of many entities’ risk management strategies. We believe that the ability to obtain hedge accounting for such activities is important and will provide a clearer picture of an entity’s risk management strategies and its results to users of financial statements.

Appendix B
**PwC network of firms letter to the IASB in response to
its Exposure Draft: Hedge Accounting**

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

9 March 2011

Dear Sirs

Exposure Draft: Hedge Accounting

We are responding to the invitation of the IASB ('the Board') to comment on the exposure draft *Hedge Accounting* (the 'exposure draft' or 'proposed standard'). Following consultation with members of the PwC network of firms, this response summarises the views of those member firms who commented on the exposure draft. 'PwC' refers to the network of firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the effort of the IASB to comprehensively review the hedge accounting requirements in IAS 39 and believe the proposed changes will be positively received. We agree the current guidance is overly complex and often yields results that do not appropriately reflect the entity's risk management strategy. We believe that overall the proposals in the exposure draft make significant progress towards aligning the accounting more closely with risk management, establishing a more principles-based approach and addressing many of the inconsistencies and weaknesses in IAS 39. We are particularly supportive of eliminating the current bright line for effectiveness testing, allowing effectiveness to be assessed on a qualitative basis, expanding the ability to hedge component risks to non-financial items, and allowing hedge accounting to be applied to groups of items that include offsetting positions.

However, there are some areas where changes to the proposed standard should be considered to better address the project's objective. Those areas include the limitation of hedge accounting to exposures affecting profit or loss, the new hedge effectiveness assessment criteria to qualify for hedge accounting, the clarity of the new component risk hedging guidance, certain of the changes related to hedging groups of items, and some of the presentation and disclosure requirements.

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We are also concerned with the timeline for finalising the hedge accounting project. The Board has decided not to address open portfolios and macro hedging as part of the exposure draft, and will instead address any changes in a second exposure draft to be issued later this year. The ability to hedge open portfolios and to hedge on a macro basis is very important to many entities and a critical component of their risk management strategies. The decisions made in finalising the macro hedging phase may have implications for the proposals in this exposure draft. We believe that the complete set of amendments to the hedge accounting standard when finalised, need to be consistent and operational as a package. Accordingly, the Board should consider not finalising the guidance in the exposure draft until there is greater clarity as to the conclusions that are expected to be reached on the ability to apply hedge accounting for risk management strategies involving open portfolios and macro hedging. However, if this would result in a significant delay, we recommend that the Board finalise the guidance in this exposure draft as planned and commit to make any necessary amendments upon completion of the macro hedging phase. We believe that: (1) developing a complete and integrated hedge accounting model, and (2) enabling entities to avail themselves of the significant enhancements proposed in the exposure draft as soon as possible, are both important goals.

Objective of hedge accounting

We agree that the objective of hedge accounting should be to allow the financial statements to more appropriately reflect the effects of an entity's risk management activities when financial instruments are used to manage exposures arising from particular risks. We believe a closer alignment of hedge accounting to an entity's risk management activities should make financial statements more reflective of the economics of these activities and therefore more understandable for users.

However, we disagree that hedge accounting should be limited to only the exposures that could affect profit or loss. There are legitimate risk management strategies that an entity may undertake with respect to exposures that may only affect items recognised in other comprehensive income (for examples see Question 1 in the appendix). In the absence of the ability to apply hedge accounting, the entity's financial statements will not appropriately reflect the effect of those risk management strategies. Given the objective of this project is to enable the application of hedge accounting to better reflect an entity's risk management activities, we believe that the Board should consider adapting the hedge accounting model to accommodate exposures that could affect total comprehensive income.

Qualifying criteria for hedge accounting

We believe that removing the 80-125 % effectiveness threshold to qualify for hedge accounting and allowing an entity, where appropriate, to qualitatively evaluate hedge effectiveness are significant improvements. We believe that removing this bright line threshold will eliminate a major stumbling block to qualifying for and applying hedge accounting and ease the administrative burden on preparers. It also enhances the information given to users, as it provides a better link to the entity's risk management strategy.

However, we are concerned with the impact of the new "objective of hedge effectiveness assessment" and the restriction on de-designations of hedging relationships. Requiring hedging relationships to produce unbiased results, minimise expected ineffectiveness and to be continually rebalanced is overly complex



and adds an “accounting only” exercise that may lead to a different designation of the hedging relationship than is done for risk management purposes.

Furthermore, it is not uncommon for entities to enter into or continue with hedging relationships that are somewhat “biased” because they are a practical means to cost-effectively hedge an exposure. An entity may accept some additional ineffectiveness in a hedging relationship, because a less than perfect hedge ratio may be operationally simpler to monitor and explain (e.g., a 1-to-1 ratio), or the reduction in reported ineffectiveness may not justify the cost of rebalancing the hedge. If a hedge is not economically rebalanced as part of a risk management strategy, the requirement to rebalance for accounting purposes does not change the economic ineffectiveness, but changes how it is reported in the financial statements by reclassifying a portion as trading. We do not believe relabeling “ineffectiveness” as “trading” within the income statement will improve a user’s understanding of the effectiveness of the risk management strategy applied.

These new requirements surrounding “unbiased” hedge relationships appear to be principally anti-abuse provisions, and we believe the desired effect can be achieved without forcing the complexities of the “unbiased” hedge requirement on the preparers. We believe requiring that (1) there is an appropriate economic relationship between the hedging instrument and the hedged item that meets the risk management objective, (2) hedge ineffectiveness be reliably measurable and recognised in profit or loss, and (3) all designations and de-designations be made prospectively, are sufficient safeguards.

Hedging component risks

We support the extension of the ability to hedge component risks in transactions involving non-financial items beyond the current ability to hedge foreign currency risk. Allowing risk components to be identified as the hedged item better reflects common risk management strategies which are often to hedge only one or more components rather than the entire item. This also provides more useful information to users on the degree of effectiveness of hedges, as the change in fair value or cash flows of components that were not part of the risk management strategy are not reported as ineffectiveness. Furthermore, this will remove an arbitrary distinction between financial and non-financial items that has not helped users understand risk management activities.

We agree with the Board’s proposal that entities should be able to apply hedge accounting to risk components provided that the component is separately identifiable and reliably measurable. We also agree that the evaluation of whether a risk component is eligible for hedge accounting should take into consideration both the market structure of the hedged item and the market for the hedging activity. Therefore, the risk components eligible for hedge accounting should not be limited to only those that are contractually specified.

However, we are concerned that the proposed guidance is not sufficiently clear to ensure consistent application in practice. Specifically, we are concerned about situations where the risk components are “implicit” in the total fair value or cash flows of the hedged item. For example, where there is a known cost component for a product, is the mere physical presence of that component and the logical belief that it would in some way influence the pricing of a product be sufficient to support eligibility for hedge accounting?



We believe that it may be helpful to further clarify the guidance for non-contractually specified risk components. One way would be to state that a known cost component of an item can be eligible for designation as a risk component, if knowledgeable and willing buyers and sellers would be expected to explicitly consider it in determining the fair value or transaction price of the total product. This will typically be the case, for example, when prices are determined using a building block approach.

Hedging groups of items

We support the application of hedge accounting to groups of items that include offsetting positions (net hedging). We also believe that when hedging a net position the overall group of items that make up the net position should be identified as the hedged item. However, we disagree with the proposed requirements that the cash flows of the offsetting hedged items designated as a group in a cash flow hedge must affect profit or loss in the same interim period. The hedging gain or loss is determined when the hedged transaction occurs, not when it is reported in profit or loss. The proposed cut-off point will create arbitrary outcomes that will reduce the comparability between entities and over time. We believe there should be no requirement that offsetting cash flows or transactions occur or affect profit or loss in the same reporting period, as this will not align the hedge accounting with the risk management practices and thus undermines the purpose of allowing hedges of net positions.

We also disagree with the proposal requiring hedges of net positions to be presented differently than hedges of gross positions, as it is inconsistent with an objective to align hedge accounting with the risk management activities undertaken. The objective from a risk management perspective may be to hedge the risk on all of the items in the group, and therefore, they should all be accounted for at the hedged rate in profit or loss.

Presentation of hedge accounting

Presentation changes to fair value hedge accounting

We agree that it is useful to provide users with information about the original accounting basis for the hedged item separately from the fair value adjustment, because it retains the information content of the (amortised) cost measurement and provides a clear understanding of the effect of fair value hedge accounting. However, we believe that disclosing the hedge accounting adjustment and the (amortised) cost in the notes to the financial statements is sufficient to provide users with the relevant information they desire without burdening the statement of financial position with excessive detail.

We believe that retaining the IAS 39 presentation, (i.e., reporting all effects in profit or loss) is preferable to the proposal in the exposure draft to present the changes in the fair value of the hedged item and hedging instrument separately in other comprehensive income. In addition, we believe a requirement to place all hedging disclosures in one note on a disaggregated basis provides users with more information, makes it easier for users to locate and assess the impact of the entity's fair value hedges and does not clutter the face of the financial statements.



Basis adjustment for the effects of cash flow hedges

We disagree with the proposal to reclassify the deferred hedging gains or losses directly from equity, instead of recycling them through other comprehensive income, as it introduces a new class of transactions in the statement of equity that is not a transaction with the owners. We believe that it is unnecessary to change the recycling out of other comprehensive income when applying basis adjustment until the purpose of other comprehensive income is determined.

Disclosures

We believe disclosure requirements are an essential part of enhancing the usefulness of the financial statements when applying hedge accounting and many of the proposed disclosures are appropriate. However, we are concerned that certain of the disclosures appear excessive, and that the exposure draft does not strike the right balance between the needs of users and the burden of providing the information.

We are particularly concerned with the requirements related to the total forecast exposures, as many preparers may find this information to be commercially sensitive. We believe that disclosure of information regarding the notional amount and key terms of derivative positions by risk category and hedge type should be sufficient to give users adequate information as to the nature and extent of an entity's risk management activities.

Our answers to the specific questions in the exposure draft are attached in the appendix to this letter.

In addition, there are a number of matters that are not addressed in the questions to the exposure draft, but which we believe should be addressed or further clarified in the final standard. These issues are described in greater detail after our response to question 16 in the appendix to this letter.

If you have any questions in relation to the letter please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 20 7804 2497), or John Althoff (+44 20 7213 1175).

Yours faithfully

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

PricewaterhouseCoopers LLP



Appendix

Responses to detailed questions in the exposure draft

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We agree that the objective of hedge accounting should be to allow the financial statements to more appropriately reflect the effects of an entity's risk management activities when financial instruments are used to manage exposures arising from particular risks. We believe a closer alignment of hedge accounting to an entity's risk management activities should make financial statements more reflective of the economics of these activities and therefore more understandable for users.

However, we disagree that hedge accounting should be limited to only those exposures that could affect profit or loss. There are legitimate risk management strategies that an entity may undertake with respect to exposures that may only affect items recognised in other comprehensive income. For example:

- an entity may wish to hedge its exposure to changes in the foreign currency risks or the changes in the fair value of its strategic investments to protect its regulatory capital from adverse market movements,
- an entity may later decide to exit a strategic relationship and wishes to hedge its exposure to the changes in the expected proceeds on the sale of the related investment, or
- an entity may wish to hedge its exposure to actuarial gains and losses in post employment benefit plans, which under the proposals in IAS 19 exposure draft would be recognised directly in other comprehensive income and not in profit or loss.

In the absence of the ability to apply hedge accounting, the entity's financial statements will not appropriately reflect the effect of the risk management strategy. Given the objective of this project is to enable the application of hedge accounting to better reflect an entity's risk management activities, we fail to see why hedge accounting should be limited to only those items that could affect the profit or loss section of total comprehensive income.

We believe that the Board should consider adapting the hedge accounting model to accommodate exposures that could affect total comprehensive income. One approach would be to recognise the effective portion of the changes in fair value of the hedging instrument in other comprehensive income and not recycle through profit or loss if this is consistent with the accounting for the hedged item.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?



We agree that non-derivative financial instruments measured at fair value through profit or loss should be eligible as hedging instruments if they are a part of the entity's risk management strategy. We believe that the eligibility of these financial instruments as hedging instruments would better align with the classification model of IFRS 9 and therefore make the hedge accounting model better able to address hedging strategies that could evolve in the future.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree that an aggregated position that is a combination of another exposure and a derivative should be eligible for hedge accounting. For example, it is not uncommon for an entity to manage the foreign exchange risk and interest rate risk associated with a foreign currency denominated financial instrument separately and to establish those hedging relationships at different points in time. Allowing aggregated positions that include a derivative as part of the hedged item better aligns hedge accounting with the entity's risk management activities.

We believe however, that it may be necessary to further clarify the application of hedge accounting to an aggregated exposure that includes a derivative instrument to ensure consistency in practice. Allowing a derivative to be designated as a hedged item may need to be limited to only those situations where the derivative is presently designated in a hedging relationship. Absent such a limitation, it will likely be challenging to determine the amounts to be recycled from other comprehensive income. In addition, we believe that when hedging an aggregated position, the derivative must be included in its entirety. It may not be appropriate to designate only selected cash flows of a derivative as the hedged item.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e., a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We support the extension of the ability to hedge component risks in transactions involving non-financial items beyond the current ability to hedge foreign currency risk. We believe that allowing risk components of non-financial items to be identified as the hedged item better reflects common risk management strategies which are often to hedge only one or more components rather than the entire item. Allowing the designation of a risk component for hedge accounting purposes also provides more useful information to users on the degree of effectiveness of hedges, as the effect of components that were not part of the risk management strategy will not be reported as ineffectiveness. Furthermore, extending risk components to non-financial hedged items removes an arbitrary distinction between financial and non-financial items that has not helped users understand risk management activities.



We agree with the Board's proposal that entities should be able to apply hedge accounting to risk components provided that the component is separately identifiable and reliably measurable. We also agree that the evaluation of whether a risk component is eligible for hedge accounting should take into consideration both the market structure of the hedged item and the market for the hedging activity. Therefore, the risk components eligible for hedge accounting should not be limited to only those that are contractually specified.

However, we are concerned that the proposed guidance, as drafted, is not sufficiently clear to ensure consistent application in practice. Specifically, we are concerned about situations where the risk components are "implicit" in the total fair value or cash flows of the hedged item. For example, where there is a known cost component for a product, is the mere physical presence of that component and the logical belief that it would in some way influence the pricing of a product be sufficient to support eligibility for hedge accounting?

We believe that it may be helpful to further clarify the guidance for non-contractually specified risk components. One way would be to state that a known cost component of an item can be eligible for designation as a risk component, if knowledgeable and willing buyers and sellers would be expected to explicitly consider it in determining the fair value or transaction price of the total product. This will typically be the case, for example, when prices are determined using a building block approach.

Cash flows of hedged component must be less than cash flows of the entire item

We understand the Board's concern regarding hedging relationships where the cash flows associated with the hedged component could theoretically exceed those of the total cash flows for the financial asset or financial liability. However, we do not agree with the proposed prohibition on the application of hedge accounting on a component risk basis in all such circumstances.

This issue is not limited to situations involving financial instruments, but also potentially exists with respect to hedges of non-financial items. For example, it is not uncommon for the pricing of a non-financial item to be based on a standard benchmark quality or location for the item (the base component price), plus or minus an amount (the basis difference) due to the actual quality or location of the item. In these circumstances, as well as those involving financial instruments, hedging the base component price for the item with a forward contract based on the standard benchmark rate or quality/location would be a reasonable risk management strategy regardless of whether the basis difference for the item is positive or negative. Furthermore, the chances of having a price movement in the benchmark rate or similar component so as to result in an overall negative rate or price would likely be rare.

We therefore believe this restriction is unnecessary and potentially undermines many risk management strategies. Nevertheless, in view of the Board's concerns, we recommend that the Board consider precluding such hedging relationships only when the likelihood of a negative rate or price is more than remote.



Question 5

(a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?

We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item since identifying a layer of the nominal amount for either a single item or a group is a common risk management strategy. Designating a percentage component of a nominal amount can give rise to a different accounting outcome compared with designating a layer component of a nominal amount. Therefore, if hedge accounting is not aligned with the risk management strategy, the result in profit or loss may be misleading or provide less useful information to users.

We also believe the possibility of prepayments or uncertainties such as breaches (or cancellations) of contracts can be better modelled when considering a layer of the nominal amount of an item or a group of items. However, we believe that the “sufficiently specific” test should be retained (i.e., when a transaction occurs, it should be clear whether or not it is part of the hedged layer). For example, a layer should not be defined as the last 100 CU to be sold or purchased in a period.

(b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option’s fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

We agree that for certain types of instruments it may be difficult to separate the effects of changes in the fair value of a prepayment option that is affected by the changes in the hedged risk. This is however a fundamental question to be resolved by the macro hedging phase of the hedging project. The solution that is appropriate for macro hedging may also be appropriate when hedging a single transaction. If considered in isolation, we agree that when a prepayment option gives the holder the right to prepay at par or at a pre-determined amount it would not be appropriate to use a layer to isolate the effects of the prepayment option.

We note however that there are situations, especially in the case of mortgages, where there may exist compensation mechanisms (e.g., a make whole provision) that substantially mitigate, but do not fully eliminate the effect of the hedged risk. In these situations, we believe it may still be appropriate to designate a layer even though there may still be some relatively small impact on the prepayment option attributable to the hedged risk (i.e., interest rate risk). However, we do not support a general prohibition of applying a layer approach to contracts that include a prepayment option, merely because the option may create uncertainty related to the effectiveness of the hedging relationship.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?



We believe that removing the 80-125 % effectiveness threshold to qualify for hedge accounting and allowing an entity, where appropriate, to qualitatively evaluate hedge effectiveness are significant improvements. We believe that removing this bright line threshold will eliminate a major stumbling block to qualifying for and applying hedge accounting and ease the administrative burden on preparers. It also enhances the information given to users, as it provides a better link to the entity's risk management strategy.

However, we are concerned with the impact of the new "objective of hedge effectiveness assessment" and the restriction on de-designations of hedging relationships. Requiring hedging relationships to produce unbiased results, minimise expected ineffectiveness and to be continually rebalanced is overly complex and adds an "accounting only" exercise that may lead to a different designation of the hedge relationship than is done for risk management purposes. This will in particular be the case for example, in commodity-based hedging strategies, where the changes in the value of the hedging instrument could "systematically either exceed or be less than the changes in the value of the hedged item" due to the presence of an unhedged basis risk. Such situations might be considered to produce a biased result if effectiveness is evaluated on the total price (i.e., inclusive of the unhedged basis risk).

Furthermore, it is not uncommon for entities to enter into or continue with hedging relationships that are somewhat "biased" because they are a practical means to cost-effectively hedge an exposure. An entity may accept some additional ineffectiveness in a hedging relationship, because a less than perfect hedge ratio may be operationally simpler to monitor and explain (e.g., a 1 to 1 ratio), or the reduction in reported ineffectiveness may not justify the cost of rebalancing the hedge. If a hedge is not economically rebalanced as part of a risk management strategy, the requirement to rebalance for accounting purposes does not change the economic ineffectiveness, but it changes how it is classified and reported in the financial statements. We do not believe relabeling "ineffectiveness" as "trading" by reclassifying a portion as trading within the income statement will improve a user's understanding of the effectiveness of the risk management strategy. In contrast, if as part of its design the risk management strategy contemplates dynamic rebalancing, we believe that rebalancing the hedging relationship without requiring de-designation and re-designation would be an improvement to current accounting.

These new requirements surrounding "unbiased" hedge relationships appear to be principally anti-abuse provisions, and we believe the desired effect can be achieved without forcing the complexities of the "unbiased hedge" requirement on preparers. If the Board's rationale for this new requirement is to prevent the deliberate designation of mismatches to achieve an accounting effect (e.g., in a cash-flow hedge, deliberately designating a larger volume of the hedged item than needed to ensure that over-hedging never occurs), it should state that an accounting motivated designation of a biased hedging relationship is not a valid risk management strategy. The Board might consider retaining the requirements of IAS 39 AG.107A to mitigate concerns regarding potential abuse.

We therefore propose that the objective for hedge effectiveness assessment is removed from the qualification criteria. The qualification criteria would thus include three parts: (1) the hedge can only include eligible hedged items and eligible hedging instruments, (2) documentation is prepared at inception that links the hedging relationship to the entity's documented risk management strategy (that, if material, is disclosed in the financial statements), and (3) the hedge achieves other than accidental



offset. Further safeguards are provided by the proposed requirements that: (1) there is an appropriate economic relationship between the hedging instrument and the hedged item that meets the risk management objective, (2) hedge ineffectiveness be reliably measurable and recognised in profit or loss, and (3) all designations and de-designations be made prospectively.

There is some lack of clarity over what the Board means by a “risk management objective and strategy” in the exposure draft. We believe the risk management objective and strategy should be specified in sufficient detail that it is possible to determine whether or not a particular transaction meets them. This issue also has implications for the discontinuation of hedge accounting (see question 8(b)).

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

As described under question 6, we believe that “the objective of the effectiveness assessment” should be removed from the qualification criteria. Requiring entities to continuously monitor the optimal hedging ratio when rebalancing is not an inherent component of the risk management strategy introduces significant complexities and burdens on preparers. Furthermore, the benefits to users are limited, because any additional ineffectiveness that results from a non-optimal hedge ratio will be reported in profit or loss. The requirement to rebalance a hedging relationship will require entities to determine a different hedging ratio for accounting purposes than they are using for risk management purposes.

We agree that if the hedging strategy includes determining the optimal hedging ratio then rebalancing would be undertaken whether or not the accounting standard requires it. Permitting entities to rebalance thus enables entities to reflect the effect of the risk management activity in the financial statements. We believe that the ability (as opposed to a requirement) to rebalance would be an improvement to current guidance that must be applied in dynamic hedging strategies (for example, delta hedging) whereby hedges must be de-designated and re-designated. For dynamic hedging strategies that explicitly consider rebalancing, rebalancing hedging ratios without having to re-designate hedging relationships would reduce complexity and be more aligned with risk management strategies.

If an entity decides that the change in the optimal hedging ratio does not require it to change the actual hedging strategy, the effect of requiring a rebalancing for accounting purposes may in many situations only have the effect of relabeling the ineffectiveness within the financial statements (i.e., as trading). We do not believe relabeling “ineffectiveness” as “trading” by reclassifying a portion as trading will improve users’ understanding of the effectiveness of the risk management strategy.

(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?



We support providing entities with the ability to rebalance a hedging relationship if that is in accordance with the risk management strategy for the hedge relationship (see comments under 7(a)).

Question 8

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

We agree that entities should be required to discontinue hedge accounting if the hedged item or hedging instrument is derecognised, the risk management strategy changes, or the hedging relationship ceases to meet the other than accidental offset criterion. The latter could occur in situations where the counterparty to the hedging instrument is experiencing financial distress.

However, we do not agree that these are the only cases that an entity should be permitted to discontinue prospectively hedge accounting (see part (b)).

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

We disagree with the proposal to prohibit an entity from discontinuing hedge accounting for a hedging relationship that still meets the risk management strategy and that continues to meet all other qualifying criteria. De-designating hedge accounting is an important tool in any dynamic hedging strategy. This is allowed under IAS 39 today, and we are not aware of problems that have arisen in practice. It is a voluntary choice to apply hedge accounting, and therefore, we believe stopping hedge accounting on a prospective basis should also be discretionary. We further note that the proposed prohibition can be circumvented by terminating the derivative and replacing it with another derivative substantially identical to the original one, albeit by incurring additional transaction costs.

Although we disagree conceptually with prohibiting the discontinuance of hedge accounting, it is not clear whether this is a significant issue. Under the proposed guidance, a hedging relationship can be discontinued if the “risk management objective” for a hedging relationship has changed. If the risk management objective is considered broadly across multiple hedging relationships, then this is potentially a significant issue. However, if the risk management objective is viewed narrowly, say at the individual hedge transaction level, then de-designation can be achieved by simply changing the risk management objective for the hedging relationship in question. This is likely to be much less of an issue, as the conditions giving rise to an entity wanting to de-designate a hedging relationship would generally result from a change in the risk management strategy for the individual hedged transaction. Regardless of what the Board decides to do on the issue of de-designations, we believe the granularity of the “risk management objective” should be clarified.



The prohibition on de-designation also has implications for some commonly used strategies which will become more complicated. For example, when hedging the cash flows from forecast sales in a foreign currency with a derivative that matches the payment date, it is common practice to discontinue hedge accounting at the point in time when the sales have occurred. After the sales have been recognised in profit or loss resulting in a balance sheet receivable being established, a natural offset is achieved and no hedge accounting is needed. De-designation may be in line with the entity's risk management policy as some entities manage the risk of receivables and payables separately from forecast transactions. We believe this practice should not be prohibited.

We do not believe that generally there is an abuse driving de-designation. The frequency of de-designating and re-designating hedge relationship that can be observed today has been to some extent due to the disconnect between the requirements to achieve hedge accounting and the risk management strategies applied. In order to achieve hedge accounting reflecting the risk management activities, a different hedged item may be identified for accounting purposes (proxy designation).

Question 9

(a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?

We agree with the decision not to apply cash flow hedging mechanics to fair value hedges, but believe that retaining the IAS 39 presentation, (i.e., reporting all effects in profit or loss) is preferable to the proposal in the exposure draft (i.e., present the changes in fair value of the hedged item and derivative separately in other comprehensive income).

We understand that users want to have greater insight into the fair value changes of the hedging instrument and the hedged item, as well as the amount of ineffectiveness that is reported. However, we believe that this type of information is better communicated in the notes to the financial statements. Presenting the effective and ineffective portions of the hedging relationship gross in other comprehensive income and then transferring the ineffectiveness to profit or loss would add three compulsory line items to the statement of comprehensive income that simply net to zero. Given this information will most likely be presented on an aggregate basis for all of the entity's fair value hedges, it will provide only marginal information to users. A requirement to place all hedging disclosures in one note on a disaggregated basis provides users with more information, makes it easier for users to locate and assess the impact of the entity's fair value hedges and does not clutter the face of the financial statements.

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

We agree that it is useful to provide users with information about the original accounting basis for the hedged item separately from the fair value adjustment, because it retains the information content of the



(amortised) cost measurement and gives a clear understanding of the effect of fair value hedge accounting. The unit of account, however, should be maintained on the face of the statement of financial position. We believe splitting the hedged asset or liability into two line items is inconsistent with the unit of account. It may also significantly increase the number of lines in the financial statement of certain entities, such as financial institutions, that likely have fair value hedges affecting multiple balance sheet line items.

We believe that disclosing the hedge accounting adjustment and the amortised cost in the notes to the financial statements provides users with relevant information they desire without burdening the statement of financial position with excessive detail.

(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

We believe the question of whether or not a linked presentation should be part of IFRS financial statements is not only limited to fair value hedge accounting. It could for example also be applicable for derecognition issues, pension accounting, subleasing, etc. and should be considered in a broader context. We therefore suggest that the issue of linked presentation be considered either within the financial statement presentation project or the conceptual framework project.

Question 10

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

We agree that when options are used for hedging, the initial time value of the option is a cost associated with the hedging relationship and should be part of hedge accounting. We also agree with the proposal to defer changes in the time value of options in other comprehensive income. Recognising changes in the time value in other comprehensive income makes sense, as this is where other effects of hedging are recognised.

However, to reduce complexity, we suggest replacing the two different recognition methods described (i.e., transaction related and time period related) with a broader principle. For example, the cost should affect profit or loss in a manner consistent with how the hedged item affects profit or loss. Such a principle is well understood in practice and would eliminate the need to provide rules distinguishing "transaction related" and "time period related" strategies.

When using the method described in the ED as "transaction related" (or the principle that we recommend above), we agree that the amount accumulated in other comprehensive income should be reclassified in accordance with the general requirements. However, please note that we disagree in general with the proposed accounting for basis adjustments that requires reclassifying directly from



equity instead of recycling through other comprehensive income (see cover letter and the “other issues” section of the appendix).

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

When using the method described in the exposure draft as time period related (or the principle described in our response to 10 (a)), we agree that the transfer from other comprehensive income to profit or loss should be on a rational basis to reflect the risk management strategy undertaken.

(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the ‘aligned time value’ determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

We agree that the measurement of the hedged item should be based on an option that has critical terms that perfectly match the hedged item. This is the normal procedure for using a hypothetical derivative to measure the hedged item for the hedged risk.

However, we do not believe that the new term “aligned time value” implies anything different from a “the time value of a hypothetical option” and would suggest that the “hypothetical derivative” terminology that is already accepted in practise be used.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree that all items in a group should individually be eligible hedged items and be managed on a group basis to be eligible as a group of items for hedge accounting. We also agree with allowing designation of a group of items to include a net position. However, clarification may be needed that eligible hedged items may include eligible aggregated positions (i.e., derivatives can be included the group).

One commonly used risk management strategy is to aggregate exposures of a group including offsetting items, as this reduces the number of external derivative transactions entered into and thus mitigates the cost of hedging. The proposed changes should improve the possibility of aligning accounting with the risk management activities undertaken. We believe being able to represent the hedging of groups that includes offsetting positions (net hedging) is important and should be addressed. We also believe that when hedging a net position, the overall group of items that make up the net position should be identified as the hedged item.



We disagree with the proposed requirements that the cash flows of the offsetting hedged items in a cash flow hedge must affect profit or loss in the same interim period. The hedging gain or loss is determined when the hedged transaction occurs, not when it is reported in profit or loss. The cut-off points will create arbitrary outcomes that will reduce the comparability between entities and over time. For example, if hedging the purchase of inventory, the treatment depends on whether or not the inventory is subsequently sold in that particular reporting period. There might therefore be differences among entities depending on their inventory turnover. There will also be significant differences in eligible strategies between jurisdictions where quarterly versus half-yearly financial statements are required.

This restriction also adds unnecessary complexity, as similar strategies may be eligible or not depending only on timing of the transactions. For example, two transactions with offsetting risks occurring 1 January and 30 June would be treated differently from two similar transactions occurring 30 June and 1 July for an entity that has a reporting date of 30 June and 6 months interim periods. Additional operational complexities arise when one item in a designated net group is delayed, as it will be necessary to exclude other transactions from the hedged group that are not delayed. In the case of a purchase of inventory, the same issue arises for hedged purchases that occurred in the expected period, but where the subsequent sale of the hedged inventory was delayed. The delay does not economically mean that no offset was achieved for the hedged period, but will be treated as such for accounting purposes. We therefore believe that there should be no requirement that offsetting cash flows or transactions occur or affect profit or loss in the same reporting period, as this will not align the accounting with the risk management practices and thus undermines the purpose of allowing hedges of net positions.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

We disagree with the presentation requirements, as they will introduce more complexity and may not truly capture the risk management activities undertaken. The proposal to present hedges of net positions differently than hedges of gross positions is inconsistent with an objective to align hedge accounting with the risk management activities undertaken. From a risk management perspective, it does not matter whether the offset is achieved through the fair value changes of a hedging instrument or another hedged item.

The objective from a risk management perspective may be to hedge the risk on all of the items in the group. However, as the fair value/cash flow changes on some items offset those on others, it may often be more cost effective to enter into a derivative or other hedging instrument only for the net position, rather than for each of the gross positions. This implies that all items in the designated group have been hedged and should therefore be accounted for at the hedged rate in profit or loss.

The exposure draft's proposal is inconsistent and gives different accounting in profit or loss for different types of hedges (individual versus group designations). Single transactions that are hedged and groups



without offsetting positions will be reported at the hedged rate. For groups with offsetting positions, there will be three ways of accounting for the same economic relationships. A hedge of offsetting positions (for example a foreign currency hedge of sales and a lesser amount of purchases) can be accounted for as follows:

- 1) Hedge with two derivatives on a gross basis. Sales and cost of sales reported at hedged rate (current IAS 39).
- 2) Hedge with one derivative designating a portion of sales. Sales partly reported at hedged rate, cost of sales at transaction rate (current IAS 39).
- 3) Hedge with one derivative designating the net position of the group of offsetting items. Sales and cost of sales reported at transaction rate, separate line item for derivative (new presentation proposed in the exposure draft).

If the entity also has hedges of single transactions or groups of items without net positions, the presentation in the profit or loss will be a mix of some hedged transactions being reported at the hedged rate, some hedged transactions being reported at the transaction rate with the effects of hedge accounting being reported on a separate line item, and some transactions being reported at an unhedged rate.

We do not believe that such alternative accounting presentations would help users understand the impact of hedge accounting, and it is not consistent with the risk management strategy. Many entities regard all items in the group as being hedged, and therefore, we believe that in such circumstances all items in the hedged group should be reflected at the hedged rate, as that best reflects the risk management strategy. This will give a consistent accounting whether or not a hedged item is part of a micro-, gross group- or net group hedge. It will also faithfully portray what the entity considers to be the full impact of its hedging strategy, and therefore, be consistent with the focus on risk management strategies in the exposure draft.

Question 13

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

We believe disclosure requirements are an essential part of enhancing the usefulness of the financial statements when applying hedge accounting and many of the proposed disclosures are appropriate. However, we are concerned that certain of the disclosures appear excessive and that the exposure draft does not strike the right balance between the needs of users and the burden of providing the information.

We are particularly concerned with the requirements in paragraph 46 of the exposure draft. We understand that information about total forecast exposures may be useful for some users, but many preparers may find this information to be commercially sensitive. If these exposures are not hedged, it is



unclear why disclosure of unhedged risk should be required as part of a hedge accounting standard. We also note that requiring forecast information in financial statements may be prohibited in some jurisdictions or may result in increased audit costs given its nature and subjectivity.

Furthermore, it is unclear why an entity that partially hedges a risk is required to provide disclosures related to its unhedged exposures when an entity that does not hedge at all, or does not apply hedge accounting, has no such disclosure obligations. As a result, such disclosure requirements could serve as a disincentive for preparers to elect to apply hedge accounting to their risk management activities, which is contrary to the objectives of this project. We believe that disclosure of information regarding the notional amount and key terms of derivative positions by risk category and hedge type should be sufficient to give users adequate information as to the nature and extent of an entity's risk management activities.

Should the Board proceed with requiring these disclosures, we recommend that some of the terminology be clarified. We believe the threshold for disclosing the monetary amount to which the entity is exposed is unclear. For example, should it be based on "reasonably expected" or "highly probable" or "firmly committed" forecast transactions? We also believe it is unclear whether "each subsequent period" is related to every interim reporting period, each annual period or aggregated annual periods (e.g., 5 year periods for hedges of long term debt). Although we disagree with the disclosure of exposures in paragraph 46, if they are required, we believe aggregation would reduce the burden to preparers and still give useful information for users.

(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

We believe that some of the information that the exposure draft would require to be presented on the face of the statement of financial position or other comprehensive income should be disclosed in the notes. (See question 9)

We do not believe that there are any other additional disclosures that should be mandatory.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

We agree with the proposed change, as it will enable some entities to better reflect the risk management activities undertaken. We note however, that this will benefit a limited number of entities where no or minor transformation is undertaken to the purchased commodity, and where 1) little or no inventory is held, and 2) purchase and sales contracts have a net settlement clause or the inventory is readily convertible to cash. There are a number of entities who manage commodity risk on a fair value basis where the commodity is transformed and the purchase and sales contracts generally do not have a net



settlement clause or where there is an inventory of the goods in question that will not benefit from the proposed change. We also believe the requirement to manage the entire business is unclear. We note that an entity may have different portfolios or businesses and should thus be allowed to apply the proposed solution for a part of its business even though other businesses may be managed differently.

We also believe that the paragraphs in IAS 39 related to the own-use exception are problematic, not only in the context of entities who want to apply financial instrument accounting for a commodity contract, but also for entities whose valid business transactions are forced into IAS 39 when fair value does not most appropriately reflect the business model. For example, if an entity has settled similar contracts net in the past, there is currently no clear mechanism for the own-use exception to be applied in subsequent periods again.

These questions are not primarily hedging issues, but they do not fall into any of the other IFRS 9 phases. We therefore propose that the Board address these issues as an additional project once hedging and impairment have been finalised.

Question 15

(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?

We are pleased that the IASB has responded to constituents who find the current difficulty of achieving hedge accounting for credit risk problematic by assessing alternative methods to achieve a reasonable accounting. We do not, however, find any of the proposed alternatives to be viable.

Nevertheless, we believe it is important to find a method for hedging credit risk and therefore, recommend that the Board further consider approaches to reasonably measure the credit risk in financial assets for purposes of applying hedge accounting. We agree that currently there are challenges in measuring “pure” credit risk. However, we believe that it should be possible to develop a reasonable measurement approach for hedge accounting purposes, and therefore do not agree with the statement made in the exposure draft that it is “impossible” to do so.

The exposure draft notes a number of structural differences between a credit default swap and a debt instrument which indicate that the use of a credit default swap to hedge credit risk might be conceptually flawed. Whilst we acknowledge that there are differences, we do not believe that they are sufficient to preclude any type of hedge accounting, especially when one considers the current approach for hedging the risk free rate in a debt instrument. For example, the issues of funding and counterparty credit risk exist for interest rate swaps hedging benchmark interest rates, as well as credit default swaps hedging credit risk. Both the interest rate swap and credit default swap are synthetic instruments that do not need to be funded and are subject to counterparty credit risk. There are also differences in liquidity between the derivatives markets versus the debt markets, although the magnitude of the difference in liquidity may be different for the credit default market compared to the interest rate swap market.



Other structural differences may exist today, but there is nothing to suggest that markets may not evolve so that these differences may be addressed over time, or more sophisticated models of adjusting for them may be developed. The market has changed since the financial crisis. For example, we understand that the “cheapest to deliver option” term is no longer used frequently in the current market place for credit default swaps, and many derivative contracts now require collateral to be posted, which lessens the effect of counterparty credit risk.

At a minimum, we believe the Board should consider the guidance in IFRS 7 and IFRS 9, which require the credit risk component of own debt to be identified and accounted for separately or separately disclosed for reporting purposes in certain circumstances. Whilst the Board acknowledged the difficulties in measuring the credit risk component, it also provided a “default” method and acknowledged there may be other methods. It is illogical to provide for separation of credit risk under these standards, but preclude its use for hedge accounting purposes. We would therefore allow the use of the default method, or any refinement of that method that an entity believes more faithfully represents the measurement of the credit risk in a financial instrument, because it better isolates the credit risk component.

(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

Please see our answer to question 15 (a).

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We agree, in principle, with the transition requirements, but believe entities should be able to elect to apply IFRS 9 hedge accounting retrospectively to allow consistent accounting on adoption of the other phases of IFRS 9.

For example, an entity may have hedged (and applied hedge accounting under IAS 39) to a financial asset measured at amortised cost with a separated embedded derivative. Under IFRS 9 this instrument may be measured at fair value through profit or loss. It will be inconsistent to require retrospective application of measurement of the financial asset, but propose that hedge accounting should be maintained in the comparatives. Conversely, an entity may have economically hedged an item that was measured at fair value through profit or loss under IAS 39 but will be measured at amortised cost under IFRS 9. The entity would not have obtained hedge accounting under IAS 39 but might do so under IFRS 9. It therefore seems inconsistent to restate comparative amounts for the change in measurement, but not allow the retrospective application of hedge accounting if the appropriate documentation is in place at the beginning of the comparative accounting period.

We also believe *allowing* IFRS 9 hedge accounting from the beginning of the transition period will enable hedge accounting for hedging strategies permitted under IFRS 9 but not under current IAS 39 to



be applied in the comparative period. If entities would apply IFRS 9 hedge accounting from the beginning of the transition period, they will need to prepare hedge documentation by the beginning of the hedging period and keep two sets of hedging accounting entries. As the transition period is expected to be fairly long, it may still be workable to have the necessary hedge documentation in place at the start of the comparative period. Furthermore, the Board should give specific consideration to how pre-existing hedges should be accounted for at transition so as to enable entities to take advantage of the new hedging requirements.

We agree that early application should be permitted. We believe that the effective date needs to be considered in the context of other related projects. For many entities outside the financial sector there is probably little or no linkage between the hedging phase and the previous phases of IFRS 9 that will change the accounting for the items being hedged. We therefore believe that allowing the hedge accounting phase to be early adopted without adopting the other phases may be appropriate.



Other issues

Deletion of the IGs

The IASB issued implementation guidance to IAS 39 in the form of IGs to further explain some of the requirements of the standard. We understand that some paragraphs of IAS 39 will be retained in IFRS 9, but the IGs attached to these paragraphs will be deleted. This raises the question whether or not the guidance in the IGs is still applicable or not. Some of the guidance in the IGs is helpful, for example, IG.F.2.5 on cash flow hedges “all in one” hedge, and IG.F.2.17, on partial term hedging. There is no equivalent guidance in IFRS 9. Additionally, IG.F.6.2 and IG.F.6.3 have also been very helpful guidance for certain financial institutions in applying hedge accounting. Until new macro hedge accounting guidance is issued, these IGs should be carried forward too. We recommend the Board comprehensively review the IGs and carry forward those that continue to provide relevant guidance.

Measuring the hedged item for ineffectiveness

In paragraph B43, the Board states that when measuring the hedged item for ineffectiveness, it must be measured using a present value basis. We agree that in many hedging relationships the time value of money should be included in the measurement of ineffectiveness. However, we disagree with requiring the hedged item to be measured on a present value basis if the interest component is excluded from the hedging instrument. This is inconsistent with both the designation of the hedge and how the hedged risk is considered in the risk management strategy.

It is common practice to use the “undiscounted spot” method when hedging foreign currency risk by separating the interest element from the foreign currency derivative. Changing current practice would make it necessary to change treasury systems and develop reporting structures to monitor changes of timing of the cash flows. We believe in most situations the resulting ineffectiveness reported will be insignificant.

Hypothetical derivatives

We agree that the hypothetical derivatives method is useful for measuring the change in the hedged risk in a cash flow hedge. However, the Board may want to consider providing some additional, principle-based guidance on how to apply a hypothetical derivatives method to ensure consistency in practice. The principle should state that the terms of the hypothetical derivative should be defined in a manner that matches the key characteristics of the hedged item such that there should be no expectation of ineffectiveness.

Under IAS 39, the hypothetical derivatives method has been applied only to cash flow hedges. Paragraphs B43-B45 in the exposure draft could be interpreted as stating it is acceptable to use hypothetical derivatives also for fair value hedges. We disagree with this change, as it would make it possible to impute cash flows that are not present in the hedged item. For example, a reset of a floating leg equal to that of the actual swap used will need to be imputed.



Basis adjustment

We do not believe that the choice between basis adjustment and leaving the amount in other comprehensive income, is a major source of complexity for the users. However, if only one of the alternatives is retained we agree that basis adjustment is the preferable alternative.

We disagree with the proposal to reclassify the deferred hedging gains or losses directly from equity instead of recycling them through other comprehensive income as that introduces a new class of transactions in the statement of equity that is not a transaction with the owners. Furthermore, the effect will be that the result of the hedge will be accounted for twice in total comprehensive income over time. In our view, this is less useful than portraying the recycling as a performance event. We believe that it is unnecessary to change the recycling out of other comprehensive income when applying basis adjustment until the purpose of other comprehensive income is determined.

Collars

Certain rules relating to the use of options as hedging instruments have been retained from IAS 39, for example, a written option may be used to hedge a purchased option. However, designating as a hedging instrument a combination of a purchased option and a written option is prohibited even if it results in a net purchased option. It is not clear why combining two options that result in a zero cost collar or a net purchased option should be prohibited from being used as a hedging instrument. Furthermore, it is unclear why a combination of two options resulting in a net written option cannot be used to hedge an embedded purchased option or a combination of embedded options constituting a net purchased option, when a single written option is eligible to hedge a single embedded purchased option.