

Document No. 377
March 8, 2011

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

To the International Accounting Standards Board

Comments on IASB “Hedge Accounting”

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) made in response to the solicitation of comments regarding the International Accounting Standards Board Exposure Draft “Hedge Accounting”. JFTC is a trade-industry association with trading companies and trading organizations as its core members, while the principal function of its Accounting & Tax Committee is to respond to developments in domestic and international accounting standards. (Member companies of the Accounting & Tax Committee of JFTC are listed at the end of this document.)

I. General Comments

The stated objective of the ED is to improve IAS 39 by such means as eliminating the 80–125 percent “bright line” for assessing hedge effectiveness so as to align hedge accounting more closely with an entity’s risk management activities and provide more useful hedge accounting information. As such, we are in favor of the overall thrust of the proposals. However, we find that certain ambiguities remain pertaining to the preparation of financial statements. Hence, we request that additional examples and guidance be offered in order to provide materials for judgment by management and to render the proposed changes more understandable and useful for users of accounting standards.

From the perspective of convergence between IFRS and US GAAP, we request that continued efforts be made to pursue consistency with the FASB exposure draft.

II. Specific Issues (Comments on Questions)

Question 1

We agree with the proposed objective of hedge accounting.

However, for the following reasons, we do not agree with the ED statement that hedge accounting cannot be applied to equity instruments designated as at fair value through other comprehensive income (FVTOCI).

- Equity instruments have an impact on corporate value by acting on other comprehensive income (OCI) to cause changes in statements of financial position and statements of comprehensive income. Therefore, entities may undertake hedge transactions to hedge against fluctuations in the value of equity instruments. In this case, if only the fluctuation in the value of the hedging instrument is recognized in profit or loss, this would generate an asymmetry in accounting and would fail to accurately reflect the economic position of the entity.

In particular, this is an important issue for Japanese trading companies that hold large amounts of strategic foreign-currency denominated investments. For such entities, foreign currency risks arising from equity instruments designated as at FVTOCI cannot be ignored.

The ED proposal argues that the above contradicts the hedge accounting principle that hedge ineffectiveness should be recognized in profit or loss, and that there is considerable resistance to allowing for exceptional treatment on this point. However, IFRS 9 does allow for exceptional treatment of designating equity instruments as at FVTOCI. Taking into consideration that entities actually undertake hedge transactions for such equity instruments, we believe that rules should be established to allow for the application of hedge accounting to equity instruments designated as at FVTOCI.

In describing the objectives of this ED, paragraph IN3 mentions the following points: (a) to align hedge accounting more closely with risk management and hence result in more useful information; and (b) to establish a more objective-based approach to hedge accounting. In light of these points, allowance for exceptional treatment should be acceptable if the end result is compatible with the aim of the ED, which is to more closely align hedge accounting with the economic reality of the entity. From the perspective of properly reflecting the economic reality of risk management related to hedging the fluctuation risks in OCI, we believe the following treatment should be allowed: the application of hedge accounting to equity instruments designated as at FVTOCI should be allowed; the ineffective portion related to the hedged item should remain under OCI; and the effective portion related to the hedging instrument should be recognized in OCI.

Question 4

We support the proposal. However, we request that the following points be given due consideration.

- The expressions “separately identifiable” and “reliably measureable” are too abstract and do not provide enough information for practical application. Therefore, we request additional guidance.
- In commodity spot contracts, prices are set separately for each risk component (forward, premium, etc.), and entities frequently undertake hedge operations for each risk component. Although such components are not necessarily specified in the contract, in almost all instances it is possible to determine them by risk component. On the other hand, for nonfinancial instruments that are not forward market traded—commodities, we believe that it is necessary to provide more detailed explanations of what constitutes a “separately identifiable” and “reliably measureable” risk component. For instance, the price of copper affects prices for copper wires, electric cables, automobile parts, automobiles, and so on. For such a chain of products, we request clarification on how far along the chain the risk component related to the price of copper can be considered identifiable.
- In certain cases, an entity will undertake hedge operations to cover the anticipated cash flow from the forecast transactions of an affiliated company engaged in selling minerals. As the investing company, suppose this entity enters into forward selling contracts to protect itself from future fluctuations in the price of minerals by hedging its share of revenue from future sales of minerals by an equity-method affiliate engaged in mineral extractive activities. From an economic perspective, the investing company has hedged its cash flow from the affiliate’s scheduled sales of minerals and has thereby acted to control the fluctuations in its equity-method profit or loss that would be recognized at some point in the future.

However, under both the current and proposed accounting treatments, hedge accounting cannot be applied to such transactions for the following reasons, and it is normally interpreted that market-price fluctuations pertaining to the forward contract must be recognized in profit or loss.

- Because the cash flow from forecast transactions pertains to the affiliate and does not accrue to the consolidated financial statements of the investing company (other than in exceptional cases where, for example, the affiliate’s cash flow is fully and immediately distributed as dividend), cash flow hedge cannot be applied.

- Because equity-method profit or loss is recognized in profit or loss, fair value hedge also cannot be applied (ED paragraph B8).

Basically, hedging is an action undertaken by management to intentionally control the impact of market fluctuations on the entity's financial statements. In this context, we believe that hedge accounting is aimed at reflecting such actions in accounting. Paragraph 18 of the ED states that a risk component may be designated as a hedged item when it is separately identifiable and reliably measureable. In the example presented above, the hedging instrument (forward contract) is clearly tied to the affiliate's hedged item (forecast transactions), and if we adopt the assumption that the hedged item is a transaction undertaken by the investing company, this becomes a transaction to which hedge accounting can be applied. Therefore, hedge accounting should be applicable to an equivalent transaction by the affiliate.

Question 5

We agree with the proposal.

For instance, take a power generation business that is subject to uncertainties related to amounts of power generated and sold. A high level of effectiveness can be ensured if only the quantity that is certain to be sold, can be designated as a hedged item.

Question 6

We agree with the proposal.

However, the hedge effectiveness requirements of "expected to achieve other than accidental offsetting" and "minimise expected hedge ineffectiveness" may be difficult to judge. Therefore, we request the inclusion of additional examples and guidance on these requirements.

Question 7

We agree with the proposal.

However, we request the inclusion of detailed guidance on rebalancing of hedging relationships.

Question 9

We do not agree with the proposal.

- The ED proposal produces the same outcome in profit or loss as the current IAS 39, which stipulates that gains or losses related to both hedged items and hedging instruments must be

recognized in profit or loss. As such, the ED proposal does not represent a substantive change. The ED proposal is expected to have the following effects: [1] presents in one place the effects of risk management activities (for cash flow and fair value hedges) (paragraph BC123(c)); and [2] provides information in OCI about the extent of the offsetting achieved for fair value hedges (paragraph BC123(d)). With regard to [1], we believe there is no compelling reason why cash flow and fair value hedges have to be presented in the same place because fair value hedges are not to be replaced by a cash flow hedge mechanism but are to be subject to a different approach. With regard to [2], the same effect can be obtained by disclosure requirements as specified under paragraph 51.

Preparers of financial statements are in compliance with IAS 39, and it can be assumed that various systems have been developed for this purpose. It is likely that the changes proposed in this ED will require changes to be made in these systems. As mentioned above, the ED proposal does not contain substantive changes. Therefore, we cannot support the proposal from a cost-benefit perspective.

- In the event that the ED proposal is adopted in its present form, we would request that consideration be given to the following points.

Under the ED proposal, changes in fair value of hedged item and hedging instrument in a fair value hedge are to be first recognized in OCI, and thereafter the ineffective portion is to be transferred to profit or loss. We understand that the intent of this procedure is to convey a more accurate picture of an entity's hedging activities to users of financial statements by separately presenting the following three components in a fair value hedge: [1] changes in the fair value of the hedged item; [2] changes in the fair value of the hedging instrument; and [3] ineffective portions transferred to profit or loss. The ED does not contain concrete explanations and examples of presentation methods. However, taking into account the intent of the proposal, we believe that [1] to [3] should be presented in gross terms. This instruction should be explicitly included in the standard. Alternatively, we believe it would be necessary to provide presentation examples in application guidance of the standard.

Question 10

We agree with the proposal. However, we request that the following points be given due consideration.

- Consideration should be given to the time value of hedging instruments in hedging net investments in foreign operations

(paragraph BC141). For instance, paragraph F.6.4 of IAS 39 stipulates the treatment of the difference between spot and forward rates when forward exchange contracts are used as a hedging instrument. On the other hand, the ED proposes that in the treatment of the time value of options, entities should distinguish between transaction related hedged items and time period related hedged items. However, we request that other treatment methods be considered for the time value of hedging instruments in hedging of net investments in foreign operations, including recognition in other comprehensive income.

- In light of the administrative burdens involved, entities should be allowed to directly recognize in profit or loss changes in the fair value of time value not designated as hedging instruments.

Question 13

We agree with the proposal.

- It is necessary for entities to provide information that is useful to the users of financial statements. As such, we believe entities should be required to disclose qualitative information regarding their thinking and policies on the application of hedge accounting to risk management.
- For derivatives valuation gains and losses (and end-term balances), amounts to which hedge accounting is applied should be disclosed separately from the rest because these provide financial statement users with useful information on the relation between the entity's derivatives transactions and its hedge accounting (amendment of IFRS 7). Regarding requirements for quantitative information, we request that due consideration be given to practical issues so as to avoid excessively detailed disclosure requirements.

Question 14

We do not agree with the proposal on the following points.

- In the proposal, the scope of the application of derivative accounting to contracts for the sale or purchase of nonfinancial items is limited to "contracts that can be settled net in cash." However, for purposes of risk management, entities may in certain cases use commodities futures, etc., as hedging instruments to hedge commodities contracts and inventory items that cannot be settled net in cash. Paragraph BC 217 states the following. "Consequently, the actual type of settlement (ie whether settled net in cash) would not be conclusive for the evaluation of the appropriate accounting treatment. Instead, an entity would not consider only the purpose (based solely on the actual type of settlement) but also how the contracts are

managed.” In consideration of this statement, we request that the scope of application of derivative accounting be broadened to include contracts that cannot be settled net in cash as well as those that can be settled net in cash. (In this case, it should be noted that although in some instances cash flow hedge accounting could be applied to a hedging instrument, an entity’s risk management activity may in itself be intended for the purpose of fair value hedging. Therefore, in this regard, we request that hedge accounting treatment be made to correspond to the economic reality of the transaction.)

- One of the conditions requires that net exposure be maintained at near zero. However, what is really important is for operations that are managed using mark-to-market accounting for a portfolio containing the entity’s outstanding commodity contracts and inventory to be appropriately reflected in the financial statements. Therefore, we believe that keeping the net exposure near zero is unnecessary (it does not have to be an alternative to hedge accounting). Furthermore, in order to achieve the above objective, it is important to allow fair value assessment of inventory contained in the portfolio. We believe that the original intent of the revision proposed in the ED cannot be achieved unless fair value measurement of inventory as stipulated under IAS 2 paragraph 3(b) is made to correspond to the scope of outstanding contracts treated as derivatives under IAS 32.

III. Others

<Forecast Transactions>

“Highly probable forecast transactions” are eligible for designation as a hedged item under cash flow hedges. In this regard, we believe that guidance is necessary on the period of forecast transactions. While some guidance on this matter can be found in paragraph F.3.11 of IAS 39, this guidance is insufficient.

<Open Portfolios>

The ED proposals effectively broaden the scope of the application of hedge accounting by eliminating the 80–125 percent quantitative criteria for assessing hedge effectiveness and by including net positions as eligible hedged items. However, the ED proposals go no further than closed portfolios that remain unchanged during the period of the hedge, and it is stated that the Board is continuing to discuss proposals for hedge accounting for open portfolios in which hedged items are subject to constant change. It should be noted that financial institutions are not the only entities with hedged items that are subject to constant change, and the same can be seen among

nonfinancial companies as well. Unless greater flexibility is permitted in this area, the aim of the ED to expand the scope of hedge accounting will meet with only limited success.

Therefore, we request that due flexibility be included in the proposals on open portfolios scheduled for release this year so that the effects of an entity's risk management activities can be properly expressed in financial statements.

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