
Project	Financial Instruments: Replacement of IAS 39
Topic	Hedge accounting: Comment letter summary

Purpose of this paper

1. In December 2010 the Board published the exposure draft *Hedge Accounting*. The three-month comment period ended on 9 March 2011 and, by that date, the IASB had received 177 comment letters. This paper provides a summary of the comments in the comment letters that were received by the comment letter deadline. We continue to receive responses. In total, 216 responses have been received as of the date of posting this paper.
2. **The purpose of this paper is to provide the Board with an overview of the general themes that are prevalent in the comment letters.** During re-deliberations we will include a detailed analysis of the comments received applicable to each issue. We will consider all responses received (including those received after the comment deadline) for re-deliberations.
3. This paper **does not**:
 - (a) provide a detailed analysis of the comments received;
 - (b) provide a quantitative review of responses or attribute comments to individual respondents;
 - (c) address drafting suggestions received from respondents.
4. The invitation to comment is attached in the appendix to this paper for ease of reference.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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Key messages

5. Overall, the comment letters had the following key messages:
 - (a) General support for the proposals. In particular there was strong support for the objective of better aligning hedge accounting with risk management and for the proposed changes to the hedge effectiveness qualification requirements.
 - (b) As the proposals introduce a number of new concepts, additional clarification and examples were requested for some areas to aid understanding and application.
 - (c) The Board should not increase its use of the other comprehensive income (OCI) section until it has had a broader discussion about the role of OCI.
 - (d) Many respondents request that the Board address macro hedging. They believe that macro hedging will form a vital part of the IASB's final overall hedge accounting model.

Overview of comments received

6. This paper separates the comments received into the following topics (these topics relate to the questions asked in the invitation to comment on the exposure draft *Hedge Accounting*):
 - (a) Objective of hedge accounting (Question 1).
 - (b) Non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit or loss as hedging instruments (Question 2).
 - (c) Aggregated exposures (Question 3).
 - (d) Designation of risk components (Question 4).
 - (e) Designation of layer components of nominal amounts (Question 5).

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- (f) Hedge effectiveness requirements to qualify for hedge accounting (Question 6).
- (g) Rebalancing of a hedging relationship (Question 7).
- (h) Discontinuing hedge accounting (Question 8).
- (i) Accounting for fair value hedges (Question 9).
- (j) Time value of options (Question 10).
- (k) Eligibility criteria of groups of items (Question 11).
- (l) Presentation for hedges of groups of items (Question 12).
- (m) Disclosures (Question 13).
- (n) Contracts for a non-financial item that can be settled net in cash as a derivative (Question 14).
- (o) Accounting for credit risk using credit derivatives (Question 15).
- (p) Effective date and transitional requirements (Question 16).
- (q) Other comments.

Objective of hedge accounting (Question 1)

7. Almost all of the respondents support the proposed objective of hedge accounting to align the hedge accounting requirements with an entity's risk management activities. They believe that the proposed objective would result in financial statements that better reflect risk management improving the quality of information provided to the users of financial statements. Even though almost all respondents support the objective, some concerns were raised. For example:
- (a) The objective of hedge accounting should not focus on risk management activities that affect only profit or loss. These respondents argue that entities undertake many risk management strategies that affect OCI. The most commonly raised concern was the proposed

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prohibition on hedge accounting for equity investments measured at fair value in OCI. In the absence of the ability to apply hedge accounting to activities that affect OCI many respondents argued that the entity's financial statements will not reflect entities' risk management strategies.

- (b) By introducing specific 'rules' the exposure draft is inconsistent with the proposed objective for hedge accounting in some situations. For example, the proposals in the exposure draft were viewed by many as limiting the application of hedge accounting for legitimate risk management activities (eg the restrictions on the hedging inflation components in financial instruments, hedging of sub-Libor cash flows, hedging of equity investments in OCI and cash flow hedges of net positions where the hedged item impacts profit or loss in different reporting periods).
 - (c) The term 'risk management' is not defined and as such it could result in different interpretations resulting in divergence in practice.
8. There are also some respondents who do not support the proposed objective for hedge accounting. They believe that hedge accounting should only be a mechanism to eliminate recognition and measurement anomalies between the accounting for derivatives (or other hedging instruments) and the accounting for hedged items. Some also believe that there is high diversity in practice regarding risk management approaches and that it is impossible to find concepts that appropriately address all of them.

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Non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit or loss as hedging instruments (Question 2)

9. Almost all respondents agree that non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit or loss should be eligible for designation as hedging instruments. Some respondents requested that the Board expand this to include all non-derivative financial assets and financial liabilities (ie even if not measured at fair value through profit or loss).
10. However, a few respondents questioned whether financial instruments that were measured at fair value through profit or loss under the fair value option on the basis of eliminating or substantially reducing an accounting mismatch should be eligible for designation as a hedging instrument in a cash flow hedge. This is because it would override the basis for designating the item as at fair value through profit or loss in the first place.
11. Some respondents also commented more generally on hedging instruments. These comments are summarised below:
 - (a) Some believe that the Board should consider whether entities should be allowed to designate components of items as hedging instruments (derivatives and non-derivatives). This is because the inability to designate selected cash flows of the derivative as the hedging instrument is viewed as being inconsistent with legitimate risk management activities. Therefore, the accounting will not necessarily reflect the entity's risk management activities.
 - (b) Some believe that the Board should reconsider the prohibition that prevents intragroup monetary items denominated in a foreign currency from being eligible hedging instruments as part of this project. This is because this restriction results in the economic rationale for such hedges not being appropriately reflected from an accounting perspective.

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Aggregated exposures (Question 3)

12. Most of the respondents welcome the ability to designate an aggregated exposure as a hedged item as it aligns the accounting better to their risk management practices.
13. However, due to the complexity involved with the accounting many respondents request more guidance on the mechanics involved with aggregated exposures. Respondents request guidance on, for example:
 - (a) how the hedge accounting mechanics should be applied for complex hedges;
 - (b) how hedge effectiveness should be assessed;
 - (c) how hedge ineffectiveness should be measured.
14. Some respondents also commented that it was not clear whether the proposed guidance for aggregated exposure requires synthetic accounting (ie to achieve amortised cost accounting for the hedging derivatives). Some other respondents commented that they believed that synthetic accounting should be allowed even if it was not the intention of the Board.

Designation of risk components (Question 4)

15. Almost all respondents strongly supported the extension of the ability to hedge risk components in non-financial items beyond the current ability to hedge foreign currency risk. They believe that this will allow entities to better reflect their risk management activities and that as a result it will provide information that is more useful to users of financial statements.
16. Many respondents specifically support the Board's principle-based approach that any risk component can be designated as long as it is separately identifiable and reliably measurable.
17. However, many respondents requested more guidance on identifying risk components that satisfy these criteria when the risks are implicit but not contractually specified in the total fair value or cash flows of the hedged item.

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They believe that without further guidance there might be divergence in how the principle is applied. For example, one respondent asks whether the presence of a component/ingredient and the (logical) assumption that it would influence the pricing of a product is sufficient to support eligibility for hedge accounting.

18. Many respondents believe that the Board should only rely on the principle of identifying components on the basis of being separately identifiable and reliably measurable and disagree with instances where they view the Board has overlaid 'rules'. For example, many respondents do not agree with the Board's rules-based approach with respect to inflation risk components for financial instruments. They believe that the principle that a risk component should separately identifiable and reliably measurable is appropriate for inflation risk components as well. They believe that is inconsistent for the Board to preclude inflation as a hedgeable risk component for financial items when the Board allows non-contractually specified risk components implicit in the total fair value or cash flows of the hedged item. Similar comments are made with respect to hedges of credit risk using credit derivatives, see the section summarising responses to question 15 below.

Designation of layer components of nominal amounts (Question 5)

19. Almost all of the respondents welcome the proposal to allow designation of a layer component for fair value hedges. The respondents believe that this aligns with common risk management strategies.
20. Many respondents also requested the Board clarify the designation of a top-layer component of an open population of items. For example, the sale of the last 100 widgets sold during a specific period. These respondents have noted that the implementation guidance in IAS 39 *Financial Instruments: Recognition and Measurement* clarifies that it cannot be identified and therefore not designated, but that the exposure draft is silent. The respondents do not think the Board's intention has changed, but they believe the Board should be clear.

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21. Many respondents disagreed with the Board's blanket proposal to disallow the designation of a layer component of a contract that includes a prepayment option. Comments included the following:
- (a) Some believe that layer components should be disallowed if the prepayment option's fair value is affected by changes in the hedged risk (at the individual instrument level). However, they believe that there are situations where the layer component is separately identifiable and reliably measurable and that for those situations layer components should be allowed. These respondents believe that the Board should not include a prohibition that will exclude these situations.
 - (b) Many respondents see the prepayment option issue as something that should be addressed as part of the Board's discussions on macro hedging. They urge the Board not to let the decision in the general hedging model unnecessarily restrict the decisions for the macro hedging model. Most of these respondents disagreed with the prohibition as they did not think such a restriction was necessarily appropriate for a group of items (assuming the group was a closed group within the scope of the ED).

Hedge effectiveness requirements to qualify for hedge accounting (Question 6)

22. Almost all respondents support the Board's proposal to remove the 80-125% effectiveness threshold and to replace the qualifying criteria with a more principles-based approach. Respondents believe that this will remove significant obstacles in applying hedge accounting and that it will increase the usefulness of information for users of financial statements.
23. However, respondents had some concerns around the effectiveness requirements. Many requested more guidance on some of the new terminology and concepts that the Board introduced with these proposals (for example, 'unbiased' and 'other than accidental'). The most common comments are summarised as follows:

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- (a) Some respondents feel that the proposed effectiveness requirements are not stringent enough to prevent inappropriate hedges from qualifying for hedge accounting. They believe that the Board should introduce some notion of reasonable effectiveness without necessarily introducing a numerical threshold.
- (b) In contrast some respondents are concerned that the new concepts are more stringent than the current 80-125% requirement. For example, some respondents request more clarity on the requirements to designate a hedging relationship in a manner that will ‘produce an unbiased result and minimise expected hedge ineffectiveness’. These respondents think that the ‘unbiased’ condition requires all bias to be eliminated at inception and on an ongoing basis and implies that the proposals require a move to 100% effectiveness. In addition to this, the need to minimise ineffectiveness seems to go even further in that rebalancing would be required even for very small changes in hedge effectiveness.
- (c) Some interpret the requirement to minimise ineffectiveness to mean that the entity must use a hedging instrument that minimises hedge ineffectiveness, ie that the proposals would dictate the choice of the ‘perfect’ hedging instrument irrespective of practicalities. They question whether this is the Board’s intent, because if so, it would affect the way in which entities conduct their risk management activities.
- (d) Some have also requested more guidance on the intended time horizon over which an entity must minimise expected hedge ineffectiveness for the given hedging relationship.

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Rebalancing of a hedging relationship (Question 7)

24. Respondents had mixed views on the proposed rebalancing of hedging relationships when the hedge relationship fails to meet the objective of hedge effectiveness but the risk management objective remains the same.
25. Generally, respondents support the inclusion of a rebalancing notion as this reflects what an entity commonly does as part of its risk management activities. It also would allow hedge accounting to continue in accordance with dynamic risk management enabling hedge accounting to be more closely aligned with risk management. However, some are concerned that by mandatorily requiring rebalancing the proposals might result in an accounting exercise rather than reflecting risk management. For example, rebalancing would only take place for risk management purposes if bias reaches a critical mass and based on an entity's risk tolerances. Conversely, the proposals seem to require rebalancing to avoid all bias and to minimise ineffectiveness.
26. Many respondents request more guidance on what would be considered an event that would require rebalancing and what would not. These respondents are concerned that the principle might not be interpreted consistently and potentially result in divergence.
27. Some respondents agree that rebalancing should be allowed but would prefer that rebalancing simply reflect risk management and that if an entity decides not to rebalance to optimal levels that that be reflected through the measurement of ineffectiveness in an ongoing hedge accounting relationship.
28. Some respondents have also raised some practicalities with the proposal for mandatory rebalancing. These respondents question whether the Board's intention is for entities to restate the financial statements (ie to reverse the application of hedge accounting) when it is determined that rebalancing should have happened in an earlier period.
29. With respect to proactive rebalancing, most respondents support the proposal.

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Discontinuing hedge accounting (Question 8)

30. Almost all respondents agree that hedge accounting should be discontinued prospectively when the hedging relationship (or part of the hedging relationship) ceases to meet the qualifying criteria (after taking rebalancing into account). However, many respondents do not agree that this should be the only time when hedge accounting is discontinued.
31. Many respondents believe voluntary discontinuation of hedging relationships is an important tool in dynamic hedging strategies. They believe that particularly in the absence of a macro model at this stage, entities should be allowed to voluntarily discontinue hedge accounting.
32. Some respondents have noted that something similar to voluntary discontinuation can be achieved depending on how granular the risk management strategy is made. For example, if the risk management strategy is documented at the level of each hedging relationship, the relationship can simply be discontinued by changing the risk management objective for the hedge relationship.
33. Some respondents have also commented that entities should be allowed to voluntarily discontinue hedge accounting when there is insufficient benefit to continue with such an administratively costly process. For example, in the case of a forecasted foreign currency cash flow. When that forecasted cash flow is invoiced, entities often want to discontinue hedge accounting. That is because the process of hedge accounting loses any incremental benefit, as foreign exchange movements will naturally offset in profit or loss. A few respondents noted that without the ability to choose to discontinue hedge accounting entities may be disincentivised to apply hedge accounting.
34. Some respondents have also commented that the restriction on allowing internal derivatives for hedge accounting increases the need to be able to voluntarily discontinue hedge accounting in order to achieve an accounting outcome that best reflects the entities activities. This is because entities need flexibility to proxy their 'real' hedging by identifying suitable external hedges. For financial

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institutions, the external hedges often result from a combination of different risk management approaches that results in a higher turnover of the external derivative portfolio compared to the internal derivatives. This requires a more frequent adjustment of the hedge designation in comparison to the actual risk management based on internal derivatives

35. Others have commented that it is an option to apply hedge accounting and therefore it should be an option to discontinue hedge accounting.

Accounting for fair value hedges (Question 9)

36. Many respondents agreed with the Board's proposal to differentiate between cash flow hedge accounting and fair value hedge accounting. However, a lot of respondents disagreed with the Board's proposed changes to the fair value hedge accounting mechanics. These comments can be summarised as follows:

- (a) Many respondents do not agree with the Board's extended use of OCI. They do not believe that there is a conceptual argument justifying the extended use of OCI. These respondents agree that it is useful to see the impact of the hedging activity in one place, however they believe that the same can be achieved by disclosing this information in the notes to the financial statements.
- (b) As the net impact on profit or loss is unchanged and the effective portion of the fair value hedge will fully offset in OCI some respondents questioned whether the incremental benefit to users would justify the costs of systems changes to implement these proposed changes.
- (c) Many respondents do not support the proposal to present the gain or loss on the hedged item attributable to the hedged risk as a separate line item in the statement of financial position. They believe that:
 - (i) this will result in a the statement of financial position looking cluttered.

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- (ii) the separate line item does not meet the definition of an asset or liability in accordance with the *Framework*.

(A lot of the respondents who made these comments suggested that as an alternative it would be better to present a single asset and a single liability that is an aggregate of the fair value hedge accounting adjustments and to provide a breakdown of these items in the notes to the financial statements. They noted that this would still enable users to see the unadjusted carrying amounts for the hedged items.)

- (d) However, a few respondents did welcome the separate line presentation. They commented that this reduces their burden to provide additional schedules to users of financial statements to show the effects of hedge accounting on the statement of financial performance.

37. Most respondents agreed that linked presentation should not be required and some agreed with note disclosure being used to provide this information. However, a few respondents (specifically from Korea) have commented that they disagree with the Board's decision not to allow linked presentation. They believe that linked presentation provides information that is more useful for users of financial statements.

Time value of options (Question 10)

38. Almost all who answered this question support the Board's intention of addressing the accounting of time value of options. They agree that the initial time value of the option is a cost associated with a hedging relationship and is better reflected as a form of insurance cost.
39. However, many have suggested modifications to the Board's proposals. A number of respondents believe that the proposals significantly add to the complexity of hedge accounting. The comments are summarised as follows:

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- (a) A few respondents request more guidance on determining when the time value of an option relates to a time period related hedged item or a transaction related hedged item.
- (b) Some respondents think that it is unnecessarily complex to have different treatments for the the time value of options and think they should be accounted for on the same basis (irrespective of whether they are time period related or transaction related). Generally, these respondents agree that the time value of the option reflects a cost of hedging and should be recognised in profit or loss over the life of the hedging relationship (as proposed for a time period related transaction).
- (c) Some respondents have requested clarification on the Board’s intention regarding the accounting for time value of options in the case of zero cost collars.
- (d) Some respondents noted that the interest element of forward and future contracts could be viewed as being similar to the time value of options. They request the Board to consider whether similar accounting requirements can be applied for interest elements in forward and future contracts.
- (e) Few respondents commented on the aligned time value proposal. However, those that did comment largely agreed with the Board’s proposal. A few respondents noted that it could be complex and potentially costly to determine aligned time value.

Eligibility criteria of groups of items (Question 11)

- 40. Respondents generally support the Board’s review of the eligibility of groups of items and net positions as hedged items. However, many respondents view this as a topic for the macro hedging discussions (financial and non-financial institutions). As a result, many respondents refrained from commenting on this topic in the absence of the proposals on macro hedging.

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41. However, a number of respondents that did provide comments disagreed with the Board's proposal that for cash flow hedges the offsetting hedged items must affect profit or loss in the same period. These respondents believe that this is inconsistent with the proposed objective of hedge accounting and that it significantly reduces the usefulness of being able to designate groups of items and net positions. Some noted that the frequency of an entity's interim reporting periods would affect how restrictive this requirement is, which they regarded as somewhat artificial.

Presentation in profit or loss for hedges of groups of items (Question 12)

42. Many respondents did not respond to this question for the same reasons they did not comment on question 11 (see section above). However, those respondents that did comment had mixed views on the proposal.
43. Some respondents agreed while others believed that the presentation would increase complexity and not reflect the risk management activities undertaken. The respondents that disagreed believe that this proposal requires inconsistent presentation depending on whether the hedged item is a group or a net position. They do not think this will result in useful information.
44. Some respondents said that there should be a choice to present amounts on a gross or a net basis so that they can present the amounts in the most informative manner.
45. Others have commented that they do not think the guidance on presentation is clear and would appreciate more application guidance to be able to apply these requirements consistently.

Disclosures (Question 13)

46. Almost all of the respondents agreed with the Board's objectives for hedge accounting disclosures. They believe that the proposed objectives would result in the provision of useful information to users of financial statements about an entities risk management activities.

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47. However, some concerns were raised about the proposed disclosure requirements. These comments are summarised below:
- (a) Many respondents raised serious concerns with respect to forward looking information that is required as part of the proposed disclosures. They believe it is inappropriate to require disclosure of future-related information.
 - (b) Many respondents have raised concerns regarding the commercial sensitivity of disclosing the hedged rates that the entity has locked itself into for future periods. They believe that entities that apply hedge accounting would be placed at a disadvantage to those that do not apply hedge accounting. This is because those that apply hedge accounting would have to disclose their hedged positions while those that do not apply hedge accounting do not have to provide any related disclosure.
 - (c) Some respondents commented that disclosures about how an entity manages risk in instances where hedge accounting has not been applied should also be required to provide users a holistic view of an entity's risk management activities.
 - (d) Some respondents think that the disclosure requirements are too extensive and add to a very extensive list of disclosures already required in IFRS 7 *Financial Instruments: Disclosures*. They think that the Board should reduce the number of proposed disclosures to only the most necessary and allow preparers to apply a greater level of judgement.

***Contracts for a non-financial item that can be settled net in cash as a derivative
(Question 14)***

48. Most respondents who commented on this proposal welcome the Board's proposal to amend the 'own use' exception in IAS 32 *Financial Instruments: Presentation* and IAS 39. They believe that this will allow entities to better reflect their business model and risk management activities.

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49. Many respondents raised concerns that the proposal mandated fair value accounting rather than it being an option. These respondents believe that there could be unintended consequences if the Board requires derivative accounting in these situations. They think it would be better to allow entities the choice of whether or not to apply the scope exception. They argued that this would be appropriate as hedge accounting is voluntary and also because it will also be more aligned to US GAAP.
50. Many respondents have also requested more guidance on whether fair value-based risk management strategy requires the entire business, or only part of a business, to be managed on a fair value basis.
51. Some respondents disagreed with the requirement that the net exposure should be maintained close to nil. They noted that an entity may choose to have a position and they did not understand why that should necessarily preclude derivative accounting. A few respondents requested a broader review of the ‘own use’ scope exclusion.

Accounting for credit risk using credit derivatives (Question 15)

52. Most of the respondents welcome the Board’s attempt to address economic hedging of credit risk with credit derivatives. However, the responses on this issue are mixed.
53. Some respondents believe that the alternatives the Board discussed will add too much complexity and that the Board should rather not pursue the issue further.
54. Some believe that none of the alternatives are appropriate, but that the Board should still strive to resolve the issue. Many noted that unless a solution is found to enable hedge accounting for credit risk entities will not be able to reflect their risk management strategy. The main comments made are:
 - (a) Some respondents believe that the principle for designating risk components are appropriate for credit risk as well. In other words, a credit risk component can be designated as a hedged item as long as it is separately identifiable and reliably measureable. These respondents

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believe that the Board should not introduce a rule that precludes hedging of credit risk components, but rather leave the principle so that entities can apply hedge accounting to credit risk components when they are considered to comply with the stated principle.

- (b) Similar to the risk component comment above, some respondents argue that the Board should consider the guidance in IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures*. In IFRS 9 and IFRS 7 the Board provided a ‘default’ method to measure the credit risk component. These respondents believe that it is inconsistent for the Board to separate credit risk under those standards but to preclude hedge accounting for it.

55. Very few respondents commented on which of the alternatives discussed by the Board to address credit risk they would prefer. Based on those that did comment, most seemed to prefer alternative three. However, most still expressed a preference for a hedge accounting solution.

Effective date and transitional requirements (Question 16)

56. Most of the respondents agree with the prospective application. However, some have noted that there might be scenarios where the Board need to consider the implications of such an approach (for example, comparative information with regard to presentation etc). Some respondents have also raised some concerns about transitional aspects with respect to classification and measurement and how that might influence the proposed hedge accounting transition requirements.
57. Many respondents agree that the hedge accounting proposals should only be adopted if all the existing IFRS 9 requirements are adopted at the same time or have already been adopted. However, some have mentioned that non-financial entities will be minimally impacted by the other phases of IFRS 9 and that early adoption without the other phases should be permitted.

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58. Many of the respondents indicated that they have provided views on the effective date in response to the Board's consultation on *Effective Dates and Transition Methods*. Most respondents think that an effective date of 2015 would be more appropriate.

Other comments

59. Many respondents made comments that were not in response to any specific question. These comments have been summarised by main themes as follows:

US GAAP convergence

60. Many respondents commented that both the IASB and the FASB should work towards a converged solution. Some respondents expressed the view that the FASB should consider the IASB proposals for incorporation into its final standard on financial instruments.

Eligible hedging instruments

61. Some respondents also asked the Board to provide additional guidance on the use of option as hedging instruments particularly in the context of using subsidised structures (collars, knock-in, and knock-out) as it is not clear from the exposure draft whether these instruments would qualify as hedging instruments.

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

62. Many respondents commented on the Board's prohibition with the regard to cash flows of components being larger than the cash flows of the entire item (this is more known for situations such as a sub-LIBOR interest rates).
63. Respondents note that this is an issue for financial and non-financial institutions. They believe that this prohibition does not reflect how entities manage risk. These respondents believe that the chance of having a price movement in the benchmark rate or similar component so as to result in an overall negative rate or price would likely be rare. Consequently, they do not think that the Board should preclude such situations from hedge accounting.

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64. A number of respondents also expressed concern if this restriction were to be retained in the macro hedge accounting proposals.

Internal derivatives

65. Many respondents commented that the Board should address the eligibility of internal derivatives for hedge accounting. They believe that prohibiting their use results in a disconnect between the accounting information and the entity's risk management activities.

Hypothetical derivatives

66. Some respondents requested that the Board provide more guidance on hypothetical derivatives and how they should be applied. These respondents ask for such guidance especially in the light of the rebalancing proposals. This is because it is unclear how hypothetical derivatives should be applied when entities have rebalanced hedging relationships. In particular, these respondents request guidance on how the hypothetical derivative should be designed at inception if the hedging derivative is not plain vanilla.

Macro hedging

67. Many respondents (especially but not only financial institutions) commented that the Board should address macro hedging as expeditiously as possible. Some commented that the Board should not finalise the general hedge accounting model until the macro model has been completed.
68. In contrast a few respondents said that they would like the general hedge accounting model to be finalised first.
69. Many respondents also expressed their concerns that some decisions in the general hedge accounting model will restrict the Board's ability to address macro hedging more comprehensively (for example the prohibition on layer components when contracts include prepayment options).

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Appendix – Invitation to comment**Invitation to comment**

- IN9 The Board invites comments on all matters in this exposure draft, and in particular on the questions set out in the following paragraphs. Comments are most helpful if they:
- (a) respond to the questions as stated.
 - (b) indicate the specific paragraph or paragraphs to which the comments relate.
 - (c) contain a clear rationale.
 - (d) describe any alternatives the Board should consider.
- IN10 Respondents need not comment on all of the questions and are encouraged to comment on any additional matters. However, the Board is not seeking comments on aspects of IFRS 7, IAS 39 or IFRS 9 not addressed in this exposure draft.
- IN11 The Board will consider all comments received in writing by 9 March 2011. In considering the comments, the Board will base its conclusions on the merits of the arguments for and against each approach, not on the number of responses supporting each approach.

Objective of hedge accounting (paragraphs 1 and BC11–BC16)

- IN12 This exposure draft proposes that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. This aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.
- IN13 The Board believes that an objective would be helpful in setting the scene for hedge accounting and to lay the foundation for a more principle-based approach. An objective also assists the understanding and interpretation of requirements.

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?

Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47)

- IN14 The exposure draft proposes that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss may be eligible for designation as a hedging instrument.
- IN15 The Board believes that extending eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems and be inconsistent with its decision not to allow hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income. However, the Board believes that extending eligibility to nonderivative financial instruments that are measured at fair value through profit or loss, if designated in their entirety, would not give rise to the need to change the measurement basis of the financial instrument. The Board also believes that extending eligibility to these financial instruments would align more closely with the classification model of IFRS 9.

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?

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Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)

- IN16 The exposure draft proposes that an aggregated exposure that is a combination of an exposure and a derivative may be designated as a hedged item.
- IN17 The Board believes that an entity is often economically required to enter into transactions that result in, for example, interest rate risk and foreign currency risk. Even though these two exposures can be managed together at the same time and for the entire term, the Board believes that entities often use different risk management strategies for the interest rate risk and foreign currency risk. The Board believes that the fact that an aggregated exposure is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude designation of that aggregated exposure as a hedged item.

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?

Designation of risk components as hedged items (paragraphs 18, B13–B18 and BC52–BC60)

- IN18 The exposure draft proposes that an entity may designate all changes in the cash flows or fair value of an item as the hedged item in a hedging relationship. An entity may also designate as the hedged item something other than the entire fair value change or cash flow variability of an item, ie a component. However, the exposure draft proposes that when an entity designates only changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component) that risk component must be separately identifiable and reliably measurable.
- IN19 The Board believes that it is not appropriate to limit the eligibility of risk components for designation as hedged items on the basis of whether the risk component is part of a financial or a non-financial item (as is the case in IAS 39). The Board believes that it is more appropriate to permit the designation of risk components as hedged items if they are separately identifiable and reliably measurable—irrespective of whether the item that includes the risk component is a financial or non-financial item. This would also more closely align hedge accounting with risk management. The determination of appropriate risk components requires an evaluation of the relevant facts and circumstances.

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 (ie 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?

Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)

- IN20 The exposure draft proposes that a layer component of the nominal amount of an item should be eligible for designation as a hedged item. However, a layer component of a contract that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk.
- IN21 Hedging a layer of the nominal amount addresses the fact that there may be a level of uncertainty surrounding the hedged item. The Board believes that designating a percentage component of a nominal amount as the hedged item can give rise to an accounting outcome different from designating a layer component of a nominal amount as a hedged item. If the designation of the component of a nominal amount is not aligned with the risk management strategy of the entity, it might result in less useful information to users of financial statements. In the Board's view there might be circumstances in which it is appropriate to designate as a hedged item a layer component of the nominal amount.

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- IN22 The Board believes that if the prepayment option's fair value changed in response to the hedged risk, a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how hedge effectiveness would be measured).

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?

Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75–BC90)

- IN23 The exposure draft proposes that a hedging relationship should meet the hedge effectiveness requirements as one of the requirements to qualify for hedge accounting. Those qualifying criteria are set out in paragraph 19.
- IN24 IAS 39 permits hedge accounting only if a hedge is highly effective, both prospectively and retrospectively. IAS 39 regards a hedge as highly effective if the offset is within the range of 80–125 per cent. The Board proposes to eliminate the 80–125 per cent 'bright line' for testing whether a hedging relationship qualifies for hedge accounting. Instead, the Board believes that an objective-based assessment would enhance the link between hedge accounting and an entity's risk management activities. The proposed hedge effectiveness requirements are that a hedging relationship:
- (a) meets the objective of the hedge effectiveness assessment (ie to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness); and
- (b) is expected to achieve other than accidental offsetting.

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?

Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)

- IN25 The exposure draft proposes that when a hedging relationship no longer meets the objective of the hedge effectiveness assessment but the risk management objective for that designated hedging relationship remains the same, an entity should rebalance the hedging relationship so that it meets the objective of the hedge effectiveness assessment again. When an entity expects that a hedging relationship might cease to meet the objective of the hedge effectiveness assessment in the future, it may proactively rebalance the hedging relationship.
- IN26 The Board believes that there are instances in which, although the risk management objective remains the same, adjustments are required to the existing hedging relationship to maintain the alignment to risk management policies. The adjustments to the hedged item or hedging instrument do not change the original risk management objective as stated in the documentation supporting the designation. The Board believes that in these circumstances the revised hedging relationship should be accounted for as a continuation of an existing hedge rather than as a discontinuation. The Board calls this adjustment rebalancing.

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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?

**Discontinuing hedge accounting
(paragraphs 24, B61–B66 and BC112–BC118)**

- IN27 The exposure draft proposes that an entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes when the hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). This may affect the entire hedging relationship or a part of it.
- IN28 The Board believes that hedge accounting should reflect an entity's risk management activities. Therefore, an entity should only discontinue hedge accounting when it no longer reflects the risk management strategy. Consequently, the Board believes that it is inappropriate for an entity 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 (after taking into account any rebalancing of the hedging relationship, if applicable).

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?

**Accounting for fair value hedges
(paragraphs 26–28 and BC119–BC129)**

- IN29 The exposure draft proposes that for fair value hedges, the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income. The ineffective portion of the gain or loss shall be transferred to profit or loss. In addition, the gain or loss on the hedged item shall be presented as a separate line item in the statement of financial position.
- IN30 The Board believes that the proposed accounting treatment:
- (a) eliminates the mixed measurement for the hedged item (eg an amount that is amortised cost with a partial fair value adjustment);
 - (b) avoids volatility in other comprehensive income and equity that some consider artificial;
 - (c) presents in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges); and

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- (d) provides information in the statement of comprehensive income about the extent of the offsetting achieved by fair value hedges.
- IN31 The Board also discussed linked presentation as an alternative for presenting information in the statement of financial position for fair value hedges. Linked presentation is a way to present information together in the statement of financial position to show how a particular asset and liability are related. Linked presentation is not the same as offsetting. This is because linked presentation displays the gross amounts together in the statement of financial position.
- IN32 The Board believes that although linked presentation could provide some useful information about a particular relationship between an asset and a liability, it does not differentiate between the types of risk that are covered by that relationship and those that are not. Consequently, linked presentation could result in one net amount for an asset and a liability that are 'linked' even though that link (ie the relationship) affects only one of several risks underlying the asset or liability (eg only currency risk but not credit risk or interest rate risk). Furthermore, the Board does not believe that linked presentation would result in more appropriate totals of assets and liabilities for the purpose of ratio analysis because the hedging affects only one risk but not all risks. Instead, the Board believes that disclosures about hedging would be a better alternative to provide information about the relationship between hedged items and hedging instruments that allows users of financial statements to assess the relevance of the information for their own analysis.

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?

Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67–B69 and BC143–BC155)

- IN33 In IAS 39 the undesignated time value of an option is treated as held for trading and is accounted for at fair value through profit or loss. The Board believes that this accounting treatment is not aligned with an entity's risk management activities. The Board noted that the time value of an option is a cost of obtaining protection against unfavourable changes of prices or rates.
- IN34 The exposure draft proposes that an entity should distinguish the time value of options by the type of hedged item that the option hedges: a transaction related hedged item or a time period related hedged item.
- IN35 The exposure draft proposes specific accounting requirements for the time value of an option when an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in the intrinsic value.

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Question 10

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

- (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 (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

**Hedges of a group of items
(paragraphs 34–39, B70–B82 and BC156–BC182)**

**Eligibility of a group of items as the hedged item
(paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)**

- IN36 The exposure draft proposes that a group of items is an eligible hedged item only if:
- (a) it consists of items (including components of items) that individually are eligible hedged items;
 - (b) the items in the group are managed together on a group basis for risk management purposes; and
 - (c) for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period (including interim periods as defined in IAS 34 *Interim Financial Reporting*).
- IN37 An individual hedging approach involves an entity entering into one or more hedging instruments to manage the risk exposure attributable to an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach. However, in a group hedge approach an entity seeks to manage the residual risk exposure from a group of items. Some of the risks in the group may offset (for their full term or for a partial term) and provide a hedge against each other, leaving the group residual risk to be hedged by the hedging instrument. An individual hedge approach and a group hedge approach are similar in concept, and so the Board believes that the requirements for qualifying for hedge accounting should also be similar. Consequently, the exposure draft proposes that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions are retained for cash flow hedges of net positions for which the offsetting risk positions affect profit or loss in different reporting periods.

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?

Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)

- IN38 The exposure draft proposes that for a hedge of a group of items with offsetting hedged risk positions that affect different line items in the statement of comprehensive income (eg in a net position hedge), any hedging

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instrument gains or losses recognised in profit or loss shall be presented in a separate line from those affected by the hedged items.

- IN39 For cash flow hedges of groups of items with offsetting risk positions (eg net positions) the hedged items may affect different income statement line items. Consequently, a cash flow hedge of such a group creates a presentation problem when amounts are reclassified from other comprehensive income to profit or loss. This is because the reclassified amounts would need to be grossed up to offset the hedged items effectively. The Board concluded that if it proposed to adjust (gross up) all the affected line items in the income statement the result would be the recognition of gross (partially offsetting) gains or losses that do not exist. This is not consistent with basic accounting principles. Consequently, the exposure draft proposes that amounts that are reclassified from other comprehensive income to profit or loss should be presented in a separate line item in the income statement for cash flow hedges of a net position. The Board believes that this avoids the problem of distorting gains or losses with amounts that do not exist.

Question 12

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

Disclosures (paragraphs 40–52 and BC183–BC208)

- IN40 The exposure draft proposes disclosure requirements that provide information about:
- (a) an entity's risk management strategy and how it is applied to manage risk;
 - (b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
 - (c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.
- IN41 The exposure draft also proposes that in the reconciliation of accumulated other comprehensive income in accordance with IAS 1 *Financial Statement Presentation*, an entity should provide sufficient detail to allow users to identify related amounts disclosed as part of the information to explain the effects of hedge accounting on the statement of comprehensive income. Furthermore, in the reconciliation of accumulated other comprehensive income, an entity should differentiate amounts recognised regarding the time value of options between transaction related hedged items and time period related hedged items.
- IN42 The Board believes that the proposed disclosures provide relevant information that enhances the transparency regarding an entity's hedging activities.

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?

Accounting alternatives to hedge accounting (paragraphs BC208–BC246)

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)

- IN43 The exposure draft proposes that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting shall apply to contracts that can be settled net in cash that were entered into and

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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.

- IN44 The Board believes that hedge accounting does not necessarily provide appropriate accounting for hedging relationships that include commodity contracts. Consequently, the Board proposes to amend the scope of IAS 39 to allow a commodity contract to be accounted for as a derivative in appropriate circumstances. The Board believes that this approach combines the purpose for a contract that can be settled net to buy or sell non-financial items (normally commodities) that are 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 and also how they are managed. This better reflects the contract's effect on the entity's financial performance and provides more useful information.

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 nonfinancial 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?

Accounting for credit risk using credit derivatives (paragraphs BC219–BC246)

- IN45 Many financial institutions use credit derivatives to manage credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer to a third party the risk of credit loss on a loan or a loan commitment. Hedges of credit risk might also reduce the regulatory capital requirement for the loan or loan commitment while allowing the financial institution to retain nominal ownership of the loan and the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (eg a facility for a particular client) or the bank's overall lending portfolio.
- IN46 However, financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item as a component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, it is operationally difficult to isolate and measure the changes in fair value that are attributable solely to credit risk for the purpose of hedge accounting.
- IN47 The Board considered three possible alternative approaches to hedge accounting when credit derivatives are used to hedge credit risk. Because of the complexities involved, the Board decided not to propose an alternative accounting treatment to account for hedges of credit risk using credit derivatives.

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?

Effective date and transition (paragraphs 53–55 and BC247–BC254)

- IN48 The Board proposes that the proposed requirements for hedge accounting be applied prospectively.

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Question 16

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