

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

Re: Discussion Paper, *Selected Issues About Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)*

Dear Ms. Cospers:

Deloitte & Touche LLP is pleased to comment on the FASB Discussion Paper (DP), *Selected Issues About Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)*.

While we support the Board's objective of improving and simplifying the accounting requirements for hedge accounting, we also believe that such efforts should be conducted with the aim of achieving the Board's larger objective of converging U.S. GAAP and IFRSs. We encourage the FASB to continue to work with the IASB, and we believe that given the complexities associated with hedge accounting, the boards should provide sufficient time for joint deliberations to ensure development of a high-quality global standard that comprehensively addresses hedge accounting. Aspects of both boards' proposals (i.e., the FASB's proposed Accounting Standards Update (ASU), *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (issued in May 2010), and the IASB's exposure draft (ED), *Hedge Accounting*) have merit, and we encourage the boards to incorporate the best features from both models into the final converged standard.

Our responses to the DP's questions are in Appendix A below. Note that many responses refer to our Deloitte Touche Tohmatsu Limited comment letter on the IASB's ED (our "DTTL comment letter"), which is contained in Appendix B. Although that letter describes our general support for the IASB's proposed accounting model for hedge accounting, it also expresses our concerns with the IASB's ED and offers recommendations on how some of these concerns might be addressed, including the effectiveness threshold, the recognition of time value of options, the prohibition against hedge accounting for risks that affect only other comprehensive income, the presentation of fair value hedges, and the prohibition against voluntary dedesignation of a hedging relationship. We believe that these and the other issues detailed in that letter should be addressed by the boards before a converged standard is finalized.

We also note that the FASB recently indicated its intention to expose for public comment proposed amendments to the *FASB Accounting Standards Codification* (the "Codification") before issuing its final standard on accounting for financial instruments (we presume that changes for hedge accounting will also be exposed). We strongly agree that such exposure is necessary because it is not possible to fully analyze and evaluate the proposed hedging model without knowing the details of the proposed amendments to the Codification.

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Deloitte & Touche LLP appreciates the opportunity to comment on the DP. If you have any questions concerning our comments, please contact Bob Uhl at (203) 761-3152 or Mark Bolton at (203) 761-3171.

Yours truly,

Deloitte & Touche LLP

Appendix A
Deloitte & Touche LLP
Responses to the DP's Questions for Respondents

Risk Management

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?

Response: See the response to Question 1 in our DTTL comment letter. We also note that paragraph 40(a) of the IASB's ED requires an entity to disclose its risk management strategy and how it is applied to manage risk. In this disclosure, an entity could describe the impact of its economic hedges on its overall risk management strategy.

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?

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?

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?

Response: The response to Question 1 in our DTTL comment letter recommends modifying the objective of hedge accounting to indicate that such accounting "is an optional accounting presentation to overcome recognition and measurement accounting mismatches that prevent an entity from presenting the effect of an entity's risk management activities." This modified objective recognizes that not all risk management activities will necessarily need, or meet the requirements of, hedge accounting. It also provides a more objective basis for determining whether application of hedge accounting is appropriate.

Risk management strategies are likely to vary between entities depending on the nature of their industries and the types of transactions they typically execute. The IASB's ED appears to provide entities with sufficient flexibility to define how they manage different risk exposures, and the disclosure requirements in paragraph 44 should provide financial statement users with the information they need to understand an entity's risk management strategy. However, to help entities consistently apply the proposed requirements, the boards should provide implementation guidance in the final standard.

Further, as noted in the “Miscellaneous” section of our DTTL comment letter, it would be helpful if the final standard clarified the interaction between an entity’s risk management activity and its classification of financial assets on the basis of its business model.

As with any new accounting standard, entities will need to establish or modify their controls, policies, and procedures to comply with the new requirements. We encourage the boards to reach out to preparers to ascertain whether they foresee significant operational challenges in making such changes and to determine whether preparers expect to modify their risk management strategies because of the new guidance (other than to respond to the new documentation requirements in paragraph 19 of the IASB’s ED).

ASC 815-10-50-1 through 50-1B currently require disclosure of an entity’s strategies and objectives for using derivative instruments, and paragraph 33 of IFRS 7, *Financial Instruments: Disclosures*, requires similar disclosure about how an entity manages risks arising from financial instruments. No significant practice issues have resulted from those requirements nor do we expect any to result from the proposed requirements in the IASB’s ED.

Hedging Instruments

*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?*

Response: See the response to Question 2 in our DTTL comment letter.

Hedged Items—Overall

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?

Response: See the response to Questions 3, 4, and 5 in our DTTL comment letter.

Hedged Items—Risk Components

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.

Question 8: *Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?*

Response: See the response to Question 4 in our DTTL comment letter. We agree that hedge accounting should be permitted for certain risk components of both financial and nonfinancial items. However, the final standard should contain implementation guidance that clarifies whether and how noncontractually specified components within nonfinancial items could satisfy the “separately identifiable” and “reliably measurable” criteria.

Hedged Items—Layer Component

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?*

Response: See the response to Question 5 in our DTTL comment letter.

Hedged Items—Aggregated Exposures and Groups of Items

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?*

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?*

Response: See the response to Questions 3 and 11 in our DTTL comment letter.

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?*

Response: See the response to Questions 5, 11, and 12 in our DTTL comment letter.

Hedge Effectiveness

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?*

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?*

Response: See the response to Question 6 in our DTTL comment letter.

Changes to a Hedging Relationship

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?

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?

Response: See the response to Questions 7 and 8 in our DTTL comment letter. We believe that if an entity wishes to rebalance a hedging relationship to reduce expected hedge ineffectiveness, it should be permitted to do so at any time provided that the revised designation does not create deliberate hedge ineffectiveness or under-hedging; however, we do not support mandatory rebalancing. Moreover, we believe that entities should have the ability to voluntarily dedesignate a hedging relationship at any time.

Accounting for the Time Value of Options

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?

Response: See the response to Question 10 in our DTTL comment letter.

Hedge Accounting and Presentation

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?

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?

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?

Response: See the response to Question 9 in our DTTL comment letter. We disagree with the proposed use of other comprehensive income for fair value hedges and do not support the IASB's proposal to present separately, in the statement of financial position, the gain or loss attributable to the hedged risk on the hedged item.

Disclosures

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?

Response: See the response to Question 13 in our DTTL comment letter. Also, as noted above, ASC 815-10-50-1 through 50-1B currently require disclosure of an entity's strategies and objectives for using derivative instruments, and paragraph 33 of IFRS 7 requires similar disclosure about how an entity manages risks arising from financial instruments. No significant practice issues have resulted from those requirements nor do we expect any to result from the proposed requirements in the IASB's ED.

We believe that the proposed requirements in paragraph 46 of the IASB's ED to provide a breakdown of the quantity of the exposure, the quantity hedged, and the effects of hedging should be optional to avoid discriminating against entities that choose to apply hedge accounting. Our DTTL comment letter also raises concerns about how some of the specific requirements of paragraph 46 would be applied in practice. These concerns should be addressed before the standard is finalized.

Other

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?

Response: We encourage the FASB to work with the IASB to develop a converged standard that comprehensively addresses hedge accounting. Aspects of both proposals (i.e., the FASB's proposed ASU and the IASB's ED) have merit, and we encourage the boards to jointly conduct their redeliberations to incorporate the best features from both models into the final converged standard.

Appendix B
DTTL Comment Letter on the IASB Exposure Draft ED/2010/13, *Hedge Accounting*



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Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
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9 March 2011

Dear Sir David

Exposure Draft ED/2010/13 *Hedge Accounting*

Deloitte Touche Tohmatsu Limited is pleased to respond to the IASB's exposure draft ED/2010/13, *Hedge Accounting* ('the ED').

We support the IASB's efforts to reform financial instruments accounting with the development of IFRS 9 *Financial Instruments*. Hedge accounting is an important part of the project and we support the Board's attempt to improve the financial reporting of risk management activities with proposed changes to hedge accounting. Although generally supportive of the ED, we have concerns with a number of the proposed detailed requirements, including, but not limited to, the effectiveness threshold, the recognition of time value of options, the prohibition on hedge accounting for risks that affect only other comprehensive income and the presentation of fair value hedges. We believe these and the other issues detailed in the Appendix to this letter should be addressed before finalisation of this standard.

We note that the ED represents the first part in reforming hedge accounting with the second part, portfolio hedge accounting, yet to be proposed. We support previous statements by the Board that the proposals and consequent deliberations in the first phase will not prejudice the conclusions in the impending second phase. We encourage the Board to complete the second part to the hedging project as soon as possible.

We also welcome the FASB's decision to publish the ED to gauge support relative to their hedge accounting proposals contained in their proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, published last year. We expect that both Boards will make sufficient time available to deliberate together in an effort to reach a common view on hedge accounting.

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If you have any questions concerning our comments, please contact Veronica Poole or Andrew Spooner in London at +44 (0) 207 007 0884 or +44 (0) 207 007 0204 respectively.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'V. Poole', written in a cursive style.

Veronica Poole
Global Managing Director
IFRS Technical

Appendix

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?

Emphasis on risk management

We agree that a stated objective for hedge accounting is helpful in setting the scene for hedge accounting and laying the foundation for a more objectives-based approach. We agree with the Board's proposal that the objective of hedge accounting is to '...represent in the financial statements the effect of an entity's risk management activities...'. However, we do not believe the objective of hedge accounting is limited to that as not all risk management activities will necessarily need, or meet the requirements of, hedge accounting. We believe that one of the objectives of hedge accounting is to mitigate the recognition and measurement inconsistencies that may arise from the normal accounting requirements applicable to hedging instruments and hedged items. A hedge accounting objective should reflect therefore both the risk management activities and accounting dimensions. If normal accounting already reflects the risk management activities (e.g. the hedging instrument and hedged item are measured using the same measurement attribute), there is no need for hedge accounting. Accordingly, the risk management activities and accounting objectives are complementary, not mutually exclusive. We therefore recommend that the Board refine the objective to reflect this. For example, the hedge accounting objective could be stated as:

"Hedge accounting is an optional accounting presentation to overcome recognition and measurement accounting mismatches that prevent an entity from presenting the effect of an entity's risk management activities."

We note that limiting the objective of hedge accounting to simply risk management activities, and not reflecting the accounting dimension, could be interpreted as prohibiting hedge accounting for some risk management activities where hedge accounting is currently applied in IAS 39. We do not believe it was the Board's intention to limit the instances of hedge accounting compared with the current requirements. This is the case currently for many entities, particularly financial institutions, for example when they designate micro hedges (one-to-one designations) for accounting purposes because of difficulties in designating at a macro level, even though the risk management activities are executed at the macro level. The micro hedges are designed to reflect most closely the risk position that is hedged at the macro level so net earnings fairly reflect the effects of risk management activities. Put another way, the micro hedges are a surrogate for not being able to apply hedge accounting at a macro level. Under the ED, as the micro hedge designations are not consistent with the risk management activity at the macro level this could be interpreted as resulting in the micro hedge designations failing the hedge accounting qualification criteria. We do not believe this was the intention and therefore propose that the standard acknowledges that entities can designate for accounting purposes in a way that fairly reflects the risk management activity even though such designations for accounting purposes may be different from the execution of hedges for risk management purposes. However, an entity should be prohibited from designating for accounting purposes a hedge which would result in an accounting effect that is not consistent with its risk management activities.

We support the Board's view that hedge accounting should not be mandatory. We do not consider it practical to require a certain presentation for risk management activities. Accordingly, as it is an optional accounting presentation and, as we suggest above, this should be clear in the hedge accounting objective.

Risks affecting other comprehensive income (OCI)

The proposed objective permits hedge accounting only for risks that could affect profit or loss. This restriction would preclude an entity from appropriately reflecting its risk management activities if the risk it hedges only affects OCI. For example, this restriction would prevent an entity applying hedge accounting to hedges of investments in equity instruments measured at fair value through other comprehensive income (FVTOCI) for a component of risk (e.g. foreign exchange risk) or hedges of fair value risk. This appears inconsistent with the spirit of the Board's proposed objective for hedge accounting. We believe that until the Board has completed its project on presentation of the performance statement, and in particular addressed the fundamental principles of what constitutes performance and what represents OCI, an entity should not be prevented from designating a risk that only affects OCI. Therefore, an entity should be permitted to designate as the hedged item an investment in equity instruments designated at FVTOCI. Our proposal would not widen eligible items to exposures other than those that impact profit or loss or OCI (i.e. issued equity instruments would continue not to be eligible). We believe this is more closely aligned with risk management activity and preserves the criteria that hedge accounting is restricted to those exposures that result in accounting gain or loss recognition.

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 in certain circumstances a non-derivative financial asset and non-derivative financial liability measured at fair value through profit or loss should be eligible to be designated as a hedging instrument. However, we believe the ability to designate should be restricted to those financial instruments that are in scope of IFRS 9. We believe this was the Board's intention but this could be made clearer.

Financial instruments designated as at FVTPL due to an accounting mismatch

The ED appears to permit a financial instrument designated as at FVTPL on the basis of eliminating or substantially reducing an accounting mismatch to be designated as a hedging instrument. This is reasonable in a fair value hedge accounting relationship as the changes in fair value of the hedging instrument will be recognised in profit or loss which is consistent with the designation as at FVTPL. It would not be reasonable to permit such a financial instrument to be designated as a hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation as this appears to override the basis for designating the item as at FVTPL (i.e. that all fair value changes are recognised entirely in profit or loss to eliminate or substantially reduce an accounting mismatch). We believe therefore that the criteria should be amended so a non-derivative financial instrument in the scope of IFRS 9 may be designated as a hedging instrument, except in a cash flow hedge or hedge of a net investment in a foreign operation if designated as at FVTPL in accordance with IFRS 9:4.1.5 & 4.2.2(a). For the avoidance of doubt, we are not objecting to financial liabilities designated as at FVTPL in accordance with IFRS 9:4.2.2(b) and certain hybrid contracts designated as at FVTPL in accordance with IFRS 9:4.3.5 or IFRS 9:4.3.6 as being designated as qualifying hedging instruments.

Financial liabilities designated as at fair value through profit or loss

Under IFRS 9, non-derivative financial liabilities designated as at FVTPL have changes in fair value due to changes in credit risk recognised permanently in OCI. The ED does not make clear whether such non-

derivative financial liabilities could be eligible hedging instruments as, despite the classification at FVTPL, not all fair value gains or losses are recognised in profit or loss. The Board should clarify whether such instruments are eligible hedging instruments.

Financial instruments measured at amortised cost

The ED does not permit non-derivative financial instruments measured at amortised cost to be qualifying hedging instruments. However, in practice, there are examples of entities using amortised cost assets as part of their risk management activities.

For example, insurance entities use portfolios of amortised cost assets under IFRS 9, such as bonds, as part of their risk management activities to economically hedge the interest rate risk arising from their insurance liabilities. The insurance liability is a non-derivative financial liability outside the scope of IFRS 9 that could, under the criteria in the ED, be eligible for hedge accounting if the designated risk, interest rate risk, is separately identifiable and reliably measurable.

We note that the accounting treatment for insurance liabilities is dependent on the outcome of Phase II of the insurance project which is currently underway. Should the final insurance standard require the liability to be remeasured for changes in interest rates through profit or loss, as included in the insurance ED, an accounting mismatch will arise between the liability and the amortised cost assets used to hedge the interest rate risk. Permitting portfolios of financial assets in the scope of IFRS 9 which are measured at amortised cost to be qualifying hedging instruments, and resulting in them being fair value adjusted through profit or loss as a result of movements in the hedged interest rate risk, could reduce or eliminate this accounting mismatch and better reflect the effect of an entity's risk management activities.

Hence, we believe that the Board should consider the merits of permitting portfolios of financial assets measured at amortised cost to be eligible hedging instruments of interest rate risk as part of its deliberations on the portfolio hedge accounting model. This would be consistent with the objective for hedge accounting discussed in our response to Question 1. As portfolio hedge accounting is being considered concurrently with the finalisation of the insurance project this would be the right time to consider how both these Standards will interact.

Components of hedging instruments

We encourage the Board to explore whether an entity should be permitted to designate a contractual cash flow component of a derivative as the hedging instrument. For risk management purposes, an entity may use only a component of a derivative as a hedging instrument. Consider the following example:

- Entity A, a U.S. Dollar functional currency entity, issues a 5-year, USD 25M, floating rate debt (6-month LIBOR +200bps) that provides for semi-annual interest payments (on June 30 and December 31). Entity A's risk management strategy requires it to maintain a fixed-rate exposure. As per the risk management policy, Entity A seeks to hedge the forecasted semi-annual interest payments.
- As part of its portfolio of interest rate derivatives, Entity A has a 10-year, pay-fixed (6.25%), receive variable (6-month LIBOR +175bps) interest rate swap with a USD 25M notional. The terms of the swap agreement require semi-annual settlements on June 30 and December 31.
- If Entity A was permitted to use a contractually specified component of a derivative as the hedging instrument, Entity A would be able to designate the semi-annual settlements for years 1 to 5 of the interest rate swap as hedging the forecasted interest rate payments on the floating rate debt.

The inability to designate selected cash flows of the derivative as the hedging instrument is inconsistent with the entity's risk management activities in this example. If the entity were permitted to designate the contractual swap cash flows (swaplets) in years 1 to 5 as the hedging instrument, this would better represent the entity's risk management activities. Depending on the shape of the forward yield curve, this swap component would most likely be off market at inception and that would result in hedge ineffectiveness, which would be recognised as such in earnings, even if all other terms of the swap component and the hedged debt match. The non-designated component of the swap (years 6-10) would be measured at fair value with changes in fair value recognised in profit or loss.

Intragroup monetary items

The ED carries over from IAS 39 the prohibition that prevents intragroup monetary items denominated in a foreign currency from being eligible hedging instruments. In the basis for conclusions the stated reason for not reconsidering this prohibition is because it 'would require a review of the requirements of IAS 21'. We do not believe this question is dependent on a review of IAS 21 as the accounting requirements in IAS 21 are clear. Hence, we request that the Board consider the appropriateness of this prohibition as part of the hedge accounting project. Should the Board decide not to reconsider this restriction then we would recommend a clearer justification for why such exposures are not eligible as hedging instruments be included in the basis for conclusions.

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 exposure that is a combination of another exposure and a derivative should be eligible as a hedged item as this would be consistent with the objective of hedge accounting discussed in our response to Question 1. However, we believe this should only be the case if either (i) the derivative(s) that forms part of the aggregated exposure is part of an existing hedging relationship, or (ii) in the case of a non-derivative that is not in a hedge accounting relationship it is designated as at FVTPL to eliminate or reduce an accounting mismatch.

We believe the first restriction is necessary for the mechanics of hedge accounting to be appropriately applied. For example, consider an entity with a highly probable forecast purchase of a fixed amount of a commodity in three years' time. The commodity purchased will be inventory and eventually be recognised as cost of sales. The purchase is hedged with a forward contract that fixes the total price at FC100. Hedge accounting is not applied. One year later the entity hedges the foreign exchange risk on the aggregate exposure of FC100 using a foreign exchange contract. It wishes to apply cash flow hedge accounting. However, because hedge accounting was not applied with the first derivative there will be no basis adjustment to the inventory when it is recognised. As a result its initial carrying value will be equivalent to the spot price of the commodity at the time of purchase. Therefore, it will not be possible to determine what amount of the forward foreign exchange contract should be deferred in OCI for recognition as a basis adjustment to the inventory recognised at the spot price. This issue is resolved if the condition of hedging an aggregated exposure is that any derivatives that form part of that aggregated exposure are designated in hedging relationships.

We believe the second restriction is necessary to ensure that those entities that choose to use the fair value option as an alternative to fair value hedge accounting can hedge account for the aggregated exposure. For example, when an entity hedges a fixed rate liability with a receive fixed pay floating interest rate

swap, instead of applying fair value hedge accounting, it could designate the liability as at FVTPL. We believe that this aggregated exposure (i.e. the synthetic floating rate debt), should be an eligible hedged item (e.g. in a partial term cash flow hedge of interest rate risk) either if the liability is designated in a fair value hedge or if the liability is designated as at FVTPL.

In addition, we would request further guidance as to how the hedge accounting mechanics would apply when an aggregated exposure is designated in a hedge accounting relationship. In cases where there are mixed combinations of hedges, e.g. where a cash flow hedge is overlaid by a fair value hedge, it is unclear how the hedge accounting mechanics would apply. For example, consider the following:

Original hedged item:	Floating rate loan payable
First hedging relationship:	Cash flow hedge for interest rate risk on floating rate loan using a receive floating pay fixed interest rate swap, creating a synthetic fixed rate loan payable.
Second hedging relationship:	Fair value hedge of synthetic fixed rate loan payable for a partial term using a receive fixed pay floating interest rate swap.

In the above case it is unclear how the fair value hedge accounting mechanics would apply to the second hedging relationship.

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 agree with the proposal that hedge accounting should be permitted for risk components of both non-financial and financial items only if the risk component is separately identifiable and reliably measurable. We believe this is consistent with the objective for hedge accounting outlined in our response to Question 1.

Conceptually, we also agree that, consistent with hedge accounting of risk components of financial items under IAS 39, a risk component need not be contractually specified and could instead be implicit in the fair value or cash flows of the whole item. However, we note that in practice it will be challenging to determine whether a non-contractually specified risk component of a non-financial item is 'separately identifiable and reliably measurable'. Therefore, we welcome the example of hedge accounting of non-contractually specified risk components in non-financial items that is cited in the application guidance (paragraph B15(b)). However, we believe that more application guidance is needed and the example requires further supporting analysis to clarify how a non-contractually specified risk component is determined to be 'separately identifiable and reliably measurable'. Without further application guidance and supporting analysis we fear there will be divergence as to how this principle will be applied in practice. For example, the reference to a 'building block' approach in paragraph B15(b) could be interpreted to mean that only the actual specific ingredients in the production of a non-financial item could represent an eligible risk component. This may not be practical. Such an approach would require detailed information about the production of the non-financial item that is hedged.

Further, greater clarification should ensure that to the extent there is basis risk between the hedging instrument and the component of the hedged item that this is recognised as hedge ineffectiveness in profit or loss. Our concern is that inferring a hedged risk component that mirrors the hedging instrument would

achieve perfect hedge effectiveness and in the process understate any economic basis risk that may exist that should be recognised in profit or loss.

In practice, where the non-financial item is produced or transformed as part of a process, the precise composition of the item is often only known by the seller who produces the item and not by the buyer. This can make it difficult for a buyer of a produced or transformed non-financial item to identify specific ingredients and apply a pure building blocks approach to hedging risk components. For example, in a hedge of risk components of jet fuel under a pure building blocks approach, it would be necessary to know the actual inputs used to make the jet fuel that is hedged. Jet fuel is clearly derived from crude oil, however, it would be necessary to know which type of crude oil, including the source and grade, was used to produce the jet fuel to be purchased. Unless it is known (i) from which refinery the jet fuel originated, (ii) from where the crude oil was purchased and (iii) what grade it was prior to refining, the crude oil component could not be identified using a pure building blocks approach. Further, in order to measure the risk component it might be necessary to know the efficiency of the refinery in order to determine how much crude oil is required to produce the jet fuel that is sold. Clearly, this approach is not practical and would require more information than is available to the buyer of the non-financial item that is seeking to apply hedge accounting. To avoid interpretations of the example in B15(b) that are divergent or are impractical and do not reflect the way entities manage risk in practice we recommend further analysis to support the conclusion reached.

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?

(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 a layer component of a nominal amount should be eligible as a hedged item as this can allow a hedge designation that is consistent with the way in which some entities identify the component of an item that is hedged. Hence, allowing an entity to designate a layer component allows an entity to reflect more accurately the effectiveness of the hedging relationship in the financial statements.

Single prepayable items

The Board has not permitted layer components of prepayable items 'where the prepayment option's fair value is affected by changes in the hedged risk' to be eligible hedged items in a fair value hedge. This is because of the Board's view that such a layer component is not 'separately identifiable and reliably measurable'. At an individual instrument level we agree with this restriction, as at this level designating a layer component of a hedged item would not capture fair value changes in any embedded prepayment option affected by the hedged risk.

However, the current drafting of this restriction may prevent layer components of prepayable items from being eligible when in fact the layer component is separately identifiable and reliably measurable. For example, consider a five year, fixed rate loan with £100m principal which allows the borrower a one-time option to prepay £20m at the end of each year. For example it may prepay £20m at the end of year one and then again at the end of year two, etc. Given the restriction on the amount that can be prepaid at the end of each year, at least £20m of the loan will remain outstanding for the full term of five years. In other words, £20m of the £100m loan behaves in the same way as a non-prepayable loan. Hence, this

component of the loan should not be precluded from hedge accounting because of the existence of the prepayment options that are attached to the other £80m of the loan. We recommend that the Board reconsider the wording of paragraph B23 and 36(e) so as not to preclude hedge accounting for layer components that are separately identifiable and reliably measurable.

Groups of prepayable items

We agree that layer components of groups of items should be permitted where the conditions set out in paragraph 36(a) to 36(d) are met.

However, we note that the Board has retained the restriction for groups of items that may include prepayment options (noted in paragraph 36(e)). We understand that this view is a carryover of the existing restriction in IAS 39 that does not allow a layer component of a portfolio of prepayable items to be eligible for fair value hedge accounting. We understand the Board will consider this as part of the deliberation on portfolio hedging. In practice, this restriction in IAS 39 has meant that financial institutions that hedge portfolios of prepayable loans for interest rate risk on a portfolio basis have found it difficult or unfeasible to apply hedge accounting. Also the accounting results of applying the current

model have been difficult to explain to users because the accounting mechanics applied are not consistent with the way in which an entity manages risk.

With regard to the wording of the restriction in paragraph 36(e), we believe this should be consistent with the wording in paragraph B23 and only apply to fair value hedges. For cash flow hedges, a hedge of a prepayable item could be eligible provided the hedged cash flows were highly probable.

Hedge of a top-layer component of an open population of items

The Board should clarify whether an entity is permitted to designate a top-layer component of a defined, open population of items as the hedged item, e.g. the sale of the last 100 widgets sold during a specific period. The exposure draft provides an example of a hedge of a top-layer component of a closed population of items (paragraph B21(d)), but does not specifically address whether a hedge of a top-layer component of an open population of items would be permitted. One view is that a top-layer component of an open population of items is not eligible to be designated as a hedged item, because a top-layer component of an open population of item cannot be separately identified with sufficient specificity, e.g. the sale of the last 100 widgets sold during a specified period cannot be identified when those widgets are sold, but only at the end of the specified period. The existing implementation guidance to IAS 39 (IG F.3.10) provides an example of a top-layer component of an open population of items and indicates that identifying the hedged item in this manner is not permitted, because when the hedged transaction occurs it is not clear whether the transaction is or is not the hedged transaction. Another view is that the exposure draft would permit an entity to designate a top-layer component of an open population of items as the hedged item, because it does not explicitly preclude it. We note, on page 9 of its Invitation to Comment, *Selected Issues about Hedge Accounting*, issued on 9 February 2010, the FASB asks respondents whether they believe the sale of the last 10,000 widgets sold during a specified period would be permitted to be designated as a layer component under the IASB exposure draft and invites views as to whether additional guidance should be provided. We encourage the IASB to address this issue explicitly.

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 agree in part with the Board's approach to amending the hedge effectiveness requirements.

We welcome the Board's willingness to address the practice issues that arise from the hedge effectiveness requirements under IAS 39. There have been many concerns with IAS 39 in this area and the Board's proposals have attempted to address these. One common concern with IAS 39 is the 'highly effective' threshold for prospective and retrospective hedge effectiveness. This requirement has resulted in the application of a quantitative threshold to determine whether a hedge is expected to be highly effective on a prospective basis or has been highly effective on a retrospective basis.

Retrospective effectiveness test

The primary complaint with the retrospective effectiveness test in IAS 39 is that the bright line threshold to qualify for hedge accounting can result in anomalies such as a hedge failing due to the 'small numbers problem'. Furthermore, hedge accounting cannot be applied in cases where a hedge only marginally fails the high threshold (e.g. is 79% effective). We welcome the Board's proposal to remove the retrospective hedge effectiveness test requirement and instead require an entity to report the effectiveness of the hedge regardless of the amount of ineffectiveness.

We believe that by not requiring retrospective testing, the majority of the effectiveness testing practice issues experienced under IAS 39 will be addressed. However, we note that removing this threshold elevates the importance of any prospective testing requirement.

Prospective effectiveness test

One complaint about the prospective effectiveness test requirement in IAS 39 is that it can require burdensome detailed fair value based quantitative testing in cases when it is evident on a less detailed assessment or on a qualitative basis that a hedging relationship is likely to be highly effective. Another complaint is that the threshold itself is set too high. It is felt by some that this high threshold prevents hedge accounting in cases where there is unavoidable (at least at a reasonable cost) basis risk that means that a 'good risk management hedge' may not be eligible.

The Board has attempted to address this concern by introducing a requirement that a hedge must be expected to 'achieve other than accidental offset'. Such a low threshold would indeed allow hedge accounting to be applied for most of the hedges that do not currently qualify under the prospective effectiveness test in IAS 39. However, we do not believe that this new notion is well understood or rigorous enough to prevent hedge accounting in circumstances when it may not be appropriate (e.g. when it is inconsistent with the hedge accounting objective).

We believe that the low threshold is potentially open to abuse as it could result in entities interpreting risk management too broadly and using hedge accounting as an alternative to the default classification and measurement requirements of IFRSs. For example, when there is an expectation of high levels of hedge ineffectiveness between the hedging instrument and the hedged item it would not be appropriate to use fair value hedge accounting as a technique to fair value a hedged item that IFRSs would not permit to be measured at fair value. We believe such potential abuses could be prevented by requiring a higher threshold than the proposed threshold of 'other than accidental offset' that at the same time does not restrict entities from fairly reflecting their risk management activities.

We would propose a qualitative threshold that requires the hedging relationship to be expected to be 'reasonably effective'. We believe that such a threshold would allow hedge accounting for hedging relationships (of eligible hedging instruments and eligible hedged items) that are consistent with the objective of hedge accounting whilst at the same time prevent hedge accounting for hedging relationships

that are not consistent with the hedge accounting objective. As a result we believe that the hedge accounting requirements would give rise to more meaningful information.

In cases where an economic hedge does not qualify for hedge accounting, an entity may seek to apply hedge accounting for a proxy hedge relationship. We believe a higher threshold for prospective hedge effectiveness will provide more rigour around the establishment of proxy hedge relationships. For example, an entity holding long term fixed rate debt may enter into a long term inflation linked swap to swap the fixed cash flows on the debt to floating inflation linked cash flows. As the entity cannot designate inflation as the risk component of the fixed rate debt, it may look to demonstrate a hedge relationship on another basis or by designating another item. For example, it could attempt to designate the inflation swap and the fixed rate debt in a hedge of benchmark interest rate risk in its entirety, for which it may well be able to demonstrate 'other than accidental offset'. However, with our proposed threshold the level of expected offset would have to be greater. Alternatively, a proxy hedging relationship could be established between the inflation swap and another item on the balance sheet such as property. Here the entity could potentially demonstrate an economic relationship and correlation between long term inflation rates and long term property prices that gives rise to 'other than accidental offset' and hence designate the swap and the property in a hedge of forward property prices. We consider that this ability to designate such hedges could be viewed as an alternative fair value option for non-financial items. Again, our proposed higher threshold would require a greater degree of offset before hedge accounting could be applied and reduce the ability to designate inappropriate proxy hedge relationships.

Application

In our view a qualitative threshold of 'reasonably effective' should overcome the practical issues arising under IAS 39 from the need to perform detailed fair value based quantitative testing to demonstrate that a hedge passes the prospective effectiveness test. However, to prevent such a threshold being translated into a numerical threshold we believe there should be supporting guidance regarding how this threshold would be applied in practice. We suggest that the standard should explicitly allow an entity to perform a qualitative test, or non-fair value based quantitative test, to demonstrate that a hedge is expected to be 'reasonably effective'. The appropriateness of such a test would depend on the specific facts and circumstances surrounding a hedge relationship. We do not believe that a detailed quantitative test should be required in cases where the critical terms match or are closely matched between the hedged item and hedging instrument, or where a basic analysis can demonstrate that a hedge is expected to pass the effectiveness criteria.

We note that all hedges will need to be measured at the end of the hedged period in order to measure the effectiveness of a hedge. We believe that such quantitative information should be considered in the assessment of whether a hedge is expected to meet the effectiveness requirements on a prospective basis. For example, if a qualitative assessment is performed at inception, but at future reporting period-ends it consistently results in hedge ineffectiveness at a level that was not expected at inception of the hedge, then the entity should be required to apply a more thorough prospective test, supported by a quantitative assessment, at the start of each reporting period thereafter.

Unbiased hedge designation and minimise expected hedge ineffectiveness

We understand that the basis for requiring a hedge to be designated in an unbiased way is to avoid deliberate hedge ineffectiveness and also to avoid deliberate under-hedging in a cash flow hedge which could avoid the measurement of actual hedge ineffectiveness. We agree with the concept of requiring a hedge to be designated in a manner that results in an appropriate measurement of hedge ineffectiveness.

However, we do not believe that the proposed requirement to designate a hedge in a manner that will 'produce an unbiased result and minimise expected hedge ineffectiveness' effectively portrays this objective. For example, some have interpreted the requirement to mean that an entity must use a hedging instrument that minimises hedge ineffectiveness and hence would affect the way in which an entity manages risk if it wishes to also achieve hedge accounting.

Also, it is not clear what the intended time horizon over which an entity must minimise expected hedge ineffectiveness is. For example, it could be over the whole hedged term or to the next reporting period. We believe that for certain types of complex hedges (e.g. those using exotic options or dynamic hedges) the hedge ratio could be different depending on the time horizon considered.

Instead of the proposed objective to produce an 'unbiased result and minimise hedge ineffectiveness' we would propose a principle that requires a hedging relationship to be designated in a manner that does not deliberately give rise to hedge ineffectiveness (e.g. result in deliberate under-hedging in the case of a cash flow hedge).

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?**
- (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?**

Our understanding of the reason for the requirement to rebalance is to maintain an expectation of an unbiased hedge designation that minimises expected hedge ineffectiveness throughout the term of the hedge and not just at inception. As explained in our response to Question 6, we do not agree with the proposed requirement that a hedging relationship be designated to produce an 'unbiased result and minimise expected hedge ineffectiveness'. Hence we also do not agree with the requirement to mandatorily rebalance a hedging relationship to maintain compliance with this requirement on an on-going basis.

It is noted that for some dynamic hedging relationships where it is anticipated that the weightings of the hedged item and hedging instrument will need to change frequently in order to optimise the hedge, a requirement to always minimise expected hedge ineffectiveness may not be operational. That is because the reweighting of a dynamic hedge from a risk management perspective will in practice only happen when the expected hedge ineffectiveness falls outside entity specific tolerance thresholds. Or put another way, rebalancing for risk management purposes will only happen when any bias reaches a critical level. This is because to constantly minimise expected hedge ineffectiveness would give rise to costs disproportional to the benefit (e.g. require hedges to be changed daily or intra-daily).

Although the proposed requirement to rebalance is an accounting requirement and not a requirement for the risk management hedge to be changed, the requirement for the weightings of the accounting relationship to be changed frequently to absolutely minimise expected hedge ineffectiveness would not be operational for many entities, would be of limited benefit and could be inconsistent with risk management activities.

We consider one of the reasons for proposing mandatory rebalancing is to require hedge ratios to be updated to avoid purposely under-hedging for cash flows hedges. We suspect this concern is exacerbated in the ED when compared with IAS 39 because of the removal of the 80-125% test, thereby potentially giving entities a greater opportunity to purposely under-hedge. However, we note that the potential for abuse with under-hedging already exists in IAS 39, and in practice this has not been a problem even though IAS 39 does not require rebalancing. As our response to Question 6 states, we would raise the threshold for effectiveness as proposed in the ED and therefore alleviate some of the risk of purposely under-hedging that could arise with the ED as drafted.

Further, we suspect in practice it will be disproportionately complex to assess when a mandatory rebalancing is required. For example, assume an entity has a derivative and a hedged item where basis risk exists between the two. At inception of the hedge the entity determines that the probability of the basis risk giving rise to an under or over hedge is equal and sets its hedge ratio (say one-to-one). At the end of the first reporting period the gain/loss on the hedged item is larger than the gain/loss on the hedging instrument. The ED would require the entity to investigate whether this difference arises from actual basis risk which confirms its initial assessment that the basis risk could result in an under or over hedge (and it turned out to be an under-hedge) or whether it represents a structural shift in the hedging instrument and hedged item that is expected to continue in the future (and therefore require a rebalancing). We consider that if the hedge ratio is determined at inception to be unbiased and the hedging instrument and hedged item are unchanged then there is no greater risk of abuse due to under-hedging that needs to be corrected through a mandatory rebalancing. The financial statements will reflect the hedge ineffectiveness of the hedge relationship.

However, we believe that if an entity wishes to rebalance a hedging relationship to reduce expected hedge ineffectiveness it should be permitted to do this at any time provided the revised designation does not give rise to deliberate hedge ineffectiveness or deliberate under-hedging. In practice, to the extent the basis risk is significant enough that it is beyond the tolerance level of the entity we would expect an entity to adjust the quantum of the hedging instrument and hedged item in executing their risk management objective. This rebalancing for risk management purposes would then be reflected for accounting purposes.

The requirement to rebalance also raises questions as to what would happen in practice if it is discovered at a later date that the rebalancing had not been performed. Presumably, the application of hedge accounting in the previous periods would have been in error as mandatory rebalancing is a qualifying criterion and, if material, would require restatement to reverse the application of hedge accounting.

We also note that the requirement for mandatory rebalancing is linked with the prohibition of de-designating a hedge unless there has been a change in the risk management objective. As detailed in our response to Question 8, we also do not believe such a prohibition is operational.

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?**
- (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 agree that an entity should discontinue hedge accounting prospectively when the hedging relationship ceases to meet the qualifying criteria. This is consistent with the requirement that for a hedging relationship to be eligible for hedge accounting it must meet the qualifying conditions.

However, we do not agree that an entity should not be permitted to de-designate and 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 continues to meet all the other qualifying criteria. This is because we believe the ability to voluntarily de-designate in IAS 39 has not resulted in issues in practice and, as described immediately below, prohibiting voluntary de-designations could lead to the unintended consequence of discouraging hedge accounting.

As the existing hedge accounting model in IAS 39 and the model proposed in the ED do not allow all types of economic hedge to be eligible for hedge accounting some entities will attempt to reduce any measurement mismatch arising from hedge accounting by designating an alternative proxy hedge relationship that can portray the effects of risk management. A common example arises in banks where due to the various restrictions around portfolio hedge accounting a bank would designate its hedging interest rate swaps in individual hedge relationships with individual hedged items to closely replicate in the financial statements the effect of its risk management activities. For these banks it is necessary to periodically de-designate the individual hedging relationships and re-designate either the hedged item, hedging instrument, or both, in different hedging relationships or to leave them out of any hedging relationship. The ED would potentially require the hedge relationship to be maintained even though the entity would wish to de-designate so that the proxy hedge reflects the overall risk position that the hedging instrument was trying to manage. Prohibiting de-designation would have the inadvertent effect in these cases of discouraging hedge accounting.

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?**
- (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?**
- (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?**

Recognition of gain or loss in OCI

We disagree with the use of OCI for fair value hedges. We believe that it will neither improve the usefulness of information for users nor simplify the existing requirements. We do not see any clear benefit of using OCI that could not be better achieved by the disclosure of the gains/losses on the hedging instrument and hedged item and the resulting ineffectiveness which is already required by IFRS 7.

Requiring gains/losses on derivatives in OCI should be an exception to the default measurement of FVTPL. The need for this exception is inevitable for cash flow hedging because the hedged item is unrecognised and therefore deferral in OCI is necessary to avoid the accounting mismatch that would result from the default measurement of the hedging instrument in IFRS 9. However, extending this concept to fair value hedging when the hedged item is recognised is not necessary. Our preference for fair value hedges is to retain the requirements in IAS 39 for the gains/losses of hedging instruments to be recognised in profit or loss with the hedge adjustment to the hedged item also recognised in profit or loss.

We also note that for fair value hedges of interest rate risk using an interest rate swap, it is necessary to recognise the interest accrual on the interest rate swap in profit or loss to match the recognition of the hedged item. This is not explicitly stated in the ED and adds unnecessary complexity to the fair value hedge accounting model.

Separate line presentation

We disagree with the proposal to present separately, in the statement of financial position, the gain or loss attributable to the hedged risk on the hedged item. We understand that the basis for this proposal was to preserve the original measurement basis for hedged items that are subsequently measured on a basis other than fair value (e.g. amortised cost). However, we believe that the benefit of not adjusting the hedged item is outweighed by the crowding out of key information on the face of the statement of financial position arising from the addition of potentially many separate line items to present the hedge adjustment for each type of hedged item. We also note that in some cases the hedge adjustment shown on the face of the statement of financial position may not be material and hence separate line presentation would give undue prominence to qualitatively immaterial information. It could also be misleading, as the separate amounts could inappropriately be viewed as separate assets or liabilities in their own right, which they are not.

We believe it would be more appropriate to address the issue of the adjusted measurement basis of a hedged item through other means. For example, we would like the Board to consider addressing this issue by either requiring an entity to report the unadjusted measure of the hedged item in parenthesis on the face of statement of financial position or, alternatively, require full disclosure of the unadjusted hedged item measure and the corresponding hedge adjustment in the notes to the financial statements.

Linked presentation

We agree that linked presentation should not be allowed for fair value hedges as we do not believe that in this case it would result in more useful information about the risk management activities of an entity for users. We believe that note disclosures would better reflect the link between hedged items and hedging instruments.

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 (e.g. 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?**

- (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?**
- (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 (i.e. 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 welcome the Board's attempt to address the issue of the accounting for the time value of an option when the option's intrinsic value is designated in a hedging relationship. However, we have the following concerns with the proposed approach, and suggest an alternative approach to address these concerns.

Accounting choice

We note that when an entity designates the intrinsic value of an option, it is mandatory to account for the time value in accordance with the proposals in the ED. We believe this could be overly onerous and propose that an entity can have a choice, on a hedge by hedge basis, not to defer any time value in OCI and instead recognise any changes in time value directly in profit or loss (as is required under IAS 39).

Transaction related items

We disagree with the approach proposed by the Board for transaction related hedged items. We do not believe that the nature of the transaction should be the determinant of when to recognise the 'cost' or time value of the option. We believe that the 'cost' of the option should be recognised in profit or loss over the period that protection has been obtained in the same way as the recognition for time period related items. This is the approach that would be applied if an entity purchased a single premium insurance contract. It would be inconsistent to defer the cost of insurance as a basis adjustment for the item that is insured when the insurance protection arrangement happens to be a derivative, particularly when the Board developed its model on the basis of insurance, yet if an insurance contract is acquired a different treatment would be applied (i.e. recognition of the cost of insurance over the period of the period of insurance cover). We therefore believe that the time value of an option at the date of hedge designation should be recognised in profit or loss over the life of the hedging relationship. Furthermore, a single treatment for both transaction related and time period related items would reduce complexity.

Time period related items

Instead of the proposed mechanics for recognition of the time value in profit or loss for time period related items we suggest an alternative that we believe to be more operational for both transaction related and time period related items.

Single treatment of time value for time period and transaction related items

We would propose recognising the lower of the initial (i.e. at inception of the hedging relationship) aligned time value of the option and the initial actual time value of the option directly in profit or loss on a rational basis (e.g. straight line) over the term of the hedge. This approach is more consistent with insurance accounting where the cost of purchased insurance is not revalued each period; the profit or loss in a given period represents the proportionate cost of the insurance over the hedged period; it avoids the complexity of recognising amounts in OCI to then be partly immediately reclassified to profit or loss.

Under this proposed approach, any difference between the initial time value amount identified to be recognised in profit or loss on a rational basis (i.e. the lower of the actual time value and the aligned time value) and the amount already recognised in profit or loss on the rational basis is accumulated in a separate component of equity along with the effective intrinsic value of the option.

If the initial aligned time value of the option is lower than the actual time value of the option then any difference between the aligned time value and the actual time value would be recognised immediately in profit or loss as this does not form part of the hedging relationship and hence should not be deferred in OCI. If the option is held to its maturity, the amount in respect of time value in OCI will have been depleted to zero as all the time value at inception will have been recognised in profit or loss. If the option is derecognised prior to its maturity any amount in OCI relating to time value will be reclassified immediately to profit or loss.

Combinations of financial options

We believe that when the intrinsic value of a financial instrument that represents a combination of options is designated as an eligible hedging instrument (e.g. it is not a net written option), the alternative accounting treatment we propose above for the time value should be permitted for the component time values of each component option. For example, consider a zero-cost collar that is a combination of a purchased foreign exchange option and a written foreign exchange option with matched terms but different strike prices, that is deemed an eligible hedging instrument. If the intrinsic value of such a contract is designated as a hedging instrument, an entity should be permitted to apply the alternative accounting treatment to the time value of both the purchased and written option. When, at inception of the hedge, the two time values are equivalent to the aligned time values and are equal but opposite in value, the sum of time value recognised in profit or loss in each period would be nil. We believe that this is consistent with the fact that the net time value for the contract is nil.

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 with the eligibility criteria for a group of individual items to be an eligible hedged item. However, we believe guidance is needed on the treatment of amounts deferred in OCI in a cash flow hedge of a net position when at designation the offsetting cash flows that comprise the net position are expected to occur in the same reporting period, but subsequently the entity expects the cash flows to occur in different reporting periods.

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 (e.g. 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 agree with the requirement to present any hedging instrument gain or loss in a separate line of profit or loss if the offsetting hedged risk positions affect different line items, as the alternative would be to gross up the gains or losses into amounts that do not exist.

However, we note that if the hedged items affect two or more non-adjacent line items the location of the separate line item may not be meaningful. For example, where the net position comprises foreign currency sales and purchases in a hedge of net foreign currency exposure, separate presentation immediately before gross profit is meaningful and intuitive. However, when the net position comprises foreign currency sales and operating expenses it is difficult to identify where the single line item should be presented as the hedged items are not presented in adjacent line items. The basis for the positioning of the single line item must be transparent in these cases and the presentation consistent period to period.

Furthermore, the guidance is not clear as to whether a single separate line item is required or permitted for each type of individual hedge of offsetting risk positions.

Question 13

- (a) **Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?**
- (b) **What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?**

We welcome proposals to reconsider the hedge accounting disclosures required by IFRS 7 as they are somewhat limited in explaining the extent of hedge accounting and the effect of hedge accounting on the financial statements. However, we have some concerns with the requirements in paragraph 46 to disclose a breakdown of the quantity of the exposure, the quantity hedged and the effects of hedging. As these requirements are only applicable to those entities that apply hedge accounting we believe that requiring information about amounts or quantities of exposures hedged discriminates against those that choose to apply hedge accounting. We do not see such information as being more or less useful on the basis of whether an entity chooses to apply hedge accounting. As a result we believe such disclosures should remain optional for all entities that hedge.

If the disclosures requirements in paragraph 46 are to be retained we have some specific concerns with paragraph 46(a). Firstly, it is not clear whether the "risk exposure" in the case of cash flow hedges only relates to exposures that meet the definition of highly probable. We presume it should and therefore this should be made explicit. Without such a statement an entity would be required to disclose its total risk exposure from all forecast transactions even though they might not be highly probable. This would not be meaningful as it would not illustrate in combination with paragraph 46(b) the degree to which highly probable forecast transactions are hedged. Secondly, providing the disclosure detailed in paragraph 46(a) for cash flow hedges would be a subjective exercise. For example, for a hedge of the foreign currency risk of forecast sales over the next five years, an entity would need to disclose the total foreign currency forecast sales the entity is exposed to over the next five years irrespective of the extent to which those sales are hedged. In practice, considerable judgement is already required in assessing high probability for forecast transactions which are hedged. The ED would require a further assessment of the probability of forecast transactions that are *not* hedged. This would be more judgemental bearing in mind the transactions that are hedged are considered the bottom layer of all forecast transactions and therefore are the ones that are more likely to occur. Disclosing the degree to which forecast transactions are hedged is no doubt of some value, but we question whether it will be practical, particularly over a long time period. In addition we note the potential commercial sensitivity of these disclosures.

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 proposals to amend IAS 32 to require derivative accounting for contracts 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, if it is in accordance with the entity's fair value-based risk management strategy.

However, the proposals are not clear as to whether this would only apply to such contracts only if they allow for net settlement. In many cases commodity contracts do not explicitly allow for net settlement due to the liquidity issues that such a term could create. We believe the amendment should apply regardless of whether or not the contracts have an explicit condition of net settlement provided the contract meets the definition of a derivative.

The proposals are also not clear as to whether a fair value-based risk management strategy requires the entire business, or only part of a business, to be managed on a fair value basis. This is particularly relevant in certain conglomerates where some parts of the entity may have a fair value-based risk management strategy where other parts of the entity, with similar contracts, may have a physical delivery objective. Further, it is not clear whether this requirement only applies when the net exposure maintained is close to nil, whether it is a condition that fair value accounting could have been applied in the absence of applying this requirement or whether the net exposure is maintained within some other parameters not necessarily close to nil (i.e. in the case where the entity purposely remains exposed to a net open fair value exposure).

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?**
- (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?**

We agree that all of the three alternative accounting treatments to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments.

We note that in practice it can be difficult in certain cases to identify the credit risk component of a debt instrument that is 'separately identifiable and reliably measurable'. However, this is true for other types of hedge relationships, for example, hedging interest rate risk and other risks such as for non-financial items. Therefore we do not believe that this warrants an exception to the hedge accounting model.

We believe that reference to the difficulties in hedging of credit risk in the basis for conclusions should be removed for a number of reasons.

Firstly, some of the difficulties cited are not unique to hedging credit risk. For example, the Board highlights that using credit default swaps (CDS) creates basis risk when hedging the credit risk in a debt instrument because the CDS is a synthetic position but the debt is a cash instrument. The difference

between cash and synthetic instruments is equally true when hedging the interest rate risk of debt instruments with vanilla interest rate swaps but the basis difference of itself is not regarded as a source of ineffectiveness. Further, IAS 39:IG.F.5.5 is clear that an entity can infer in a fixed rate debt the LIBOR swap curve and therefore explicitly permits inference of a risk from the synthetic market onto an instrument in the cash market.

Secondly, the hedging of credit risk could change over time as risk management techniques change. As a result the analysis in the basis for conclusions that might be relevant currently may not be relevant in the future and may unnecessarily call into question the ability to apply hedge accounting for credit risk.

Finally, the comments in the basis for conclusions are more consistent with application guidance rather than basis for conclusions. We do not believe that having such observations on the difficulties in application of hedge accounting for credit risk in the basis for conclusions is appropriate.

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 with the general principle that, when finalised, the hedge accounting requirements should be applied prospectively as this is consistent with the way hedge accounting is normally applied, except for some limited circumstances noted below. We also agree that earlier application should be permitted.

However, we note that there are several scenarios where it is unclear how prospective application would apply or where prospective application could be inappropriate. Consequently, we encourage the Board to consider further the scenarios described below and to provide guidance on how to apply the transition requirements in these cases.

Continuation of IAS 39 hedging relationships

The ED states that for hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with the proposed new requirements shall be regarded as continuing hedging relationships. However, it is not explicit that such hedges must satisfy all the new qualifying criteria (e.g. revised hedge effectiveness requirements). We assume from paragraph 54 that this would be a requirement and hence suggest an explicit statement to that effect to avoid misapplication.

We believe that it was the Board's intention to allow an entity, on transition from IAS 39 to IFRS 9, to revise its documentation of an existing hedging relationship established under IAS 39 to comply with IFRS 9 and to then treat that hedging relationship as a continuing hedging relationship. We recommend that the Board make this clear as part of the application guidance for transition.

Date of earlier application

We note that paragraph 53 and 54 refer to both the 'date of initial application' and the 'date of adoption'. It is not clear whether the two phrases have different or the same meaning. If the meaning is the same we

propose the terminology to be aligned. If they are intended to have different meaning then we request the Board to provide further guidance to clarify their meaning. We note that IFRS 9:7.2.2 has a specific definition for the date of initial application and it is not clear whether that definition will equally apply to the hedge accounting requirements when included in that Standard.

Hedge accounting in the comparative period

An entity with a 31 December year end will be required to adopt IFRS 9 for its reporting period beginning on or after 1 January 2013. As the hedge accounting requirements would have to be applied prospectively, an entity would have to comply with the IFRS 9 requirements from 1 January 2013 if it wanted to apply hedge accounting from that date. However, given the short time period between the date the Standard is finalised and the start of the comparative period, say 1 January 2012, an entity may wish to designate hedges on the basis of the revised standard. It is not clear whether if documentation has been put in place at the start of the comparative period whether it can present hedge accounting that complies with the new standard in the comparative period.

We considered this issue, amongst others, in formulating our response to the Request for Views on Effective Dates and Transition Methods in which we noted that an effective date of 1 January 2013 appears unrealistic.

Presentation of fair value hedges

As noted in our response to Question 9, we do not support the proposed changes to the presentation of fair value hedges. However, if these proposals are retained we would welcome application guidance explaining how the prospective transition requirements would apply to IAS 39 fair value hedges that are treated as continuing hedges under IFRS 9. We assume prospective application would mean that only fair value hedge adjustments from the date that the new requirements are applied would follow the revised presentation but it is not clear. Further, we question the usefulness of this presentation as it would result in inconsistent treatment of fair value hedge adjustments depending on whether they were posted to the statement of financial position pre or post transition.

We believe the Board should consider whether a retrospective application for presentation would be more appropriate for fair value hedging relationships that, from IAS 39, are treated as continuing hedging relationships under the transition requirements of IFRS 9. In this case, previous fair value hedging relationships that have ceased on or before transition would continue to be presented as before under IAS 39 and not be restated.

Fair value-based risk management strategy for non-financial items

We note that the proposed amendment to IAS 32 in Appendix C does not have explicit transition requirements. Prospective application of this amendment only to newly recognised non-financial contracts entered into as part of this business model would not result in useful information. This approach would result in inconsistent treatment of contracts that are part of the same business model and not reflect the risk management strategy in the financial statements.

Continuation of hedge designation of intrinsic value of an option

The ED proposes a change to the way time value of an option is accounted for when the intrinsic value is designated in a hedging relationship. However, it is not clear how existing IAS 39 hedge designations of

only the intrinsic value of an option are treated on transition to the new requirements. For example, it is not clear whether the terms of the aligned option whose critical terms match the hedged item are determined at inception of the original hedge under IAS 39 or as at the date of transition. The differing date would in many cases have a significant effect on the subsequent accounting entries. We believe the date should be the inception of the original hedge under IAS 39 as the hedge relationship is a continuation of an existing hedge, as opposed to a new hedge relationship.

De-designation of hedging relationships

Given the conditional de-designation allowance proposed under the ED, it is not clear how IAS 39 hedging relationships that have not been de-designated at the date of transition would be treated if none of the conditions for de-designation of the hedging relationship are met. For example, say a hedging relationship is eligible under both IAS 39 and IFRS 9, however, the hedge ratio to comply with the objective of hedge effectiveness has not been determined under the new proposals as at transition. In this case it is not clear if this would be subject to a mandatory rebalancing and prohibition from de-designation if the de-designation conditions are not met, or if this would be treated as an ineligible hedge as the qualifying conditions for hedge accounting have not been satisfied at the date of transition.

Change in designation from proportion to a layer

The ED explicitly allows an entity to designate a layer (e.g. bottom layer) of an item in a fair value hedge if certain conditions are met and this is consistent with an entity's risk management objective. We note that on transition to the new requirements an entity may choose to change a designation from a proportion of an item (eg 40% of a CU100m fixed rate loan) to a bottom layer of an item (e.g. the last CU40m to remain of a CU100m fixed rate loan). It is not clear from the transition requirements whether such an alteration to the way in which the hedged item is identified would result in a de-designation of the previous hedge and a re-designation of a new hedge. We note that if such a change does result in a break in the hedge this would require the recalculation of the effective interest rate to amortise some or all of the previous fair value hedge adjustments which would not provide useful information as this would distort the natural amortisation of the hedge adjustment that would otherwise occur if treated as a continuing hedging relationship. Hence, we would recommend an explicit allowance for an entity to alter a hedge designation from a proportional component to an equivalent layer component without creating a break in the hedging relationship.

Hedges of groups of items (including net positions)

The ED allows more types of groups of items to be eligible for hedge accounting. As a result, on transition, an entity may choose to combine individual hedging relationships into single group hedging relationships. It is not clear from the transition requirements whether such a combination would be treated as a continuing hedging relationship or a new hedging relationship. In the case where the individual items included in the group hedge continue to be hedged for the same and only that risk, we believe this should be treated as a continuing hedge. However, where this is a hedge of a net position, this would call into question how any prior period gains or losses recognised in profit or loss should be presented, as from transition such gains or losses would be presented in a separate line item. Consistent with our view on the presentation of fair value hedges that continue after transition, we believe the presentation requirements should be applied retrospectively.

Hedging aggregated exposures

The ED allows an aggregated exposure that includes a derivative to be an eligible hedged item. Hence, at transition an entity could designate an aggregated exposure in a cash flow hedge which under IAS 39 would not have been eligible. We note that in this case, it would be necessary to define the hypothetical derivative as at the date of transition as this would be the start of the hedging relationship. However, we believe that the Board should consider a concession to allow an entity to define the hypothetical derivative as at the start date of the original economic hedge relationship as this is the date the entity would have been able to apply hedge accounting had IAS 39 permitted such an approach.

Basis adjustment of non-financial items

We note the ED requires basis adjustments for cash flow hedges of forecast transactions that result in the recognition of non-financial items. However, it is not clear how this requirement would apply to past cash flow hedges which have already resulted in the recognition of the non-financial item but have not been basis adjusted (i.e. the gain/loss on the hedging instrument remains deferred in OCI). It is not clear whether such amounts deferred in OCI should be recognised as part of the recognised non-financial item or not.

First-time adoption of IFRSs

We also note that the ED does not propose any specific amendment to IFRS 1. As already commented in our comment letter on the Request for Views on Effective Dates and Transition Methods, if the current exceptions to retrospective application in IFRS1.B4-B6 are to be retained, depending on the final effective date of the final standards and the date of transition, first-time adopters may be prohibited from reflecting their risk management activities in their financial statements, merely because they are not practically able to comply with hedge documentation requirements before their date of transition to IFRSs. This consequence is not consistent with the objective of hedge accounting and does not result in useful information for users. We recommend the Board take this point into consideration when finalising the effective date and/or requirements for the first-time adopters. In addition, many of our comments above on transition should also be considered in the context of first-time adoption.

Other issues

Measurement of hedge ineffectiveness

Paragraph B44 permits the use of a hypothetical derivative method for measuring the hedged item but does not restrict its use to the measurement of cash flows in a cash flow hedge. As a result some may interpret this to mean that a hypothetical derivative method could be used to measure changes in fair value of a hedged item in a fair value hedge. In some cases, using the hypothetical derivative method to measure the hedged item in a fair value hedge can give rise to a different result to measuring the hedged item directly. For example, using an interest rate swap with a pay fixed leg and receive floating leg to measure the change in fair value of a fixed rate instrument that matches the terms of the fixed leg of the swap will not necessarily give the same result as measuring the fixed rate instrument directly. That is because the floating leg of the swap is not replicated in the hedged item and hence may give rise to fair value changes that do not arise from the hedged item (for example arising from the existence of a basis swap spread in the hypothetical derivative that does not exist in the hedged item). We do not believe it is necessary to use the hypothetical derivative to measure a hedged item in a fair value hedge as the item can

be measured directly. However, if the Board wish to retain the proposed guidance we recommend that either (i) it refers only to cash flow hedges, or (ii) if it can apply to any type of hedge relationship it is made clear that the method is only appropriate for a fair value hedge if it replicates the fair value change of the hedged item that would be derived by measuring the hedged item directly.

Paragraph B44 is clear that the time value of money should be included when measuring the hedged item. When the Board discussed this requirement it also discussed whether credit risk should be included in the measurement of a hedged item. The lack of guidance in the ED regarding the inclusion or exclusion of credit risk in the measurement of a hedged item, including whether or not credit risk is incorporated in the measurement of the hedged item when the hypothetical derivative method is used could give rise to diversity in practice. We recommend that the Board clarify its position on this matter.

Basis adjustments for cash flow hedges of non-financial items

For cash flow hedges that result in the recognition of a non-financial item on the statement of financial position, the Board has proposed mandatory basis adjustment. This removes the choice that exists under IAS 39 to retain amounts deferred in accumulated OCI to reclassify them directly to profit or loss when the non-financial item affects profit or loss.

We do not believe that any benefit arising from simplifying the hedge accounting model, by removing a choice, outweighs the difficulty that some preparers would face to comply with this requirement. The difficulty in practice arises from the tracking of basis adjustments when the volume of hedged items is large and tracked by complex systems.

The highly probable criterion

We agree that the highly probable criterion for designating a forecast transaction as a hedged item in a cash flow hedge should be retained, however, we believe this criterion needs to be amended to reflect that an entity may attempt to eliminate its exposure arising from the hedging instrument should the transaction not occur. This is not the same as hedging a transaction that does not occur, but instead ensuring that should the forecast transaction not occur then the entity is not exposed to the risks inherent in the hedging instrument. In practice in IAS 39, the highly probable criterion has led to the disqualification of these sound economic hedge relationships. For example, it is increasingly common when hedging the foreign currency risk associated with a commitment to complete a future business combination that is still subject to regulatory approval, that the entity will enter into a foreign currency derivative with a purchased knock-out option that results in the hedging instrument settling for zero in the case that the transaction fails to occur (i.e. if the business combination is not approved). Such instruments hedge the foreign currency risk that arises if the transaction occurs and also eliminate the exposure from the hedging instrument should the transaction not occur. Therefore, from a risk management perspective the hedging instrument is a very effective hedge at hedging foreign currency risk and the uncertainty that if the transaction does not occur the entity will continue to be exposed to the hedging instrument.

As IAS 39, and the ED, assume the transaction will occur when assessing hedge effectiveness (even though it is not certain), a deal-contingent derivative is ineffective due to the inclusion of the purchased option. This is counter-intuitive. In effect, a derivative without the purchased option is regarded as fully effective for a transaction that may not occur, yet a derivative with a purchased option is not regarded as fully effective when that purchased option reflects the probability that the forecast transaction might not occur. The Board should give consideration to whether the highly probable criterion should be amended to reflect this anomaly.

Intragroup hedged items

We note that the Board has carried over from IAS 39 the accounting requirements and associated guidance in relation to hedge accounting highly probable forecast intragroup transactions (in IAS 39.80 and IAS 39.AG99A and paragraphs 17 and B10 of the ED). In practice, this had led to a number of interpretative issues, particularly as the standard states that royalty payments, interest payments or management charges between members of the same group do not qualify unless there is a related external transaction. Questions arise as to how the internal transaction is related to the external transaction. For the sale of inventory between entities prior to an onward sale of inventory to an external party the guidance is more intuitive, but for sale of non-physical goods, such as licences and resulting royalties etc, it is less clear. It would be beneficial if the standard made clear that an internal transaction is eligible as a hedged item if the internal transaction only arises because the external transaction occurs. There must be a clear link between the internal and external transaction. In cases where external transactions, such as sales of goods, give rise to internal royalty payments, it would appear that the internal transaction is related to an external transaction, even though currently the standard implies that generally internal royalties cannot be hedged.

Net investment hedges

In considering the proposed new hedge accounting model, the Board did not specifically discuss potential changes to net investment hedge accounting. However, some of the proposed general changes that apply to both cash flow and fair value hedges could equally apply to net investment hedges. For example, the changes to the effectiveness testing requirements, the prohibition of de-designating a hedging relationship unless conditions are met and the proposed accounting for the time value of an option when its intrinsic value is designated in a hedge all appear to be relevant for net investment hedges. We recommend that the Board clarify whether the proposed changes would apply to net investment hedges.

It is not clear how the Board's proposal for the treatment of time value for purchased options would interact with net investment hedging. Would the hedge of the net investment be a time period or a transaction related hedge? Specifically, would the remeasurement of time value be always deferred in OCI until disposal of the net investment in foreign operation?

Presentation of hedge ineffectiveness

We note that the ED is silent on the presentation of hedge ineffectiveness in the income statement. The increased tolerance of hedge ineffectiveness arising from the proposed removal of the highly effective requirement will increase the importance of the appropriate presentation of hedge ineffectiveness. Under IAS 39, hedge ineffectiveness tends to be reported as part of the recognition of the hedged item in the income statement or in finance income/expense. The Board should consider the appropriateness of this in light of the removal of the highly effective criterion.

Miscellaneous

As the hedge accounting requirements will be included in IFRS 9 it would be helpful if the Standard clarified the interaction of risk management activity on the classification of financial assets based on an assessment of the entity's business model (IFRS 9:4.1.2). Our understanding is that the business model assessment focuses on the entity's objective for managing assets without considering risk management activities, such as hedging of the contractual cash flows from such assets. It would be beneficial if IFRS 9 clarified this. For example, an entity may conduct risk management activities to monitor and achieve a desired level of exposure to interest rate risk in a portfolio of financial assets. We do not believe this is

intended to be seen as a business model where a portfolio of financial assets managed and whose performance is evaluated on a fair value basis (IFRS 9:B4.1.6) merely because of the risk management activities.

We note that the Board did not discuss the implementation guidance for hedge accounting that currently exists in IAS 39. Although this guidance is not authoritative, it is widely used in practice to understand the application of the requirements. As such, much of this guidance remains relevant for the proposed new rules. We recommend that the Board incorporates the relevant guidance as part of IFRS 9.

Paragraph B2 appears to indicate that an entity's own equity instruments are not eligible for hedge accounting because they are not financial assets or financial liabilities of the entity. However, items that are not financial assets or financial liabilities can be eligible hedged items (e.g. forecast transactions). The reason why own equity instruments are not eligible for hedge accounting is because they do not affect profit or loss (nor do they affect OCI, which would be relevant if the objective of hedge accounting were to be extended to include such risks). We recommend that this paragraph is amended to reflect this.

Paragraph B3 clarifies that for a hedge of foreign currency risk, an entity may designate the foreign currency component of a non-derivative financial instrument determined in accordance with IAS 21. However, it is not clear for a non-derivative, such as foreign currency monetary liability, that is measured at fair value through profit or loss, whether the foreign currency component is based on the fair value of the non-derivative instrument or its deemed amortised cost. We recommend that this is clarified to avoid inconsistencies in practice.

Paragraph B4 states that 'This [draft] IFRS does not restrict the circumstances in which a derivative may be designated as a hedging instrument, except for some written options'. However, IAS 39 also restricts combinations of options that in aggregate are net written options from being eligible hedging instruments. We do not believe that the Board had intended to change its position on eligibility of net written options and therefore recommend that paragraph B4 is amended to refer to both written options and net written options.

Paragraph B6 refers to the eligibility of a 'single' hedging instrument that hedges more than one type of risk. This could be read to preclude the eligibility of 'multiple' hedging instruments used to hedge more than one type of risk. We do not believe that the Board intended to restrict the eligibility of multiple hedging instruments as a hedge of multiple risks and therefore recommend that paragraph B6 is amended so as not to be restricted to only 'single' hedging instruments.

Paragraph B7 clarifies that a 'firm commitment' to acquire a business combination cannot be a hedged item except for foreign currency risk. We believe the Board intends this restriction to also apply to 'forecast transactions' to acquire business combinations and hence recommend paragraph B7 is amended to reflect this.

Other issues relevant for the portfolio hedge accounting model

We note that the Board continues to deliberate the portfolio hedge accounting model. We believe the following items, which although relevant for the general hedge accounting model will be more relevant for the portfolio model and hence should be considered by the Board:

- hedging groups of prepayable items;
- hedging interest risk in the case where the interest rate is sub-LIBOR (e.g. deposits); and
- effectiveness testing for groups of items.