

International Accounting Standards Board (IASB)
30 Cannon Street
London, EC4M 6XH
United Kingdom

8 March 2011

Dear Sir/Madam,

Re: Response to ED/2010/13 Hedge Accounting

Thank you for the opportunity to comment on the exposure draft on hedge accounting. The comments made below are my own views and do not reflect the views of current or previous employers, nor do they reflect the views of any professional organisations I am a member of.

I have laid out my responses to the individual questions below but in general the exposure draft has moved hedge accounting in a positive direction, and the attempt to align the accounting more closely with an entities risk management objectives is definitely the correct approach.

However, the main issue I have with regards to the exposure draft is in respect of the failure to review hedge accounting for internal management recharges. This element of the ED has been copied over directly from IAS39, seemingly without due consideration, despite the fact that many organizations management view this as being a valid exposure to hedge. The views of the IASB on this point should be reconsidered prior to finalizing the exposure draft to allow financial statements to be prepared more fully aligned with the way that an entities management views the entity.

Management recharges are, most often, simply a way for an organization to pass centrally incurred costs to its operating units as appropriate. These operating units will often have a different functional currency to the centre of an organization and therefore the recharge mechanism will create a foreign exchange exposure to some part of the organization. If the foreign exchange exposure sits with an entities operating units because the centre charges in their own functional currency then the cost of the management charges will vary with exchange rate movements. An entities operating units will seek to recover the variable management recharges through product sales. In the short term variability in management recharges will impact the profitability of operating units, but in the medium term the operating units will adjust product selling prices to recover the costs. It should be apparent therefore that hedging these exposures is a valid form of controlling risk and limiting volatility in operating unit profits.

Many entities take the approach that if an accounting standard does not allow their financial statements to adequately reflect their objective of a hedging strategy then, rightly or wrongly, the entity will not hedge the risk rather than accept volatility in the income statement. We should be mindful of our role as accountants when preparing accounting standards, and our role should not be to impose on an entities risk management and treasury functions what they can or cannot hedge.

Yours sincerely,
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Responses to specific 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?

Response:

This is a very sensible objective. The objective of hedge accounting should be to reflect in an entities financial statements the results of management efforts to mitigate risk in accordance with management intentions. However, this objective is not just limited to managing risks that impact profit or loss as the current ED suggests.

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?

Response:

I think this is acceptable. Management may choose to hedge a risk exposure with a non-derivative asset or liability. Permitting this designation would allow the financial statements to be more closely aligned with management intention.

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?

Response:

This is acceptable. If management have a reason for believing that viewing a combination of an exposure and a derivative is needed to achieve the risk mitigation objectives of the organization.

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?

Response:

This seems a very sensible approach. If the risk being hedged is not able to be reliably measured then management would be unable to confirm if the risk management objective is effective or not. Clearly then, hedge accounting should only be applied to a risk that can be separately 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?

Response:

(a)/(b) I agree with this approach.

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?

Response:

Yes. This seems to be a sensible approach.

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?

Response:

(a)/(b) The standard may need rewording to make the intentions clearer. However, assuming I interpret this correctly then this seems to be a correct approach and seems to be aligned with management practices regarding risk management. An organizations management continually assess the risk exposure and will adjust the hedging relationship as appropriate. To recognize rebalancing without it resulting in additional ineffectiveness would be the right move.

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?

Responses:

(a) This is the correct approach to take. If a hedge relationship no longer meets the qualifying criteria then hedge accounting should cease.

(b) I agree with this approach, if management risk management objectives are still being met then there should be no need for management to discontinue hedge accounting.

Question 9

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

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

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

Responses:

(a) No, I do not believe this is the correct approach. The gains or losses on the hedging instrument and hedged item in a fair value hedge should be recognized in either OCI or profit or loss depending on the nature of the item being hedged. The risk management objectives of management will often stem from a desire to minimize volatility in the income statement and therefore it seems inappropriate to force an entity to report these gains and losses in OCI and it would be misleading in respect of management intentions.

Management intentions are detailed sufficiently under the requirements of IFRS7 and there is no need to try to highlight the impact again within OCI.

(b) I think this is a sensible approach and will remove a source of misunderstanding in respect of the mixed measurement for the hedged item.

(c) Agreed, linked presentation would add no value as the hedge relationships are already disclosed under the requirements of IFRS7. Linked presentation would potentially create misunderstanding for users of accounts about what the entity is trying to achieve in 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?

(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?

Response:

The proposals seem reasonable.

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?

Response:

The proposal as it stands seems reasonable.

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?

Response:

No, this is not correct. Hedging a net position is often the correct approach to take by an entity and the gains/losses on hedging instruments should be grossed up to show the full impact on the correct lines of the income statement. If this is seen as too complex then hedge accounting should be applied only to an element of the net position as currently under IAS39.

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?

Response:

(a)/(b) Management intentions towards risk management are sufficiently detailed within the requirements of IFRS7 and existing Risk Management Disclosures. Additional information is likely to be commercially sensitive, onerous to produce and will result in disclosures so voluminous that they will be of use only to competitors.

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?

Response:

This seems acceptable.

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?

Response:

I think the third option is the most appropriate. While it is likely to be more complex the flexibility the option provides an entity seems appropriate.

Question 16

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

I agree partially. The new standard should be applied prospectively as this is the simplest approach, it would be a very complex issue to apply retrospectively and would result in restatement of prior years accounting results. However, to require adoption for 1 January 2013 seems too soon. The cost of redesigning and rebuilding accounting systems should not be underestimated and more time should be allowed for entities to prepare.