



**KPMG IFRG Limited**  
8 Salisbury Square  
London EC4Y 8BB  
United Kingdom

Tel +44 (0)20 7694 8871  
Fax +44 (0)20 7694 8429  
mary.tokar@kpmgifrg.com

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
1<sup>st</sup> Floor  
30 Cannon Street  
London  
EC4M 6XH

Our ref **MT/288**  
Contact **Mary Tokar**

9 March 2011

Dear Sir

**Comment letter on IASB Exposure Draft ED/2010/13 *Hedge Accounting***

We appreciate the opportunity to respond to Exposure Draft ED/2010/13 *Hedge Accounting* (the ED or the proposals), issued by the International Accounting Standards Board (IASB). We have consulted within the KPMG network in respect of this letter, which represents the collective views of the KPMG network.

We support the development of a standard based on the core principles in the proposals. Hedge accounting is currently rules-based and requires detailed requirements to be met. The ED proposals have a different starting point and adopt a more principles-based approach which includes aligning hedge accounting more closely with risk management. We agree with this directional change. However, we do have concerns about the clarity of certain principles in the proposals. In particular, risk management functions and activities vary from entity to entity and therefore it is important to get more clarity around the principle of aligning hedge accounting with risk management in order to achieve consistency of application. We discuss this and our other key concerns below. We expand on these points and discuss other issues in Appendix A to this letter.

**Risk management**

The proposed objective of hedge accounting makes an entity's risk management a determining factor in assessing whether hedge accounting can be applied. However, even though risk management is discussed in IFRS 7 *Financial Instruments: Disclosures* (IFRS 7), it is not defined under IFRSs or ISAs. Entities may have difficulties aligning hedging relationships at the transaction level with risk management which is often applied at a much higher level. Therefore, we are concerned that entities may interpret risk management in the context of the proposals differently and apply hedge accounting in situations the Board did not intend or vice versa. This issue also would create difficulties in auditing an entity's assertion that it has aligned its hedging relationships with its risk management activities. We ask the Board to clarify the objective of hedge accounting to address this issue.

In particular we ask the Board to clarify whether it believes that risk management would need to include policies and processes at a lower level than entity-wide or other high level, such as an individual hedging strategy level, and if not, how linking such high-level policies and processes to individual hedging relationships could be achieved.

### **Risk components**

We believe that the Board should clarify the principles of ‘separately identifiable’ and ‘reliably measureable’ as they are key in determining the eligibility of risk components of financial and non-financial items as hedged items.

For example, it is unclear whether in order for a risk component to meet the separately identifiable and reliably measureable conditions any or all of the following are needed:

- A forward market for the hedged component for the hedging relationship period;
- A statistical correlation between the hedged component and the non-financial item and whether such correlation is based on the cost or fair value of the component and non-financial item; and
- Each component that makes up the non-financial item, and not just the hedged component, is separately identifiable and reliably measureable.

Clarification of these principles also would assist in the evaluation of whether non-contractually specified inflation and credit risk are hedgeable components.

### **Effectiveness assessment**

We support the removal of the current ‘bright-line’ quantitative thresholds for expected and actual effectiveness. However, the proposed qualitative descriptions are not sufficiently specific to drive consistent application. We believe that the Board should clarify the principles of ‘minimising expected hedge ineffectiveness’ and ‘producing an unbiased result’. As different readers of the proposals might interpret the principles differently, the proposals could create application challenges and auditing issues.

### **Other issues**

***Eligibility criteria for including items in a group:*** It is difficult to comment fully on the proposed requirements for group hedging until we have seen the Board’s proposals on open portfolio hedging. We are concerned that the proposals do not appear to contain any eligibility criteria for groups of hedged items, whether gross or net, other than aligning the relationship with an entity’s risk management activities and limiting net position cash flow hedges. As the hedged items in a group of items effectively “hedge” one another, we believe that they should be subject to analogous requirements to those of a hedging instrument and hedged item in a

traditional hedging relationship (i.e. some type of similarity test). To do otherwise could be interpreted as hedge accounting being the rule and the normal recognition and measurement requirements of IFRSs the exception.

**Risks that affect profit or loss:** We do not agree with the proposed requirement that a hedged risk must affect profit or loss. We suggest that risks that affect other comprehensive income also should be hedgeable.

**Cash flow hedge accounting for groups of items:** We do not support the proposal to limit cash flow hedge accounting for groups of items with offsetting positions to only those that affect profit or loss in the same period. We believe that it is common for an entity's risk management activities to include exposures on a group basis that affect multiple periods. We believe that the accounting should be aligned with an entity's risk management activities and the eligibility of hedge accounting should not be impacted by the frequency of an entity's reporting.

**Fair value hedge accounting:** We do not believe that the proposed changes to the mechanics for fair value hedge accounting are improvements or reduce complexity. We support retaining the current fair value hedge accounting model as it relates to recognising the changes in fair value of the hedged item and hedging instrument in profit or loss and disclosing ineffectiveness in the notes to the financial statements.

Although we support the separate line item approach in the proposals over the current mixed measurement model, we believe that the benefits of using a separate line item approach will be negated by the effects of entities having multiple additional line items in the statement of financial position. Therefore, we propose two possible alternatives: all valuation adjustments would be aggregated into a single line item or all valuation adjustments for hedged assets would be aggregated into a single line item and all valuation adjustments for hedged liabilities would be aggregated into a single line item.

**Layers of prepayable items:** We do not support the proposal to preclude a layer component of a contract or group of contracts that contains a prepayment option for which the option's fair value is affected by changes in the hedged risk from being designated as a hedged item. Instead, we believe that the changes in fair value of the layer should include the change in fair value attributable to the prepayment option, if any, that is expected to affect that layer.

**Accounting alternatives for 'own-use' contracts:** We believe that the criteria for the suggested accounting are too restrictive. Instead, we believe that an entity should have the option to designate such contracts at fair value through profit loss based on the same criteria as the fair value option under IFRS 9 *Financial Instruments* (October 2010) (IFRS 9) for financial liabilities.

## **Portfolio hedging**

We support the Board's proposal to develop an exposure draft on open portfolio hedge accounting or macro hedging which might better enable entities that manage their risks in this

way, in particular financial institutions, to reflect this in their financial statements. Portfolio hedging is also of particular importance in Europe as it is subject to the current 'carve-out' in the European Union. We note that the Board may need to revisit certain aspects of the proposals in this ED once it has received feedback on the portfolio hedge accounting proposals and constituents have had the opportunity to evaluate the package as a whole.

### **Convergence**

We also note that the ED proposes changes that are significantly different from those proposed for hedge accounting under US GAAP in the Financial Accounting Standards Board's (FASB's) comprehensive financial instruments accounting exposure draft published in May 2010. We continue to reiterate the importance of the Boards working together to create a single set of high quality global accounting standards.

Our responses to the individual questions asked in the ED are set out in Appendix A of this letter.

If you have any questions about our comments or wish to discuss any of these matters further, please contact Mary Tokar +44 (0)20 7694 8871 or Enrique Tejerina +1 (212) 909-5530 with KPMG's International Standards Group.

Yours faithfully

*KPMG IFRG Limited*

KPMG IFRG Limited

## **Appendix A – Responses to the Board’s questions**

### **Objective of hedge accounting (paragraphs 1 and BC11–BC16)**

#### **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 generally agree with the objective that hedge accounting should represent in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks. Including a clear, principles-based objective in the standard would avoid situations in which hedge accounting is arbitrarily not allowed even though the hedge relationship is consistent with appropriate risk management activities. However, we believe that the Board should clarify its objective so that entities can interpret risk management in the context of the proposals consistently and determine how to align hedging relationships at the transaction level with risk management which is often applied at a much higher level. We believe this is necessary because the proposed objective of hedged accounting makes an entity’s risk management a determining factor in assessing whether hedge accounting can be applied. In addition, we do not agree that the hedged risk must affect profit or loss.

#### ***Risk management***

In deliberating other areas of the IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) replacement project, the Board has required entities to make accounting determinations based on their business model. Under IFRS 9 one of the criteria for determining if a financial asset is classified at amortised cost is based on whether “the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.” Under the IASB’s supplemental document on impairment of financial assets managed in an open portfolio, the determination of whether an asset held in an open portfolio is carried in the ‘good book’ or ‘bad book’ would be based on the entity’s credit risk management objective.

Although these aspects of financial instrument accounting have a link to an entity’s business model or credit risk management, the current hedge accounting model is particularly rules-based. This creates at times a disconnect from an entity’s risk management activities. Therefore, we note that in practice, aligning existing hedges with risk management may require significant effort and changes to risk management documentation, as some current hedges may have been designed or designated to primarily achieve an accounting objective. However, realignment will need to be done since the proposed objective of hedge accounting makes an entity’s risk management a determining factor in assessing whether hedge accounting can be applied.

Adding to this challenge is the fact that risk management is not defined under IFRSs or ISAs. IFRS 7 requires qualitative disclosures of an entity’s policies and processes for accepting, measuring, monitoring and controlling risk and discusses certain components that may be part of these policies and processes. However, the policies and processes used by an entity to manage risk are typically developed and applied at a high level and not at an individual transaction level. Entities may have difficulties aligning hedging relationships at the transaction

level with risk management. Therefore, we are concerned that entities may interpret risk management in the context of the proposals differently and apply hedge accounting in situations the Board did not intend or vice versa. This issue also would create difficulties in auditing an entity's assertion that it has adequately aligned its hedging relationships with its risk management activities. We ask the Board to clarify the objective of hedge accounting to address this issue.

In particular we ask the Board to clarify whether it believes that risk management would need to include policies and processes at a lower level than entity-wide or other high level, such as an individual hedging strategy level, and if not, how linking such high-level policies and processes to individual hedging relationships could be achieved.

We also suggest that the IASB consult with the International Auditing and Assurance Standards Board (IAASB) about this key proposal so that the IAASB can consider whether any of the existing ISAs need to be amended and whether new IAPs need to be issued.

Lastly, we suggest that the Board clarify that the application of hedge accounting is not mandatory, despite the objective that the effects of risk management activities should be reflected in the accounting.

***Risks that affect profit or loss***

While we believe in principle that hedge accounting should be aligned with an entity's risk management activities, we recognise that this might not be the optimum answer in certain circumstances (e.g. using written options as hedging instruments since these instruments expose the writer to open-ended risk). However, we do not believe that hedgeable risks should be limited to those that affect profit or loss. We suggest that they be expanded to include risks that affect other comprehensive income when such an approach is consistent with the entity's risk management.

For hedges of risks that affect other comprehensive income, changes in fair value of the hedging instrument and the hedged item in a fair value hedge, and the resulting volatility due to ineffectiveness, could be reflected in other comprehensive income. For a cash flow hedge, the change in fair value of the hedging instrument could be reflected in other comprehensive income as could the subsequent effect of the hedged item. This accounting would be analogous to hedges of risks that affect profit or loss.

**Instruments that qualify for designation as hedging instruments (paragraphs 5–7 and BC28–BC47) 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. There appears to be no conceptual reason to preclude a non-derivative financial instrument measured at fair value through profit or loss from being designated as a hedging

instrument when this is consistent with an entity's risk management. Below we point out two issues we suggest that the Board clarify in this area.

In paragraph B5, we assume that a proportion of a non-derivative financial instrument measured at fair value through profit or loss could be designated as a hedging instrument, as is the case for a proportion of a derivative hedging instrument. We suggest that this be clarified.

In addition, we suggest that the Board clarify the prohibition on designating a hedging instrument for only part of its life. We understand that the Board's intention, consistent with the way in which IAS 39 is applied generally, is that, for example, an interest rate swap with a remaining term of 10 years may be designated as a hedge of an instrument with a remaining term to maturity of 9 years, but that some ineffectiveness would result. The restriction is on separating the interest rate swap into a 9-year swap and a forward-starting one-year swap and designating only the 9-year swap as the hedging instrument. Some have interpreted the requirement in IAS 39 as precluding a hedging instrument from being designated in a hedging relationship when the hedged item has a shorter maturity.

**Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48–BC51)**

**Question 3**

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

We agree with the principle. This is an example of aligning hedge accounting with an entity's risk management activities. In the past in many situations, workarounds to the prohibition of aggregated exposures have been achieved by combining multiple derivatives to be the hedging instrument in a hedge of one or more risks. We believe that either approach should be acceptable (i.e. aggregated hedged item or aggregated hedging instrument), depending on how the combinations of hedged items and hedging instruments are viewed from a risk management perspective. However, it is unclear from the guidance provided how to account for the aggregated exposures.

We ask the Board to clarify:

- Whether the combination of the derivative and non-derivative(s) that form the aggregated exposure, and thus the first hedging relationship, is subject to all of the hedge accounting requirements as any other hedging relationship;
- The accounting for both the first hedging relationship and the combined hedging relationship (e.g. is the first derivative accounted for under the hedging model governing the first or second hedging relationship?);

- How an entity would assess hedge effectiveness for both hedging relationships (e.g. is hedge effectiveness assessed for each individual hedging relationship or the combined relationship?).

Without clarification the principle could be misapplied, such as allowing hedge accounting for the first hedging relationship (aggregated exposure) when currently it would not qualify. For example a written option could be included in an aggregated hedged item or the aggregated hedged item could involve foreign currency risk on a foreign currency fixed-rate instrument which is exchanged for a different foreign currency risk (Dollar functional currency entity converting a Euro-denominated debt instrument to a Yen-denominated debt instrument with a foreign currency forward contract).

**Designation of risk components as hedged items (paragraphs 18, B13–B18 and BC52–BC60)**

**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. There should be consistent hedge accounting eligibility requirements for non-financial and financial items. However, we believe that the Board should clarify the principles of separately identifiable and reliably measureable as they are key in determining the eligibility of risk components as hedged items.

Paragraph B15 notes that the reliably measurable condition is met when a forward market for the underlying exists and the separately identifiable condition is met when there is a relationship between the prices of the component being hedged and the non-financial item. The discussion describes such a relationship as a ‘building block’. In addition, paragraph B14 states that the assessment of whether risk components are hedgeable is made in the context of the particular market structure to which the risk relates and in which the hedging activity takes place. We do not believe that the guidance in this area is robust enough to allow entities to understand and therefore comply with such principles. In addition, this lack of clarity would make auditing the assertions that these conditions have been met difficult.

For example, it is unclear whether the following are needed in order for a risk component to meet these conditions:

- A forward market for the hedged component for the hedging relationship period;
- A statistical correlation between the hedged component and the non-financial item and whether such correlation is based on the cost or fair value of the component and non-financial item; and



- Each component that makes up the non-financial item, and not just the hedged component, is separately identifiable and reliably measureable.

Although the principles of separately identifiable and reliably measureable are included in the current guidance for assessing risk components of financial items under IAS 39, issues in practice have arisen. For example, even though the basis for conclusions of IAS 39 notes that non-contractually specified inflation is not separately identifiable and reliably measureable, the conceptual basis behind this determination has not been explained adequately. In addition, the Board notes that they believe credit risk hedging to be operationally difficult, if not impossible, to achieve. Although we address the issue of credit risk hedging specifically in our response to question 15, we believe that the Board should consider credit risk hedging, as well as inflation, when they clarify the principles of separately identifiable and reliably measurable.

**Designation of a layer component of the nominal amount (paragraphs 18, B19–B23 and BC65–BC69)**

**Question 5**

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

We agree with (a). A layer component of a nominal amount, such as the bottom 10,000 widgets of inventory, is not different from any other layer component of the nominal amount. Therefore, similar to the eligibility of a proportion or percentage of an item to be designated as a hedged item, a portion or layer should be an eligible hedged item as long as the layer can be identified with sufficient specificity to track for accounting purposes (i.e. separately identifiable). For example, we would not expect that a layer designated as the last 10,000 widget sales in a period would meet the separately identifiable condition for hedge accounting as such an amount could not be specified sufficiently to track for hedge accounting purposes and other accounting processes, when applicable, such as impairment testing, income recognition and derecognition. In addition, we do not believe that the example in paragraph B21(b), “a part of a physical volume, eg 50,000 cubic meters of natural gas stored in location XYZ” is sufficiently specified since the timing of the sale or use of these cubic meters of gas could not be identified. Thus, we do not believe that this layer component would qualify as a hedged item. We ask the Board to clarify this example.

We do not agree with (b). We believe that a layer component of a contract or group of contracts that contains a prepayment option(s) for which the option(s)'s fair value is affected by changes in the hedged risk should not be precluded from being designated as a hedged item in a fair

value hedge. This is consistent with practice when hedging a bottom layer of variable cash flows subject to prepayment.

However, we believe that the changes in fair value of the layer should include the change in fair value attributable to the prepayment option, if any, that is expected to affect that layer. That is to say that an entity should take into consideration expectations of prepayments of the items within the layer when calculating the changes in fair value of the layer. For example, there may be scenarios for which an entity has designated a layer of items, such as the interest receipts of the bottom 10,000 USD of a group of prepayable loans that total 100,000 USD, and determines that there is substantially no likelihood that the layer will be prepaid. In such a scenario, the change in fair value of the layer due to changes in fair value attributable to the prepayment option would be nil.

**Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27–B39 and BC75–BC90)**

**Question 6**

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

We support the elimination of the bright-line effectiveness requirements in IAS 39. We support the proposal that only a prospective effectiveness test should be required, and that in many simple cases only a qualitative assessment would be needed at each reporting date or when a hedge is rebalanced. However, we believe that the Board should clarify the principles of minimising expected hedge ineffectiveness and producing an unbiased result.

The current bright-line effectiveness requirements in IAS 39 are arbitrary and lead to a lack of clarity and comparability in the financial statements. Under IAS 39, the accounting results for two similar hedging relationships, based on the same risk management objective, are different if one is determined to be 79% effective and the other is 81% effective. In other words, the former does not qualify for hedge accounting while the latter does.

***Minimising expected hedge ineffectiveness and producing an unbiased result***

We believe that the objectives of the effectiveness requirements are not clear enough to ensure that entities will apply the principles consistently and as the Board may intend. In addition, this lack of clarity would make auditing the assertion that the requirements have been met difficult. Producing an unbiased result implies no hedge ineffectiveness while minimising expected ineffectiveness implies the possibility of some ineffectiveness. Also, the ED notes that an entity should have no expectation that changes in the fair value of the hedging instrument will systematically either exceed or be less than that of the hedged item, but that this does not mean that there should be an expectation of perfect effectiveness. Thus, somewhere between some level of random ineffectiveness and perfect effectiveness may be the appropriate effectiveness level. Different readers of the proposals might interpret the effectiveness conditions as being more or less restrictive than the current requirements. While these conditions would be based on

an entity's risk management activities, it is unclear whether a hedging relationship would qualify if risk management called for a very low effectiveness threshold.

In addition, it is unclear how an entity should align the evaluation of whether an individual hedging relationship meets the conditions of minimising expected hedge ineffectiveness and producing an unbiased result with its risk management which often is applied at a much higher level. For example, risk management may not address the expected level of hedge effectiveness at the individual hedging relationship level. Instead, it may address an objective of risk mitigation at a division or some other high level of an entity's structure.

#### ***Other than accidental offset***

We agree that 'other than accidental' is an appropriate criterion. In our experience, it is unlikely that an entity would put in place hedges using offset that is 'accidental'. We expect risk management to be based on offsetting risks that can be demonstrated to be economically effective. However, we do not believe that the examples provided in paragraph B31 are useful to explain this principle. Thus, we suggest that these examples be deleted and replaced with a general statement that an entity's risk management normally seeks to use hedging instruments that provide an appropriate degree of offset in cash flows or fair values based on demonstrated economic relationships.

Another area for which there is lack of clarity is whether the changes in fair value of the hedged item can be determined using a hypothetical derivative for fair value hedges.

It is unclear why the Board states in paragraph BC 36 that *most* hedging relationship using cash instruments would not achieve other than accidental offsetting. For example, if an entity designates an investment in fixed-rate bonds as the hedging instruments in a hedge of the change in fair value of fixed-rate liabilities attributable to the change in a benchmark interest rate, it is unclear why this strategy would fail the other than accidental offsetting criterion in most scenarios. Although the changes in fair value of the hedging instruments would in many cases include changes due to credit risk and liquidity risk that would not be included in the hedged risk, this would be the same if a derivative were designated as the hedging instrument. The effect of a change in credit risk on a derivative hedging instrument is considered by the Board in paragraph B31. Paragraph B31 provides an example in which the counterparty to an uncollateralised derivative hedging instrument experiences a severe deterioration in its credit standing and it then is determined that any offsetting between the change in fair value of the hedging instrument and the hedged item's fair value or cash flows might become accidental. Paragraph B31 does not indicate that the mere possibility of changes in the credit risk of the derivative would invalidate the hedge effectiveness requirements in other circumstances.

Furthermore, we note that if an entity designated, say, fixed-rate German government bonds as the hedging instruments in a hedge of fixed-rate Euro-denominated liabilities for changes in fair value attributable to changes in the German government bond yield, the hedging relationship would appear to meet the hedge effectiveness criteria. Therefore, we do not believe that the Board's view in BC36 is consistent with the qualifying criteria for hedge accounting in the

proposals and believe that the Board should clarify its reasoning in paragraph BC36 for stating that most hedging relationships using cash instruments would not achieve other than accidental offsetting.

### **Rebalancing of a hedging relationship (paragraphs 23, B46–B60 and BC106–BC111)**

#### **Question 7**

- (a) *Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?*
- (b) *Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?*

We agree with the proposed requirement in (a). Under the current requirements, entities are required to de-designate their hedging relationships when they fall outside of the bright-line hedge effectiveness requirements. These entities often re-designate such hedging relationships given that there is no change to their risk management objectives. De-designations and re-designations of relationships have led to unnecessary complexity. We believe that in cases in which the entity's risk management objective has not changed, rebalancing the hedging relationship would be a simpler solution and would reflect more accurately the entity's risk management objectives. However, we believe that the Board should clarify the circumstances in which an entity would be required to rebalance the hedging relationship. For example, is rebalancing required only as a response to changes in the relationship between the hedged item and hedging instrument arising from their underlying or risk variables as noted in paragraph B48 or is it also required when the probability of occurrence of some of the volume of the hedged item changes as noted in paragraph B65(b)?

As to the proposal in (b), the Board should clarify how an entity could determine that the hedging relationship meets the objective of the hedge effectiveness assessment (a prospective test) and at the same time conclude that it would not be effective in the future. The two conclusions seem contradictory.

### **Discontinuing hedge accounting (paragraphs 24, B61–B66 and BC112–BC118)**

#### **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 agree with (a) and (b) that an entity should discontinue hedge accounting prospectively only when the hedging relationship ceases to meet the qualifying criteria and that discontinuing the hedging relationship in any other circumstance should be precluded.

However, as voluntary discontinuation of hedge accounting is prohibited, we believe that the Board should clarify the principle behind discontinuing hedge accounting to explain the consequences for the following actions since they could be interpreted to cause voluntary discontinuations of hedging relationships:

- Failing to rebalance a hedging relationship that no longer meets the objective of the hedge effectiveness assessment;
- Failing to amend hedge documentation subsequent to a rebalancing; or
- Cancelling hedge documentation.

In addition, it is unclear whether an entity would be able to voluntarily discontinue hedge accounting if its risk management policies allowed for voluntary de-designations.

#### **Accounting for fair value hedges (paragraphs 26–28 and BC119–BC129)**

##### **Question 9**

- (a) *Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?*
- (b) *Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?*
- (c) *Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?*

##### ***Fair value hedge mechanics (a)***

We do not support (a) as we believe that the proposed changes to the mechanics for fair value hedge accounting are not improvements and do not reduce complexity; rather, they may cause confusion for users. Thus, we support retaining the current fair value hedge accounting model as it relates to recognising the changes in fair value of the hedged item and hedging instrument in profit or loss. We agree that ineffectiveness should be visible to readers of financial statements, and, therefore, suggest that the ineffectiveness amount be disclosed in the notes to the financial statements.

***Fair value hedge adjustments (b)***

Although we support the separate line item approach in the proposals over the current mixed measurement model, we believe that the benefits of using a separate line item approach will be negated by the effects of entities having potentially numerous additional line items in the statement of financial position. Therefore, we believe that the Board should consider the merits of:

- All the valuation adjustments being aggregated into a single line on the statement of financial position; or
- All the valuation adjustments for hedged assets being aggregated into a single line item and all the valuation adjustments for hedged liabilities being aggregated into a single line item.

We believe that either approach is preferable to the multiple separate line item approach in the proposals as both alternatives would avoid the mixed measurement attribute which was noted by constituents to be overly complex and confusing while avoiding the disclosure of numerous additional line items in the statement of financial position. Under either alternative approach, we recommend that the Board require an analysis of the amounts in the notes to the financial statements.

***Linked presentation (c)***

We do not support linked presentation because we believe that although an asset and a liability may be 'linked' for a specific risk, they might not be linked for all risks. For example, this could result in one net amount for an asset and a liability that are linked even though that link affects only currency risk but not credit risk or interest rate risk. Further, we believe that disclosures about hedging would be a more appropriate alternative to provide information about the relationship between hedged items and hedging instruments.

**Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67–B69 and BC143–BC155)**

**Question 10**

- (a) *Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?*
- (b) *Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?*
- (c) *Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined*

*using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?*

***Transaction-related and time period-related hedged items***

We agree with the proposals in (a) and (b). The proposed accounting is consistent with the view that an option premium paid represents a premium for protection against risk.

***Aligned time value***

We agree with the proposals in (c). We believe that this requirement results in avoiding the recognition of cumulative profit or loss over the hedge period from the under-insured portion of an exposure (i.e. when the aligned time value is greater than the time value of the actual option).

***Zero cost collars***

We noted during the IASB's outreach activity that the IASB Staff's view appears to be that the time value component of a zero cost collar designated as a hedging instrument would not be accounted for in a manner similar to the time value component of a purchased option. The Staff noted that they believe that as no premium is paid at inception of a zero cost collar the subsequent changes in time value would be recognised directly in profit or loss. We believe that as long as the instrument is not a net written option, the proposed accounting for purchased options should apply.

**Hedges of a group of items (paragraphs 34–39, B70–B82 and BC156–BC182)**

***Eligibility of a group of items as the hedged item (paragraphs 34, B70–B76, BC163, BC164 and BC168–BC173)***

**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?*

Although it is difficult to comment fully on the proposed requirements for group hedging until we have seen the Board's proposals on open portfolio hedging, we generally agree with the principle that a group of items is eligible to be a hedged item. We believe that this would be an improvement to the approach of IAS 39 and would align hedge accounting with how entities manage risks. However, we are concerned that the proposals do not appear to contain any eligibility criteria for hedges of groups of items, other than aligning the relationship with an entity's risk management activities and limiting net position cash flow hedges. In addition, we do not support the proposal that, in a portfolio cash flow hedge, offsetting cash flows must affect profit or loss in the same period.

***Eligibility requirements for groups of items***

We recommend that the Board clarify if there are any qualifying criteria for aggregating a group of hedged items into gross or net positions. As the hedged items in a group, whether gross or

net, 'hedge' one another, we believe that they should be subject to analogous requirements to those of a hedging instrument and a hedged item in a traditional hedging relationship (i.e. some type of similarity test). These criteria also would mitigate operational issues dealing with the subsequent accounting of the individual hedged items such as impairment.

Our view is based on the fact, as the Board states in paragraph BC 11, that hedge accounting is an exception to the normal recognition and measurement requirements of IFRSs. Allowing hedged items to be grouped without some type of similarity test on the basis that it is consistent with the entity's risk management could be interpreted as hedge accounting being the rule and the normal recognition and measurement requirements the exception. For example, taken to the extreme, an entity could hedge its entire fixed-rate financial instrument net position by hedging these net assets or liabilities, no matter how dissimilar these instruments may be, if that was in line with its risk management objective.

#### ***Cash flow hedges of groups of items***

We do not support the proposal that, in a portfolio cash flow hedge, offsetting cash flows must affect profit or loss in the same reporting period. An entity might choose, for risk management purposes, to define hedged portfolios by time period, depending on when the hedged item affects profit or loss. Alternatively, an entity might define its hedged portfolios more broadly by encompassing numerous periods. We believe that an accounting standard should not be a barrier to hedge accounting in those circumstances. We believe that accounting considerations such as the frequency of an entity's financial reporting should not impact the availability of hedge accounting.

If portfolio cash flow hedging with offsetting cash flows that affect profit or loss in different reporting periods were allowed, then it could raise accounting issues that would need to be resolved. It is unclear how an entity would recognise the separate components of the cash flow hedge without 'grossing up' the effect of the hedging instrument. As we note in Question 12, we do not support grossing up the change in fair value of a hedging instrument that hedges a net position.

#### ***Presentation (paragraphs 37, 38, B79–B82 and BC174–BC177)***

##### **Question 12**

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

We agree with the proposals on presentation. We believe that the gains and losses of a hedging instrument designated in a hedge of a net position should be presented as the actual change in fair value of the hedging instrument.



## Disclosures (paragraphs 40–52 and BC183–BC208)

### 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 disclosure objective and with most of the disclosure proposals. We agree that the current scope of IFRS 7 is too narrow to address hedging activities for many entities as IFRS 7 requires an entity to disclose risks *arising from* the use of financial instruments. As there are many scenarios for which an entity's risks are *mitigated by* the use of financial instruments, we believe that the additional disclosures proposed would provide a clearer and more useful depiction of an entity's risk profile.

We agree that the disclosure requirements should be integrated with IFRS 7. At the same time, we believe that the Board should consider whether any existing risk disclosure requirements in IFRS 7 are redundant or duplicative and could be deleted.

We believe that the Board should consider requiring disclosures, based on risk management, of how the effectiveness requirements are established, what requirements are in place and how this is tested for each type – but not each individual - hedge relationship. This would enable users to distinguish between entities that apply lower vs. higher effectiveness thresholds for similar types of hedges. We also believe that disclosures should include the nature of hedging instruments that are used to manage each type of risk.

## Accounting alternatives to hedge accounting (paragraphs BC208–BC246)

### *Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209–BC218)*

#### 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?*

#### **Own-use contracts**

We believe that the criteria for the suggested accounting are too restrictive and entities will find it difficult to comply with the requirements in practice, especially that the net exposure be maintained next to nil. Therefore, we believe that an entity should have the option to designate contracts that can be settled net in cash at fair value through profit or loss based on the same criteria as the fair value option under IFRS 9 for financial liabilities.

We also believe that there might be additional, similar scenarios for which certain types of contracts not reflected currently as assets or liabilities should be treated as derivatives to align

their accounting with an entity's risk management activities (e.g. loan commitments). However, we believe that considering these further issues is not a necessary step to finalising the general hedge accounting model. This issue might be better addressed in a broader project.

Entities that are not commodity broker-traders cannot measure their inventory at fair value. Thus, the proposals for own-use contracts would not affect the measurement of these inventories, even though they may be included with contracts in a fair-value-based risk management strategy. We suggest that the Board clarify whether this was their intention.

### ***IAS 39 scope***

In its March 2010 update the International Financial Reporting Interpretations Committee (IFRIC) noted as part of its agenda decision on IAS 39 – Unit of account for forward contracts with volumetric optionality, that the Board will consider the scope of IAS 39, including the guidance about contracts to buy or sell non-financial items in IAS 39.5-7, as part of the replacement for that standard. We believe that the Board should clarify if they believe that they have addressed all the IAS 39 scope issues they intend to address as part of the IAS 39 replacement project.

### ***Accounting for credit risk using credit derivatives (paragraphs BC219–BC246)***

#### **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 support any of the alternative approaches described. We do not believe that there is anything 'special' about hedges of credit risk that would justify the complexity created by any alternative fair value option approach. Rather, hedge accounting should be applied to hedges of credit risk if the requirements are met, and otherwise no special accounting should apply.

Having said that, we disagree with the assumption in the ED that hedge accounting for credit risk is operationally difficult (if not impossible) to achieve, either under IAS 39 or under the model proposed. In our view, under both IAS 39 and under the proposed model, a credit default swap under which the hedged item can be delivered on default, and which is traded in an active market, provides an adequate basis for identifying and reliably measuring changes in the fair value of that hedged item due to changes in credit risk.

In particular, we believe that the ability to deliver into the settlement mechanism for a credit default swap the item within which the credit risk component being hedged is included shows that specified credit risk can be transferred through this market mechanism. The ability to transfer such risk provides a strong argument that credit risk, or perhaps more accurately,

‘default risk’, can be identified separately using the default events specified in an ISDA-compliant credit default swap contract.

We agree that there are factors relevant to the measurement of a credit default swap, including counterparty credit risk, liquidity, settlement mechanisms, etc, that need to be adjusted for in measuring the fair value of the hedged item and whose significance needs to be considered in making the judgment about whether the risk component can be properly identified. However, this is no different from the adjustments and judgments that need to be made for other types of hedges.

Paragraph B14 notes that, in considering whether a risk component is eligible for hedge accounting, an entity assesses the risk component in the context of the particular market structure to which the risk relates and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market. We agree with these principles. In the context of credit risk, we can see no reason why the application of these principles should make hedge accounting for credit risk more difficult to apply than hedge accounting for other risks.

For example, both IAS 39 and the proposals would permit the risk component in an interest rate fair value hedge to be identified and measured by reference to either LIBOR, EURIBOR or similar curves of various durations. LIBOR is considered to represent a benchmark market interest rate which reflects the credit risk of AA rated banks. It is widely accepted that LIBOR includes the credit risk of the participating banks, and that different LIBOR tenors carry different credit and liquidity spreads, none of which are reflective of the interest rate risk being hedged within the selected item. Nevertheless it is generally accepted that, given the particular market structure, changes in a specified LIBOR rate, which is not contractually specified in the selected item, provide a reasonable means by which to identify and reliably measure changes in the fair value of the item for changes in market interest rates. We see no reason why credit spreads derived from actively traded credit default swaps cannot be accepted for pricing credit as LIBOR is for the pricing of interest rate risk.

Another example is provided in the paragraph B15(b) of the ED, which considers a hedge of the crude oil/gas oil components of future jet fuel purchases by an airline. In that paragraph, it is noted that “on the basis of its analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances, entity B concludes that although crude oil and gas oil are not specified in any contractual arrangement there is a relationship between their prices and jet fuel prices. This relationship results from different refining margins that allow the entity to look at the hedging relationship as a ‘building block’”.

We agree that hedge accounting for the crude/gas oil risk component could be permitted in this example. Nevertheless, judgment would need to be applied to determine the specific market, quality and delivery location to be chosen as the ‘benchmark’ crude oil price used to identify the hedged risk. In making that choice, assumptions would need to be made about which market price best reflects the risk component in the jet fuel purchase. Adjustments might be made to a specified price to reflect the liquidity of the chosen market, credit risk, etc. Nevertheless, as long

as the same approach is applied consistently over time, we would accept that the methodology provides a reasonable means, within the market structure, by which to identify and reliably measure changes in the fair value or cash flows of the hedged item due to changes in a benchmark market price for crude oil.

We see little or no difference between these examples and the judgments, adjustments and assumptions that need to be made to conclude that a method to determine the price of credit based on the price of an actively-traded credit default swap under which an item may be delivered provides a reasonable means by which to identify and reliably measure the credit risk component in an item.

We believe that the Board should not provide specific detailed guidance on hedge accounting for hedges of credit risk using credit derivatives. Practice should be allowed to develop from the objectives and principles in the proposed standard, and should reflect the economic risk management in the accounting, without limitations specific to any particular type of hedge. However, in our view it is important for the standard to recognise that hedge accounting for credit risk is appropriate when the objectives and criteria for hedge accounting are met.

If this difference of opinion as to whether credit risk is a hedgeable component raises any issue, then it is that the principles behind the conditions of separately identifiable and reliably measureable need to be made clearer as discussed in our response to question 4.

#### **Effective date and transition (paragraphs 53–55 and BC247–BC254)**

##### **Question 16**

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

We agree with the proposed transition requirements. However, we ask for clarification on accounting for continuing hedging relationships. We do not agree with the proposed effective date and early application requirements.

Even though we agree with the proposed prospective application of the proposals, it is unclear how continuing hedging relationships (relationships that qualified under IAS 39 and would continue to qualify under the proposals) would be accounted for at transition. For example, in a hedging relationship in which only the intrinsic value of a purchased option is designated as the hedging instrument, the fair value changes in the option's time value would have been reflected in profit or loss under IAS 39 vs. included for a time in other comprehensive income under the proposals. The treatment of such a change in accounting is not clear, including whether a true-up adjustment, calculated as if the proposed hedge accounting had been applied since the hedge inception, is necessary when continuing the hedging relationship. A related issue may arise with respect to derivatives entered into for risk management that did not qualify for hedge accounting under IAS 39 but would qualify under the proposals. The issue is whether, for a hedging relationship established at transition, the assessment and measurement of ineffectiveness could be performed as if the relationship had been established when the derivative was entered into.

We note that the IASB published in October 2010 a request for views on effective dates and transition methods for IFRSs expected to be issued in 2011 as well as other new IFRSs. Our response included views on the effective date and transition method for the hedge accounting proposals and the other areas of the financial instrument project. The comment letter response is attached as Appendix B.

As noted in our comment letter, we suggest that the Board should require that the hedge accounting proposals, along with the other components of the IAS 39 replacement project proposals, have a single mandated effective date three to four years after all of the new and revised standards are published. This extended period is due to more significant preparation being needed prior to implementation. We also suggest that early application of any of these standards and the Insurance proposals individually not be permitted. Early application would be permitted only for all these standards together. This suggestion does not apply to entities in jurisdictions that have already adopted final standards related to the IAS 39 replacement project.

#### **Other comments**

Paragraph 10 notes that an entity may designate combinations of derivatives and non-derivatives as the hedging instrument. The Board should clarify that paragraph 10(b) refers to non-derivatives that are measured at fair value through profit or loss.

Designating and documenting a hedging relationship and its related risk management objective is a qualifying criterion for hedge accounting as per paragraph 19(b). This paragraph should be clarified to state that in addition to an entity documenting its risk management objective, a qualifying criterion for hedge accounting is that the hedging relationship is consistent with the entity's risk management objective. As noted in paragraph B64(a), an entity would be required to discontinue a hedging relationship if it no longer pursues the risk management objective based on which it originally qualified for hedge accounting.

Paragraph 32 notes that the effective portion of a hedge of a net investment in a foreign operation would be accumulated in the cash flow hedge reserve. We believe that such a gain or loss should be recognised in other comprehensive income and accumulated in the foreign currency translation reserve, which is consistent with the current treatment under IAS 39.102 and IFRIC 16.16.

In paragraph B46, the box that is in the upper left hand corner asks "Does the hedging relationship meet the qualifying criteria for hedge accounting?" We believe that the term "qualifying criteria for hedge accounting" should be replaced with the term "objective of hedge effectiveness assessment."

Paragraph B68 notes that the time value of an option relates to the hedged item if the critical terms of the option are aligned with the hedged item. To operationalise this concept, an entity would have to construct a hypothetical option contract with critical terms that align with the hedged item. Please provide guidance as to the style (e.g., American, European, etc) of such a hypothetical option.



## **Appendix B**

**Comment letter on IASB Request for Views on Effective Dates and Transition Methods,  
19 October 2010 and FASB Discussion Paper Effective Dates and Transition Methods  
(File Reference 1890-100)**