

Comment Letters  
IASB  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Paris, March 9, 2011

## Exposure Draft 2010/13: Hedge Accounting

Dear Sir or Madam,

MAZARS welcomes the opportunity to comment on the IASB exposure draft, *Hedge Accounting*. Our answers to the Exposure Draft questions are shown in the appendix to this letter which summarises our concerns and opinion.

The proposals in the exposure draft evidence the Board's efforts to address the limits of the existing guidance on hedge accounting that has been widely criticized for being rule-based, overly complex and not reflecting an entity's risk management.

In our view, the exposure draft contains significant improvements in the following areas:

- We support the proposed objective to better align risk management practice with hedge accounting. This will benefit users and limit situations where accounting treatment is disconnected from risk management with potential undesirable results.
- We welcome the Board's efforts to propose hedge effectiveness requirements as a qualifying criterion for hedge accounting that rely on an objective-based model instead of some arbitrary bright lines. We believe that the arbitrary 80%-125% range has precluded sound hedging strategies to meet IAS 39 effectiveness qualifying criterion for hedge accounting. We also welcome the Board's proposal to allow the entity to elect to use a qualitative or a quantitative hedge effectiveness method depending on the complexity of the hedge relationship.
- We 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 risk component, provided that the risk component is separately identifiable and reliably measurable.

- The proposal will align the designation of risk components as hedged items for financial and non-financial items. It will be helpful for corporates that are increasingly seeking risk strategies to hedge commodity prices on non-financial items.
- We believe that an aggregated exposure that is a combination of an exposure and a hedging derivative may be designated as a hedged item. This will address common risk management practices where an aggregated exposure (also often referred to as a “synthetic exposure”) is managed as one exposure for a particular risk.

We encourage the Board to give further consideration to the following areas:

- We believe that the exposure draft should provide additional guidance on the level at which the risk management objective shall be assessed in order to establish the right linkage between risk management strategy and hedge accounting (see our answer to questions 7 and 8).
- Even though we support the Board's initiative to address the volatility generated by the changes in value of the time value component of an optional hedging strategy, we believe that the Board should simplify the proposed approach that is overly complex (see our answer to question 10).
- We consider that requiring the rebalancing of a hedging relationship, for which the risk management objective remains the same, each time the hedging relationship fails to meet the objective of the hedge effectiveness assessment adds unnecessary operational complexity. The objective of the hedge effectiveness assessment to “minimize expected hedge effectiveness” creates uncertainties over the frequency and timing of rebalancing (see our answer to question 7).
- Even though we understand the Board’s concern regarding the interaction between the prepayment option and the change in fair value of the risk being hedged, we consider that the way the exposure draft is written would preclude entities from using hedge accounting on a layer component of a portfolio because of the existence of prepayment clauses (see our answer to question 5b).

Our major areas of concern related to the exposure draft are as follows:

- A critical point is that the exposure draft does not solve the European carve-out on IAS 39 (e.g. sub-LIBOR issue). Indeed, the proposed guidance requires that if a component of the cash flows of a financial asset or financial liability is designated as the hedged item, that component must be less than or equal to the total cash flows of the asset or liability. We are convinced that the IFRS 9 project is an opportunity to reconcile the IFRS framework and the accounting framework adopted within the European Union that should not be missed.

- Therefore we urge the Board to continue its deliberation with preparers to find a pragmatic solution to this issue (see our answer to question 4).
- We think that the proposed objective of hedge accounting should be expanded to include risks that impact other comprehensive income or balance sheet line items. While the proposed exposure draft is limited to risks that could affect profit or loss, actual management activities also include the use of financial instruments to hedge risk exposures that will not affect profit or loss.
- We consider that the guidance on inflation and the basis for conclusions on credit risk hedging is rule-based and preempts the entity's own analysis so as to determine whether these components are separately identifiable and reliably measurable risk components in its specific circumstances. The proposed explicit prohibition to designate inflation as a hedged item could have unintended consequences on the eligibility of other kind of risk components (especially in the non-financial area) as it does not rely on a principle mentioned in the exposure draft (see our answer to question 4). In addition, we believe that it would not be relevant to impede entities to apply hedge accounting on their hedging strategy related to credit risk, since management of credit risk is a critical part of entities' actual risk management practices especially within the banking sector (see our answer to question 15).

Finally, even though the exposure draft addresses the general model of hedge accounting, it contains proposals that will influence the macro-hedging model (e.g. prepayment options, sub-LIBOR issue). Therefore our comments on the global hedge accounting approach cannot be comprehensive before we get a better understanding of the IASB's direction in respect of macro-hedging.

Do not hesitate to contact us should you want to discuss any aspect of our comments.

Best regards,



Michel Barbet-Massin  
*Head of Financial Reporting Technical Support*

## Objective of hedge accounting

### 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?

The exposure draft proposes that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that uses financial instruments to manage exposures arising from particular risks that could affect profit or loss.

We agree that the objective of hedge accounting should be to reflect in financial statements the effect of transactions entered into for risk management purposes. Users will benefit from closer alignment between risk management and hedge accounting. This will limit situations (e.g. accounting for the time value of options) where accounting treatment is disconnected from risk management, with the following potential undesirable results:

- Economic hedging is not implemented: The entity abandons its hedging strategy because the requirements to qualify for hedge accounting are burdensome.
- Hedge accounting is not attempted by the entity: The entity accepts unnecessary volatility in its profit or loss because it considers that costs of applying hedge accounting outweigh its benefits.
- Hedges documented for accounting purposes are not aligned to the risk management objective.

Any of these outcomes is undesirable and will result in less relevant and understandable information for users of financial statements. We therefore agree that the changes envisaged by the Board constitute an improvement to the IAS 39 rules.

However, we believe that the proposed objective of hedge accounting should be expanded to include risks that impact other comprehensive income or balance sheet line items. While the proposed exposure draft is limited to risks that could affect profit or loss, actual management activities also include the use of financial instruments to hedge risk exposures that will not affect profit or loss. Under IFRS 9 as currently written, changes in the fair value of investments in equity instruments designated at fair value through other comprehensive income will never impact profit or loss. Consequently, the proposed guidance precludes the application of hedge accounting to such instruments, even though it may contradict the entity's risk management activities.

Similarly, the proposed guidance will impede the application of hedge accounting to the following risks exposures since they do not impact profit or loss: actuarial gains or losses (IAS 19), revaluation of property plant and equipment (IAS 16), revaluation of intangible assets (IAS 38), changes in fair value of own equity instruments (IAS 32). Hedge accounting on own equity instruments is relevant for example when the entity's objective is to hedge share based payments. In this case, the entity may want to fix or cap the cost of buying shares in the market to satisfy the promise at vesting date. Therefore, the limitations in the proposed guidance may contradict entities' risk management practices and lead to situations where entities document hedging relationships that are disconnected from their actual risk management practices in order to limit volatility in profit or loss.

We believe that the principles of the proposed hedging guidance should thus be extended so as to allow the hedging of risk exposures even though they will not impact profit or loss. Advocating for that change, we note that the proposed guidance enables the documentation of hedge relationship on net investments in a foreign operation even though the probability that the risk exposure will impact profit or loss may be remote.

### **Instruments that qualify for designation as hedging instruments**

#### **Question 2**

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

The exposure draft proposes that non derivative financial instruments measured at fair value through profit or loss should be eligible hedging instruments.. Current guidance under IAS 39 allows the designation of non derivative financial instruments as hedging instruments for a hedge of foreign currency risk.

Non derivative financial instruments measured at fair value through profit or loss correspond under IFRS 9 to:

- Financial instruments not held within a business model whose objective is to collect contractual cash flows.
- “Complex” financial instruments held within a business model whose objective is to collect contractual cash flows.
- Financial instruments for which the fair value option was elected to eliminate an accounting mismatch.

Hedge accounting may be needed only in the case of “complex” non financial instruments not held within a business model whose objective is to collect contractual cash flows. However, for those instruments, the benefits of the proposal will be limited since the non derivative financial instruments shall be designated in its entirety (except for foreign currency risk). Consequently, the effects of risk components of the non-derivative financial instruments that are not related to the risk being hedged cannot be excluded from the hedging relationship, thus negatively affecting the effectiveness assessment.

Even though we do not foresee its actual benefits, we agree with the Board’s proposal to expand the eligibility of non derivative financial instruments measured at fair value through profit or loss as hedging instruments

We also think the Board should reconsider the ability to designate net written options as a hedging instrument. The proposed guidance leads to inconsistencies in accounting for similar economic hedges depending on the nature of the hedging instrument used.

For example, a corporate may decide to hedge a FX exposure on its sales by buying a floor.

To reduce the cost of its policy, it could either sell a cap or combine both instruments by buying a tunnel at no cost. In this second case, as the tunnel is not a net written option, it would qualify as a hedging item, while the combination of a floor and a cap would not, thus creating undue volatility in profit and loss coming from changes in the fair value of the cap.

While we recognize that the use of net written options in a hedging policy is rare and needs precise documentation, we consider that the exposure draft should not preclude the use of such instruments, leaving to the management to justify and document that the risk management strategies that use such instruments are consistent with the principles of the standard.

### **Derivatives that qualify for designating as hedged items**

#### **Question 3**

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

We agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item. This will address common risk management practices where an aggregated exposure (an exposure with a derivative) is managed as one exposure for a particular risk.

As discussed in question 11, we also believe that the Board should clarify that a group comprised of (i) items that are individually eligible hedged items and (ii) a derivative can be seen as an aggregated exposure that may be designated as a hedged item.

### **Designation of risk components as hedged items**

#### **Question 4**

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (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 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 risk component, provided that the risk component is separately identifiable and reliably measurable.

The proposal will align the designation of risk components as hedged items for financial and non-financial items. It will be helpful for corporates that are increasingly seeking risk strategies to hedge commodity prices on non-financial items. In addition the proposed guidance may potentially enable insurance companies to hedge separately identifiable and reliably measurable risk components in insurance contracts (e.g. foreign exchange risk, interest rate risk, credit risk and also non financial risks such as mortality risk).

However, we do not support IASB's proposed guidance on the designation of inflation as a hedged component. Paragraph B18 of the exposure draft states that *"inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified"*.

We consider that the guidance is rule-based and preempts the entity's own analysis so as to determine whether inflation is separately identifiable and reliably measurable in its specific circumstances. The proposed explicit prohibition to designate inflation as a hedged item could have unintended consequences on the eligibility of other kind of risk components (especially in the non-financial area) as it does not rely on a principle mentioned in the exposure draft. We encourage the Board either:

- To remove the explicit prohibition to designate the inflation component as a hedged item unless it is contractually specified; or
- To explain the principles underlying this prohibition in order to help preparers to adopt a consistent approach on other "identifiable and measurable" components.

Another critical issue for banks and insurance companies is the sub-LIBOR issue. The Board's proposal on the relationship between components and the total cash flows of a hedged item is one of the most sensitive as it forms part of the current European IAS 39 carve out. We are convinced that this IFRS 9 project is an opportunity to reconcile the IFRS framework and the accounting framework adopted within the European Union that should not be missed. Therefore we urge the Board to continue its deliberation with preparers to find a pragmatic solution to this issue.

Our understanding is that the current provision of IAS 39 retained in this exposure draft prevents entities (especially banks) from reflecting their actual risk management policy in their financial statements. The Board's proposal to document the hedging relationship on the total cash flows of the instrument does not seem to be operational. Indeed it will lead to the use of a hedging ratio which will have to be reset frequently to take into account changes in market condition whereas the actual risk management of the entity will manage its exposure on a component basis with a constant hedging ratio. This disconnection between actual risk management and hedge accounting documentation is in contradiction with the Board's objective regarding hedge accounting.

In addition, the exposure draft seems to consider that LIBOR represents a risk free interest rate, but it is not. LIBOR, being an inter banks offered rate, corresponds approximately to an "AA" credit risk. That is why, especially following the recent financial turmoil, high credit quality issuers rated "AAA" can issue "sub-LIBOR" instruments.



This negative residual component is therefore nothing but a convention related to the most active and liquid interest rate index: the interbank one. We therefore consider that a simple market convention should not result in flawed accounting outcome.

Finally, we consider that the Board should clarify the “highly probable forecast transaction” criterion for cash-flow hedges in order to deal with the following specific situation: It is not uncommon that an entity hedges future cash flows which are not highly probable (e.g. tender hedge) with a hedging derivative that perfectly replicates the uncertainty of the hedged exposure. Although there is a perfect economic hedge, it is unclear whether hedge accounting may be applied before the hedged item becomes “highly probable”. In this kind of specific situation where the uncertainty of the future cash flows is fully replicated in the hedging instrument, we consider that the future non highly probable cash flows should be considered eligible hedged items and that the final standard should be clarified in this regard.

### **Designation of a layer component of the nominal amount**

#### **Question 5**

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

Yes, we agree. An entity should be allowed to document the hedged exposure as a layer where that it is consistent with the way it actually manages its risks. We strongly support the Board’s proposal to extend this possibility to fair value hedging.

(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 understand the concern of the Board regarding the interaction between the prepayment option and the change in fair value of the risk being hedged. But we consider that the way the exposure draft is written is too ruled based and does not sufficiently rely on a strong principle. For example, we believe that the existence of a deeply out of the money prepayment option should not preclude the use of hedge accounting. We are particularly concerned that the principles developed in this exposure draft should be consistent with the ones underlying the future approach for an open portfolio (such as bank ALM).

It is clear that in an open portfolio, sound risk management practice will take into account behavioral effects. For instance, on large portfolios of mortgages loans, banks are able to take into account the expected behavior of their clients in terms of prepayment and identify the most stable layer of the portfolio. They will then be able to hedge this stable layer without taking account of the risk of prepayment. Consequently, we disagree that a bank or any other entity should be prevented from using hedge accounting of a layer component of a portfolio because of the existence of prepayment clauses.



Moreover, we also encourage the Board to consider the following proposal. We believe that, when the prepayment option is within the control of the entity, in order to determine whether or not the option is relevant to the determination of fair value, it should be possible to rely on an analysis of its past practice, in a way similar to the one applied to the cash settlement condition in the "own use" exemption. Indeed, in some circumstances, entities may not be interested in prepayment options and never exercise them. The option may constitute a standard clause of financial liability contract. This is especially true when removing such "standard" features would cost to the entity because "tailored" transactions are generally more expensive, even if from an economic point of view, the entity gives up its option.

### **Hedge effectiveness requirements to qualify for hedge accounting**

#### **Question 6**

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

The exposure draft proposes that the hedging relationship meets the hedge effectiveness requirements if:

- It meets the objective of the hedge effectiveness assessment, that is to say it ensures that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness.
- It is expected to achieve other than accidental offsetting.

We welcome the Board's efforts to propose hedge effectiveness requirements as a qualifying criterion for hedge accounting that rely on an objective-based model instead of some arbitrary bright lines. We believe that the arbitrary bright line of 80%-125% has precluded sound hedging strategies to meet IAS 39 effectiveness qualifying criterion for hedge accounting, thus disconnecting hedge accounting from risk management. The introduction of principle-based approach for effectiveness requirements will better align hedge accounting and risk management practices and, therefore, will ease financial communication between preparers and users.

We also welcome the Board's proposal to allow the entity to elect to use a qualitative or a quantitative hedge effectiveness method depending on the complexity of the hedge relationship. We agree that a qualitative method is appropriate when the critical terms of the hedging instrument and the hedged item are closely aligned. Similarly, we agree that a quantitative method may be more appropriate when the hedge effectiveness during the term of the hedging relationship is more difficult to predict.

Next, we agree with the Board's proposal to remove the requirement for retrospective hedge effectiveness testing. First, the entity is required to perform the forward-looking hedge effectiveness assessment at each reporting period or upon a significant change in the circumstances affecting the hedge effectiveness requirements. Second, any ineffectiveness is recognized in profit or loss.

However, we consider that the Board should more clearly describe the qualifying criteria for hedge accounting related to hedge effectiveness requirements. Paragraph 19(c)i states that a hedging relationship needs to meet “*the objective of the hedge effectiveness assessment*” so as to meet “*the hedge effectiveness requirements*”. This objective is detailed in the implementation guidance B29: “*The objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness.*”

In order to simplify the presentation of qualifying criteria for hedge accounting related to hedge effectiveness requirements, we propose to amend the paragraph 19 (c) as follows:

*“The hedging relationship meets the hedge effectiveness requirements (see paragraphs B27-B39). The hedging relationship meets the hedge effectiveness requirements if it:*

- i. ensures that the hedging relationship corresponds to a strategy that will produce an unbiased result and minimize expected hedge ineffectiveness taking into account entity’s risk management objectives (see objective of hedge effectiveness requirements in paragraph B29); and*
- ii. is expected to achieve other than accidental offsetting.”*

In addition, we consider that “produce an unbiased result” is not clearly explained in the exposure draft and may lead some to believe that a prospective 100% effectiveness is required. We think that the Board should provide additional guidance in order to clarify this point.

## **Rebalancing of a hedging relationship**

### **Question 7**

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

We welcome the Board’s efforts to increase entity’s flexibility to adjust (“rebalance” in the exposure draft) existing hedging relationship without discontinuing the hedging relationship. Current IAS 39 treats adjustments to an existing hedging relationship that were not envisaged at the inception of the hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. We think that rebalancing reinforces the alignment between hedge accounting and risk management practices since it enables an entity to reflect in hedge accounting changes in hedge ratio made for risk management purposes.

However, we believe that requiring the rebalancing of a hedging relationship, for which the risk management objective remains the same, each time the hedging relationship fails to meet the objective of the hedge effectiveness assessment adds unnecessary operational complexity.

Operational complexity will arise from the following sources:

- The interaction with the objective of the hedge effectiveness assessment “minimizing expected hedge ineffectiveness” may create operational issues and cause unnecessary burdens for entities. For example, an entity may assess that a change in basis risk requires a rebalancing of the hedge ratio by increasing the volume of the hedged item in order to continue meeting the qualifying criteria for hedge accounting, in particular the “minimizing expected hedge ineffectiveness” objective. Rebalancing will add complexity since the hedged item after rebalancing will be comprised of two layers. We believe that this complexity may be unnecessary since any ineffectiveness arising from the hedging relationship is recognized in profit or loss.

The proposed objective to “minimize expected hedge ineffectiveness” creates uncertainties over the frequency and timing of rebalancing. The decision to rebalance or not will be very difficult to document and justify for entities as soon as some ineffectiveness arise.

- There are uncertainties over the level at which the risk management objective shall be assessed.

One solution would be to consider that rebalancing is optional and not mandatory. We believe that the entity should be allowed to elect either to dedesignate or to rebalance when a hedging relationship ceases to meet the objective of the hedge effectiveness assessment but the risk management objective for that designated hedging relationship remains the same. To make this proposed solution operational, the Board should specify that “minimizing expected hedge ineffectiveness” does not mean “targeting 100% effectiveness”, but “reasonably minimizing expected hedge ineffectiveness”.

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

Yes, we agree. We believe that an entity should be allowed to proactively rebalance the hedging relationship if it expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future.

## **Discontinuing hedge accounting**

### **Question 8**

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

While we support a solution that permits the entities to reflect the way they manage their risks with the least restrictions possible, we agree with the Board's proposal that an entity should normally discontinue hedge accounting prospectively only when the hedging relationship ceases to meet the qualifying criteria. This is consistent with the exposure draft's objective to align hedge accounting with risk management practices. However, we encourage the Board to maintain the option for entities to voluntarily discontinue hedge accounting since the removal of this option might have unintended consequences.

(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?

Yes, we 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. This is consistent with the exposure draft objective to align hedge accounting with risk management practices.

However, we believe that the Board should provide further guidance so as to indicate at which level the risk management objective shall be considered.

### **Accounting for fair value hedge**

#### **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?

We support the Board's proposal to amend the fair value hedge mechanics instead of replacing it with the cash flow hedge mechanics, as initially envisaged. We believe that replacing the fair value hedge mechanics with the cash flow mechanics would have caused artificial volatility in other comprehensive income and equity since the hedged items would not have been remeasured.

We believe that the two-step approach proposed for recognizing hedge ineffectiveness for a fair value hedge adds operational complexity with no corresponding benefit. We believe that, for fair value hedge, users of financial statements are more interested in the amount of ineffectiveness recognized in the profit or loss than in the extent of offsetting achieved in other comprehensive income.

(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?

We support presenting the gain or loss on the hedged item attributable to the hedged risk separately from the hedged item. This eliminates the coexistence of two measurement methods to value the hedged item (e.g. an amount that is amortized cost with a partial fair value adjustment).

However, we do not support adding an additional line in the statement of financial position for every category of items that have such remeasurements. This will reduce the clarity of the presentation by adding too many lines on the face of the balance sheet. Rather, we believe that all remeasurements of the hedged risk should be presented in the statement of financial position in one line without offsetting debit and credit figures, with a distinction for current and non-current portions, where relevant. Our proposal would prevent distorting financial ratios in the statement of financial position. As this is a rather controversial issue, we also recommend the Board to address the problem of the current / non-current classification when dealing with derivative instruments.

Further analysis and disaggregation of the impact of remeasurements into risk types and asset/liability categories would be provided in the notes.

(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 it should be presented?

We agree that linked presentation should not be allowed for fair value hedges. We believe that the face of the primary financial statements is not the best place to disclose complex hedging strategies involving a large number of underlying items. Moreover, we consider that linked presentation is beyond the scope of the hedge accounting project. This issue should be addressed within the context of the project *Financial Statement Presentation*.

### **Accounting for the time value of options for cash flow and fair value hedges**

#### **Question 10**

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. like a basis adjustment if capitalized 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?

We support the Board’s initiative to address the volatility generated by the changes in value of the time value component of an optional hedging strategy.

We note that the Board's proposal relies on the following general principles which already apply to other hedging relationships:

- As any derivative, an option should be measured at fair value on balance sheet;
- Any ineffectiveness of a hedging relationship should be recognized in profit or loss;
- The effective part of the hedge impacts profit or loss in a way consistent with the hedged item (e.g. basis adjustment for non financial items).

We agree and support all the above general principles.

We therefore agree with the outcome of the proposed approach regarding time value of options. We also consider that the Board should clearly state that the proposed accounting treatment could also apply to forward points in forward contracts.

However we have concerns about the complexity of the approach proposed by the Board.

We recommend to the Board to simplify the proposed approach without changing the above underlying principles.

We have identified 2 main sources of complexity:

1. The split of the actual time value between the "aligned" time value and the residual which implies an additional measurement process to the already existing effectiveness test of the hedging relationship.
2. The distinction between "transaction related" and "period related" hedged exposure.

We recommend to the Board to consider the following alternatives in order to simplify the approach without changing its main underlying principles:

1. We understand the Board objective related to the identification and measurement of the “aligned time value”. However we have strong concern about the complexity of this approach.

We consider that most entities, given the complexity of the “aligned time value” approach would prefer not applying hedge accounting (or even not entering into option based strategy) for cost-benefit reason. This would be a major impediment to the Board objective to reflect the actual risk management of entities in the financial statements.

Therefore we recommend to the Board to give up the “aligned time value” concept and treat the full actual time value similarly to how the exposure draft proposes to treat the “aligned time value” component. Though less robust conceptually, this approach seems acceptable to us for the following reasons:

- a. If the difference between actual time value and the “aligned” time value component is likely to be significant, the instrument will probably not benefit from hedge accounting.
- b. Consistently with the Board approach explained in paragraph BC 146 and BC 147, initial time value of an option is not a component of ineffectiveness but rather a cost of protection. Therefore it is not inconsistent with the Board general approach on ineffectiveness to consider that the actual time value should not be split into 2 components.

2. While we agree with the outcome of the approach regarding the timing of profit or loss impact of aligned time value, we consider that the proposed distinction between “period related” and “transaction related” exposure is complex in practice.

Thus we recommend the Board to adopt a principle based approach such as: *“the initial time value component (to the extent that it relates to the hedged item) should impact profit or loss in a manner consistent with the profit or loss impact of the hedged exposure. If the hedged transaction subsequently results in the recognition of a non financial instrument, basis adjustment (as defined in paragraph 33 (b) i of the exposure draft) is required.”*

## Hedges of a group of items

### 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 welcome the Board’s proposal to loosen the criteria for the eligibility of groups of items as a hedged item.

- We particularly support the removal of existing IAS 39 requirements stating that the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.
- We consider that the ability to designate a net position in a hedging relationship is a significant improvement, particularly for corporates in the case of foreign exchange risk. We support the Board’s approach requiring the entity to designate the two gross exposures that together give rise to the hedged net position.
- We agree with the Board’s proposal to allow an entity, when the hedged item is a group that is a nil net position, to designate it in a hedging relationship that does not include a hedging instrument provided certain criteria are met.



However, we draw the Board's attention to the fact that it is not possible to comment on these proposals in full before gaining a better understanding on the Board's direction in respect of macro-hedging.

Our comments on the qualifying criteria proposed to document a group of items as hedged item are detailed below:

- With respect to the first proposed criteria (all items are individually hedged items), we believe that the Board should make it clear that an aggregated exposure (including a derivative) can be seen as an individually qualifying hedged item. In addition, we believe that the first proposed criteria may preclude an entity to designate a portfolio of tenders as a hedged item because, while a proportion of the cash flows of the portfolio of tenders can be deemed "highly probable" cash flows, each tender's cash flows cannot be considered individually as "highly probable". We draw the Board's attention to the fact that this kind of portfolio analysis is also relevant for open portfolio hedging and should therefore also be taken into account in the future macro-hedging proposal.
- The second criterion (items in the group are managed together on a group basis for risk management purposes) enables a greater alignment between hedge accounting and risk management policy.
- The third criterion states that *"for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items, exposed to the hedged risk, affect profit or loss in the same and only in that reporting period (including interim periods as defined in IAS 34)"*. We consider that the third criterion applicable to cash-flow hedge is too restrictive and not in line with the way entities actually manage their risks. This impairs the benefits of the proposed guidance.

This third criterion would make the extension offered by the exposure draft to designate a net position as a hedged item unworkable for many corporates. Corporates would not be able to document on net basis in a cash flow hedge relationship foreign exchange exposures arising on long term contracts. This would contradict risk management practices to hedge foreign exchange risk on a net basis so as to guarantee the level of gross margin over the life of the long-term contract from the contract signature date. We consider that this also contradicts the Board's intention to allow the designation of net position as hedged item in a hedging relationship.

One argument supporting the ability to designate a hedge relationship when the net position impacts the profit or loss in different reporting periods is that the entity could achieve the desired accounting outcome by structuring the operation differently. Assuming that the entity faces foreign exchange exposures on a long-term contract, it could achieve the desired outcome by entering into two forwards

contracts, each with a maturity date in a different reporting period, documented as cash flow hedge with forward points being excluded from the hedge relationship. Another argument is that the entity could, in the case of a long-term contract that came into force, document the foreign exposures on net basis in a fair value hedge relationship in the case of firm commitments. However, the co-existence of fair value and cash flow mechanics on long-term contracts adds unnecessary operational and system complexity.

Were the Board to maintain its position, we think that it should clarify the meaning of “*including interim periods as defined in IAS 34*”. Does it mean that the hedged items shall impact the profit or loss in the same reporting period, with the reporting period including interim periods? Or does it mean that the hedged items shall impact the profit or loss in the same interim period? In such a case, the proposal would disadvantage entities that report quarterly compared to those that report only half yearly and annually.

**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?

Presentation of hedging relationship documented on a gross basis:

We welcome the Board’s clarification, stated in paragraph B80, that the performance of the hedging instrument shall impact the line item in the income statement affected by the hedged item.

Presentation of a hedge of items with offsetting risk positions that affect different lines in the income statement:

We understand the Board’s concerns (BC 174 – 177) regarding the recognition of gross (partially offsetting) gains or losses that do not exist.

However, we believe that the Board should provide greater flexibility on the presentation of instrument gains or losses in the income statement to help entities reflecting their actual risk management in their financial statement. This would enable better alignment between management reporting and financial communication, thus reducing the need for non-GAAP measures, reducing operational complexity and better supporting hedge accounting objectives.

While the presentation of the performance of the hedged instrument in a separate line item above the gross margin enables to display a hedged “gross margin”, it distorts the level of sales and cost of sales that cannot be presented at the guaranteed hedged rate. This may contradict the management risk’s objective to protect the level of sales. We consider that the requirement to present the performance of the forward contract on a separate line item will limit much of the benefits of the possibility to document a hedging relationship on a net basis.

In addition, a potential discrepancy in the exposure draft reinforces our argument supporting the ability to designate a hedge relationship in a cash-flow hedge when the net position impacts the profit or loss in different reporting periods. The proposed fourth criteria (*“not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes as the accounting would not recognize the offsetting risk position that would otherwise be recognized in a hedge of a net position”*) raises the issue of the interaction between the paragraphs § 37 and BC 181 of the exposure draft:

Paragraph 37 states that *“for a hedge of a group of items with offsetting hedged risk positions that affect different line items in the income statement, any hedging instrument gains or losses recognized in profit or loss shall be presented in a separate line item from those affected by the hedged items”*.

According to BC 181:

- 
- 
- *“(a) in periods where hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument) the transactions would reflect an overall hedged rate or price; whereas*
- *(b) in periods where hedge accounting would not be permitted (because the net position is nil), transactions would be recorded at prevailing spot rates or prices.”*

It stems from BC 181 that hedging on a net basis a margin could lead to the recognition of both sales and cost of sales at the hedged rate. However this contradicts the guidance proposed in paragraph 37 stating that the performance of the hedging instrument shall be presented in a separate line item on the income statement.

## Disclosures

### Question 13

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

We welcome the Board’s proposal to allow an entity to incorporate disclosures by cross-reference from the financial statements to some other statement, such as management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. This will provide relief to preparers that are already subject to extensive disclosure requirements and may make it easier for users to find the relevant disclosure.

Additionally, we support the Board’s effort to promote a clear disclosure of the risk management policy. This is consistent with the proposed hedge accounting objective that is to represent in the financial statements the effect of an entity’s risk management activities. This will urge entities to refine the description of their risk management strategies so as to justify that hedge accounting is in line with risk management policies.

However, the proposed disclosure requirements raise the following issues:

- The Board should specify at which level the risk management exposure shall be disclosed in the notes. We believe that entities should disclose the risk management strategy as envisaged at group level by top management. We consider that a too detailed level of information, such as disclosures at the individual hedging relationships level, would impede the clarity of financial statements.
- Paragraph 44 of the exposure draft requires that the entity explains its risk management strategy for each category of risk exposure that it decides to hedge and for which hedge accounting is applied. The Board should precise the interaction between disclosure requirements in the exposure draft and those established in IFRS 7. Moreover under the current proposal, there is no disclosure requirement on risk exposures arising from non financial instruments even though this issue is not included in the scope of IFRS 7. We believe that the Board should propose a comprehensive set of disclosures on risk exposures presenting the entity's risk management strategy no matter which accounting is applied. Entities should be allowed to disclose this information either in the notes or in a management commentary report that is available at the same time as financial statements.

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

As stated in our comment letter, we believe the following notes would provide useful information:

- Effective portions of hedging relationships for fair value hedges provided this information corresponds to a need expressed by users during outreach activities (question 9a).
- Remeasurements of hedged items in the case of a fair value hedge: Further analysis and disaggregation of the impact of remeasurements into risk types and asset/liability categories (question 9b).

### Accounting alternatives to hedge accounting

#### 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 consider that entities should be allowed to apply derivative accounting for a commodity contract that would otherwise meet the “own use” exception if that is in accordance with the entity’s risk management strategy. Applying derivative accounting may be more operational and less onerous for entities than applying hedge accounting.

However, we consider that accounting for a commodity contract that would otherwise meet the “own use” exemption should remain a choice of the entity upon contract signature. We believe that the hedge accounting project is not the relevant mean to establish mandatory requirements on “executory contracts”, which is an issue that has raised many practical issues. Accounting for executory contracts should be re-assessed in the frame of a comprehensive project on the scope of IFRS 9.

### Accounting for credit risk using credit derivatives

#### Question 15

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

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

We agree that the three alternative accounting treatments to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments.

We believe that entities should use the criteria set forth in the exposure draft, that is to say that the risk component is separately identifiable and reliably measurable, to assess whether credit risk can be designated as hedged item. We consider that the proposed guidance is rule-based and preempts the entity’s analysis so as to determine whether the credit risk component is separately identifiable and reliably measurable.

Management of credit risk is a critical part of entities’ actual risk management practices. As such, we believe that it would not be helpful to prevent entities from applying hedge accounting to their hedging strategy related to credit risk.

Thus we disagree with BC 220 wording that “*financial institutions that manage credit risk using credit derivatives do not achieve hedge accounting because it is difficult (if not impossible) to isolate and measure the credit risk of a financial item as a component that meets the eligibility criteria for hedged items*”. BC 225 adds that “*measuring the credit risk component of a loan or a loan component is complex*”.

We consider that the objective of Basis for conclusions is to summarize the Board’s considerations in developing the proposals in the exposure draft, and not to establish rules on how to apply the principles in the standard.

We also disagree with the Board's arguments in BC 221 and BC 222 supporting that it is not possible to document a hedge relationship on credit risk using CDS:

- They are not specific to CDS and may also apply to interest rate and foreign exchange swaps: BC 221 (a), BC 221 (c), BC 222 (a) and BC 222 (b). Similarly to interest rate and foreign exchange swaps, CDS do not require funding and are subject to counterparty risk. 'Cheapest to deliver' options also exist in other vanilla derivatives.
- They are not relevant for all types of CDS: BC 221 (b), BC 221 (d), BC 222 (a) and BC 222 (d). Some types of CDS do not pay the coupon accruals between the last coupon date and the date of default. Some CDS may specifically identify the bond that shall be delivered.
- Auction processes are consistent with market participants approach used in the determination of fair value: BC 222 (c).

Finally, there is an additional argument supporting the fact that credit risk may meet the requirements of a risk component that is separately identifiable and reliably measurable. The Board assessed that changes in own-credit risk were identifiable enough to be separately recorded in other comprehensive income for financial liabilities measured at fair value.

## Effective date and transition

### Question 16

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

We agree that the new guidance on hedge accounting should be applied prospectively to all hedging relationships.

We believe that hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with the criteria of the exposure draft shall be regarded as continuing hedging relationships. However, we do not think that existing hedging relationships that do not meet all the qualifying criteria in the proposed guidance shall be discontinued. We believe that such hedging relationships should be grandfathered until they can be redesignated or rebalanced.

We consider that a retrospective application would be less operational and would contradict the prospective designation set forth in the exposure draft. We agree with the Board that requiring a prospective application only for new hedging relationships would entail the complexity of applying two hedge accounting models simultaneously until hedge accounting is discontinued for hedge relationships established in accordance with IAS 39.

Consistent with our position expressed in the request for views, *Effective Dates and Transition Methods*, we believe that entities should apply all requirements of IFRS 9 (with all phases completed) at a single date, being January 1, 2015.