

CA/DTS/IASB/2011-2052

March 9, 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

COMMENTS ON EXPOSURE DRAFT OF 'HEDGE ACCOUNTING'

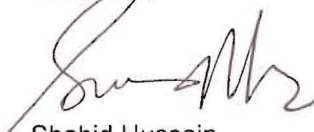
Dear Sir

The Institute of Chartered Accountants of Pakistan welcomes the opportunity to offer comments on the above mentioned exposure draft.

Please find enclosed the comments of the relevant Committee of the Institute for your perusal.

If you require any further clarification, please do not hesitate to contact us.

Yours truly



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Encl.: As above

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**COMMENTS ON EXPOSURE DRAFT OF 'HEDGE ACCOUNTING'****Question no 1**

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

ICAP Response

We agree with the proposed objective of hedge accounting i.e. to reflect, in the financial statements, the extent and effects of an entity's risk management activities. We also believe that hedge accounting should not be restricted to risk that affect the profit and loss only. We request the IASB to reconsider carefully why it is necessary to prohibit hedge accounting for items that affect other comprehensive income or equity as well. The Board has recently increased the use of other comprehensive income without recycling to profit or loss and restricting such items from eligibility of hedge accounting would contradict the objective i.e. aligning risk management activities and financial reporting whereas it is common practice to hedge such items.

Question no 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?

ICAP Response

We agree with the Board decision to widen the scope of the instruments that are eligible as hedging instrument by including non-derivative financial instruments measured at fair value through profit or loss to align with the objective of the hedge accounting. Furthermore, we also believe that non-derivative instruments other than those at fair value through profit or loss should be eligible as hedging instruments or further guidance should be available why it is only restricted to non-derivative financial instruments at fair value through profit or loss.

Question no 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?

ICAP Response

We agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item to align with the objective of hedge accounting, as entities often consider different aggregated exposures for risk management purposes. This would help in implementing the objective of aligning hedge accounting with risk management activities. However, we suggest that more implementation guidance on the accounting for derivative in an aggregate exposure that constitutes a hedging relationship should be made available.

Question no 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 (i.e. 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?

**ICAP Response**

We agree with the said proposal as it better reflects an entity's risk management policies and allows reflecting economic hedge in financial reporting. However, one practical difficulty that might arise is with respect to effectiveness assessment of risk component that is specifically identifiable and reliably measurable but not contractually specified. In such cases, it is difficult to ascertain whether such risk component achieves perfect hedging where other undesignated risk component of non financial items (i.e. residual portion) contributes towards an overall offsetting. This might result in an entity concluding that designated risk component is perfectly effective when it is actually not. We consider that this area should be further explored and further application guidance should be provided to help the entities in applying the requirement for effectiveness testing.

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?

ICAP Response

- (a) We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item as this gives entities greater flexibility in accounting for different scenarios, however, we note that the accounting treatment would be different as uncertainties in terms of quantum and/or timing could arise in respect of hedged items.
- (b) We 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. We agree with the Board's assessment that the identifiability of the risk component is questionable if the prepayment option's fair value changes in response to the hedged risk.

Question no 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?

ICAP Response

We agree with the Board proposal to remove the quantitative criteria for assessing and measuring the hedge effectiveness and welcome the introduction of objective based assessment as aligned with the overall objective of the hedge accounting. This yields a more principals-based hedge effectiveness assessment.

We also see merit in the proposal to abolish the IAS 39 retrospective testing of hedge effectiveness. This would minimize the need to de-designate hedging relationships which fail the retrospective hedge effectiveness test owing to transitory and/or marginal market changes

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?

ICAP Response

- (a) We support the proposal regarding rebalancing of an existing hedging relationship in circumstances where the original risk management objective remains unchanged. However, we believe that additional guidance needs to be provided on when rebalancing would be appropriate so as to accommodate a fair presentation of the hedging relationship.
- (b) Yes, in accordance with the application of hedge accounting an entity should also apply the concept of rebalancing proactively.

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?

ICAP Response

- (a) Yes, we agree that hedge accounting be discontinued only when the hedging relationship ceases to meet the qualifying criteria after taking into consideration any rebalancing of the hedge relationship if applicable.
- (b) 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, as the previous version of the IAS allowed voluntary discontinuation, which might have enabled entities to manipulate their results.

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 recognized 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?

**ICAP Response**

- (a) We agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss. This would result in better presentation for the users of financial statements.
- (b) We recommend that the gain or loss on all the hedged items attributable to the hedged risks should be presented as a separate single line item in the statement of financial position with additional information provided in the notes to the financial statements so as to provide more meaningful information to the users by keeping minimal information on the face of the statement of financial position.
- (c) Yes we agree that linked presentation should not be allowed for fair value hedges and we agree with the board's opinion that linked presentation does not differentiate between the types of risk that are covered by that relationship and those that are not.

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 (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

ICAP Response

- (a) Agreed
- (b) Agreed
- (c) Agreed

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?

ICAP Response

Yes, we agree with the criteria for the eligibility of groups of items as a hedged item as this will be more consistent with the entity's risk management strategy. We also agree with the proposal to permit the net position for hedging of a group of items.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognized 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?

**ICAP Response**

Agreed. Board's argument in Paragraph BC175 that adjusting or grossing up all the affected line items could lead to the recognition of gross gains or losses that are fictitious makes sense. Therefore, separate presentation in the income statement of the reclassified hedging instrument gains or losses would be appropriate.

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?

ICAP Response

- (a) We agree with the proposed disclosure requirements in the ED. However, we would suggest that the additional disclosures should be aligned with the existing risk disclosures in IFRS 7 so as to avoid any duplication.
- (b) None

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?

ICAP Response

Agreed

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?

ICAP Response

(a) & (b) We agree that the alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity and would be a deviation from the Board's existing principal based strategy.

Question 16

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

ICAP Response

We agree with the transition requirement that this be applied prospectively, as otherwise it would be an unnecessary exercise with no meaningful information being provided to the users of the financial statements, since the objective of hedge accounting and disclosure is to provide information to the users about the entity's existing and future risks.