

# STANDARD & POOR'S

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March 11th, 2011

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

Via upload to [www.ifrs.org](http://www.ifrs.org)

### **Re: *Exposure Draft - Hedge Accounting (ED/2010/13)***

Dear Sir/Madam:

Standard & Poor's Ratings Services (Standard & Poor's) appreciates the opportunity to provide the International Accounting Standards Board (IASB, or the Board) comments on its ***Exposure Draft - Hedge Accounting (ED/2010/13)*** (the Exposure Draft). The views expressed in this letter represent those of Standard & Poor's Ratings Services and do not address, nor do we intend them to address, the views of any other subsidiary or division of Standard & Poor's Financial Services LLC or of its parent, The McGraw-Hill Companies. We intend our comments to address the analytical needs and expectations of our credit analysts<sup>1</sup>.

### **Overview**

We broadly support the changes proposed in the Exposure Draft, which we believe will make hedge accounting more accessible for companies using derivatives for risk management purposes. Companies that have not used hedge accounting because of costs, complexities in conducting periodic tests, and/or meeting the highly effective threshold, could now more efficiently apply hedge accounting, an outcome we support. It will serve to reduce accounting-driven volatility in reported results and provide greater information in the financial statements and accompanying notes about the nature and extent of hedge activities and the ineffectiveness in hedge relationships, thereby improving peer data comparability.

In particular, we welcome the following elements (which we believe will lead to greater application of hedge accounting and, as a consequence, a reduction of artificial volatility in the reported results and financial position):

- A revised objective definition for hedge accounting that better aligns it with risk management activities.
- Widening of the eligibility criteria to include nonfinancial items, if they are separately identifiable and reliably measurable; aggregate exposures combining a derivative and

<sup>1</sup> The opinions stated herein are intended to represent Standard & Poor's Rating Services' views on potential changes in accounting and financial reporting standards. Our current ratings criteria are not affected by our comments on the Exposure Draft.

another exposure; layer components<sup>2</sup>; and groups of items (including net positions) as hedged items.

- Permissibility to include nonderivative financial instruments measured at fair value under the new hedge criteria as hedging instruments.
- Relaxing hedge effectiveness criteria, by allowing a qualitative effectiveness assessment and removing retrospective effectiveness testing and arbitrary “bright line” thresholds.
- Introducing the concept of rebalancing, which should promote better depiction in financial reporting of the ongoing, dynamic nature of risk management activities.
- Removing the option to voluntarily discontinue hedge accounting when the hedge relationship still meets the risk management objective and strategy and all other qualifying criteria, which introduces arbitrary differences in reporting and impedes comparability.
- Allowing derivative accounting for own-use contracts, which will eliminate accounting mismatches in the financial statements.

We welcome other elements of the Exposure Draft that provide greater transparency about hedging activities. Specifically, we support:

- Requiring disclosure about how the entity’s hedging activities may affect the amount, timing, and uncertainty of future cash flows.
- Introducing disclosures (qualitative and quantitative), improving the link between hedge accounting and risk management activities.
- Requiring disclosure of the effects of hedge accounting on the reported results and financial position.
- Changing the mechanics for fair value hedge accounting, with presentation of gains or losses on hedged items on a separate line in the statement of financial position.
- Improving disclosures by separating the cash flow hedge accounting reserve into balances that relate to continuing hedges and to hedges that have been discontinued; and requiring more detail for amounts transferred from the cash flow hedge reserve into profit or loss.

However, we believe the Board, as further explained below, should consider additional significant improvements to certain areas of the proposed framework.

### **Mandatory hedge accounting would enhance peer comparability and reduce volatility**

If hedge accounting remains optional, some companies may elect not to use hedge accounting, despite entering into derivative contracts for risk management purposes. The resulting mark-to-market accounting would create accounting mismatches and volatility in earnings, which obscure the representation of the reported results and financial position. We believe mandating the use of hedge accounting whenever derivatives are used as economic hedges should remove much of this accounting-driven volatility, further reduce

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<sup>2</sup> We also agree with the proposal to disallow a layer approach in fair value hedge relationships where a prepayment option’s fair value is affected by changes in the hedged risk, as this calls into question the extent to which the risk component can be considered separately identifiable.

inconsistencies arising from company-specific optionality, and enable more straightforward peer comparisons.

We further note that allowing free choice about whether or not to apply hedge accounting appears to contradict the proposed objective of the Exposure Draft to represent the effect of an entity's risk-management activities in the financial statements.

If the Board does not follow our recommendation to make hedge accounting mandatory for derivatives that companies deem to be economic hedges, we suggest below additional disclosures that we believe will assist us with our analysis.

#### **Improved disclosures when companies do not use hedge accounting**

Generally, where companies do not apply hedge accounting, we would welcome narrative setting out the objective of the derivative use, a roll-forward of the carrying value of derivative assets and liabilities, and detail about any gains and losses on the derivatives for the period. One issue for our analysis is that, for companies that do not elect to apply hedge accounting (despite entering into derivatives for economic hedging), the resulting mark-to-market accounting of the derivative may create significant volatility in earnings (and equity) from period to period. In these circumstances, the income statement impact of gains and losses on derivatives relating to transactions settled in the period are qualitatively different from fair value movements on derivatives relating to future transactions, which we may adjust out of current year earnings under our methodology<sup>3</sup>. Accordingly, we would welcome disclosures that allow users to distinguish between realized derivative gains and losses on settled transactions, future transactions, and hedged transactions that are no longer likely to occur. Failing this, we would welcome mandatory disclosure of realized and unrealized gains and losses for derivatives, as required under U.S. GAAP.

#### **A solution should be reached for the accounting for hedging of credit risk using credit derivatives**

In the basis for conclusions, the Board explored three potential alternatives of elective fair value through profit or loss accounting for derivatives used to hedge credit risk, but proposed not to permit any of the alternatives in light of attendant complexities. Despite the complexities, we believe alternative 2 is preferable to the accounting mismatch and accounting-driven volatility that result from the current hedge accounting framework. We therefore urge the Board to conclude its consultation on this issue and provide an operational solution. We provide further views on this issue in the appendix to this letter, in our response to question 15.

#### **Harmonization with U.S. GAAP**

We believe that convergence between International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (U.S. GAAP) on financial instrument accounting (and specifically, hedge accounting) should be achieved. The IASB's and Financial Accounting Standard Board's (FASB's) proposals are inconsistent in timing and in the nature of what they propose, which could result in long-lasting inconsistencies for

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<sup>3</sup>See "Corporate Ratings Criteria", April 15, 2008, Nonrecurring Items section.

analysis. We suggest that the Boards take steps to avoid the potential for meaningful distinctions in reported financial results and financial positions of companies by joining their efforts and converge these standards. Because we rate companies globally, comparable accounting is critical to our peer analysis and comparisons.

As previously indicated in our comment letters to the Boards, if divergence remains in this important area, we suggest the Boards require disclosures that facilitate analytical comparisons, and enable potential adjustments to achieve greater comparability.

**A comprehensive disclosure framework is needed**

The complex nature of business transactions means footnote disclosures are ever important in providing essential information to users and allowing them to interpret financial statements. This is of particular importance for derivatives, because their use may affect every financial statement line item and meaningfully modify reported results. We have previously commented that we support the development by the Board of a more structured approach to disclosure in the form of a disclosure framework.

**A finalized general hedge accounting model must provide a foundation for a macro hedging solution**

Given the importance of macro hedging, we urge the Board to consider the impact of the general hedge accounting model on the potential for developing a coherent and operational solution for macro hedging. While we recognize the benefits and practical accommodations of a piecemeal approach, we would prefer the Board not to finalize a standard on the general hedge accounting model before developing a model for macro hedging.

We provide more detail to the above comments and responses to specific questions listed in the Exposure Draft in the appendix to this letter.

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We thank you for the opportunity to provide our comments on the Exposure Draft. We would be pleased to discuss our views with any member of the Board or your staff. If you have any questions or require additional information, please contact the undersigned.

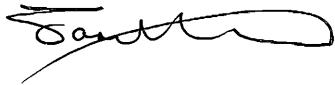
Very truly yours,

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## Appendix – Response to Specific Questions in the Invitation to Comment

### ***Question 1 - Objective***

***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 support the proposed objective of hedge accounting. The proposal should lead to greater comparability and consistency in accounting and financial reporting, and reduce accounting-driven volatility. The proposed objective (and the proposals that flow from it) should lead to more companies being able to apply hedge accounting that are unable or unwilling to under IAS 39 either because of costs or because of complexities in conducting periodic tests and/or meeting the highly effective threshold. As a result, we believe the proposal would better reflect the effect of a company's risk management activities in the financial statements.

However, we believe allowing a free choice in whether or not to apply hedge accounting contradicts the proposed objective of the Exposure Draft to represent in the financial statements the effect of an entity's risk management activities. We prefer that hedge accounting be mandatory for all economic hedges. We believe this is the best way to ensure consistent accounting treatment, improve peer comparability, and better align financial reporting with the economic substance of the business activities.

### ***Question 2 - Extending eligibility to non-derivative financial instruments FVTPL as hedged items***

***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 with this proposal, which would enable more companies to elect to apply hedge accounting and more instruments to qualify when they provide for economic hedges.

### ***Question 6 – Hedge effectiveness***

***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 proposal to replace “highly effective” with “reasonably effective” as the qualifying criteria for determining whether hedge accounting can be used. We favor the removal of the somewhat arbitrary 80%-125% “bright lines” for assessing hedge effectiveness, and providing greater emphasis on qualitative, rather than quantitative, requirements to assess effectiveness. We also agree with the removal of the requirement to retrospectively assess hedge effectiveness. We believe these changes will encourage more companies to apply hedge accounting, leading to reduced accounting-driven volatility.

However, in our view, financial statements could provide greater comparability and transparency if hedge accounting is made mandatory, rather than optional.

***Question 7 – Rebalancing***

***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?***

(a) and (b): Generally, we support the proposals for rebalancing, which should promote better reflection in the accounting and financial reporting of the active and dynamic nature of risk management activities. Rebalancing should reduce hedge ineffectiveness and accounting-driven volatility in the reported results and financial condition of companies.

We believe that requiring companies to rebalance hedging relationships is appropriate in circumstances where the risk management objective for a hedging relationship remains the same. The approach currently taken under IAS 39 (requiring a discontinuation of the existing hedging relationship and the start of a new hedging relationship where hedges are not effective) does not reflect economic reality where the hedge ineffectiveness arises from unforeseen changes in circumstances. The current approach leads to greater ineffectiveness and volatility in the reported results and financial condition of companies than is necessary.

We agree that companies should be permitted to proactively rebalance hedge relationships when circumstances arise that indicate the designated hedging relationship might fail the objective of the hedge effectiveness assessment. Permitting rebalancing allows companies to adjust hedge accounting relationships and strengthen the link between hedge accounting and risk management.

However, we believe the accounting notion of rebalancing could be articulated in the final standard in a way that would convey the concept and the Board's intent more clearly. For example, the Exposure Draft should make clearer that (as we understand it), despite rebalancing being mandatory in accounting terms, a company would not be required to adapt its economic hedges, i.e., enter into external transactions, merely because of the rebalancing requirement.

***Question 8 – Discontinuing hedge accounting***

***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 both the above proposals because we believe they provide greater consistency of treatment and comparability, and reduce the potential to manage reported results. We further believe the current IAS 39 option to voluntarily discontinue hedge accounting creates arbitrariness and introduces differences in the accounting.

For similar reasons, there should not be an accounting choice about whether to apply hedge accounting in the first place where companies use derivatives as economic hedges. We believe hedge accounting should be mandatory in such cases.

***Question 9 – Accounting for fair value hedges***

***(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?***



(a) We support the proposal for accounting for fair value hedges to the extent that it will ensure that information on both cash flow hedges and fair value hedges will be provided within the same primary financial statement, i.e., other comprehensive income (OCI), which can help users understand the impact of broader hedging activities.

However, we are concerned by the expanded use of OCI, because it still lacks a defined meaning beyond a catch-all caption for changes in assets and liabilities that have escaped earnings. Further, certain OCI items are recycled to profit or loss at some stage, while others are not, even if the related asset is sold or the liability settled. As noted in our report, “Standard & Poor’s Views On The IASB/FASB Financial Statements Presentation Proposal” published on RatingsDirect on May 29, 2009 (submitted to the Board as an appendix to our comment letter on that proposal), we recommend that these inconsistencies on OCI be dealt with more comprehensively. We are concerned about such changes occurring in the absence of developing a principled framework for OCI. We believe there should be greater clarity on the principles guiding the permissibility and prohibition in recycling (i.e., why some items of income and expense will never be reported in profit or loss).

(b) We support the proposal to present the gain or loss on the hedged item as a separate line item in the statement of financial position. We believe this presentation will provide additional useful information, e.g., when a fair value gain or loss adjusts the carrying value of a debt instrument held at amortized cost. In our current methodology, we may adjust (neutralize) reported income, equity, and debt for the gains or losses resulting from valuing liabilities at fair value.<sup>4</sup> This is not always easy, because the fair value adjustments made (or the amortized cost amount of the debt) may not be readily apparent in the financial statements. Accordingly, disclosing the gain or loss on the hedged item as a separate line item should help our analysis.

(c) We agree that linked presentation should not be permitted for fair value hedges. We concur that the value of linked presentation is limited, because it does not distinguish the various types of risk that are covered by the hedging relationship from risks that are not affected. The linked presentation may present incomplete--or inaccurate--risk-management interconnectedness; therefore, the outcome reflected in the statement of financial position could be misleading.

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<sup>4</sup> For more on our corporate ratings criteria, see “Criteria | Corporates | General: Criteria Methodology: Calculating Adjusted Debt And Interest For Corporate Issuers”, published June 2, 2008 available at <http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245199733275> and “Criteria | Financial Institutions | Banks: Bank Capital Methodology And Assumptions” published December 6, 2010 available at <http://www.standardandpoors.com/servlet/BlobServer?blobheadname3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadvalue2=inline%3B+filename%3DCriteriaFinancialInstitutionsBanksBankCapitalMethodologyAndAssumptions.pdf&blobheadname2=Content-Disposition&blobheadvalue1=application%2Fpdf&blobkey=id&blobheadname1=content-type&blobwhere=1243806129513&blobheadvalue3=UTF-8>

**Question 13 – Disclosures**

***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?***

(a) We broadly believe the proposed disclosures linking hedge accounting to the risk management activities of companies would assist financial statement users' understanding of derivatives and hedging activities including their effect on the financial statements. The following are comments on specific aspects of the proposed disclosures.

As noted in our response to question 9(b) above, we agree with the proposed disclosure requirement for fair value hedges to present the gain or loss on the hedged item as a separate line item in the statement of financial position.

**Disclosures on the components of (and transfers from) the cash flow hedge reserve—**

For cash flow hedges, the effects of the changes in the value of the hedge derivative are recorded in equity (OCI) before the hedged transaction takes place. This accounting treatment can result in volatility in equity, even though the margin and cash flows of the transaction may economically have been locked in, potentially causing future results to be less volatile. Lack of visibility in the financial statements of how the cash flow hedge reserve was generated, and how modifications to the hedge were made, can make the analysis of the changes reported in equity unnecessarily difficult.

We welcome the new proposed disclosures, which will separate the cash flow hedge accounting reserve into balances that relate to continuing hedges and hedges that have been discontinued. We also welcome the improved disclosures of amounts reclassified from the cash flow hedge reserve into profit or loss, which differentiate between amounts that have been transferred because the hedged items have affected profit or loss and amounts for which hedge accounting had previously been used, but for which the hedged future cash flows are no longer expected to occur.

We would also welcome further detailed disclosure on the origin of, and changes in, the fundamental elements of the cash flow hedge reserve that would allow us to identify:

- amounts deferred in equity relating to future transactions;
- amounts relating to derivatives for which companies may have discontinued hedge accounting because the hedge failed to meet the effectiveness requirements; and
- amounts relating to derivatives that have already been settled or terminated.

(b) As noted in our letter, we believe several additional disclosures would provide useful information in analyzing hedge accounting activities.

***Question 14 – Derivative accounting for “own use” contracts***

***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 welcome this proposal, which should eliminate an accounting mismatch that can occur under the current accounting framework. Derivatives used to hedge commodity supply contracts are measured at fair value through profit or loss, while the contracts themselves can be scoped out of IAS 39 as “own use” contracts. Applying hedge accounting to contracts that can be settled net in cash that were entered into and held for the purpose of the receipt or delivery of a nonfinancial item should reduce accounting-driven volatility in reported results.

***Question 15 - Accounting for credit risk using credit derivatives***

***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?***

(a) While we agree that the three alternative accounting treatments may add complexity, we do not believe that outweighs the arguments for finding a solution to accounting for credit derivatives used to hedge credit risk that would better depict the economics of the risk-management activities. Most significantly, we believe that, for companies using credit derivatives for risk management purposes, the current accounting framework--whereby changes in fair value of credit default swaps are recognized in profit or loss, while loan portfolios are measured at amortized cost (and loan commitments are not recognized under certain circumstances)--is inadequate. Although the current accounting rules allow companies to use the fair value option to account for loans at fair value and thereby match the fair value basis of accounting with credit derivatives, many companies do not use this option. The hedge designation must be made at the loan’s inception and applied to the entire loan balance. Both of these requirements generally are not in line with credit risk management derivative practices and therefore would not effectively hedge the loans. As a result, financial statements currently reflect accounting-driven volatility and misalignment of risk management activities.

(b) We believe that alternative 1 has significant drawbacks. Notably, the fact that a fair value through profit or loss election that could only be made at initial recognition (of the loan or loan commitment) does not necessarily align with risk management strategies, whereby credit

protection for an exposure often occurs subsequent to the initial recognition of that exposure. Accordingly, we believe alternative 1 would not go far enough in eliminating the accounting mismatch.

In our view, alternative 2 has several benefits, notably in providing the option to elect fair value through profit or loss subsequent to initial recognition of a loan or loan commitment. We believe alternative 2 would better reflect the active and flexible nature of risk management practices, hence better eliminating the accounting mismatch that arises currently. We also believe the proposal to immediately recognize any difference between the carrying amount and fair value of the loan in profit or loss reflects the economic reality in such circumstances. If a company decides to take out credit protection at a time when the fair value has already moved below the carrying value of the loan because of credit concerns in the market, we believe it is appropriate for a loss to be recognized.

The key difference between alternatives 2 and 3 is that under alternative 3 any difference between the carrying amount and fair value of the loan would be deferred and/or amortized rather than immediately expensed to profit or loss. As previously mentioned, we believe the accounting would less accurately represent the economic reality in such circumstances. We also believe alternative 3 may introduce unnecessary complexity into financial reporting, including presentational implications for the measurement change adjustment and its subsequent amortization.

We urge the Board to continue its consultation on accounting for credit risk using credit derivatives to reach a definitive, operational solution for this important issue.

***Question 16 – Effective date and transition***

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

We generally believe that full retrospective implementation of new standards is most helpful to our analysis. Retrospective implementation best suits period-to-period trend assessments. However, we recognize the complexity and operational burdens that could be required in implementing the proposed accounting framework under a full retrospective transition method. Therefore, we agree that the proposed requirements for hedge accounting could be applied prospectively. We also agree that the effective date for the new hedge accounting requirements should be aligned with the effective date for IFRS 9 and that earlier application should be permitted, providing all existing IFRS 9 requirements have already been adopted or will be adopted together with the new hedge accounting requirements. We encourage the Board to require disclosures that explain significant period-to-period variations in the company.