

INTERNATIONAL ACCOUNTING STANDARDS BOARD

E.D. HEDGE ACCOUNTING

CBI RESPONSE

MARCH 2011

I INTRODUCTION AND SUMMARY

1. The Confederation of British Industry (CBI) is pleased to respond to the Board's Exposure Draft.
2. The CBI welcomes and supports the efforts of the Board to develop a more principles-based approach to hedge accounting linked to a company's risk management strategy, and that hedge accounting should remain optional for reporting entities.
3. However, notwithstanding the principles-based approach, there remain instances where the Board proposes rules-type requirements involving excessive detail and complexity, such as in connection with the proposals for hedge accounting of net positions, mandatory rebalancing of hedge relationships, prohibition of voluntary de-designation of hedge relationships, and the accounting mechanics for fair value hedges. The Board should reconsider whether these exceptions to principles-based accounting are necessary. We do not believe that they are.
4. We also note that the focus of the proposed guidance remains financial institutions, and we believe that the Board should consider the proportionality and applicability of the proposals on non-financial institutions.
5. Similarly, the approach to disclosures should be more holistic and, in pursuing a principles-based approach, the Board should avoid those disclosures that are too detailed and inappropriate for many companies, or which are likely to involve the disclosure of commercially sensitive information. In addition, before IFRS 9 as a whole is finalised, the IASB should review the disclosures across each project phase as well as the existing disclosures in IFRS 7, and eliminate disclosures which do not provide useful information.
6. We look forward to further outreach and field testing by the Board in developing the final Standard.
7. We comment further below in response to the specific consultation questions.



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II RESPONSES TO CONSULTATION QUESTIONS

Question 1

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

We agree that an objective for hedge accounting should be set out, and we think we understand the intent of the Board in setting the objective.

However the proposed wording in the ED requires some adjustment.

Hedge accounting is not about risk management per se. It is a financial reporting method that is designed to enable entities to report the effects of their hedging strategy in their financial statements more clearly than would otherwise be the case.

We also note that the objective of hedge accounting in paragraph 1 of the ED restricts the use of hedge accounting to those risk exposures that affect profit or loss.

However, we strongly consider that investments in equity instruments at fair value through OCI should be eligible for hedge accounting if this is in line with the company's risk management strategy, and that any ineffectiveness on these instruments should be recognised in P&L.

We agree that, due to the complexities associated with hedge accounting, the use of hedge accounting should be voluntary.

We also agree that setting out an objective facilitates a principles-based approach but, as noted in this response, we do not consider that this is always reflected in some of the proposed provisions at various places in the ED.

INSTRUMENTS THAT QUALIFY FOR DESIGNATION AS HEDGING INSTRUMENTS

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?

Yes. If a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss is used for business hedging purposes, it seems reasonable that it is an eligible hedging instrument. It enables an entity to align its hedge accounting closer to its risk management objectives.

We also consider that there is no conceptual basis for excluding as eligible hedging instruments any non-derivative financial instruments that are not at fair value through profit or loss, even though such practice may be limited. That should not be a reason for excluding these instruments.

DERIVATIVES THAT QUALIFY FOR DESIGNATION AS HEDGED ITEMS

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 with the combination of an exposure and a derivative as a hedged item as this allows the accounting to reflect what is sometimes the most practical way to hedge the different risks that may exist in the underlying item.

In the context of raising funding in one currency and swapping it into a second currency a business may subsequently want to convert that second currency from fixed to floating (or vice versa) in which case, the ability to designate a derivative as the hedged item is most welcome.

However, we do not believe that restricting the qualification for hedge accounting to a combination of a derivative and the underlying exposure is necessary.

We are aware of situations in certain industries – for example, agro-processing – where the cost of sales components of executor purchase and sales contracts would be marked-to-market (and would be regarded as derivatives- see our response to Q.14) as part of a business's risk management strategy, and the variable price element of the sales contract would then be hedged. We are concerned that the proposals would not allow for hedge accounting of this latter hedging element.

DESIGNATION OF RISK COMPONENTS AS HEDGED ITEMS

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?

Yes. We agree that risk components should be eligible hedged items if the risk component is separately identifiable as, this reflects how risks are hedged in practice.

We also welcome the relaxation of the IAS 39 requirements relating to designation of risk components in non-financial items. In particular, this will enable companies to achieve hedge accounting where, for example, a risk component of a commodity contract is hedged.

Inflation

We support the more principles based approach to determining the risk components based on an evaluation of the facts and circumstances. However, we do not agree with the bright line that inflation cannot be designated as a risk component of a financial instrument unless it is contractually specified. Whilst it may be difficult to separately identify and reliably measure inflation as a risk component, an entity should be left to determine whether they can do this rather than including a separate rule in the standard. Furthermore, no such restriction exists for non-financial items which results in an inconsistency with the treatment for financial items.

Sub-LIBOR

Both IAS 39 and the ED restrict hedge accounting for interest-rate risk exposures at sub-LIBOR. This is an issue for financial institutions as hedging the sub-LIBOR component of an interest bearing financial asset or financial liability is a risk management strategy applied by banks. It is not clear why there are such restrictions, and perhaps the Board should explore this issue further.

DESIGNATION OF A LAYER COMPONENT OF THE NOMINAL AMOUNT

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?

Yes. This reflects commercial reality for companies who apply layer components in their risk management strategies.

(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?

No. We do not believe that there should be any such restriction.

At a portfolio level, it may be possible for some companies to separately identify and reliably measure the risk component, but this should be left to the business and not prescribed in the ED.

We suspect that the restriction is designed as an anti-abuse provision. However, such provisions should be a matter for the relevant regulator and the particular jurisdiction, not the standard setter.

HEDGE EFFECTIVENESS REQUIREMENTS TO QUALIFY FOR HEDGE ACCOUNTING

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 support the removal of the arbitrary 80-125% test that exists in IAS 39 and the move towards an objective-based approach to effectiveness testing. We also support the elimination of retrospective effectiveness testing. The removal of these provisions in the qualifying criteria will make hedge accounting available to a wider range of businesses and circumstances.

Paragraph 19(c) and paragraphs B27-B39 require that the hedging relationship meets the hedge effectiveness requirements. A clearer explanation of the objective of hedge effectiveness assessment in paragraph 19(c)(i) would be helpful, as well as more clarity around the references to "unbiased" result and "expected to achieve other than accidental offsetting".

There is a danger of a disconnect between the risk management view of hedge effectiveness and the accounting view, which could cause a departure from the objective to reflect a company's internal risk management in its financial statements.

We are also concerned about the timing and frequency of hedge effectiveness assessments.

Accordingly, we favour an approach that is more closely aligned with that applied to property, plant and equipment, and in particular impairments, as follows :

- Under the proposals, a hedge relationship can only be designated as such if it meets the entity's risk management strategy; assuming the strategy does not change, in our view there is no need to additionally review the effectiveness of the relationship unless circumstances indicate otherwise. This is analogous with the treatment of property, plant and equipment, which is recognised if it meets the recognition criteria and tested for impairment when there are triggering indicators.
- Once designated, the hedge relationship will be periodically reviewed to ensure that it continues to be aligned with the entity's risk management strategy, regardless of any requirements in the final standard, simply because risk management is an ongoing process. To additionally require period end assessments seems to us an unnecessary duplication. This is analogous with the requirement to review estimates such as useful economic lives only annually rather than at each interim reporting date.
- At each reporting date, hedge effectiveness and ineffectiveness must be measured and accounted for; it seems to us that if, at this point, hedge ineffectiveness is identified as being or becoming significant such that rebalancing will not be appropriate, this should be the trigger for reviewing whether, overall, the hedge relationship is expected to be effective. This is analogous to the impairment indicator (trigger) approach under IAS 36 Impairment of Assets.

If one of the aims of the Board is to encourage greater use of hedge accounting, we fear that many companies will continue to view the administrative burden of applying hedge accounting as being prohibitive. It would therefore be helpful if the Board could reconsider its approach to effectiveness testing in order to reduce this administrative burden.

REBALANCING OF A HEDGING RELATIONSHIP

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 agree with the introduction of the concept of rebalancing as it acknowledges that a company can and does make adjustments to a hedge without the need to discontinue and then re-designate a new hedge in order to achieve hedge accounting.

However we do not agree with mandatory rebalancing of hedging relationships. Whilst the exposure draft purports to align hedge accounting with risk management by removing the bright lines for hedge effectiveness, it has replaced them with mandatory rebalancing, an approach inconsistent with a principles-based objective. Rebalancing should be voluntary at the company's discretion and not compulsory.

We believe that an entity's risk management will reflect practical rebalancing, and therefore we do not believe mandatory rebalancing in the guidance is necessary. We would note that any ineffectiveness will flow through the profit and loss account.

Should mandatory rebalancing be retained, the accounting standard or the application guidance notes should provide comprehensive further details and examples of rebalancing.

(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?

Yes, voluntary proactive rebalancing should be permitted, as this will enable hedge accounting to follow a company's risk management where it anticipates a change in the effectiveness of a hedge.

DISCONTINUING HEDGE ACCOUNTING

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?

(a) & (b) No. Voluntary discontinuation should be permitted when this is in line with a company's hedge accounting strategy. This would enable the effects of an entity's hedging strategy to be reflected in the financial statements. For example, an entity may apply hedge accounting when an entity hedges future sales proceeds but stop hedge accounting at the point when the receivable is recognised on the balance sheet.

The Board's proposals for discontinuation would result in an inconsistency with an entity's dynamic hedging strategy, where hedge accounting is discontinued as and when appropriate; and with the Board's objective for hedge accounting.

ACCOUNTING FOR FAIR VALUE HEDGES

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?

No. We do not support the two-step approach for recognition of gains and losses in OCI and then a transfer of any ineffectiveness to the profit or loss account. We would prefer a one-step approach where any ineffectiveness is recognised immediately in profit or loss.

The two-step approach would result in additional line items on the face of the primary financial statement but is unlikely to add value to users. It would better appear as a footnote.

It would also be helpful for the Board to establish a principle for determining which items are presented on the face of the primary financial statements and which items should be presented in the notes.

(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?

(b) & (c) No. We agree that the hedged item should not be adjusted for the fair value gains and losses on the hedged items. The current adjustment that exists in IAS 39 today results in the hedged item being at neither amortised cost nor fair value which is not desirable. We believe that linked presentation is a more appropriate presentation method for fair value hedges as it better reflects the economic substance of the transactions. Where fair value hedge accounting is applied to a firm commitment, the change in fair value of the firm commitment is recognised on the balance sheet.

In our view, showing this as a separate balance sheet line item does not provide meaningful information, and adds complexity. It would better appear as a footnote. This not only reduces clutter on the face of the balance sheet, but also does not represent the item as a separate asset or liability in its own right, which it is not.

Linked presentation is a concept that has existed in UK GAAP for some time, in FRS 5 Substance of transactions. For hedge accounting purposes, application of a similar concept reflects the 'real' exposure to the hedged risk whilst still showing the gross amounts of the face of the balance sheet.

ACCOUNTING FOR THE TIME VALUE OF OPTIONS FOR CASH FLOW AND FAIR VALUE HEDGES

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 with the above as the timing of the profit and loss impact for the hedging instrument matches that of the underlying hedged item.

(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?

We agree with the above as it smoothes the profit and loss impact of the option's time value.

However clarification is requested of what amortisation methods are deemed acceptable on "a rational basis".

(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 assume that it is not necessary to consider aligned time value when the principal terms (i.e. notional, length of time, underlying) of the hedged item and hedging option exactly match. However this should be made clear.

Whilst we understand what the IASB is trying to achieve in calculating "aligned time value" we believe that very few companies will have the system capability or expertise to calculate this. Option valuation models do not present time value as a separate component and this will need to be calculated or outsourced at additional expense.

We also consider that the profit and loss impact is unlikely to be material between accounting for aligned time value and actual time value. The time value component of an option's total value is usually quite small relative to the intrinsic value. The proposal requires a considerable amount of work to calculate and account for the aligned time value and should only be performed for expected material differences, if at all.

HEDGES OF A GROUP OF ITEMS

ELIGIBILITY OF A GROUP OF ITEMS AS THE HEDGED ITEM

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 do not believe the proposals reflect reality. For example, forecast transactions (cash flow hedges) practically it would appear that for an average manufacturing company the foreign exchange risk in forecast sales and purchases cannot be hedge accounted on a net basis because they will typically impact the profit and loss in different periods – even when the cash flows are expected to be in the same disclosure period.

In any case, a forecast sales receivable cash flow impacts profit and loss when the sale is made, but a forecast purchase payable cashflow impacts profit and loss only when the manufactured item(s) is/are sold, which is dependent on the rate of stock turnover and divisibility of the product. One purchased quantity may go to make many finished product that may be sold over many periods, but which periods may not easily be tracked.

We consider that the ED has not gone far enough and should allow hedge accounting for sales and purchases, even if they impact the profit and loss account in different reporting periods .]

We understand that these proposals represent an intermediate step towards the development of an accounting model for hedges of open portfolios (i.e. macro hedges). However, until we have a better understanding of the Board's direction in respect of macro hedging, we are not able to comment on these proposals in detail.

At present, it is not immediately evident what the principle is underlying the resulting changes in the hedge accounting model, and outreach and field testing should be undertaken. There is a risk of replacing one set of complex, rules-based, requirements with another, and we look for a principles-based solution.

PRESENTATION

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 agree with the proposals regarding the presentation in profit or loss of the effects of hedge accounting for groups of items.

We disagree with the way gains or losses from fair value hedges of net positions are proposed to be presented. Rather than requiring presentation on a gross and disaggregated basis in the statement of financial position, we would recommend that all fair value changes be aggregated into a single item in the statement of financial position and to provide details in the notes.

DISCLOSURES

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 ?

(a) and (b)

No. We seek a principles - based approach to disclosures.

We support the disclosures which, as set out in paragraph 40 of the ED, provide information about a company's risk management strategy, its hedging activities and the effect of hedge accounting on the financial statements. However, there is an excess of detail required by Paras 44 -52 of the ED.

At the same time the disclosures focus on hedges where hedge accounting is applied. Whilst the scope of this ED is hedge accounting, there is presumably a need for some disclosure or explanation where derivatives are used for hedging but hedge accounting is not applied, if shareholders are to have a full understanding of a company's risk management strategy.

We also have concerns over the commercial sensitivity of the disclosures proposed in the ED. This arises from the amount of the quantitative information required for each type of risk and category of hedge. The requirement to disclose volumes of commodities, for example, is a problematic area.

If the IASB adopts a principles-based approach to disclosure, this will help mitigate against unnecessary and excessive detail and a one size fits all approach. Many companies in similar industries will face similar risks but address them in different ways, and companies in different industries will have different risks to face. Attempting to force comparability through detailed standardised could also clutter accounts with information of little or no use or relevance to shareholders in a particular company.

We also have a general concern that the Board is adding additional layers of disclosure in its proposals on hedge accounting, impairment and offsetting.

This increases the disclosure burden for companies and increases clutter in financial statements. Before IFRS 9 is finalised, the Board should review the disclosures across each project phase as well as the existing disclosures in IFRS 7, and eliminate those disclosures which do not provide useful information.

We are also concerned by the proposed requirements in paragraphs 42 and 45 that disclosure be provided of how the entity's hedging activities may affect the amount, timing and uncertainty of future cash flows for all categories of hedged risk to which *some* hedge accounting has been applied.

For example, suppose that an entity is exposed to commodity price risk, which it hedges but for which only some transactions or assets are hedge accounted for. Our reading of the proposals is that the forward looking disclosures are required for the entire risk category, rather than just those that are hedge accounted for.

It is not clear from the Basis for Conclusions if this was intended or not, and implementation guidance on this is not offered. We therefore assume and trust that this was an oversight and that the Board intended such disclosures to be required only for those items for which hedge accounting has been applied.

If, however, the Board did intend this interpretation, we would advise against it. For many businesses obtaining the information on such a scale would be prohibitively expensive and would discourage them from applying any hedge accounting, which runs counter to the Board's aim. In our view, disclosure should be restricted to those risks (rather than risk categories) to which hedge accounting has been applied.

ACCOUNTING ALTERNATIVES TO HEDGE ACCOUNTING

ACCOUNTING FOR A CONTRACT FOR A NON-FINANCIAL ITEM THAT CAN BE SETTLED NET IN CASH AS A DERIVATIVE

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 that, if it is in accordance with the entity's fair value-based risk management strategy, contracts should be accounted for as derivatives. However we do not believe the concession should be restricted to only those contracts that can be cash settled.

For example, an entity may undertake cost of sales risk management by balancing sales obligations (contracts), inventory and purchase commitments with cash-settled futures (utilised to secure price rather than supply). Allowing the sales obligations (which are unlikely to be cash-settled) to be accounted for as derivatives would result in more faithfully representative accounting than would be achieved under the current proposals.

ACCOUNTING FOR 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?

(a) & (b) No.

We support the principle that risk components should be eligible as hedged items. Using credit derivatives to manage credit risk is a common risk management strategy for financial institutions.

We do not believe that there should be an explicit prohibition on hedge accounting for credit risk. If an entity is able to demonstrate that a hedge is effective then hedge accounting should be permitted regardless of the type of hedge.

We acknowledge that it may be difficult to find an effective hedge for credit risk but this should be left to the company should determine rather than prescribed in the Standard.

There is also always the possibility of a new instrument developed in the future which provides an effective hedge for credit risk.

EFFECTIVE DATE AND TRANSITION

Question 16

Do you agree with the proposed transition requirements? Why or why not?

If not, what changes do you recommend and why?

Yes. We support prospective application as it is more practical.

We also propose an Effective Date of 1 January 2015, with earlier adoption permitted, at least in respect of a group of related Standards.

The Board will need to review transition requirements across the different phases of the IAS 39 replacement project to avoid inconsistencies in transition requirements.