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11 March 2011

Dear Sir

IASB Exposure Draft ED/2010/13: Hedge Accounting

We are pleased to comment on the above exposure draft (the ED). Following consultation, this letter summarises the views of the BDO network¹.

We support the development of new requirements for hedge accounting based on the principles set out in the ED. The current hedge accounting requirements, set out in IAS 39 *Financial Instruments: Recognition and Measurement*, are rules based and require a range of detailed requirements to be met, some of them being 'bright line' tests which have little conceptual merit. In contrast, the ED proposes to link hedge accounting to the risk management approach adopted by an entity, and we agree with this different mechanism.

However, we do not agree with certain of the proposals, and have outlined our concerns in the detailed responses in the attached Appendix. In particular, we disagree with:

- the prohibition on hedge accounting for risks that affect only Other Comprehensive Income;
- the restrictions on the designation of an inflation component as a hedged risk and the proposal to prohibit hedge accounting for hedges of credit risk using credit derivatives;
- a requirement for the rebalancing of a hedging relationship if it fails to meet the hedge effectiveness assessment; and
- the prohibition on voluntary dedesignation of hedging relationships for the purposes of hedge accounting.

We also consider that some of the principles outlined in the ED need further explanation. In particular, the proposals note that the objective of a hedging relationship is to produce an unbiased result and minimise expected hedge effectiveness. It would be helpful for there to be greater clarity around what is meant by 'unbiased result' and 'minimise expected hedge effectiveness' as these could be interpreted in an overly restricted manner. Similarly, questions are likely to arise around the meaning of 'other than accidental offsetting'.

We note that the ED is the first step in bringing improvements to hedge accounting with the second phase, portfolio hedge accounting, still to be proposed. We acknowledge and support the Board's statements that conclusions reached in this first phase will not prejudice the conclusions that will be reached for portfolio hedge accounting. However, for some entities

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the conclusions reached in the second phase will have a significant effect, and we encourage the Board to complete its work in this area as soon as practicable.

We note, and welcome, the FASB's publication of the IASB's proposals as part of its own work in improving and simplifying hedge accounting. We hope that both Boards will make sufficient agenda time available to enable, as far as possible, a common approach for hedge accounting to be reached.

We hope that our comment and suggestions are helpful. If you would like to discuss any of them, please contact Andrew Buchanan at +44 (0)20 7893 3300.

Yours faithfully

BDO IFR Advisory Limited

BDO IFR Advisory Limited

Appendix

Question 1

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

We agree with the proposal, except for the limitation to items that might affect profit or loss (see below). We note that the risk management objective and strategy for undertaking a hedge would be documented separately for each hedging relationship, meaning that it would not be necessary to link each hedging relationship to an overall entity-wide risk management strategy. We support that approach.

We disagree with the proposal to prohibit hedge accounting for items whose change in value could affect Other Comprehensive Income (OCI). While we note the Board's discussion and conclusions in paragraphs BC22 to BC26, we are not convinced. There would seem little reason why, for example, an equity instrument designated as at Fair Value Through Other Comprehensive Income (FVTOCI) should not be designated as a hedged item in a fair value hedge, with all hedge ineffectiveness being recorded in profit or loss. We would not view amounts recorded in profit or loss as being tantamount to recycling, with these instead representing the extent to which changes in the fair value of the hedging instrument resulted in it either the under or over hedging of changes in the fair value of the hedged item. We consider that this approach might be helpful in the insurance industry, where a number of entities are likely to designate equity instruments as at FVTOCI; while it might be suggested that these could simply be accounted for as at Fair Value Through Profit or Loss (FVTPL), this ignores the possibility that an insurer might wish to hedge account for an equity investment for only part of its life. We also note that, if hedge accounting for equity instruments designated as at FVTOCI were to be prohibited, an entity that entered into a commercially effective hedge for such investments would automatically record an accounting mismatch, with gains and losses on the hedging instrument(s) being recorded in profit or loss.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

We agree. An example of where this would be helpful is where an entity has an existing fixed rate loan and then extends a portfolio of fixed rate loans. The proposal would enable hedge accounting to be achieved; while it might be suggested that the entity could use the fair value option on the basis that this would eliminate or substantially reduce a measurement mismatch, the use of this option under both IAS 39 and IFRS 9 would only be possible on initial recognition of the fixed rate loan, at which point it might not qualify for the fair value option as the portfolio of loans would not yet have been advanced.

However, we believe that it would be appropriate to permit the designation of hedging instruments for only a portion of the period during which they are outstanding, and for hedging instruments to be disaggregated into components, provided that the entity can disaggregate and measure the instruments reliably and that the change in fair value of all components in time periods which have not been designated are recorded in profit or loss.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

While we agree that an aggregated exposure as described should be eligible to be designated as a hedged item, we believe that the guidance should be extended. Many central treasury functions enter into internal derivatives with entities in a group, with the net (combined) exposure from these internal derivatives then being hedged with an external derivative. We believe that this net (internal) position should be capable of being designated as a hedged item, and consider that this would be consistent with the principle that has been outlined in the ED.

However, we are concerned that the text of paragraph B9(b) could be read by some as permitting synthetic accounting by aggregating derivative and a non derivative instruments and, in consequence, permit amortised cost accounting for derivatives. In the example, a fixed rate foreign currency denominated debt instrument is combined with a cross currency interest rate swap to create a synthetic domestic currency variable rate instrument. While this is noted as being for risk management purposes, those who advocate amortised cost measurement for derivatives might interpret this as permitting this approach for accounting purposes as well. We suggest that it is made clear that all derivatives are required to be measured at fair value, regardless of how they managed.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We agree that risk components should be eligible hedged items if the risk component is separately identifiable. We support the less onerous requirements for the designation of risk components in non-financial items, and note that this will enable hedge accounting for certain commodity contracts where this was precluded under IAS 39.

We do not agree with the proposals as they relate to inflation, which would only be eligible to be designated as a risk component if it was contractually specified. While it might not be straightforward separately to identify and reliably measure an inflation component, we believe that any final standard should set out clear principles to be followed in identifying eligible components, eliminating 'bright line' rules, with entities being left to apply those principles in determining whether they meet the criteria.

We also note, in the context of inflation components, that no similar restriction has been included for non-financial items and we do not see a clear justification for the inconsistency.

Question 5

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

We agree, and note that a layer approach is often operational where there is uncertainty about the absolute amount of an item that might be hedged. We assume that it is intended that an interim layer could be designated (for example, the second \$100m of sales during a specified time period).

Paragraph B20 refers to a specified percentage of a nominal amount of a loan. We assume that in such cases the nominal amount of the loan would need to be fixed, or there would need to be a dynamic hedging relationship that was rebalanced in the event that the nominal amount of the loan changed. It would be helpful for this to be made clear.

Paragraph B21(b) refers to part of a physical volume as a potential hedged item. While we agree that this is appropriate, the example given is not clear as it does not specify which 50,000 cubic meters are being referred to (for example, the first 50,000, the second 50,000 or some other layer).

5 (b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

We do not agree.

We note that the proposal to prohibit the designation of a layer component that contains a prepayment option is on the basis that the risk component cannot be separately identified (paragraph BC69). However, in certain portfolios we believe that it would be possible for this component to be separable and reliably measurable. Again, and consistent with our response to question 4, we believe that the final standard should exclude this type of specific rule, with entities being left to apply the principles of the standard in determining what can and cannot be designated as a hedged item. We also note that the question of prepayment options may be important in the context of portfolio hedge accounting by financial institutions, and it may be appropriate to avoid limiting the application of hedge accounting in the way suggested in the ED.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We strongly support the elimination of the arbitrary and rules based thresholds in IAS 39, and the elimination of retrospective effectiveness testing. In general, we support the proposals. However, we believe that further clarification is required of how the proposed guidance is to be implemented.

We note from paragraph B29 that the objective of a hedging relationship is to produce an unbiased result and minimise expected hedge ineffectiveness. This might be viewed as being overly restrictive, as it would imply that an entity would need to select the most effective hedging instrument available. In practice, this may not be the case, either due to the type of

hedging instrument that is normally available through market convention, or cost. We suggest that reference is also made to the economics of the hedging instrument(s) in the context of the overall hedging relationship. It is also not clear whether the requirements of paragraph B29 are wholly consistent with those of paragraph 19(c); it would be helpful to clarify what is meant by 'the objective of the hedge effectiveness assessment'.

It would also be helpful to clarify what is meant by 'other than accidental offsetting'. It might be argued that the extent to which a hedging relationship is ineffective is unimportant, provided all hedge ineffectiveness is recorded in profit or loss; if this is the case, then there would appear to be little need for the extent to which a hedging relationship is expected to be effective to be included within the qualifying criteria. We believe that as drafted, the proposals would give rise to questions about how effective a hedging relationship needs to be before it qualifies to be designated as a hedging relationship for accounting purposes. If it is considered that a (non bright line) threshold is needed, then it would be appropriate to give further guidance to be applied in determining where that threshold lies.

When testing hedging relationships for effectiveness, the hypothetical derivative method is often an efficient approach. It would be helpful for an example to be included in the application guidance, illustrating the mechanics.

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

While we agree with the proposed ability for an entity to rebalance a hedging relationship, we disagree with the proposal that this should be mandatory.

We assume that the Board's intention is that a hedging relationship should be managed proactively, adjusting the ratio of hedging instruments and hedged items as required when there is an economic change in the hedging relationship. However, it is not clear what an entity would be required to do and, in the event that an entity did not rebalance a hedging relationship, what the consequences would be. It would appear that, unless the effectiveness became only 'accidental', hedge ineffectiveness would simply be recorded in profit or loss. Alternatively, if an entity had documented a hedging relationship in such a way that it anticipated rebalancing a hedging relationship in the event that circumstances changed to ensure as perfect an offset as possible, but subsequently failed to do so (perhaps because in the event it was very costly to do so), does that mean that hedge accounting would need to be discontinued even though the actual relationship, although not perfectly effective, was (for example) 70% effective?

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

We agree that voluntary, proactive, rebalancing should be permitted. This would permit an entity's hedge accounting to be consistent with its risk management strategy in the event of changes in the hedging relationship.

Question 8

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

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

We disagree with the proposals.

While concerns might arise at the potential for manipulation of results, through the voluntary designation and dedesignation of hedging relationships, we believe that there should be a free choice of when to discontinue hedge accounting as well as the proposed free choice as to when to commence hedge accounting. As an example, an entity might consider, after entering into a hedging arrangement where hedge accounting was followed, that the cost of regular effectiveness testing outweighed the benefits obtained from the accounting effect. In such cases, dedesignation should be permitted. It is possible that this is intended from the guidance, since the lack of an effectiveness test would mean that not all of the qualifying criteria set out in the ED would be met. If this is the case, it would be helpful for this to be clarified.

It is also not clear what might constitute a sufficient change in risk management strategy (which itself is not clearly defined in the ED) to permit (or require) dedesignation of a hedging relationship. We assume that a significant change in strategy would be required (such as a change from a policy of having 50% of fixed and 50% of floating rate debt to one of 100% fixed rate debt), but again it would be helpful for there to be some further guidance in the final standard.

In the event that voluntary dedesignation was permitted, we believe that clear disclosure of any hedging relationships that were dedesignated in each accounting period should be required, including the reason(s) for that dedesignation.

Question 9

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

While we agree that all hedge ineffectiveness should be recognised in profit or loss, the two step approach that has been proposed appears unnecessary and would add additional clutter to the primary statements. We suggest that hedge ineffectiveness is simply recognised directly in profit or loss, with the effective portions being taken to OCI and the gross amounts being disclosed in the notes to the financial statements.

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

While we acknowledge that the combination of changes in the fair value of a component of a hedged item with other components that are measured at amortised cost means that the item is presented at an amount which is neither fair value nor amortised cost, we consider that the proposed approach would risk including too much detail on the face of the primary statement. Again, we suggest that the detail is included in the notes to the financial statements.

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

We agree, and again would include the more detailed disclosures in the notes to the financial statements.

Question 10

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

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

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

We do not agree with the proposals.

We do agree with the proposal to account for the time value element of an option separately, with the choice of approach that is available under IAS 39 being eliminated. However, regardless of the hedged transaction, we would account for the time value element in the same way, with this being charged to profit or loss on a systematic basis (typically over the life of the option) in a similar way to, for example, a financial guarantee contract asset. We believe that a requirement to distinguish between transactions and account for them differently adds unnecessary complexity, which is undesirable.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree with the proposals. However, we note that any proposed approach for groups of items may have an effect on hedge accounting for open portfolios, on which the IASB has yet to propose a revised approach. We encourage the Board to conclude its discussions on portfolio hedge accounting as soon as possible.

Question 12

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

We agree with the proposals.

Question 13

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

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

We agree with the proposed disclosures set out in paragraphs 40 to 43. However, while we do not entirely disagree with the detailed disclosures proposed in paragraphs 44 to 52, we question whether they are all required. We suggest that the following might be used as principles to determine the information that is ultimately required:

- What is being hedged?
- Why is it being hedged?
- How effective/ineffective has the hedge been?
- What is the effect on the primary financial statements?

We note that no disclosures are required for those items which have not been designated in a hedging relationship, but are used for the purposes of hedging in the context of an entity's risk management strategy. We agree that for many transactions which are routine and fit within an entity's risk management strategy, disclosures should not be required. For example, an entity might sell goods in a particular foreign currency and purchase raw materials required to produce those goods in the same foreign currency from a supplier. We would expect risk management disclosures for those types of transaction to be covered by management's more general discussion of risks arising from business activities, and not by those covering hedge accounting.

However, in certain cases entities enter into specific external contracts, often derivative contracts, for the purposes of risk management but do not designate these external contracts as hedging instruments in a qualifying (accounting) hedging relationship, even though it would be possible to do so. To an extent, this existing practice has been driven by the complex and onerous requirements of IAS 39; if taken forward, the proposals in the ED may make hedge accounting more attractive for a wider range of entities. However, we believe that it would be appropriate to require disclosures for these instruments, in order that two entities undertaking the same or very similar risk management activities using specific hedging instruments contracted with external parties do not have substantially different disclosure requirements simply due to whether hedge accounting has been applied.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

We agree, although we note our comments about the linkage of each hedging relationship to an entity's risk management strategy in the first paragraph of our response to question 1.

Question 15

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

(b) If not, which of the three alternatives considered by the Board in paragraphs BC226-BC246 should the Board develop further and what changes to that alternative would you recommend and why?

We do not agree with the proposal. Financial institutions often manage credit risk through the use of credit derivatives and, consistent with our support for the ability to hedge components of instruments, we do not believe that there should be a prohibition on hedge accounting for credit risk.

We acknowledge that each of the three alternatives set out in the Basis for Conclusions would introduce unnecessary complexity in accounting for these types of hedge. However, we believe that a specific model for credit risk should not be developed, with it instead being left to each entity to determine whether it can demonstrate that its hedges of credit risk are effective.

Question 16

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

In general we agree with the proposals, although we note that for some entities that structured hedging arrangements in order to accommodate the requirements of IAS 39 may not find it straightforward to designate these in accordance with the proposed approach.

In addition, and as noted in our comment letter in response to the Request for Views on effective dates and transition, we believe that it is likely to be appropriate for the mandatory effective date for the financial instruments standard to be aligned with that for the new insurance standard, with early adoption being permitted. This might result in the effective date for IFRS 9 being modified to at least periods beginning on or after 1 January 2014.