

ED/2010/13



Comment Letters
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

25 Farringdon Street
London
EC4A 4AB
Tel: +44 (0)20 3201 8000
Fax: +44 (0)20 3201 8001
DX: 1040 London/Chancery Lane
www.bakertilly.co.uk

8 March 2011

Dear Sirs

**Exposure Draft 'Hedge Accounting'
Invitation to Comment**

We welcome the International Accounting Standards Board's comprehensive review of the hedge accounting requirements and the opportunity to comment on the exposure draft.

We agree there is a need to reduce the rigidity and complexity of the current hedge accounting requirements in IAS 39 to appropriately recognise the transactions entities use to manage risk exposures in the business. We see the removal of the strict and rules-based criteria for assessing hedge effectiveness in IAS 39 as a positive step in achieving this, but ask the Board to consider additional criteria that link hedge effectiveness to the achievement of the risk management objectives.

We are in agreement with the majority of the Board's other proposals, including the alignment of hedge accounting with the entity's risk management activities, the criteria for discontinuing hedge accounting and the broadening of the types of hedging instrument and hedged item that may be designated in a hedging relationship.

However, we ask the Board to consider some amendments to the proposed presentation and disclosure requirements and we would welcome further implementation guidance to assist entities in applying new concepts, such as rebalancing and accounting for the time value of options.

Our responses to the questions raised in the exposure draft are set out in the Appendix to this letter.

Please contact my colleagues Donna Wilcox (donna.wilcox@bakertilly.co.uk) or Nicky Warburton (nicky.warburton@bakertilly.co.uk) should you wish to discuss any of the points raised in this response.

Yours faithfully

A handwritten signature in dark ink, appearing to read "John Hudson", with a long horizontal line extending to the right.

John Hudson
Head of Audit Technical
Baker Tilly UK Audit LLP



APPENDIX

ED/2010/13 Hedge Accounting Invitation to Comment

Question 1

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

We agree with the proposed objective as, in our view, the financial statements should provide information on how successful an entity's risk management activities have been in meeting its risk management objectives.

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 with the proposal and the Basis of 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 and concur with the reasons set out by the Board. However, we would ask the Board to clarify how the hedge accounting model would apply to such hedging relationships which under the proposals will incorporate more than one derivative instrument. In addition, we would ask the Board to include an illustrative example based on a similar example to that set out in BC50.

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?



We agree with the proposed criteria. In our view, a risk that is not separately identifiable is not capable of being managed and hence this condition is in line with the objective of aligning hedge accounting with risk management. We also concur that the effectiveness of a risk component cannot be assessed and recognised (i.e. hedge accounting cannot be applied) if the risk cannot be measured reliably.

Question 5

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

We agree as, in our opinion, the proposal is in line with the objective that hedge accounting should reflect risk management activities.

(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 with the proposal and the Board's conclusion that where the fair value of the prepayment option is affected by changes in the hedged risk a layer approach is tantamount to identifying a risk component that is not separately identifiable.

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 with the Board's conclusion that effectiveness should be forward-looking and based on expectations of hedge ineffectiveness and accidental offsetting.

Whilst we agree with the reasons for the objective of the hedge effectiveness assessment being to ensure that the hedging relationship will produce an unbiased result and minimise ineffectiveness, we ask the Board to consider an additional criterion which links effectiveness to the achievement of the risk management objective set out in the hedging documentation.

We support the flexibility provided by the continuation of the stance in IAS 39 not to specify a particular method for testing hedge effectiveness but to permit the alignment of methods with the characteristics of the hedging relationship. In our opinion, the requirement to document how hedge effectiveness will be assessed at the inception of the hedge restricts the ability of entities to use this "free choice" to manipulate effectiveness testing and, consequently, manage earnings.



We agree that qualitative assessments of hedging relationships based on a comparison of the critical terms of the hedging instrument and hedged item are appropriate in certain circumstances, principally when those terms match or are closely aligned as this reflects the assessments made by management when taking out hedging instruments.

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?

We support the objective to align hedge accounting with risk management and, therefore, agree with the conditions for rebalancing of the hedging relationship. However, we would ask the Board to consider developing implementation guidance to assist entities in applying this new concept.

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

We agree as we consider proactive rebalancing of the hedging relationship to be in line with risk management activities which are often proactive.

Question 8

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

We agree with the proposals and the conclusions reached by the Board.

(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 as we consider that discontinuing hedge accounting when the risk management objective and strategy is still met has an adverse effect on comparability within an entity.



We recognise and appreciate the Board's concerns that voluntary discontinuation of hedge accounting facilitates manipulation of the method of assessing hedge effectiveness. In our view, restricting the circumstances when an entity can designate a previously discontinued hedging relationship using the same hedging instrument and hedged item would address this concern. We would suggest that a restriction other than in the circumstances required for rebalancing would be appropriate.

Question 9

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

We agree as the Board's proposal facilitates the presentation of the net impact of the hedging activity. We also agree that the gain or loss on the ineffective portion should be transferred to profit or loss as this is in line with the recognition of fair value movements on derivatives that are not designated in a hedge relationship.

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

We do not agree with the proposal as a separate line item will add clutter and will potentially be confusing when a liability exists in respect of a hedged financial assets or an asset exists in respect of a hedged financial liability. We agree that information on the gain or loss attributable to the hedged risk is useful to users of financial statements but consider disclosure in the notes to the accounts to be more appropriate.

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

We agree. In addition to the points raised by the Board on only some of the risks underlying the assets and liability being hedged, in our opinion, linked presentation may also be misleading when only a portion of the hedging instrument or hedged item is part of the hedging relationship.

Question 10

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



We agree that the accounting treatment for the time value should be dependent on the nature of the hedged item and concur with the Board's proposals and the conclusions on which they are based. However, we would ask the Board to provide additional implementation guidance due to the additional layer of complexity introduced by these proposals.

(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?

See response to Question 10(a).

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

We agree with the proposals in principal. However, in our view, the additional information provided to users by separating the actual and aligned time value may not justify the complexity and cost of this approach. If effectiveness is linked to the achievement of the risk management objectives (as suggested in our response to Question 6) it would be reasonable to assume that the aligned time value and the actual time value would not be substantially different.

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 as the proposed criteria are in line with the objective to align hedge accounting with risk management and the criteria for an individual hedge.

We agree that, for cash flow hedge accounting, offsetting cash flows must arise in the same reporting period to avoid the deferral of gains and losses on forecast transactions where the hedged expected future cash flows have already affected profit or loss.

We also concur with the designating of a hedging relationship within a group that is a nil net position for the reasons set out by the Board in the Basis of Conclusions.

See our responses to Question 4 and Question 5(b) on the requirement for components to be separately identifiable and reliably measurable and the restriction on prepayment options being an eligible hedged item in a fair value hedge.



Question 12

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

We concur that the presentation of gains and losses should reflect the risk management strategy. Hence, we agree with the proposal to present gains and losses arising from hedges of net positions differently from those arising from gross positions to be appropriate for cash flow hedges.

We agree that this will be achieved by the presentation of gains and losses as a separate line item in profit or loss when the group of items has offsetting hedged risk positions, and as an allocation against the individual line items affected where hedged risk positions are not offsetting appropriately.

See our response to Question 9(b) on the presentation of separate line items in the statement of financial position.

Question 13

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

We agree, except for the additional disclosures suggested below. We also believe it is fundamental to users of financial statements that information is disclosed in one place and agree that this should be by cross-reference to other sections of the financial statements, where applicable, to avoid repetition of information.

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

Whilst we agree that the risk categories should not be prescribed, we believe further guidance on factors to consider when identifying risk categories would be useful. For example, by consideration of risks identified by the Board and managed separately.

The proposals do not require any explicit disclosures with regards to rebalancing even though such events provide relevant information about the entity's ability to react to unexpected causes of ineffectiveness and the financial effects on the entity. Therefore, we would ask the Board to consider adding additional disclosure requirements where an entity has rebalanced the hedging relationship.



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 for non-financial items and the Board's rationale for the proposed accounting set out in the Basis for Conclusions.

Question 15

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

We agree with the Board's conclusion.

(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?

See response to Question 15(a).

Question 16

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

We agree as we believe that retrospective application could be very difficult in practice.

We agree that existing hedging relationships which meet the hedge accounting criteria set out in the proposals should be accounted for as continuing hedge relationships. However, we recognised that it may be necessary for the entity to apply the rebalancing provisions to do so and would request that the Board clarifies whether rebalancing provisions can or cannot be used to determine whether an existing hedging relationship achieves the hedge accounting criteria in IFRS 9.