

9 March 2010

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

Dear David

ED/2010/13 *Financial Instruments: Hedge Accounting*

The Financial Reporting Standards Board (“FRSB”) of the New Zealand Institute of Chartered Accountants is pleased to submit its comments on ED/2010/13 *Financial Instruments: Hedge Accounting*.

The FRSB fully supports the efforts of the International Accounting Standards Board (“IASB”) to reduce the complexities in accounting for financial instruments, particularly hedge accounting. The FRSB is very receptive to the proposals within the Hedge Accounting ED as they are significantly more principles-based than the existing standard IAS 39 *Financial Instruments: Recognition and Measurement*.

The FRSB understands that the IASB considered whether to make hedge accounting mandatory where entities have a risk management objective of hedging risks, but rejected that approach. The FRSB agrees that on cost benefit grounds it is not appropriate to mandate hedge accounting. However the FRSB does have some concerns about the current approach. What has been proposed in the ED is neither a mandatory, nor a wholly optional approach – rather it is optional to hedge account on a transaction by transaction basis, but optional de-designation is prohibited. The FRSB disagrees with this hybrid approach. The FRSB is of the view that entities should be able to choose to designate or de-designate hedging arrangements. We assume that the prohibition from de-designation is an anti abuse provision, but we are not aware of what that abuse might be, or that such abuse has occurred under the current, option requirements.

Although the FRSB considers the proposals in the ED are a significant improvement on the current requirements in IAS 39, we believe that there are a number of areas that could be improved further. These areas principally involve proposals in the ED that seem to us to be the imposition of rules to limit the application of the proposed ED principles. The FRSB assumes that some or all of these rules have been proposed as anti-abuse provisions, but we are not convinced they are necessary. The following are examples that it seems to the FRSB are in the nature of rules that limit the application of the proposed principles.

- The prohibition of voluntary de-designation (as more fully explained above).
- The prohibition of hedging items that are recognised in other comprehensive income (OCI). That is restricting hedging only to items that impact profit or loss. It seems to the FRSB contradictory to encourage constituents to consider the performance of an entity in terms of its total comprehensive income, and then limit hedge

accounting to only part of that performance. It is also difficult to justify the restriction of these items from hedge accounting when most entity risk management objectives would not prohibit this.

- The requirement to rebalance the hedge if the relationship ceases to be unbiased subsequent to initial designation. For all sorts of valid reasons, such as avoidance of additional cost, or an acceptance that the existing hedge is “good enough”, an entity may choose not to rebalance in every circumstance. In the view of the FRSB, entities should be allowed to elect not to rebalance, but merely account for the additional ineffectiveness in profit or loss as normal.
- The requirement to present the effect of a fair value hedge separately on the face of the balance sheet, rather than in the notes (if it is so important that the amount needs to be disclosed). The FRSB considers this presentation treatment could clutter up the balance sheet and make the accounts even more inaccessible to non-expert users. Consequently an entity should have the ability to choose the most appropriate place to disclose these items based on its individual circumstances.

The FRSB also has some concerns surrounding the proposed disclosure requirements for hedge accounting.

- The proposal to allow management to cross-refer to disclosures made in a document or documents that exist independently of the financial statements is in our view a highly undesirable and dangerous precedent. All information required to make the financial statements accessible and understandable to users should be contained within the financial statements. The FRSB accepts that constituents are concerned and critical of the ever increasing volume of disclosures in financial statements; however we believe the appropriate response to that concern is to ensure that only those disclosures that meet the objectives of general purpose financial reporting should be required.
- The FRSB is supportive of the principle of entities being required to outline their risk management strategies, but considers that the disclosure requirements are overly prescriptive and far reaching – to the point of being onerous for entities to comply with.

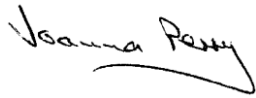
The FRSB urges the IASB to adhere strongly to the principles they have developed during the process to rewrite the hedge accounting standard, and not to succumb to pressure to provide “guidance” in the form of rules as to how to apply the proposed standard. Such a result would clearly undermine the principles proposed.

FRSB response to questions

Responses to the specific questions raised in ED/2010/13 are attached to this letter, together with other comments.

If you have any queries or require clarification of any matters in this submission, please contact me.

Yours sincerely



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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?

Question 1

The FRSB is very supportive of the proposed objective and considers it is important to acknowledge that hedge accounting is aimed at disclosing the entity's management of risk exposures. It is also important that economic phenomena drive accounting and not the other way around, which is sometimes the case under the current standard.

The FRSB understands that the IASB considered whether to make hedge accounting mandatory where entities have a risk management objective of hedging risks, but rejected that approach. The FRSB agrees that on cost benefit grounds it is not appropriate to mandate hedge accounting. However the FRSB does have some concerns about the current approach. What has been proposed in the ED is neither a mandatory, nor a wholly optional approach – rather it is optional to hedge account on a transaction by transaction basis, but optional de-designation is prohibited. The FRSB disagrees with this hybrid approach. The FRSB is of the view that entities should be able to choose to designate or de-designate hedging arrangements. We assume that the prohibition from de-designation is an anti abuse provision, but we are not aware of what that abuse might be, or that such abuse has occurred under the current, option requirements

The FRSB would also support the extension of the proposals to encompass the management of risks impacting on other comprehensive income (OCI), rather than its current limitation to profit or loss. It seems to the FRSB contradictory to encourage constituents to consider the performance of an entity in terms of its total comprehensive income, and then limit hedge accounting to only part of that performance. There also seems to be no conceptual reason for the distinction (particularly as the conceptual basis for distinguishing between the two parts of the income statement has not yet been developed). The FRSB can not see any rationale for this limitation in the ability to hedge account.

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?

Question 2

Yes, the FRSB agrees that this approach will enable entities to align hedge accounting closer to their actual risk management objectives.

Derivatives that qualify for designation 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?

Question 3

Yes, the FRSB agrees that the proposals will enable entities to structure their hedge accounting to better reflect the risks they are trying to hedge using their risk management practices.

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?

Question 4

The FRSB agrees that it is appropriate that the cash flows or fair values of an item that can be attributed to a specific risk or risks without distraction as to the nature of the hedged item. It will assist entities that manage individual risk components separately to hedge account with greater ease, as well as align their risk management objectives to the accounting treatment.

However, the FRSB notes that there is concern about the practicalities of consistently being able to identify items attributable to the specific risks. Therefore it would be valid for the IASB to provide greater clarity on what is meant by “a risk component must be separately identifiable and reliably measurable”. The FRSB stresses that they are not looking for a rule to be added to the standard, but simply guidance to make the designation of risk components as hedged items workable for entities to understand and apply.

Therefore the FRSB is of the view that further clarity is required around the principles set out in the proposed standard. This should not be construed as a request for further guidance or rules.

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?

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?

Question 5

The FRSB agrees that entities should be allowed to designate a layer of the nominal amount of an item as the hedged item. This will enable entities to hedge their specific risks more accurately.

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?

Question 6



The FRSB agrees with the removal of the 80 – 125% bright line effectiveness test and the introduction of an objectives-based assessment of effectiveness. It will allow entities greater flexibility when structuring and implementing hedge accounting. There is an argument that supports the removal of any effectiveness test, instead merely accounting for all ineffectiveness in profit or loss as it occurs. Indeed, the FRSB made such a recommendation in response to the earlier discussion paper published by the IASB. However, the FRSB accepts that such an approach is perhaps too radical at the moment. Subsequently the “unbiased” effectiveness test seems to be appropriate to the FRSB.

Further, we support the removal of retrospective effectiveness testing – we believe this will support the application of hedge accounting, as it will prevent involuntary de-designation due to minor price changes causing a hedge to be retrospectively ineffective.

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?
- 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?

Question 7

The FRSB supports the proposal to allow rebalancing both proactively and as it becomes necessary, as it will enable entities to reflect changes in hedge relationships from a risk management viewpoint. However, we are concerned that rebalancing is required, ie mandatory, in the ED. For all sorts of valid reasons, such as avoidance of additional cost, or an acceptance that the existing hedge is “good enough”, an entity may choose not to rebalance in every circumstance. In the view of the FRSB, entities should be allowed to elect not to rebalance, but merely account for the additional ineffectiveness in profit or loss as normal. The requirement to rebalance seems to be more in the nature of a rule than as a result of good, conceptual reasoning.

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?
- b) Do you agree that any 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 continue to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

Question 8

The FRSB disagrees with each of these requirements.



The FRSB's reasons for this view have been given in the covering letter to this submission and also in response to Question 1 above.

Accounting for fair value hedges

Question 9

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

Question 9

The FRSB considers that there are supportable arguments for either type of treatment. On balance, the FRSB opposes the gross up in OCI and then the immediate recycling of ineffectiveness to from OCI to the profit and loss. A requirement to recycle ineffectiveness seems inconsistent with the move towards one primary statement.

The requirement to present the effect of a fair value hedge separately on the face of the balance sheet, rather than in the notes; (if it is so important that the amount needs to be disclosed), the FRSB considers this presentation treatment could clutter up the balance sheet and make the accounts even more inaccessible to non-expert users. Subsequently an entity should have the ability to choose the most appropriate place to disclose these items based on its individual circumstances.

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 (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?
- b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?
- c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged time)? Why or why not? If not, what changes do you recommend and why?

Question 10

The FRSB agrees with the proposals, as they appear to be a useful solution to a practical problem.

Hedges of a group of items

Eligibility of a group of items as the hedged item

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?

Question 11

The FRSB supports the criteria proposed. The FRSB notes the difficulties pertaining to open portfolios and macro hedging as outlined in paragraphs BC 17 to BC 21 of the ED. However, the FRSB encourages the IASB to address these issues quickly so as to fully complete the hedging phase of the review of IAS 39.

Presentation

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?

Question 12

The FRSB agrees with the presentation proposals in the profit or loss account for groups of items re hedge accounting effectiveness.

However, the presentation fair value gains and losses of a net position hedge should be presented as transparently as possible and we suggest that sufficient detail be required in the notes to the financial statements to ensure users can fully assess the use and impact of hedge accounting.

The FRSB considers that the proposed presentation in the income statement when a net position is hedged will not necessarily reflect the hedging strategy or risk management objectives of the reporting entity. The proposed requirement to report the net effect as a separate line may result in preparers considering that economically they have hedged both the gross revenue and gross expenses, and is likely that this would be preferred disclosure, which is less than transparent for readers of the financial statements.

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

Question 13

The FRSB is supportive of the principle of entities being required to outline their risk management strategies, but considers that the disclosure requirements are overly prescriptive and far reaching – to the point of being onerous for entities to comply with.

The FRSB believes it is important for users of financial statements to understand the risks entities are facing and the way in which each entity manages those risks. Comprehensive disclosure requirements are



fundamental as different entities, even those in the same industry, may manage the same or similar risks quite differently and users should be able to compare and contrast entities approaches to managing risk.

However, the FRSB is concerned that too much disclosure is proposed by the ED, particularly in terms of timing and sensitivity, which may make entities reluctant to provide the envisage quantitative information due to reasons of commercial sensitivity.

The following are suggestions as to the revision of the current disclosure proposals:

- *Paragraph 44: risk management strategy - retain*
- *Paragraph 45: quantitative information about each risk category, the extent to which it's hedged, and effect of hedging – The FRSB suggests that this paragraph is retained, but the word "summarised" is inserted into the first line, so that it reads "....shall disclose summarised quantitative information".*
- *Paragraphs 46 – 48 should be removed as the disclosures required are too prescriptive and detailed. The requirements in paragraph 45 are sufficient.*
- *Paragraphs 49 and 50 should be removed as they require too much detail, some of which is already required to be disclosed by IFRS 7 Financial Instruments: Disclosure.*
- *Paragraph 51(a): retain only the information for each type of risk on amounts in OCI, P&L and the whereabouts of hedge ineffectiveness reporting*
- *Paragraphs 51(b) and (c) should be deleted as the existed disclosure requirements in IAS 1 Presentation of Financial Statements are sufficient.*

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?

Question 14

The FRSB has no response to make to this question.

Accounting for credit risk using 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 consider by the Board in paragraphs BC226 – BC246 should the Board develop further and what changes to that alternative would you recommend and why?

Question 15

The FRSB has no response to make to this question.



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?

Question 16

The FRSB agrees with the proposed transition requirements.



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