



Setting the global standard for investment professionals

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Re: Comment Letter on Hedge Accounting

Dear Sir David and Ms. Seidman,

The CFA Institute¹, in consultation with its Corporate Disclosure Policy Council (“CDPC”)², appreciates the opportunity to comment on the International Accounting Standards Board’s (“IASB”) Exposure Draft (“IASB Exposure Draft” or “IASB ED”), *Hedge Accounting*, and the Financial Accounting Standards Board’s (“FASB”) Discussion Paper, *Selected Issues About Hedge Accounting* (“FASB Discussion Paper” or “FASB DP”), collectively referred to herein as the Hedging ED and DP. The IASB and FASB are collectively referred to as the Boards.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

¹ With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 106,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 94,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners’ perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

Summary of Position

Before finalizing a hedging project, we urge the Boards to address the following concerns:

- 1) Conceptual Basis for Proposal – The conceptual foundations for the IASB hedging standard are tenuous. Such foundation relies upon an ill-defined concept of “risk management strategy” which lacks connection to the fair representation of assets and liabilities and the increased use of other comprehensive income (which has also yet to be defined). This lack of foundation in the conceptual framework means that preparers and auditors will likely struggle to reach common answers resulting in widely disparate interpretations.
- 2) Degree of Change Needed – The Boards have not reached consensus regarding the need for such extensive changes in hedge accounting. Resolution of this fundamental difference of opinion regarding the need to overhaul hedge accounting is necessary before proceeding further on this specific project and seems integral to the overall objective of convergence.
- 3) Investor Preferences – Many investors, including CFA Institute, have consistently recommended increased use of fair value measurements. Increased use of fair value measurement would reduce the need for hedge accounting yet the IASB is proposing an expansion of hedge accounting instead.
- 4) Lack of User Benefits – In addition to concerns noted above, there are few benefits and many issues for investors/users, including that the proposed standard:
 - relies heavily on management intent;
 - utilizes ill-defined concepts of “risk management strategy” and other comprehensive income;
 - may provide a mixed message to users regarding risks being managed;
 - expands the use of hedge accounting;
 - allows nearly unlimited choice in classification and measurement;
 - increases complexity and reduces transparency;
 - increases flexibility in effectiveness assessment and masks potential ineffectiveness;
 - decreases comparability;
 - inappropriately accounts for the time value of options and results in a piecemeal approach to executor contracts;
 - fails to increase disclosures sufficiently relative to increased complexity of hedging allowed;
 - results in little ability to truly assess the economic effect of hedging outcomes;
 - will not eliminate pro-forma disclosures;
 - may be misused to manage earnings.
- 5) Potential Interpretations and Lack of Auditability & Enforceability – As presently written, the IASB ED can be so broadly interpreted that we do not believe it produces principles for addressing hedge accounting which preparers can apply consistently and users can widely understand and accept as decision-useful. The IASB needs to consider in its redeliberations, the ability of the proposed standard to be effectively interpreted, implemented, audited and enforced given its lack of foundation in the conceptual framework.
- 6) Time Needed for Developing Quality, Highly-Technical Standards – This standard is as complicated and complex as nearly any the Boards create. We are concerned about rushing this standard and the issues and consequences it may create upon implementation. We note that the present timeframe would be aggressive in normal times, much less in the current rush toward converging a range of other highly-complex standards. We urge the Boards to proceed carefully and more deliberately to ensure proper due process. Importantly in this context, the totality of the IASB ED proposal must be holistically considered in terms of its impact and interplay with other standards such as impairment and insurance contracts yet to be completed



Organization of Our Response & Efficiency of Hedging Standard Development

We are submitting one response to both Boards because we believe this is the most efficient means of providing feedback. Separate requests for comment at separate stages of development are inefficient for all stakeholders to the standard setting process – particularly at this time when there is such a significant volume of input being requested. We have organized our comment letter around responding to the IASB ED rather than the FASB DP. Where we believed appropriate, comments relative to the FASB DP have been considered and included.

We have provided three comment letters in the last two and one-half years where we have addressed hedging issues from the investors' perspective as follows:

- August 2008 comment letter in response to the FASB's Exposure Draft, *Accounting for Hedging Activities: An Amendment to FASB Statement 133, Accounting for Derivative Instruments and Hedging Activities*.
- September 2008 comment letter to the IASB in response to their Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*.
- September 2010 comment letter in response to the FASB's Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

The IASB is now proposing a major change to hedge accounting – with limited time remaining in the convergence timeline – and investors and other stakeholders are being requested to comment on the IASB ED and the FASB DP. This amounts to five requests for input on hedging issues in just over two years. This is not an efficient means of standards development as responding to highly complex subjects such as hedging is a time consuming undertaking.

Further, as described below, the Boards continue to seek input from stakeholders without themselves having reached a consensus regarding whether a major change in, and expansion of, hedge accounting would result in more transparent and decision-useful information for investors.

Responsiveness to Investor Interests

Investor Feedback on Reducing Complexity in Reporting Financial Instruments

Our review of the handful of investor comment letters submitted in response to the IASB Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, found that most investor respondents requested additional use of fair value and increased rigour around the permissibility of hedge accounting (i.e. restriction rather than expansion of hedge accounting.) The increased use of fair value was seen as a means to better explain risks and to reduce the need for hedge accounting.

Accessibility of Exposure Draft to Users

Despite dealing with one of the most complex accounting concepts, neither the IASB ED nor the education efforts have attempted to convey the proposals in a user-friendly fashion. The proposals are presented using accounting parlance rather than language, diagrams or illustrations which convey the meaning of the changes to users and their consequences on the financial statements of those engaging in hedge accounting. We have found outreach to be limited and, when done, presented in a way that is highly technical and lacking in accessibility to the user community because the flexibility, broader economic meaning and implications of the proposed standard are not emphasized. In addition, the short comment and due process period is a disservice to users as it provides limited time to absorb and analyze such substantive changes to such a complex subject. We believe that the accelerated schedule for redeliberation of the proposal has resulted in the process being abbreviated to such an extent that questions raised have not been able to be answered.

Further, no aspects of the alternative view are included in formal presentations. The alternative view, which has considerable merit, is buried deep within the basis of conclusions document. The alternative view perspectives are very instructive in understanding the changes proposed and their meaning.

Without outreach activities to users which move beyond the accounting parlance to the substance, meaning and consequences of a proposed standard, the IASB cannot expect to receive user feedback which is meaningful to the development of a proposed standard with such accounting complexity.

IASB Needs to Demonstrate Proposal's Benefit to Investors &

Proposal's Ability to Meet Objective of Financial Reporting (Investor Primacy)

We do not find investors calling for a standard which allows broader and more liberal application of hedge accounting and which permits its use to alter the IASB's classification and measurement of financial instruments. Rather, our research indicates that users find hedge accounting and disclosures to be confusing, difficult to understand and low in quality. We would be interested to hear how the IASB's outreach to users allows them to conclude that this proposal will benefit users.

We believe the IASB should consider whether any empirical evidence exists to demonstrate that investors will benefit from this standard. Perceived benefits need to extend beyond simply saying that investors want to understand the risk management strategies of an entity. If the underlying accounting reflects economic reality, then hedge accounting is not needed to enable investors to understand the risks associated with a financial instrument.

If financial reporting standards are to be developed with the objective of providing more decision-useful information for investors, it is unclear to us how the IASB could conclude that this standard meets this objective as more fully described below. If investor interests are not paramount, the Boards' mandates and conceptual frameworks should be modified to reflect their lack of primacy.

Investor Interests Should Be Priority in Redeliberations

We urge the IASB to consider investor input in their redeliberations on this project. As presently articulated, we believe that the IASB ED is quite likely detrimental to investor interests. Given our concerns, and those expressed by other users, we urge the IASB to reconsider pursuit of this project. Resources should be allocated



to higher priority projects (e.g. revenue recognition) and this proposal deferred until appropriate time and attention can be devoted to resolving its complexities and considering its usefulness to investors.

Convergence

Fundamental Differences of Opinion on the Degree of Change in Hedge Accounting Required

The Boards seem to have fundamental differences of opinion on the level of change needed. The IASB appears to believe a significant overhaul of hedge accounting guidance is required whereas the FASB believes only certain strategic changes are necessary. This fundamental difference has yet to be resolved and the IASB ED has widened the divide between the proposed U.S. GAAP and IFRS hedge accounting guidance.

Converged Solution Should Not Be Developed By Stakeholders

Our view is that the current process of issuing competing standards places the onus of comparing the U.S. GAAP guidance and proposed IFRS guidance and determining the best global solution on the shoulders of the stakeholders rather than the IASB working toward a converged solution with the FASB. As published, the IASB ED and FASB DP do not readily facilitate a comprehensive comparison of the differences between the U.S. GAAP and IFRS proposals and their respective changes from historical guidance. Comparison of the two proposals to determine what would be the most decision-useful to investors is not an exercise that users as a group will undertake on their own. The Boards need to work together to facilitate and communicate the differences in their proposals and the impact of those differences on financial statements to enable users (and other stakeholders) to more thoughtfully comment on which proposal provides the most decision-useful information. Convergence should not be achieved by stakeholders picking one proposal over another.

Boards Must Work Together

If the objective of the 2006 Memorandum of Understanding is convergence, then we have seen little action on the part of the IASB to work toward this goal on the hedging standard. It is our view that no final standard should be issued by either the IASB or FASB without a joint solution. The Boards must work jointly to finalize an approach on hedge accounting. By working together the Boards will be better able to solicit user input which will more appropriately inform the debate regarding the usefulness of this proposed standard. Such input can then be weighed against the flexibility and benefits this proposal provides to preparers.

Benefits to Users are Questionable

We consider hedge accounting to be an anomalous accounting construct whose primary purpose is to enable reporting entities to minimize earnings volatility resulting from the use of derivatives and differences in recognition (e.g., fixed price executory contracts) and measurement (e.g., derivatives measured at fair value while financial assets or liabilities measured at historical cost). The IASB ED, however, proposes that the objective of hedge accounting is to represent the risk management activities of an organization. Articulating “representation of risk management activities” as the hedging objective appears to bestow a conceptual justification for hedge accounting. In addition, we don’t understand how the IASB can provide a conceptual justification for hedge accounting prior to defining the purpose of other comprehensive income. In other words, from a conceptual standpoint, the IASB should articulate why the reporting of volatility through other comprehensive income is preferable to its reporting through the income statement. In addition, the conceptual objective should explain the improvement provided by hedge accounting in representing and measuring assets and liabilities of an organization. We find the absence of either of these discussions to be an indication that the proposal lacks conceptual merit. Consequently, we question how comparable solutions to questions not specifically addressed by the standard can be achieved as the standard itself is not rooted in principles that derive from the conceptual framework.

We agree with the alternative view that the benefits to users of the IASB ED are questionable. To reiterate our previous comment, if financial reporting standards are to be developed with the objective of providing more decision-useful information for investors, it is unclear to us how the IASB could conclude that this standard meets this objective.

We have responded to the specific questions set forth in the IASB ED in **Appendix A**. We summarize below our view that the IASB ED does not improve the information provided to investors:

- 1) *Overreliance Upon Management Intent and Ill-Defined Risk Management Terminology* – We do not concur with the belief that accounting should depend on business strategy, with the accounting objective being to reflect risk management. Such an approach is antithetical to the objective of generating comparable financial statements as it engenders reporting that is highly subjective and based on managerial intent that is not comparable across entities, between jurisdictions, and over time even for the same management team. Management intent does not change the value of a financial instrument to an entity. Nor should management intent affect the balance sheet recognition or measurement of assets or liabilities.

As articulated in the alternative view, as currently understood, ‘*risk management is not defined, it has no boundaries and is not applied uniformly.*’ We agree with the alternative view as we too find no definition of risk management in the existing IFRS accounting literature. Our experience is that risk management can be defined very differently among, and even within, organizations, and risk management can be stated at varying degrees of specificity, disaggregation or aggregation within and between organizations. What constitutes a change in risk management strategy (and what can be used to justify a change in the accounting under the proposal) is highly dependent upon the specificity with which the risk management strategy was originally defined.

In our view, using a concept which has not been well defined, and which can be stated in very broad or general terms, to alter the recognition and measurement of specific financial instruments as well as non-financial assets and liabilities is not appropriate. Therefore, we believe the IASB is premature in its use of this ill-defined “conceptual” construct as a basis of an accounting approach. This is especially a concern when it has an impact on accounting for derivatives instruments, as these are laden with significant economic risk and have a history of misapplication by many preparers.

Overall, we strongly agree with the alternative view expressed in the IASB ED. The alternative view suggests the retention of a high threshold for financial assets and liabilities to qualify for what amounts, under the existing conceptual framework, to be an exception to the customary accounting model.

- 2) Model May Create Mixed Message to Users Regarding Risks Being Managed – We would like to be clear that our support for the alternative view is not equivalent to saying that an understanding of an entity’s risk management strategy – and how it has been implemented – is not important. Some seem to suggest that not basing accounting on intent, or what is now being more popularly referred to as “business strategy based” accounting, is equivalent to indicating that an enterprise’s strategies to identify and manage risks are not important to investors. This is not the case. We just do not believe that the ill-defined notion of a “risk management objective”, or other intent-based measurements, should be used as a means to alter the accounting for a financial instrument (or a non-financial asset or liability). Our view is that reflecting the hedged position at fair value along with the hedging instrument at fair value through net income and allowing users to see any ineffectiveness – along with supplementing this accounting with effective disclosure which connects and explains the underlying risk and how it has been economically hedged or not hedged for accounting purposes – is the most effective method of portraying the economics of such transactions.

Further, we are concerned that this proposal may actually convey a mixed message to users regarding risk management activities because of the optionality with which hedge accounting may be applied. The model allows – but does not require – risks being managed to be designated (and their measurement basis altered) in hedge accounting relationships. As such, the standard may imply to users that if a risk is being managed, hedge accounting will be sought; however, there are risks which may be managed where management chooses not to seek hedge accounting and there will be important risks (such as inflation and credit) which will not be subject to the proposed standard’s provisions. Under the recognition, measurement and disclosure provisions of this standard, such risks (that is, those not hedged) will not be communicated or disclosed to the same degree. This ability to selectively choose to apply hedge accounting will result in lack of comparability among organizations and possibly connote to users that risks which are not in hedge accounting relationships are not being managed.

We would also observe that the users of the financial statements are not just interested in the risks being managed and hedged. They are equally, if not more, interested in the risks not being managed or hedged because of the very fact that those risks are unhedged and because generally the risks hedged are those which can be most easily and cost effectively hedged.

- 3) *Inappropriate Expansion of Hedge Accounting* – The utilization of a risk management hedging strategy objective combined with the:
- a) low effectiveness threshold,
 - b) ability to use non-derivative financial assets and liabilities as hedging instruments,
 - c) creation of hedged items by aggregating derivative and non-derivative exposures,
 - d) option to designate risk layers and components as hedged items,
 - e) introduction of the concept of “nil net positions,”
 - f) ability to hedge groups of items,
 - g) capacity to regularly rebalance hedging relationships, and
 - h) discontinuance of hedging relationships when risk management strategies change;

will all act in concert to expand the use of hedge accounting and circumvent the classification system of IFRS 9 while at the same time decreasing the transparency of the presentation of the hedging results by reflecting them in other comprehensive income.

Informing investors about risks and risk management or mitigation techniques can be accomplished without increasing the use of hedge accounting – which is an accounting rather than an economic construct. We do not find any evidence that investors believe that an expansion in hedge accounting would better portray the risks of financial instruments. Rather, we find they prefer increased fair value accounting which would reduce the need for hedge accounting. As noted above, the risk management objective seems to be a justification for accounting based on management intent rather than economics. The IASB ED will make hedge accounting the norm, rather than the exception as is noted in the alternative view.

Our recent study of users’ views regarding hedge accounting disclosures found that users were not highly satisfied with the portrayal of hedge accounting results through existing disclosures. Most users found the disclosures confusing and our review found that the compliance with and quality of the required hedging disclosures was low. For further description of our findings see the disclosure section of **Appendix A** and the chart in **Appendix B**. The proposed disclosures seem intended to improve the quality of hedging disclosures, but relative to the increased volume and complexity of hedging which will result from the IASB ED they will fall far short.

- 4) *Free Choice in Classification and Measurement* – The factors which increase the ability to apply hedge accounting as articulated above will also have the effect of enabling all financial assets and liabilities, and portions thereof, to be reflected using whatever financial statement measurement management chooses. Management simply has to develop a loosely defined risk management strategy, with only minimal effectiveness, and with the ability to modify at will based upon a change in the strategy and the classification and measurement of financial assets or liabilities can be changed. Examples of how free-choice will result in superseding existing IFRS requirements are as follows:
- a) Designating cash instruments in a nil net hedging relationship will enable a company to alter the accounting for the cash instruments without having met the hedge accounting requirements – had this exception in Paragraph 39 not been allowed. This provision will enable management to change the accounting for a cash instrument in its entirety, or in portions, and to switch the measurement through a similar change in the articulation of risk management strategy. Substantively, the third category of fair value through other comprehensive income can be created and earnings managed with even greater flexibility than exists under existing requirements.
 - b) Expanding hedge accounting to include the ability to hedge debt securities carried at amortized cost contradicts the reasoning in IFRS 9 for the amortized cost category to begin with, that is, the objective of the entity’s business model is to hold the financial asset to collect the contractual cash flows rather than to sell the instrument prior to its contractual maturity to realise its fair value changes.

- c) Complex financial instruments not subject to amortized cost accounting under IFRS 9 (i.e. they must be accounted for using fair value through profit and loss) can be designated in a hedging relationship and their changes will be reflected in other comprehensive income rather than profit and loss.
- d) Designation of a foreign currency denominated cash instrument in a hedging relationship will allow the foreign currency provisions of IAS 21 to be circumvented and the foreign exchange component to be reflected in other comprehensive income rather than in profit and loss.
- e) IFRS currently restricts the election of the fair value option to the inception of an instrument, whereas the hedging standard will allow such fair value optionality throughout the life of the instrument.

This “free choice” will unequivocally diminish comparability. We also fear, moreover, that it will be used to decrease transparency of risk exposures and manage earnings.

- 5) *Increased Complexity* – We believe that the expanded use of hedge accounting and the complexity of the type of hedge accounting permitted under the IASB ED (aggregated exposures, net exposures, nil net positions, partial exposures, use of non-derivatives as hedging instruments, and so forth) will increase complexity for investors.

It appears paradoxical to suggest that such complex hedging can be accomplished – and changes in measurements so precisely parsed, measured and managed to achieve hedge accounting – while at the same time claiming that fair value accounting is not relevant or reliable as the primary measurement basis for all financial assets and liabilities. One must conclude that fair value measurements are not complicated, irrelevant or unreliable when management chooses to hedge them

The alternative view rightly notes *“that the significant effort to link hedge accounting to risk management decreases complexity for preparers but increases it for users because it results in considerable free-choice accounting to change recognition and measurement requirements in other IFRSs.”*

- 6) *Lack of Robust Method for Assessing Effectiveness* – We are concerned by the absence of a robust and consistently understood criterion for determining initial and continuing eligibility for hedge accounting. We acknowledge that rigid, bright-line tests (e.g. 80-125%) that are used in the high effectiveness assessment under IAS 39 may have led to distortions in the assessment of economic hedge effectiveness by issuers. However, the proposed qualitative criteria of “unbiased and other than accidental offsetting” is neither sufficiently robust, well understood by stakeholders, nor an acceptable alternative to existing requirements which require a higher threshold for achieving this exception-based accounting. The IASB ED proposes to establish this effectiveness assessment on an entirely forward-looking and qualitative basis (noting that a quantitative assessment might be necessary in certain situations). In our response to Question 6 in **Appendix A**, we more fully articulate our specific concerns regarding the effectiveness objective and criteria.

Overall, it is our view that this new definition of hedge effectiveness lacks rigour and that users will be unable to make judgments on whether legitimate hedging relationships are in place and to assess whether they are, in fact, effective. This concern is exacerbated by the inadequate levels of disclosure regarding the entity-specific judgments for determining hedge effectiveness. There are no disclosure requirements that enable users to judge whether preparers have in fact entered into unbiased hedging relationships (i.e. avoiding systematic under-hedging), despite the significant incentive for preparers to under-hedge so as to avoid recognising hedge ineffectiveness through profit and loss for cash flow hedge accounting pairs. We do not believe that the disclosures are sufficiently comprehensive to enable an investor to pro-forma out the effects of hedge accounting on the balance sheet or profit and loss statement. Further, there are no disclosure requirements regarding the requirement or need to rebalance hedging relationships or adjust hedge ratios.

We strongly believe the IASB needs to go back to the drawing board on this aspect of the proposed standard and develop a robust, qualitative assessment framework for making hedge effectiveness judgments. Creating such a definition or framework is necessary so as to ensure consistent and comparable accounting within and across reporting entities. As it stands, this proposal might reduce the number of effective economic hedges that fail to qualify for hedge accounting; however, it will also likely increase the number of inappropriately designated hedging relationships. This will simply lead to a different type of mis-classification and one that results in users underestimating rather than overestimating the risk exposures. Given the latitude that underlies many of the hedge accounting provisions, we question whether ineffectiveness will ever be captured by the proposed accounting.

- 7) *Ineffectiveness May Not Be Appropriately Reflected in Profit and Loss* – Under the IASB ED hedging ineffectiveness may not be appropriately reflected in net income when hedging a portion of a financial instrument. Because the proposed standard does not require the hedged and unhedged portions to be independent and priced separately, basis risk may be inappropriately considered an unhedged portion and not reflected in profit and loss. (See response to Questions 4 & 5 in **Appendix A**). The proposed standard allows portions of risks with financial instruments to be separated and hedged without significant guidance regarding how the portions are “separately identifiable” and “reliably measurable.” Separable identifiable seems to be equal to separately describable and, without more significant rigour regarding these definitions, they can be customized to the related hedging instrument and any hedge effectiveness eliminated.

Our view is that rebalancing will also act to minimise future ineffectiveness and convert ineffectiveness in the hedging relationship over time to the price of the underlying risk being hedged. We understand that ineffectiveness is measured just prior to rebalancing; however, the act of rebalancing on a frequent basis, based upon a proactive assessment, will mitigate ineffectiveness. This lack of ineffectiveness will have the effect of communicating to financial statements users that an effective constraining or offsetting of the risk has occurred. Only over time, as the price of the underlying risk rises (or declines) because of the rebalancing will users have any chance of seeing that hedging was not as effective as they originally believed because of the lack of ineffectiveness observed. In our response to Question 7 in **Appendix A** we raise this issue as it relates to rebalancing and we also articulate our concerns with respect to rebalancing more broadly including its impact of changing the meaning of hedging risk to managing risk and its impact on the discontinuance of hedging relationships.

- 8) *Decreased Transparency Regarding Fair Value Hedging Through Increased Use of Other Comprehensive Income* – The purpose of other comprehensive income is yet to be resolved at a conceptual level. Therefore, the belief that it is preferable to report derivatives gains or losses, as well as some of the changes in fair value of hedge items, through other comprehensive income rather than the income statement is simply part of the trend toward exception accounting for items that the IASB considers controversial. Other comprehensive income is being used to avoid income statement volatility without distinguishing whether such volatility is artificial or economic. Other comprehensive income has been and is used here as a holding bin for gains or losses that fail to meet the definition of an asset or liability. We are concerned that the IASB is mandating an even greater use of other comprehensive income by now requiring its use to report fair value hedge accounting gains or losses.

We believe that users as a group are in favour of eliminating the reporting of gains and losses on cash flow hedges in other comprehensive income (given the often inappropriate deferral of cash flow hedging losses on forecasted transactions) rather than expanding the population of gains and losses that are reported through other comprehensive income such as proposed for fair value hedges in the IASB ED. We agree that greater consistency between cash flow and fair value hedge accounting is necessary; however, that consistency should be achieved through changing cash flow hedge accounting not fair value hedge accounting.

- 9) *Decreased Comparability* – We agree with the alternative view that the relaxation of the effectiveness test, together with the expansion of hedge accounting in reliance on an articulation of risk management, is not an improvement in financial reporting. With the ability to alter the accounting for virtually any financial asset or liability or combination or partition thereof, as well as non-financial items, it is unlikely that investors will be able to make comparisons between entities. Further, as we have highlighted previously, anchoring hedge accounting in an entity's risk management strategy may inappropriately convey to investors which risks are, or are not, being hedged based upon an accounting election. This will, at best, create a significant lack of comparability and may miscommunicate the nature of risks being managed. Overall, we believe the IASB ED represents "free-choice" accounting that will diminish consistency and comparability and complicate the investment decision-making process.
- 10) *Inappropriate Accounting for the Time Value of Options* – We disagree with the proposed accounting for the time value of options since it adds complexity and lacks appropriate disclosures. We also question whether this accounting treatment benefits investors.

We agree with the alternative view that the capitalization of time value for transaction based hedges will result in the deferral and recognition of expense in a period beyond the hedging period. We do not believe that time value should be capitalized – even in a time period based relationship – unless it can be recouped. The IASB inappropriately analogizes time value to insurance premiums. Insurance premiums are considered prepaid assets because, if the contract is cancelled, the insurance premiums can be recovered from the insurer.

- 11) *Piecemeal Approach to Addressing Executory Contracts* – The IASB ED proposes that contracts to buy non-financial items – which are typically accounted for as normal purchases and sales – be reflected as derivatives if they are managed on a fair value basis. This effectively extends the fair value option by recognizing the fair value changes of selected executory contracts immediately based on an organization's asserted risk management strategy. Existing fair value hedge accounting currently eliminates earnings volatility for such arrangements as the hedged item (the executory contract) and the derivative are both reflected in the financial statements if fair value hedge accounting is applied. The IASB asserts that this existing fair value hedge accounting and the discipline it provides are "burdensome" and "less meaningful" than fair value accounting. Substantively, the proposal permits election of a fair value option if the executory contract is managed on a fair value basis. Otherwise, the executory contract will not be reflected in the financial statements until the normal purchase or sale has been completed.

This proposal is emblematic of the trend towards allowing desired accounting outcomes to shape accounting rules. It amounts to a piecemeal approach to addressing executory contracts and one that is lacking in internal consistency across different standards. For example, we have asked that the Boards address all executory contracts in a holistic fashion (e.g. in lease accounting and revenue recognition proposals) and the Boards have declined to do so. However, in this case, due to the anchor to an ill-defined risk management objective, the IASB is prepared to address a sub-set of executory contracts so as to avoid the "burden" of an available hedge accounting solution. In addition, while we agree with the IASB that fair value accounting is more meaningful than elective hedge accounting, we believe that it is the appropriate measurement attribute for all financial contracts. We are disappointed that the IASB embraces fair value accounting only selectively to respond to preparer requests rather than holistically to serve investor interests.

- 12) *Disclosures Insufficient Given Increased Complexity and Management Intent Bias* – Given our view that hedge accounting is an artefact of an anomalous recognition model, a flawed mixed attribute measurement basis of accounting and a conceptually unfounded application of other comprehensive income, we necessarily place more emphasis on the disclosure requirements as they are the only means by which users can understand the risk management activities that entities undertake. The stated objective of the proposed

disclosures is the top-down portrayal of risk management activities; however, they do not go far enough in explaining the aggregation, netting and linkages associated with the various hedging strategies being proposed nor do they address the cash flow statement impacts of derivatives used. The disclosures are not nearly sophisticated enough to portray the complex hedging which will be allowed under this proposal. Further, the disclosures assume that users are interested only in hedged risks even though in many cases the risks hedged by derivatives are those that are most easily and cheaply hedged.

The alternative view in Paragraph AV 15 is correct in stating that: "...it would be impossible for users to understand the effects of risk management activities without extensive disclosures of the fair value and changes in fair values in their entirety and the carrying amount and changes therein for assets and liabilities and firm commitments that were the subject of any hedge accounting."

It is our view that the disclosures proposed do not sufficiently articulate the risks and the hedging activities undertaken. The disclosure requirements are highly principles based and very broadly articulated. The resulting disclosures will likely be very generic given the complexity of the underlying risk management strategies undertaken by most firms. We are concerned by the lack of specificity in the requirements. Illustrative, but not all inclusive, examples of disclosures which are important, but have not been included in the proposal, are as follows:

- a. There are no disclosures regarding risks which are being managed by management but where hedge accounting has not been elected and why. Also, there are no disclosures regarding risks which management has chosen not to hedge and why. If "risk management" is the underlying principle upon which the standard is predicated, then disclosure should address all risks, not just those risks that management has chosen to apply hedge accounting to. Decisions not to apply hedge accounting or not to manage a particular risk are a part of the risk management strategy, and should be a required element of the disclosures. Investors are equally, if not more, interested in unhedged risks and their economic consequences.
- b. There are no disclosures required regarding how hedge effectiveness is assessed (e.g. quantitatively or qualitatively), how ineffectiveness is measured, or how hedge ratios are established.
- c. There are no disclosures regarding the requirement, or election, to rebalance and the impact of such rebalancing actions on hedge ratios or hedge accounting relationships.
- d. There are no disclosures required regarding the discontinuation of hedging relationships during the reporting period.
- e. The disclosure requirements are written in a way that does not seem to acknowledge that the IASB ED allows portions of instruments along with groups of items and net positions to be hedged (or allows cash instruments in themselves to be used to form nil net positions of which portions may be hedged). The IASB ED disclosures seem to suggest that the entirety of instruments on an individual basis (i.e. rather than as groups or net positions) will be hedged. We do not find the disclosure requirements sufficiently specific to accommodate the complexity of the hedge accounting practices permitted.
- f. The examples provided in Paragraphs IE1 to IE3 illustrate that though hedged items are organized and associated by risk in one table and hedging instruments are organized and associated by risk in another table, there is no linkage of the hedging instruments and hedged items by risk in a way that enables one to understand their combined impact on profit and loss and other comprehensive income. Without greater connection of the hedging instruments and hedged items, in association with their risks, and their presentation in the financial statements, it will be difficult for users to understand the tactics implemented to manage the strategic risks and the effectiveness of this management, let alone try to contrast these with other entities. Users are most interested in a "with" and "without" analysis of the impacts of hedging activities.
- g. There are no disclosures which enable users to understand how the application of elective accounting treatment alters the measurement of assets and liabilities and of profit and loss. For example, the use of cash instruments as hedging instruments or the introduction of the nil net position provision provides multiple means to circumvent the IFRS 9 classifications of financial assets and liabilities such as

enabling debt and equity securities to be carried at fair value through other comprehensive income. As another example, companies are provided the option to begin amortizing the effects of fair value hedges of financial instruments immediately or to wait until the hedge is terminated. If the latter alternative is elected, users should be informed of the amount of gain or loss that is being deferred. In addition, it should be made clear to users that while the fair value hedge of a fixed rate instrument would be expected to create variable interest, if the latter option is elected, that is not case. Because of the ability to delay the earnings impact of the adjustment, we are concerned that this has and will continue to result in cherry picking of gains and losses.

Further, some have suggested that the disclosures are sufficiently detailed to allow users to reverse the effects of hedge accounting and see the impacts of the financial statements without hedge accounting. We are not convinced all elements will be sufficiently disclosed to achieve this “with and without” analysis, but we are certain there will not be sufficient detail to allow users to understand the impacts of specific strategies as the requirements are very generic and there is no required linkage of the hedged item and hedging instrument.

We would also like to note that we do not believe that the disclosures required by Paragraph 46 are forward-looking information that cannot be included in the financial statements. These are not projections of future events but reflections of application of managements’ risk management strategy upon which they have altered the classification and measurement of financial instruments. If management can sufficiently assert these matters to change the accounting, they can provide these disclosures to users.

Our view is that the disclosure proposals are not likely to yield disclosures that are useful to investors, especially as they provide issuers’ leeway to avoid providing the level of disclosure that would be meaningful and informative to users. Our experience with prior disclosure requirements for hedging activities suggests the result will be boilerplate rather than entity-specific disclosures that truly explain the effects of hedging on the financial statements.

- 13) *Little Ability to Assess Hedging Outcomes* – Overall, we question whether users will have the ability to assess the overall effectiveness of the hedging of economic risks under the IASB ED. The disclosures will not provide sufficient insight regarding the specific risks and the aggregation, netting, partitioning, and the like which has occurred. Further, because of the lack of rigour in effectiveness testing along with the likelihood that hedge ineffectiveness will not always be measured there is minimal chance that users will be provided with a clear and complete picture of the hedging of economic risks of the enterprise. For example, managers will now be able to allocate basis risk to unhedged portions. In addition, they will also have the ability to rebalance demonstrably ineffective relationships.
- 14) *Revising Hedge Accounting Will Not Benefit Users By Eliminating Pro-Forma Disclosures* – Some have suggested that the IASB ED will better reflect management’s risk management strategy and eliminate the preparation of pro-forma information provided outside the financial statements which management believes better reflects their risk management practices. There is no demonstrable evidence to support this claim.

We agree that there is a vacuum in current risk reporting and pro-forma information is sometimes provided to investors. However, this vacuum does not justify the erroneous marketing of hedge accounting as the panacea that will, or is absolutely necessary to, shed light on entity’s risk management activities. Accordingly, positing that investors should settle for either pro-forma, voluntary management disclosure or an inappropriately expansive hedge accounting regime is a false choice. Hedge accounting in itself is neither necessary nor sufficient to allow users to have a full understanding of economic risk exposures, risk transformation, risk management and risk management effectiveness.

Users want reporting of entity wide risk exposures, risk management activities and risk transformation to understand the nature of an entity's activities and risks and management's mitigation of such risks. They want to know the entity's risk profile "with and without" hedging activities, so as to assess the underlying business risk profile and thereafter the impacts of any risk transformation activities.

The notion that hedge accounting will eliminate pro-forma disclosure because it will better communicate risk management activities in the financial statement is not accurate because: a) hedge accounting is optional and some entities will not apply the elective treatment and still provide pro-forma information; b) users don't simply want to see hedge accounting activities they want to see gross risks and the transformation of the risks which the disclosures in the proposed standard do not provide; c) users really need better risk reporting irrespective of hedge accounting and until this is included in the financial statements along with the impacts of hedged and unhedged risks investors will request such information and management will prepare pro forma information when it makes the entity look better.

- 15) *Ability to Manage Income* – The optionality and latitude provided within the IASB's ED with regard to when something may or may not be designated in a hedging relationship; when a hedge accounting relationship may be rebalanced; and when a hedging relationship may be discontinued; combined with the different measurement and classification of the related financial instruments, portions of financial instruments, which corresponds to the application or discontinuance of hedge accounting provides enormous flexibility for companies to manage income. This is of significant concern to investors.

Interpretation and Implementation of Standard

While we understand the IASB seeks to write principles-based standards. A principle is not a principle if it cannot guide or regulate conduct or practice or establish a standard means of doing something. A principle must also be widely understood and accepted to produce a result, practice or behaviour. Only then can it (i.e. a principle) be a reasonable guide to financial statement preparation and interpretation. As presently written, the IASB's proposed standard can be so broadly interpreted that we do not believe it produces principles for addressing hedge accounting which preparers can apply consistently and users can widely understand and accept as decision-useful. The comment letters received by the IASB illustrate these interpretation issues. If the IASB seeks to issue a standard which is subject to diverse interpretation, then we believe that implementation guidance should be issued to illustrate the application of these concepts. We also believe that field testing should be done to test the viability of these concepts, answer application questions, and assess their ability to produce decision-useful information for investors. We would also highlight that with such flexibility incorporated into the proposed standard – and with such breadth of interpretation possible under the proposed standard – that there appears little ability for auditors to audit and regulators to enforce differing interpretations of the standard or practices which may be harmful to investors. The IASB needs to consider, in its redeliberations, the ability of the proposed standard to be effectively interpreted, implemented, audited and enforced given its lack of linkage to the conceptual framework.

Timing and Ability to Develop Quality Standard

We are concerned about the amount of time being allowed to carefully consider this proposed standard and the issues and consequences it may present or create upon implementation. Presently, there are approximately nine months (or less) between issuance of the Exposure Draft and release of a Final Standard and six months (or less) between receipt of comment letters and release of a Final Standard. While we do not believe the quality of a standard should be measured by how long it has been deliberated, hedging is highly complex accounting which requires time to review, comprehend, perform appropriate outreach, and consider implementation issues. The totality of the proposed standard's impact needs to be holistically considered and other standards such as impairment and insurance contracts need to be completed to understand overlapping implementation and application issues.

We note that the present timeframe would be aggressive even if nothing else was on the Boards' or stakeholders' agendas. We believe the due process on this standard is being hurried and short-changed. As an example, there are no roundtables proposed to be held on this highly complex topic – a topic which could alter all of the other decisions made under recognition and measurement standard as well as impairment proposal – and this proposal has an expected issuance date before other projects with exposure drafts released prior to this proposal. We question why a "last-in first-out" strategy is being employed in the development of this proposal and, as noted previously, we believe that the accelerated schedule for redeliberation of the proposal has resulted in the process being abbreviated to such an extent that questions raised have not been able to be answered.

Overall, we do not believe the proposed timeframe allows for a thorough understanding of the proposals for IFRS and certainly not as a replacement for U.S. GAAP given the divergence on underlying classification and measurement issues. We believe the IASB's time frame for issuing this standard presents a significant risk to the development of a high-quality standard.

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If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, PhD, CFA, by phone at +44.207.531.0763 or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht

Kurt N. Schacht, JD, CFA
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Gerald I. White, CFA
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

Responses to Specific Questions

Objective of Hedge Accounting & Reliance on Risk Management (Question 1)

Hedge Accounting is an Accounting Construct & Risk Management is Not An Appropriate Conceptual Justification

The IASB ED proposes that the objective of hedge accounting is to represent the risk management activities of an organization. Articulating “representation of risk management activities” as the hedging objective appears to bestow a conceptual justification for hedge accounting. However, we consider hedge accounting to be an anomalous accounting construct whose primary purpose it to enable reporting entities to minimise their derivatives-related earnings volatility due to differences in recognition (e.g., fixed price executory contracts) and measurement (e.g., derivatives measured at fair value while financial assets or liabilities measured at historical cost). In addition, we don’t understand how the IASB can provide a conceptual justification for hedge accounting prior to defining the purpose of other comprehensive income. In other words, from a conceptual standpoint, the IASB needs to demonstrate that the reporting of volatility through other comprehensive income is preferable to its reporting through the income statement.

We question how comparable solutions to questions not specifically addressed by the standard can be achieved as the standard itself is not rooted in principles that derive from the conceptual framework. Further, the lack of foundation in the conceptual framework means that the preparers and auditors will be unable to reason to common answers that are not specifically laid out in the standard as there are no fundamental principles that constrain interpretations.

Intent Based Accounting is Not Appropriate - Particularly When Intent is Based Upon Ill-Defined Risk Management Terminology

Another concern for investors is the trend of increased application of accounting approaches that are based on managerial intent and the concomitant high level of subjectivity that will arise from these approaches and how these will effectively reduce the comparability in the accounting of economically similar, if not identical, financial instruments. This tendency of ingraining a higher degree of managerial intent as a basis of performance reporting is evident through various recent standards, including the application of business model as a criterion for determining the classification and measurement approach of different financial instruments; the determination of impairment based upon a “good book vs. bad book” demarcation; and now the use of this ill-defined and conceptually insufficient “risk management strategy” to justify hedge accounting. Management intent does not change the value of a financial instrument to an entity. Nor should management intent affect the recognition and measurement of assets or liabilities.

Risk Management Lacks Definition

As articulated in the alternative view, as currently understood, ‘*risk management is not defined, it has no boundaries and is not applied uniformly.*’ We agree with the alternative view as we too find no definition of risk management in the existing IFRS accounting literature. Our experience is that risk management can be defined very differently among, and even within, organizations, and risk management can be stated at varying degrees of specificity, disaggregation or aggregation within and between organizations. For example, is the risk management strategy sufficiently stated as to “manage interest rate risk” or does it need to be specified as to “hold fixed rate liabilities and creating floating rate assets in a rising interest rate environment?” Still further, what constitutes a change in risk management strategy (and what can be used to justify a change in the accounting under the proposal) is highly dependent upon the specificity with which the risk management strategy was originally defined.

In our view, using a concept which has not been well defined, and which can be stated in very broad or general terms, to alter the recognition and measurement of specific financial instruments as well as non-financial assets and liabilities is not appropriate. Therefore, we believe the IASB is premature in its use of this ill-defined “conceptual” construct as a basis of an accounting approach. This is especially a concern when it has an impact on accounting for derivatives instruments, as these are laden with significant economic risk and have a history³ of misapplication by many preparers.

Not Supporting Risk Management Justified Hedge Accounting Is Not Equivalent to Indicating That Understanding Risks & How They Are Managed Is Not Important

We would like to be clear that our support for the alternative view is not equivalent to saying that an understanding of an entity’s risk management strategy – and how it has been implemented – is not important. Some seem to suggest that not basing accounting on intent, or what is now being more popularly referred to as “business strategy based” accounting, is equivalent to indicating that an enterprise’s strategies to identify and manage risks are not important to investors. This is not the case. We just do not believe that the ill-defined notion of a “risk management objective”, or other intent-based measurements, should be used as a means to alter the accounting for a financial instrument (or a non-financial asset or liability). Further, we are concerned that this provision in conjunction with other provisions of the IASB ED which: a) require nothing more than “other than accidental effectiveness” to qualify for hedge accounting, b) result in a reduction in the transparency and recognition of ineffectiveness, c) increase the ability to hedge portions of risks without consideration of the residual portion of the financial instruments, and d) extend the use of other comprehensive income, will increase hedging which users already find highly complex and confusing, increase the complexity of what can be hedged and with what instruments, decrease transparency regarding the accounting and its effects on the nature of the risks an entity is exposed to, and decrease comparability across organizations.

Our view is that reflecting the hedged position at fair value along with the hedging instrument at fair value through net income and allowing users to see any ineffectiveness – along with supplementing this accounting with effective disclosure which connects and explains the underlying risk and how it has been economically hedged, or not hedged for accounting purposes - is the most effective method of portraying the economics of such transactions.

Model May Create Mixed Message to Users Regarding Risks Being Managed

Further, we are concerned that this proposal may actually convey a mixed message to users regarding risk management activities because of the optionality with which hedge accounting may be applied. The model allows – but does not require – risks being managed to be designated (and their measurement basis altered) in hedge accounting relationships. As such, the standard may imply to users that if a risk is being managed, hedge accounting will be sought; however, there are risks which may be managed where management chooses not to seek hedge accounting and there will be important risks such as inflation and credit which will not be subject to the proposed standards provisions. Under the recognition, measurement and disclosure provisions of this standard, such risks (that is, those not hedged) will not be communicated or disclosed to the same degree. This ability to selectively choose to apply hedge accounting will result in lack of comparability among organizations and possibly connote to users that risks which are not in hedge accounting relationships are not being managed.

³ The risks are exemplified by a number of high-profile cases of derivatives related corporate losses in the 1990s – Banc One, Procter and Gamble, Gibson’s Greetings and Baring Bank. More recently, Enron, Reliant Energy, Encana Corporation, China Aviation Oil and South African Airways have suffered derivatives related losses and recently Italian municipalities being faced with the prospects of massive interest rate swaps derivatives related losses.

We would also observe that the users of the financial statements are not just interested in the risks being managed and hedged. They are equally, if not more, interested in the risks not being managed or hedged because of the very fact that those risks are unhedged and because generally the risks hedged are those which can be most easily and cost effectively hedged.

Objective & Definition of Hedge Accounting Are Being Changed

Under IAS 39, hedge accounting recognized the offsetting effects on profit or loss of changes in the fair value of the hedging instruments and hedged item (Paragraph 85 of IAS 39). Under the IASB's ED, the objective of hedge accounting is now to represent in the financial statements the effect of an entity's risk management activities which manage exposures from particular risks that could affect profit or loss. The revised approach aims to convey the context of hedging instruments in order to allow insight into their purpose in effect. (Paragraph 1 of the IASB ED)

Substantively, the IASB is changing the commonly understood definition and meaning of hedge accounting. Under IAS 39 "hedge accounting" connoted to users the idea that a risk had been constrained or offset. Under the revised proposal, hedge accounting is really "management of risk accounting" where risks are not necessarily achieving offset or being constrained at the time the hedging relationship is established but being managed over the time the hedging relationship is in place. We understand that hedge effectiveness as articulated in Paragraph B27, emphasizes the notion of offsetting; however, the concept of assessing effectiveness while considering the ability to rebalance as specified in Paragraph B28 is an illustration of how risks are being "managed" over time rather than "offset" at the inception of the relationship as under the previous guidance.

Summary

Overall, we strongly agree with the alternative view expressed in the IASB ED that calls for a high threshold for asset or liabilities to qualify to what amounts to, under the existing conceptual framework, to be an exception to the customary accounting approach. The combination of a number of flawed provisions in the IASB ED based on an ill-defined 'risk management objective' will lessen the governance and capital market oversight over the use, or misuse, of derivatives by reporting entities.

Use of Nonderivative Financial Assets and Financial Liabilities as Hedging Instruments (Question 2)

In principle, we understand that non-derivative financial instruments can be, and are, used for risk management by reporting entities, and therefore should be considered for hedge accounting purposes. However, we reiterate the concerns that we severally express throughout this and previous comment letters, regarding the qualification for and application of hedge accounting, and the fact that it may allow managers to mislead investors on their risk management effectiveness. The concerns include:

- The reduced threshold to qualify for hedge accounting;
- The proposal to allow rebalancing for hedges when they fail to meet the hedge effectiveness tests in subsequent assessments;
- The deferral of fair value hedge accounting items through the other comprehensive income and consequently the increased application of other comprehensive income prior to establishing a conceptual basis for its use;
- The insufficient disclosure requirements that do not go far enough in explaining to users the aggregation, netting and rebalancing of exposures.

These concerns influence our reservations regarding the extended application of hedge accounting method to a broader universe of financial instruments beyond derivatives. We also concur with the alternative view expressed in the IASB ED that these provisions could simply provide a means to circumvent

existing classification and measurement requirements. A loosely defined hedging strategy is all that is needed to alter the classification and measurement of a financial asset to effectively achieve fair value through other comprehensive income classification.

Also, while the proposal would restrict the use of cash instruments as hedging instruments to those that are at fair value through profit and loss, the expansion of hedge accounting to “nil net positions” in which the components of the nil net positions are hedged *items* versus hedging *instruments* circumvents that restriction.

Hedged Items Represented By Aggregating Derivative and Non-Derivative Exposures (Question 3)

As stated in our response to Question 2, we are concerned about the application of hedge accounting to a broader universe of items. Similarly, we have reservations about the eligibility for hedge accounting of synthetically aggregated exposures that are based on underlying derivative and non derivative exposures. This is due to the inadequately specified criteria to ensure that aggregation of similar risk exposures is being determined consistently across reporting firms. There is also strong likelihood that economically equivalent financial instruments will end up being accorded differing accounting treatment as a result of the aggregation process. In addition, aggregation provides another way of circumventing the fair value through profit and loss recognition requirement of derivatives and provides one means to hedge a derivative with a derivative, and this will likely result in structuring by reporting entities so as to avoid portraying real economic volatility associated with derivatives use.

In addition, we question how the gains and losses of the hedging instrument will be associated with the changing gains and losses or cash flows of the aggregated exposures if those aggregated exposures are dynamic (vs. static) which produces a need to associate the changes in the hedging instrument with the exposures leaving the group (i.e. though this proposal deals only with closed portfolios this association will be necessary because items will be leaving the group or changing over time.) We also do not support the extension of hedge accounting to a “dynamic” grouping of assets and/or liabilities.

Designation of Risk and Layer Components as Hedged Items (Questions 4 & 5)

In past comment letters we have expressed our reservations regarding bifurcation of specific risk categories. This was due to the often very poor or non-existent disclosures that are necessary to allow users to differentiate between hedged versus non-hedged components. Further, the value of the hedged and un-hedged components of an instrument can be interdependent, making it inappropriate to have differentiated treatment for different portions of the same instrument. As expressed in the IASB ED's alternative view, there are in fact provisions within the IASB ED that will create latitude for the non-recognition of ineffectiveness arising from basis risk; for example, when a hedged item is a portion that is either not contractually specified or a portion that is inferred. This could then result in the interdependence between the hedged portion and unhedged portion being ignored which may result in the basis risk being misleadingly categorised as an unhedged portion. This has the impact of hedge ineffectiveness being ignored⁴ because the proposed standard allows portions of risks with financial instruments to be separated and hedged without significant guidance regarding how the portions are "separately identifiable" and "reliably measurable." Separately identifiable seems to be equal to separately describable and without more significant rigour regarding these definitions, they can be customized to the related hedging instrument and any hedge effectiveness eliminated.

These provisions of the IASB ED that allow for eligibility of specific risk categories and portions of hedged items will simply increase structuring opportunities. These concerns can be extended to designation of the layer component of hedged items and, therefore, we do not support their eligibility as proposed by the IASB ED. However, we concur with the IASB ED position that the prepayment option of a layer component should not be eligible for hedge accounting.

⁴ For example, consider an entity hedging the copper component of brass using a copper forward contract. The price of brass consists of copper, zinc and conversion costs. The price of brass will also be affected by the value of the zinc component and this could be offset by the value of the copper component. Nevertheless, the copper component and copper forward contract may be categorized as an effective hedge and the mismatch between the zinc component and the overall price of brass be ignored.

Hedge Effectiveness Being Other Than Accidental (Question 6)

We are concerned by the absence of a robust and consistently understood criterion for determining initial and continuing eligibility for hedge accounting. We acknowledge that rigid, bright-line tests (e.g. 80-125%) that are used to make a high effectiveness assessment under IAS 39 may have led to distortions in the assessment of economic hedge effectiveness by issuers. However, the proposed qualitative criteria of “unbiased and other than accidental offsetting” is neither sufficiently robust, well understood by stakeholders, nor an acceptable alternative to existing requirements which require a higher threshold for achieving this exception-based accounting. The IASB ED proposes to establish this effectiveness assessment on an entirely forward-looking and qualitative basis (noting that a quantitative assessment might be necessary in certain situations). We would make several specific observations regarding the hedge effectiveness objective and assessment set forth in the IASB ED:

- 1) **Unbiased Result** – Some appear to have interpreted “unbiased result” and “minimise expected hedge ineffectiveness” in Paragraph B29 to mean that the hedging relationship must be perfectly effective. However, the last sentence of Paragraph B29 indicates that perfect effectiveness is not what is required to qualify for hedge accounting under this proposal. As such, it is difficult to see how some have reached this interpretation. Further, we understand the wording in Paragraph B29 and Paragraphs BC81 and BC82 to mean that the hedging relationship is not to be established with the intention of systematically over or under-hedging, and creating or accepting additional ineffectiveness at times, when establishing the hedge ratio. We believe that Paragraph BC82 makes it clear that all the IASB proposal requires that for a hedging relationship to exist is that there not be a deliberate mismatch of the weightings of the hedged item and hedging instrument when establishing the hedge ratio. This is not the same as saying the relationship will be, or should be, perfectly effective or even highly effective. The term “highly effective” refers to the degree to which the changes in fair value (or cash flows) of the hedging instrument and hedged item offset each other. The weightings of the instruments to establish their hedge ratio is not the same thing as saying the changes in their relative fair values or cash flows will be highly effective over time because items such as basis risk may make result in ineffectiveness. Our view is that a “lack of intentional bias towards systematically over or under-hedging the relationship” is not a significantly high threshold for establishing hedge accounting. See further our remarks below regarding proof or evidence required to support this management assertion.
- 2) **Other Than Accidental Offsetting** – The second criteria required to qualify for hedge accounting is that the hedging relationship must be established with the intent to achieve other than accidental offsetting. Statistically speaking only a weak correlation between the hedged item and hedging instrument values is sufficient to say something is other than accidental. We find this to be such a low barrier to entry for hedge accounting that it is effectively a non-criteria.
- 3) **Analysis of Sources of Hedge Ineffectiveness** – When designating the hedging relationship the proposal requires the sources of hedge ineffectiveness to be identified. We read Paragraph B28 to suggest that the ability to rebalance should be considered. As we describe more fully below, ineffectiveness can and will be mitigated by rebalancing. As such, the necessity to consider the ability to rebalance in making the hedge effectiveness assessment works to mitigate the possibility that a hedge will be biased or not minimise effectiveness. Further, the ability to rebalance and minimize ineffectiveness will work to make demonstration of an initially biased hedging relationship very difficult for auditors and others to prove.
- 4) **Demonstration & Support For Ability to Meet Hedge Effectiveness Objective & Criteria** – As we consider the hedge effectiveness criteria, it also strikes us that because the assessment is entirely forward looking (unlike IAS 39 and U.S. GAAP which required both a prospective and retrospective assessment) and qualitative (i.e. other than instances where a quantitative assessment “might” be required) in nature that there is very limited ability to challenge management’s assertions in the

application of hedge accounting. As such, it is our belief that these effectiveness “criteria” along with the use of “risk management” as the conceptual underpinning for the model provide too much flexibility in establishing hedging relationships.

5) Other Matters – We have several other observations regarding the IASB ED’s effectiveness proposals as follows:

- a. Critical Terms Match – We believe the provisions of the IASB’s ED (e.g. Paragraph B34) allow the continued use of critical terms match (and short-cut) based upon a qualitative assessment of effectiveness. Our review of the effectiveness criteria/objectives would suggest that management could assert in their hedging documentation that no sources of ineffectiveness were identified. While ineffectiveness is supposed to be measured to profit and loss, we are sceptical given previous experience that such ineffectiveness will actually be measured without an explicit requirement to do so for hedging relationships established on such a highly qualitative basis. There are numerous instances which can be pointed to where there have been restatements because such critical terms did not exactly match and where ineffectiveness was assumed not to, but did, exist.

In addition, because a portion of an item may be identified as the hedged item, little ineffectiveness is likely to be captured as the hedged portion would be expected to be defined to match the critical terms of the derivative.

Finally, we find the language in Paragraphs B34 and B35 to go so far as to suggest that critical terms match is allowed – without quantitative assessment – even when the hedging instrument is in-the-money at the inception of the hedging relationship. Without quantitative assessment, we do not believe a valid hedging relationship should be established in such circumstances.

- b. Hedge Ratio Definition – We find the use of the term hedge ratio lacking sufficient definition given its importance in establishing the hedging relationship and in assessing the need to rebalance or results of rebalancing. Appendix B provides hedge ratio illustrations with reference to numbers of forward contracts (e.g. Paragraph B30) or where qualitative assessment suggests a 1:1 hedge ratio exists because the terms are identical (e.g. Paragraph B34). The IASB’s ED does not, however, address more challenging circumstances in the establishment of the hedging ratio. For example, where hedge ratios are established based upon value based measurements of the hedging instrument and hedged item in a fair value hedge. The establishment of such a hedging ratio assumes some element of a historical correlation, yet the effectiveness assessment is to be entirely prospective. As the assessment is to be forward looking, will hedge ratios be allowed to be established based upon implied correlations? When such values are not perfectly correlated, how is the hedging ratio to be rebalanced given it will naturally shift with changes in values unless perfectly correlated? Will rebalancing be required back to the original hedge ratio or will the hedge ratio be allowed to fluctuate within a previously identified range?

Overall, it is our view that this new definition of hedge effectiveness lacks rigour and that users will be unable to make judgments on whether legitimate hedging relationships are in place and to assess whether they are, in fact, effective. This concern is exacerbated by the inadequate levels of disclosure regarding the entity-specific judgments for determining hedge effectiveness. There are no disclosure requirements that enable users to judge whether preparers have in fact entered into unbiased hedging relationships (i.e. avoiding systematic under-hedging), despite the significant incentive for preparers to under-hedge so as to avoid recognising hedge ineffectiveness through profit and loss for cash flow hedge accounting pairs. We do not believe that the disclosures are sufficiently comprehensive to enable an investor to pro-forma out the effects of hedge accounting on the balance sheet or profit and loss statement. Further, there are no

disclosure requirements regarding the requirement or need to rebalance hedging relationships or adjust hedge ratios.

We strongly believe the IASB needs to go back to the drawing board on this aspect of the proposed standard and develop a robust, qualitative assessment framework for making hedge effectiveness judgments. Creating such a definition or framework is necessary so as to ensure consistent and comparable accounting within and across reporting entities. As it stands, this proposal might reduce the number of effective economic hedges that fail to qualify for hedge accounting; however, it will also likely increase the number of inappropriately designated hedging relationships. This will simply lead to a different type of mis-classification and one that results in users underestimating rather than overestimating risk exposures. Given the latitude that underlies many of the hedge accounting provisions, we question whether ineffectiveness will ever be captured by the proposed accounting.

Rebalancing Hedging Relationships (Question 7)

Rebalancing Required vs. Rebalancing Permitted

Paragraph B46 of the IASB ED appears to require mandatory rebalancing if a designated hedging relationship fails the qualifying criteria for hedge accounting but continues to meet the intended risk management objective and the hedging relationship still achieves other than accidental offset (Paragraph B46). However, the requirement to rebalance can be mitigated by simply asserting the relationship continues to meet the qualifying criteria – most significantly that it is unbiased. As noted above, this is simply an assertion that is forward-looking and qualitative in nature and is a relatively low threshold to achieve.

The IASB ED, however, also allows (but does not require) proactive rebalancing if the hedging relationship is expected to fail the hedge effectiveness objective (Paragraphs B46 and B59). While Paragraph B51 implies that rebalancing, and changing the hedge ratio, cannot be done to simply minimize hedge ineffectiveness, the guidance in Paragraphs B50, B52 and B59 seem to supply sufficient latitude to allow proactive rebalancing, as management may desire, based upon their view regarding the continued appropriateness of the hedge ratio and fluctuations around the hedge ratio.

Overall, it appears that the risk management objective (i.e. management intent) being the same is all that is needed to keep a hedging relationship going and for management to have the ability to rebalance at their option. We strongly disagree with this approach – particularly in light of the fact that there are no disclosures required to reflect that such rebalancing actions have been taken to maintain the hedging relationship or to reflect the retrospective analysis of how well the hedging relationship performed in the past.

This approach is going down the road of further allowing accounting based on managerial intent and assertion. This could readily result in inappropriately avoiding recognising hedge ineffectiveness gains or losses. When there is evidence to the contrary. Further, hedges will likely never fail to be accounting hedges based upon the existence of this provision. Combined with the need for only other than accidental effectiveness, little is necessary to maintain the free-choice option for classification and measurement afforded by the IASB ED.

Rebalancing Converts Ineffectiveness To The Price of Hedged Risk

Our view is that rebalancing acts to minimise future ineffectiveness and converts ineffectiveness in the hedging relationship over time to the price of the underlying risk being hedged. We understand that ineffectiveness is measured just prior to rebalancing; however, the act of rebalancing on a frequent basis, based upon a proactive assessment, will mitigate ineffectiveness. This lack of ineffectiveness will have

the effect of communicating to financial statements users that an effective constraining or offsetting of the risk has occurred. Only over time, as the price of the underlying risk rises (or declines) because of the rebalancing will users have any chance of seeing that hedging was not as effective as they originally believed because of the lack of ineffectiveness observed.

Rebalancing Changes Notion of Hedge Accounting from Offsetting Risk to Managing Risk

As we note in our response to Question 1, the IASB is changing the commonly understood definition and meaning of hedge accounting. Under IAS 39 “hedge accounting” connoted to users the idea that a risk had been constrained or offset. Under the revised proposal, hedge accounting is really “management of risk accounting” where risks are not necessary achieving offset or being constrained but being managed. The concept of assessing effectiveness while considering the ability to rebalance is an illustration of how are risks are being managed rather than offset under the previous definition of hedge accounting.

Discontinuing Hedge Accounting (Question 8)

We support the restriction of de-designation in situations other than the hedge ineffectiveness, termination, selling or exercising of derivative contracts. This restriction will minimise gaming through the opportunistic application of hedge accounting. This can occur in situations where companies arbitrarily get “in and out” of designated relationships for reasons other than those dictated by the underlying economic circumstances of the hedging relationship. We have previously expressed this in our comment letter to the FASB in September 2010.

We would observe, however, that while the IASB ED precludes de-designation if the initial risk management objective and strategy and the hedging relationship continue to meet all other qualifying criteria (after taking into account any rebalancing which may be possible); it does not preclude taking actions to change the risk management objective and strategy on a hedge by hedge basis. Given the establishment of a hedging relationship is based on an asserted risk management objective of management’s choice, the supposed restrictions are artificial barriers to de-designation.

Presentation: Changes to Fair Value Hedge Accounting (Question 9)**Fair Value Hedges Recorded in Other Comprehensive Income**

The ED proposes that changes in the fair value of hedged items and hedging instruments be recognized in other comprehensive income with ineffectiveness – of which there is likely to be little – transferred to profit and loss. We strongly disagree with this proposal.

In previous comment letters we have expressed concern regarding the inclusion of fair value gains or losses in other comprehensive income because users face a significant challenge in making meaningful economic interpretations of gains or losses that are shifted on an inter-temporal basis between other comprehensive income and net income, via deferral and recycling. Our concern about the inclusion of more items in other comprehensive income arises due to the greater attention accorded to numbers that are portrayed in the income statement. This concern is exacerbated by the failure, thus far, of the IASB to prioritise a fundamental review of the purpose of other comprehensive income. As currently applied, other comprehensive income has no conceptual basis, and can be considered an artefact of compromise-based standard setting, as it has often been used as a repository for items that conceptually belong in the income statement. It serves as a means of avoiding the portrayal of relevant economic volatility. Avoiding the portrayal of real economic volatility, as an objective, is contrary to the need for financial reporting information to be neutral and relevant.

As we understand⁵, the initial trigger for seeking changes to fair value hedge accounting was to address statement of financial position confusion that some users claimed existed when a mixed measurement basis is applied to a single instrument due to the partial application of hedge accounting to specific risk component. The initial proposal for amending fair value hedge accounting was to restrict changes to statement of financial position changes of fair value hedge accounting. It is then unclear why this initial trigger then justified going as far as necessitating the deferral of fair value hedge accounting gains or losses through other comprehensive income.

We would agree with the statement in Paragraph BC9(e) that different accounting for fair value hedges and cash flow hedges adds complexity. However, we believe that this should result in the change in the accounting for cash flow hedges – whereby changes in the fair value of hedging instruments on cash flow hedges should be recognized in profit and loss – rather than a change in fair value hedges. Our basis for this conclusion is the abuses which have existed with respect to the deferral of hedging losses for forecasted transactions which failed to occur. The proposed accounting for fair value hedges which requires separate disclosure of the changes in the hedged items in other comprehensive income is insufficient as it does not provide the user with the separate presentation of the change in the hedging instrument and the change in the hedge item together with the resulting ineffectiveness presented in the profit and loss statement.

The pursuit of consistency should not occur at the expense of overall quality of information. Higher levels of derivatives transparency can only occur if most derivatives-related gains or losses are recognised through the income statement. Hence, the Board should have considered ways of ensuring a lower degree of deferral of cash flow hedges through other comprehensive income rather than altering fair value hedging.

⁵ Previous IASB stakeholder outreach meetings in 2010.

Balance Sheet Effects

As in our comment letter to the FASB in September 2010 we have supported separate presentation of the adjustment to the hedged item on the statement of financial position. That said, the alternative view suggests these “adjustments” may not represent assets and liabilities per se. While the adjustments may not represent separable assets and liabilities in their own right, we believe that like other valuation adjustments for some assets, for example, allowances, there is sufficient relevant information provided by the amount and the change in the amount of these adjustments to warrant separate presentation on the face of the statement of position.

Amortization of Hedged Item Adjustments

One important element of fair value hedge accounting left unaddressed by the IASB is the optionality of the amortization of the hedged item adjustments. Presently, amortization can commence immediately upon adjustment or entirely when the hedged item matures, repays, or is settled. This optionality reduces comparability and the proposed standard fails to address this issue. We believe uniform treatment for such adjustments should be proposed. Failing that, users need disclosures that communicate whether the effects of the hedge reflect a variable or fixed rate interest stream, if the latter option is elected. In addition, if the latter option is elected users should be informed of the amount of the adjustment that is not being amortized.

Linked Presentation or Disclosure

A linked presentation or disclosure would be particularly pertinent for fair value hedge accounting. The underlying principle of hedge accounting is to match risk management pairs (i.e. hedging instrument and hedged item). A linked presentation or disclosure can help users more easily distinguish risk management relationships and thereafter monitor risk management effectiveness. We, therefore, consider it a missed opportunity, if the IASB opts not to require this as a disclosure.

Time Value of Options (Question 10)

In each of our responses over the last two years we have explained to the IASB and/or FASB that the time value of a purchased option is a cost, and such ineffectiveness, should not be deferred in other comprehensive income – or as a basis adjustment.

While the IASB analogizes the time value to an insurance premium and believes the time value should be recorded as an asset at inception of the contract and then released to net income based on the type of item the option hedges, we do not agree. For a forecasted transaction, that means including the time value as a basis adjustment and impacting net income when the forecasted transaction impacts net income. When the hedged item is, for example, interest on debt (i.e. a time period hedge) the time value is recognized on a time proportionate basis. We disagree with the IASB’s approach because we do not believe the time value represents an asset unless you have the right to recoup the time value.

We share the perspectives expressed in the alternative view that the time value of a purchased option is a cost for the protection it provides when the intrinsic value of the option is effective in offsetting a risk in a hedging relationship. As rightly articulated in the alternative view: *The recognition of the time value of an option as a basis adjustment of a hedged item, is not a required part of the purchase price and does not enhance the value of the item purchased. It has the effect of spreading the cost into future periods for which the protection is not provided.*

Further, we believe the addition of various options on how to treat the time value of an option adds unnecessary complexity and reduces comparability. Additionally, other than explaining which items included in accumulated other comprehensive income are transaction-related amounts and those which

are time period-related amounts, there is no disclosure to explain why and how the various elections have been made or when the amounts accumulated in other comprehensive income will be included in profit and loss.

Hedges of Groups of Items and Nil Net Positions (Question 11)

Overall Perspectives

These provisions of the proposed standard represent another instance of the balance shifting from reasonable restrictions placed on an anomalous accounting approach under current provisions, to opening of the floodgates without there being sufficient safeguards against the misapplication of the standard. In addition, we question whether the effects of changes in values of hedging instruments can be appropriately related to the changes in values or cash flow of the components of a group when those components may be constantly changing. A process of constant remeasurement and allocation of gains and losses would be required whenever the items within the group change.

Similar to aggregation of derivatives with an underlying exposure to create an aggregated synthetic risk exposure, this provision related to groups of items and nil net positions does not provide a robust framework of application. Accordingly, it is our view that this will likely result in incomparable accounting across reporting entities as well as expanded structuring opportunities. Emphasis should have been on laying adequate and rigorous conceptual foundations and specifically developing robust principles of risk aggregation. The criteria of eligibility of a group of items as a hedged item, stated in Paragraphs BC163 and BC164, does not shed light, in any meaningful manner, on when the transformation to an aggregated risk exposure is warranted from an accounting perspective.

Another concern we have is that the justification provided in the basis of conclusions Paragraph BC159(c)⁶ goes beyond the principle of accounting standards needing to be neutral. The objective of the standard should not be to incentivise what are expected, or claimed to be, optimal economic hedging strategies. Especially given that the design of optimal hedging strategies and risk transformation is outside the purview of accounting standard setting. Besides, there is no empirical evidence showing that existing accounting provisions (i.e. IAS 39 or SFAS 133 that also has restrictions on group items as hedges) have hindered any form of economic hedges that managers consider optimal. In fact, the evidence indicates that derivatives use is pervasive and has been rapidly growing across both financial and non-financial institutions.

Nil Net Position Provisions Illustrate Free-Choice Accounting

It is our view that Paragraph 39 with respect to the ability to hedge nil net positions may result in some of the most egregious abuses of this standard resulting in free-choice accounting and “recognition and measurement management.” Paragraph 39 allows entities to hedge nil net positions of cash instruments without the use of a hedging instrument and with the knowledge that the nil net position will not remain a nil net position (i.e. it will need to be rebalanced) as per Paragraphs 39(a) and (b). Because the items comprising the net nil position are each considered to be *hedged items* as opposed to *hedging instruments* the prohibition on using cash instruments that are carried at amortized cost as hedging instruments can be successfully circumvented. Taking that a bit further, because the net nil position is comprised of hedged items, it appears that a portion of the net nil position in itself would qualify as a hedged item.

⁶ Paragraph BC 159(c) notes that one of the reasons for allowing hedge accounting of group items is: the expediency (cost, practicality, etc) of entering into fewer derivatives to hedge a group rather than hedging individual exposures.

The IASB acknowledges in Paragraph BC 180 the eligibility of nil net positions for hedge accounting is inconsistent with the general requirement for hedge accounting as follows:

The Board considered whether, when an entity hedges risk on a net basis, a nil net position should be eligible for hedge accounting. Such a hedging relationship could be in its entirety outside the scope of hedge accounting if it did not include any financial instruments. Furthermore, eligibility for hedge accounting would be inconsistent with the general requirement that a hedging relationship must contain both an eligible hedged item and an eligible hedging instrument.

The IASB, however, dismisses this violation of the hedge accounting requirements in Paragraphs BC 181 and BC 182 and permits the hedge accounting (i.e. the change in the measurement of the underlying cash instruments) for nil net positions:

However, the Board noted that the accounting result of prohibiting the application of hedge accounting to nil net positions could distort the financial reporting of an entity that otherwise hedges (with eligible hedging instruments) and applies hedge accounting on a net basis.

Consequently, the Board proposes that nil net positions should qualify for hedge accounting. However, the Board notes that such situations would be coincidental and hence it expects that nil net positions would be rare in practice.

We have several observations regarding these remarks in the basis of conclusions:

- 1) Paragraph 39 violates, by the IASB's own admission, the hedge accounting requirements of the proposed standard.
- 2) Fair value accounting could eliminate the "distortions" mentioned in Paragraph BC181. This discussion appears to be an admission that the underlying measurement principle of the hedged items is flawed.
- 3) The Board indicates in Paragraph BC182 that they believe these circumstances would only be coincidental and they would expect use of these provisions to be rare. As written in Paragraph 39, the position only need be nil at inception which can be a contrived/structured situation and will not be rare. If the Board believes the circumstance should be rare, the provisions of Paragraph 39 should be more restrictive and this "rarity" should be articulated in the body of the standard. We question how the Board could consider that managing risks on a net basis to be rarity given this is a common risk management practice.

Alternative View Paragraphs AV 6 to AV 8 are correct in their articulation of how Paragraph 39 will be applied and utilized to manage results. These provisions of the IASB ED will:

- 1) Permit free-choice in classification and measurement of associated cash instruments.
- 2) Be utilized to create the fair value through other comprehensive category no longer permitted under IFRS 9.
- 3) Allow management to switch hedge accounting on and off by changing the risk management strategy.
- 4) Be utilized to manage earnings volatility.
- 5) Result in a lack of comparability between organizations. Most organizations manage risk considering their offsetting effects. Under this proposal some will alter their accounting, others will not.
- 6) Eliminate the need for the fair value option as described below.

Provisions Obviate Need for Fair Value Option

We viewed the introduction of the fair value option as a means to enable managements to reflect accounting measurement anomalies associated with aggregated, or net, risk positions. These provisions of the proposed standard – particularly the nil net provisions – obviate the need for the fair value option. All that needs to be done is to designate a hedging relationship.

Overall, the requirements for the application of the fair value option in IFRS 9 are moot as the net nil position need not be at the inception of the instrument, it need not be permanent, and the accounting result is not fair value through profit and loss.

Disclosures Proposed Are Insufficient in Explain Proposals' Complexities

Finally, these provisions of the IASB's proposal would only be understandable to users if they were accompanied by disclosures of the individual exposure components that comprised the net or aggregated risk exposures (including composition of hedged items and hedging instruments and their relationship to each other and their related impact on profit and loss and comprehensive income). Such disclosures would allow capital market participants to gain an understanding of – and ability to assess the effectiveness of – the claimed risk management strategies by reporting entities. However, there is no indication that these disclosures are currently required or proposed. Without sufficient disclosures the entire objective of the hedging accounting standard – that being to convey management's risk management strategy – will fail to be communicated to investors.

Separate Presentation of Net Position as Hedging Item Gain (Loss) (Question 12)

The board proposes that for cash flow hedges of a net position, the gains or losses reclassified from other comprehensive income (i.e. ineffective hedge portions or in the period the hedged future cash flows affect profit and loss) should be presented in a separate line on the income statement. This means that adjusting the individual line items in the income statement which would be affected is not allowed.

By this choice, the Board is overlooking information content for investors. As we have severally argued, netting reduces transparency on underlying individual risk exposure. The recycled gains or losses arising from the net exposure provide a signal of hedge effectiveness and ineffectiveness. Users' understanding regarding the sources of ineffectiveness, can only be possible if there is a disaggregation of the net amount to its constituent parts. Users would like to be provided with the unadjusted individual line items along with the adjustment by line item for the impact of the hedging.

The assertion made in Paragraph BC175 that adjusting the individual lines items when reclassifying cash flow hedge accounting net exposures will be inconsistent with general accounting principles, is incomprehensible. The notion that adjusting the individual items would represent fictitious entries, yet presenting the net hedging gain or loss is appropriate, seems contradictory. This is because the net amount is simply the sum of the gains or losses related to underlying individual risk exposures. This also appears contradictory because cash flow hedge accounting is an exception to generally accepted accounting principles, as it allows the recognition of forecast transactions. Hence, it is surprising that the IASB is hesitant to violate generally accepted accounting principles when this will yield more useful information to investors but appears to have no reservations when facilitating preparer concerns about income volatility.

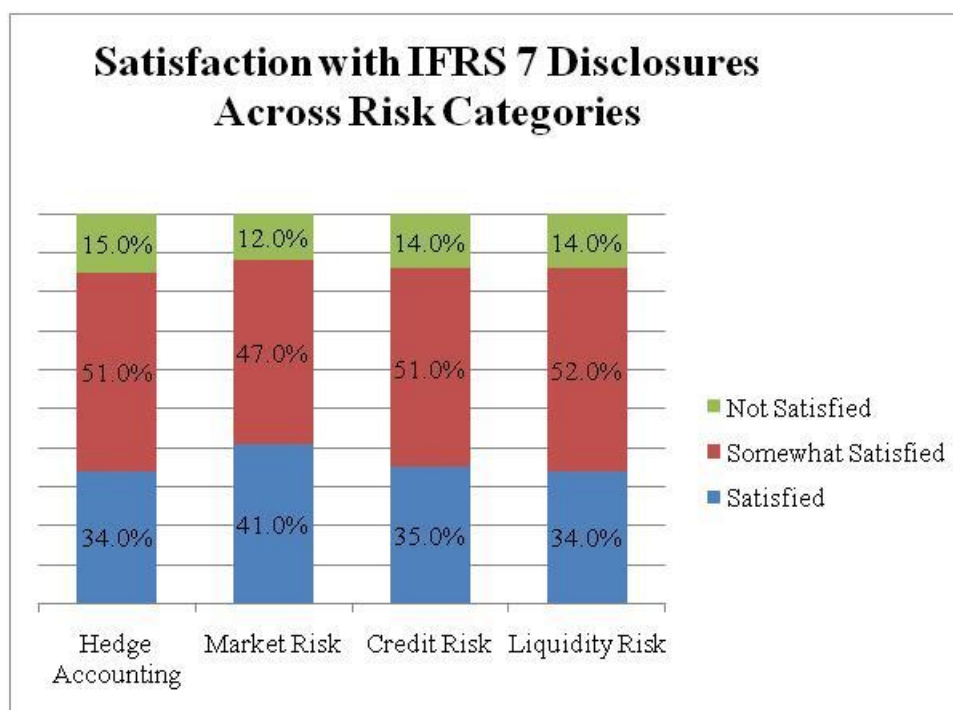
Disclosures (Question 13)

Convergence – Given the convergence premise, we believe that the Boards should be jointly considering the derivatives disclosures. The most effective starting point for disclosure enhancement, would have been to assess the best disclosure requirements from existing U.S. GAAP and IFRS literature (i.e. IFRS 7, IAS 39, SFAS 133 (Topic 815) and SFAS 161 (also Topic 815)). Thereafter, to make the existing best practice from the overall body of literature to be the lower bound and frame of reference for subsequent improvements. The IASB and FASB’s compartmentalised approach to addressing disclosures has left stakeholders with the onerous task of comparing the detailed aspects of the disclosures and determining what best practices should be.

User Assessment of Existing Disclosures – Hedge accounting is an artefact of mixed attribute measurement basis and selective recognition and the proposed accounting relies on and expands the conceptually unfounded application of other comprehensive income. Necessarily, we place more emphasis on the disclosure requirements as a primary means of conveying to users the risk management activities that entities undertake. Nevertheless, existing derivatives related disclosures are generally considered inadequate.

We recently conducted a study of derivatives and hedging disclosures under IFRS 7, *Financial Instruments Risk Disclosures*, and found that users are often confused by and not fully satisfied with existing IFRS 7 disclosures including hedge accounting disclosures (See Figure 1). A copy of this study is available on request.

Figure 1: Feedback from users on satisfaction with IFRS 7 disclosures.
Feedback obtained from 80 CFA Institute members and 50 sell side analysts.



In addition to interviewing and surveying users regarding their satisfaction with existing risk disclosures (including hedging), we also constructed a disclosures quality index reviewing the compliance of twenty-five multinational organizations and their compliance with the IFRS 7 risk (including hedging disclosures). The results of these findings are included in **Appendix B**. Based on derivatives disclosures for these 25 IFRS reporting companies, we find that there is very inconsistent information across disclosures that will help users understand: a) risk exposure and hedging strategy; b) income statement, balance sheet and cash flow statement effects; and c) derivatives instrument specific risk. The assessment of disclosures shows that it is necessary to provide as much detail as possible as well as examples of best practice disclosures. As we note in the following section, we are not sure the IASB ED disclosures provide such information.

IASB's ED Proposed Disclosures – In Paragraphs 40 to 52 and Paragraphs BC183-BC208, the IASB ED proposes disclosures that aim to provide a holistic view of an entity's risk management activities. The stated objective of the proposed is top-down portrayal of risk management activities through disclosures is a step in the right direction; however, these disclosure do not go nearly far enough in explaining the aggregation, netting and linkages associated with the various hedging strategies being proposed nor do they address the cash flow statement impacts of derivatives used. The disclosures are not nearly sophisticated enough to portray the complex hedging which will be allowed under this proposal. Further, the disclosures assume that users are interested only in hedged risks even though in many cases the risks hedged by derivatives are those that are most easily and cheaply hedged.

It is our view that the disclosures proposed do not sufficiently articulate the risks and the hedging activities undertaken. The disclosure requirements are highly principles based and very broadly articulated. The resulting disclosures will likely be very generic given the complexity of the underlying risk management strategies undertaken by most firms. We are concerned by the lack of specificity in the requirements. Illustrative, but not all inclusive, examples of disclosures which are important, but have not been included in the proposal, are as follows:

- 1) There are no disclosures regarding risks which are being managed by management but where hedge accounting has not been elected and why. Also, there are no disclosures regarding risks which management has chosen not to hedge and why. If "risk management: is the underlying principle upon which the standard is predicated, then disclosure should address all risks, not just those accounting or not to manage a particular risk are a part of the risk management strategy, and should be a required element of the disclosures. Investors are equally, if not more, interested in unhedged risks and their economic consequences.
- 2) There are no disclosures required regarding how hedge effectiveness is assessed (e.g. quantitatively or qualitatively), how ineffectiveness is measured, or how hedge ratios are established.
- 3) There are no disclosures regarding the requirement, or election, to rebalance and the impact of such rebalancing actions on hedge ratios or hedge accounting relationships.
- 4) They are no disclosures required regarding the discontinuation of hedging relationships during the reporting period.
- 5) The disclosure requirements are written in a way that does not seem to acknowledge that the IASB ED allows portions of instruments along with groups of items and net positions to be hedged (or allows cash instruments in themselves to be used to form nil net positions of which portions may be hedged). The IASB ED disclosures seem to suggest that the entirety of instruments on an individual basis (i.e. rather than as groups or net positions) will be hedged. We do not find the disclosure requirements sufficiently specific to accommodate the complexity of the hedge accounting practices permitted.
- 6) The examples provided in Paragraphs IE1 to IE3 illustrate that though hedged items are organized and associated by risk in one table and hedging instruments are organized and associated by risk in

another table, there is no linkage of the hedging instruments and hedged items by risk in a way that enables one to understand their combined impact on profit and loss and other comprehensive income. Without greater connection of the hedging instruments and hedged items, in association with their risks, and their presentation in the financial statements, it will be difficult for users to understand the tactics implemented to manage the strategic risks and the effectiveness of this management, let alone try to contrast these with other entities. Users are most interested in a “with” and “without” analysis of the impacts of hedging activities.

- 7) There are no disclosures which enable users to understand how the application of elective accounting treatment alters the measurement of assets and liabilities and of profit and loss. For example, the use of cash instruments as hedging instruments or the introduction of the nil net position provision provides multiple means to circumvent the IFRS 9 classifications of financial assets and liabilities such as enabling debt and equity securities to be carried at fair value through other comprehensive income. As another example, companies are provided the option to begin amortizing the effects of fair value hedges of financial instruments immediately or to wait until the hedge is terminated. If the latter alternative is elected, users should be informed of the amount of gain or loss that is being deferred. In addition, it should be made clear to users that while the fair value hedge of a fixed rate instrument would be expected to create variable interest, if the latter option is elected, that is not case. Because of the ability to delay the earnings impact of the adjustment, we are concerned that this has and will continue to result in cherry picking of gains and losses.

Further, some have suggested that the disclosures are sufficiently detailed to allow users to reverse the effects of hedge accounting and see the impacts of the financial statements without hedge accounting. We are not convinced all elements will be sufficiently disclosed to achieve this “with and without” analysis, but we are certain there will not be sufficient detail to allow users to understand the impacts of specific strategies as the requirements are very generic and there is no required linkage of the hedged item and hedging instrument.

We would also like to note that we do not believe that the disclosures required by Paragraph 46 are forward-looking information that cannot be included in the financial statements. These are not projections of future events but reflections of application of managements’ risk management strategy upon which they have altered the classification and measurement of financial instruments. If management can sufficiently assert these matters to change the accounting, they can provide these disclosures to users.

Overall, our view is that the disclosure proposals are not likely to yield disclosures that are useful to investors, especially as they provide issuers’ leeway to avoid providing the level of disclosure that would be meaningful and informative to users. Our experience with prior disclosure requirements for hedging activities suggests the result will be boilerplate rather than entity-specific disclosures that truly explain the effects of hedging on the financial statements.

A key finding from the IFRS 7 study referred to above was that a principles-based disclosure regime does not yield comprehensive and comparable information across reporting entities. The aforementioned disclosure index showed the extent to which current disclosures are not as informative as they should be.

The alternative view in Paragraph AV 15 is correct in stating that: “It would be impossible for users to understand the effects of risk management activities without extensive disclosures of the fair value and changes in fair values in their entirety and the carrying amount and changes therein for assets and liabilities and firm commitments that were the subject of any hedge accounting.”

Disclosure Adequacy – Through previous comment letters, we have proposed that disclosures should be refined based on a holistic understanding of user analytical requirements. Overall, disclosure adequacy should be judged by the extent they enable users to understand:

- Hedged versus un-hedged risk exposures;
- The extent to which the hedge accounting election is applied;
- Economic hedges that are excluded from hedge accounting treatment (including economic hedges achieved through election of the fair value option);
- Derivatives that are used for taking active positions;
- Derivatives that are included as hedged items;
- Cash instruments used as hedging instruments;
- Effectiveness of hedging relationships including profit and loss effects;
- Differences between intended and realised hedging effectiveness;
- The effects of electing either method for recognizing the adjustment of fair value hedges;
- Instrument specific risk (e.g. counterparty risk and covenants within derivatives that impact on liquidity);
- How hedging strategies change over time (e.g. percentage of risks hedged changes over time);
- The effect of derivatives on current period cash flows.

We do not believe the IASB ED's proposed disclosures would achieve all of these.

Accounting Alternatives to Hedge Accounting (Question 14)

The IASB ED addresses contracts to buy non-financial items. These types of contracts include those that are currently not within the scope of IAS 39 and are accounted for as normal purchase or sales contracts (i.e. a subset of executory contract). The risks inherent in these contracts may be hedged using fair value hedge accounting. The IASB ED is proposing to change the accounting for these types of contracts because fair value hedge accounting is asserted to be burdensome. In the basis of conclusions, Paragraphs BC209 to BC218, the IASB evaluates two alternatives: a) allowing an entity to elect to account for commodity contracts as derivatives (i.e. free-choice); and b) accounting for a commodity contract as a derivative if that is in accordance with the entity's fair value-based risk management strategy. The IASB has selected the latter option. However, although elaborating on the basis of preference of selected choice, the IASB ED does not adequately outline the consequential accounting impacts of either option, and it is difficult to make a judgement regarding the balance sheet, income statement and other comprehensive income effects that will arise from the proposed approach relative to the respective alternatives. We would also note that while the IASB has said they have eliminated free-choice by selecting the latter alternative all that is required to change the accounting is to change the risk management strategy which does not appear to be a substantial barrier to free-choice.

Our reading of the IASB ED is that commodity contracts that previously were settled by physical delivery and were considered to be outside scope of financial instrument accounting will be included in the scope of financial instruments and accounted for as derivatives if an entity manages such contracts on a fair value risk management basis. Previously, the contract would only be accounted for at inception (rather than at settlement as an executory contract) when it was documented to be in a fair value hedging relationship. In other words, when the contract was considered to be part of a hedging relationship the contract would have been accounted for as a derivative. Now an entity must simply assert that it managing that normal purchase and sale contract (executory contract) as being managed on a fair value basis and it will be recorded at inception on the balance sheet. When the entity does not manage the contracts on a fair value basis (i.e. changes its risk management strategy) then these contracts are not accounted for as financial instruments and revert to being off-balance-sheet.

Overall, the basis of conclusion paragraphs are very confusing and it is not clear in what respect this is effectively an alternative to the hedge accounting proposals or the expansion of the fair value option. In other words, it is unclear whether the proposal has simply widened the eligibility for commodity contracts hitherto excluded from being considered as financial instruments or whether it is considered an alternative to hedge accounting because there is flexibility in whether such contracts can be considered financial instruments. It would have been more effective to include illustrative examples, so that stakeholders can have a consistent understanding and make an evaluation of whether or not these changes represent an improvement.

This proposal is emblematic of the trend towards allowing desired accounting outcomes to shape the accounting rules. It amounts to a piecemeal approach and one that is lacking in internal consistency across different standards. We have asked that the Boards address all executory contracts (e.g. leases and revenue recognition proposals) in a holistic fashion and the Boards have declined to do so. However, in this case, due to the anchor to an ill-defined risk management objective, the IASB is prepared to address a sub-set of executory contracts so as to avoid the "burden" of an available hedge accounting solution.

Accounting for Credit Risk Using Credit Derivatives (Question 15)

We find it unusual that the IASB finds it “difficult (if not impossible) to isolate and measure the credit risk of a financial item as a component which meets the eligibility criteria for a hedged item” when such separation is a part of how credit impairment is recognized currently under U.S. GAAP and when “own credit” measures for financial liabilities are determined routinely on embedded derivatives and liabilities accounted for under the fair value option. Further, the IASB is asking stakeholders to consider how credit impairment on open portfolios of loans should be assessed without providing a proposal on how the related interest income should be determined in its current discussion document.

Investors have highlighted the importance of this issue and the analysis and conclusions seem incomplete given the push to complete this hedging proposal. We believe this issue should be thoroughly vetted and deliberated and with more time we could provide you with a more comprehensive response to your queries.

Effective Date & Transition (Question 16)**Overall**

As currently exposed we do not believe this IASB ED will provide meaningful information to users of financial statements. Accordingly, providing comments on effective date and transition seems otiose.

Transition Methods

A transition which does not provide comparative information is not useful to investors. We recognize that a purely retrospective application that would require the designation, re-designation or de-designation of already existing hedge accounting pairs in hindsight is probably not feasible. However, these proposed changes being implemented on a purely prospective basis will create a discontinuity that makes it difficult for investors to discern a reporting entity's risk exposure, risk transformation and risk management activities as much of such communication and understanding comes from review of the information over time. Preparers will be charged with explaining these results without the benefit of historical information and trends to provide context. As such, we would propose a delayed effective date whereby pro-forma information is provided for the period leading up to the actual effective date. In this way, preparers will benefit by not being required to retrospectively assess hedging relationships and users will be provided with necessary comparative information. This will also ensure that comparative disclosure information is available for context. The current requirement to omit comparative disclosures will be detrimental to users.

Transition Issues

We believe the transition provisions associated with the IASB ED need further consideration. The guidance in Paragraph 55 is insufficient to address the number of issues which will likely arise upon implementation. For example, it would be helpful to clarify whether Paragraph 55 requires a comprehensive review of all existing hedging relationships to ensure that they meet the new requirements. Similarly, it would be helpful for the final standard to clarify the treatment of terminated cash flow hedge accounting relationships where the derivative instrument has been terminated but the forecast transactions (i.e. hedged item) is still intact, with cumulative gains or losses recognized in other comprehensive income, but yet to be recognized in the income statement. These are just two examples of the many transition issues which may arise upon implementation of a new standard. Effective implementation requires more complete transition guidance.

Effective Date

We agree that this standard should be adopted consistent with the effective date of other elements of the overall financial instruments project.

Early Adoption

Finally, we would be opposed to allowing entities to early adopt the new financial reporting standards. Allowing entities this option introduces further complexity for investors who rely on comparability in their analysis.

Derivatives and Hedge Accounting Disclosure Index

Index Constructed Using Data from 2009 Financial Statements of 25 IFRS Reporting Companies⁷

DERIVATIVES AND HEDGING DISCLOSURE ELEMENTS	NUMBER OF ELIGIBLE COMPANIES	PERCENTAGE COMPLIANCE BY ELIGIBLE COMPANIES
DISCLOSURES (TO ASSIST WITH USER JUDGEMENT ON ENTITY RISK EXPOSURE & HEDGING STRATEGY)		
NOTIONAL AMOUNTS		
- Notional amount of derivatives.	25	74%
- Disaggregation of notional amounts by hedging versus non hedge accounting categories.	25	32%
HEDGING RATIO		
- Quantitative amount of hedging ratio (i.e. extent of hedging).	25	8%
DISAGGREGATION		
- Adequately disaggregated risk exposure with quantitative information.	25	14%
- Adequate disaggregation that allows differentiation of hedge accounting approaches (e.g. cash flows vs fair value hedge).	25	74%
- Disaggregated disclosure of unqualified hedges including economic hedges and speculative derivatives.	25	4%
MATCHING OF HEDGE RELATIONSHIPS		
- Clear matching of hedging instrument and hedged item.	25	16%
CASH FLOW FORECASTS		
- Anticipated cash flow hedging forecasts when cash flow hedging is applied (i.e. maturity analysis).*	25	36%
DISCLOSURES (TO ASSIST WITH USER ASSESSMENT OF DERIVATIVES INSTRUMENTS RISK)		
- Breakdown of derivatives by instrument type.	25	34%
- Fair value hierarchy of derivatives.*	25	64%
- Derivatives asset maturity analysis.	25	8%
- Derivatives liability maturity analysis.*	25	92%
- Derivatives maximum credit exposure amount.*	25	34%
- Derivatives related covenants.	25	0%
- Derivatives sensitivity analysis.*	25	6%
DISCLOSURE UNDERSTANDABILITY (EXTENT TO WHICH DISCLOSURES FACILITATE USER UNDERSTANDING)		
- Sufficient tabular presentation (extent to which disclosures facilitate user understanding).	25	80%
- Ease of use of disclosures (e.g. centralized location and well-referenced).	25	92%

* - Items with asterisk are prescribed IFRS 7 disclosures.

⁷ Alcatel Lucent, Anglo American, Allianz, Anheuser Busch, British Airways, BMW, BP, BAT, BASF DE, BHP Billiton, Barclays, Deutsche, EADS, Fiat, GDF Suez, GSK, HSBC, Ibedrola, Lufthansa, Nestle, Novartis, Nokia, RBS, SAP, Unilever

PRESENTATION (TO ASSIST WITH USER ASSESSMENT OF HEDGE EFFECTIVENESS INCLUDING INCOME STATEMENT, BALANCE SHEET AND CASH FLOW STATEMENT EFFECTS)		
FAIR VALUE HEDGES		
- Jointly present details of gains or losses of hedge instrument and hedged item.*	22	55%
- Balance sheet presentation of hedged item in fair value hedge relationship	22	5%
CASH FLOW HEDGES		
- Display recycled amount to income statement.*	25	60%
- Display amount recycled to balance sheet carrying value.*	25	20%
- Distinction between over and under hedges.	25	0%
- Sufficient disaggregation of cash flow hedge accounting recycled to income statement.	25	0%
- Clearly differentiating discontinued and ineffective hedges.	25	0%
- Disaggregation on cash flow statement.	25	0%
NET INVESTMENT HEDGES		
- Provide details of realized gains/losses recognized in income statement.*	12	17%

* - Items with asterisk are prescribed IFRS 7 disclosures.