



09 March 2011

Our ref: ICAEW Rep 22/11

Your ref: ED/2010/13

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

Dear Sir David

ED/2010/13 *Hedge Accounting*

ICAEW is pleased to respond to your request for comments on the exposure draft *Hedge Accounting*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ED/2010/13 *HEDGE ACCOUNTING*

Memorandum of comment submitted in March 2011 by ICAEW, in response to the IASB's Exposure Draft *Hedge Accounting* published in December 2010.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft *Hedge Accounting* published by the International Accounting Standards Board (IASB).

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure that these skills are constantly developed, recognised and valued.

MAJOR POINTS

Welcome for the exposure draft

4. We welcome the publication of the exposure draft and the development of a revised approach to hedge accounting. The existing approach has been widely criticised for being rules-based and overly complex, and for not reflecting an entity's risk management activities. This makes it difficult for users to understand the hedge accounting and related disclosures and for preparers to explain the results of hedge accounting. We therefore welcome the proposed replacement of the existing approach with a more principles-based one, with a stronger link to the underlying risk management strategies of the reporting business.
5. Overall we believe the proposals are a significant improvement on current requirements and that they will make hedge accounting more flexible and therefore more accessible. In doing so the IASB will allow entities better to align their accounting with their risk management objectives and so facilitate more meaningful and understandable accounting and disclosure.
6. At one end of the spectrum, hedge accounting can be seen as an exception to normal accounting practices that either should not be permitted or which must be so strictly regulated and controlled that entities cannot recognise or explain how the hedge accounting relates to their risk management activities. At the other end of the spectrum, some believe that hedge accounting should faithfully reflect all of an entity's risk management activities, even where the hedge accounting would go beyond the norms of accounting principles. Pitching accounting requirements at either end of the spectrum is unlikely to result in accounting that meets the objectives of relevance and reliability. The exposure draft moves the requirements away from overly tight control and the main question arising is whether, in practice, the proposals will result in a meaningful reflection of risk management activities consistent with general accounting principles. We expect that the IASB will remain open to further revisions, if necessary, better to meet the objectives as experience is gained in implementing the final standard. A good and timely post implementation review is thus vital.

Linkage between risk management strategy and hedge accounting

7. In our view, the key to making the proposals work is establishing the right linkage between risk management strategy and hedge accounting. We support the proposal that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities. In our view, the individual accounting hedges in aggregate at the level at which the risk is managed, should reflect the application of the overall risk management

strategy as documented by the entity and as reported to and reviewed by senior management for risk management purposes. This will naturally vary between different entities depending on their management structures and the nature of the risks being managed but typically risk management objectives will be set at an entity-wide level, a business unit level, a portfolio level or some other lower level. The concept should be consistent with the determination of the business model in IFRS 9, which is not at the level of an individual instrument. This could be particularly important if risk management objectives are defined in the standard to better differentiate between rebalancing and discontinuing hedge accounting.

Entities that are not financial institutions

8. Much of the most sophisticated and detailed issues around hedge accounting are mainly, if not entirely, only relevant to financial institutions. Hedge accounting is nevertheless a key issue for other corporate entities. The IASB needs to ensure that the needs of those corporates and the users of their accounts are not overlooked.

Significant improvements

9. In our view the proposals contain significant improvements in the following areas:
 - Relaxing the restrictions on hedging instruments to include non-derivative financial assets and liabilities measured at fair value through profit or loss (see our reply to question 2 below).
 - Relaxing the restrictions on hedged items to include aggregated exposures that are a combination of another exposure and a derivative ie, synthetic exposures (see our reply to question 3 below).
 - Permitting risk components to be hedged items for both financial and non-financial items provided they are separately identifiable and reliably measurable (see our reply to question 4 below).
 - Removing the 80-125% rule and instead introducing a more principles-based approach to assessing hedge effectiveness on a prospective basis (see our reply to question 6 below).
 - Relaxing the criteria to better permit groups of items, including net positions, to be eligible for hedge accounting (see our reply to question 11 below).
10. In our view all of the above proposals help to better align hedge accounting with the risk management practices of the entity.

Areas where retaining the IAS 39 approach is considered a good thing

11. In some instances the Board have retained the existing IAS 39 *Financial instruments: Recognition and Measurement* approach even though the FASB's proposals differ. We are supportive of the Board's decision not to make changes in the following areas:
 - Retaining a choice of either cash flow or fair value hedge accounting for foreign currency risk of a firm commitment.
 - Retaining the 'lower of' test for determining ineffectiveness in cash flow hedges.
 - Retaining the current approach to hedges of net investments.

Operation of the proposals in practice

12. There are some areas where we have concerns regarding the operation of the proposals in practice, where we believe further consideration is needed or where we feel that the hedge accounting proposals do not go far enough in reflecting valid risk management practices. Our most significant concerns relate to:
- The level and detail at which an entity must demonstrate the linkage between risk management objectives and hedge accounting (see our reply to question 1 below)
 - The hedge accounting objective focuses only on risks that could affect profit or loss and not risks that could affect other comprehensive income or the statement of financial position (see our reply to question 1 below).
 - Restrictions on the ability to hedge certain risk components, specifically non-contractually specified inflation risk, prepayment risk and credit risk (see respectively our replies to questions 4, 5 and 15 below).
 - Restrictions on the ability to hedge interest rate risk where LIBOR is below the absolute of the negative spread (see our reply to question 4 below).
 - The requirement to rebalance and the prevention of de-designation for accounting purposes in circumstances where this is part of the risk management approach (see our reply to questions 7 and 8 below).
 - The treatment of the time value of options which seems overly complex (see our reply to question 10 below).
 - Restrictions on the ability to hedge net positions (see our reply to question 11 below).

Disclosures

13. By moving to a principles-based approach, the proposals will introduce significantly more judgement than was the case under IAS 39. Because of this we agree that increased disclosures are necessary so that users of the financial statements can better understand the nature and effectiveness of an entity's risk management strategies and how they impact upon the financial statements.
14. While we support the proposed disclosure objectives, we feel that the detailed nature of the requirements may mean that the macro level information that is of most interest to most users may be lost among the potentially vast amount of micro level detailed disclosures.
15. We further believe that the proposed disclosures may be operationally onerous in practice. Moreover, they could potentially require disclosure of proprietary information such as strike prices at which hedges apply, the current hedge coverage, roll dates etc. This could disadvantage entities when they next go to the market. The overall package of disclosures should be reconsidered to ensure that they properly focus on the overall hedge objectives of the entity and how successfully the hedging strategy has met those objectives rather than in a detailed analysis of individual hedge positions.

Costs and benefits

16. The proposals introduce new complexities, particularly in relation to rebalancing and the accounting for the time value of options. We are not convinced that the additional costs outweigh the benefits and in our answers to the questions below we include some suggestions for reducing the potential burden without undermining the objectives.

Macro hedging

17. We are generally supportive of the proposed general hedge accounting model. In our view the proposals relating to hedging groups of items and net positions, together with the concept of hedging layers, suggest the Board is heading in the right direction when it comes to hedges of

portfolios. However, we can not comment fully until we have seen the Board's proposals on macro hedging.

18. We believe that the self-imposed deadline of June 2011 for completing this project, including developing a model for macro hedging, is unlikely to prove feasible. We believe a delay would be more than worthwhile if it results in a comprehensive and more robust standard. We therefore encourage the IASB to reconsider their timetable.
19. We believe that the IASB should not finalise a standard on hedge accounting until it has models in place for both general and macro hedging. However, if the Board decide to issue a standard that initially only includes a general hedge accounting model, they would need to be willing to reopen the standard if developments in the macro hedging debate indicate that doing so would be beneficial.

Convergence with US GAAP

20. While the IASB and FASB have a joint project to improve accounting for financial instruments and a shared objective of improving comparability internationally, the Boards' efforts have been complicated by different project timetables established to respond to their various stakeholders.
21. On 26 May 2010 FASB published a draft Accounting Standards Update (ASU) as part of its comprehensive project to revise accounting for financial instruments. The draft ASU proposed only limited changes to hedge accounting. Hence, the IASB's proposals on hedging are much wider in scope than the FASB's project. Reaching an agreement on accounting for financial instruments in general and on hedging in particular is critical if convergence between the two sets of accounting standards is to become a reality.
22. Desirable though convergence may be, we are nevertheless supportive of the IASB's approach of considering hedge accounting more widely and to including non-financial instruments in the scope of the proposals. Even if the FASB cannot be convinced of the merits of a wider ranging hedging project at this stage, we would nonetheless urge the IASB to continue in this direction. We feel that in this instance the IASB should not compromise its overall approach in the interests of convergence.

Effective date

23. We refer you to our submission in response to your *Request for Views on Effective Dates and Transition Methods*.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

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?

24. We agree that defining an objective of hedge accounting is a useful foundation for a more principles-based approach and that a clear definition will assist the understanding and interpretation of the requirements. We broadly support the proposed objective of hedge accounting, which generally sets the scene for the hedge accounting that is permitted by the exposure draft.
25. We support the proposal that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities. However, this linkage must not end up being interpreted as a rule which is seen to require that each individual accounting hedge should be able to be traced back to a matching economic hedge, supported by the documentation of the risk management strategy. Rather, the individual accounting hedges in aggregate at the level at which the risk is managed, should reflect the application of the overall risk management strategy as documented by the entity and as reported to and reviewed by senior management for risk management purposes. This will naturally vary between different entities depending on their management structures and the nature of the risks being managed but typically risk management objectives will be set at an entity-wide level, a business unit level, a portfolio level or some other lower level. While we believe this principle is supported by the ED, for example paragraph BC92 recognises that the risk management perspective and hedge accounting may not be aligned, it would be helpful for this to be made clear in the body of the final standard. The concept should be consistent with the determination of the business model in IFRS 9, which is not at the level of an individual instrument. This could be particularly important if risk management objectives are defined in the standard to better differentiate between rebalancing and discontinuing hedge accounting.
26. We note that the objective focuses only on risks that could affect profit or loss, hence excluding risk management strategies that affect other comprehensive income or attempt to reduce volatility in the statement of financial position. In our opinion there is no reason why transactions should not be eligible for hedge accounting even if there is not a direct impact on profit or loss. The requirement for an impact on profit or loss also places undue emphasis on impacts on profit or loss which can be theoretical, for example that there will eventually be a disposal of a subsidiary in the case of the hedge of net investments.
27. Examples of risk management activities that do not affect profit or loss and therefore are not within scope of the proposals include:
- Where an entity wishes to hedge its exposure to the equity price risk or foreign currency risk associated with a strategic investment in the equity instruments of a foreign company ie, under IFRS 9 *Financial instruments* an entity may elect to carry such investments at fair value with gains and losses recognised in OCI but such gains or losses can never affect profit or loss as they are never recycled, even on disposal of the investment.
 - Where an issuer is exposed to foreign currency risk on the expected proceeds of foreign currency debt securities and enters into derivative transactions to reduce this risk.
 - Where an entity wishes to hedge risks associated with hybrid securities that are classified as equity under IAS 32 *Financial instruments: Presentation*.
 - Where an entity wishes to hedge the equity price risk associated with providing shares to employees to satisfy share based payments.
28. As all of these hedges can be part of an entity's overall risk management strategy, we believe that hedge accounting should be available provided the relevant criteria are met.

29. The proposed revisions to IAS 1 create a single performance statement, albeit with two sections. However, the IASB has not yet developed principles to determine which gains and losses should be included in which sections of this single performance statement. This again leads us to question whether the objective for hedge accounting should restrict itself to risks that could affect profit or loss or whether it is more appropriate to allow hedge accounting for risks that could affect other areas of comprehensive income.
30. While this conundrum was explored by the Board, as set out in BC22 to BC27, the underlying issue is related to the purpose of OCI and it may not be possible to finalise the objective of hedge accounting to everyone's satisfaction until this issue is resolved.

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?

31. We agree that non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit or loss should be eligible hedging instruments. By extending the range of eligible hedging instruments in this way it may become easier for entities to qualify for hedge accounting and hence better align their accounting with their risk management objectives.
32. We believe that the Board should further extend the range of eligible hedging instruments as in practice other items may be used as part of a valid risk management strategy, and excluding them from the definition of hedging instruments would be inconsistent with the aim of better aligning accounting with risk management objectives.
33. We would therefore specifically extend the definition of an eligible hedging instrument to include:
- Equity instruments measured at fair value through OCI;
 - Written options; and
 - Net written options.
34. Given that aggregated exposures that include derivatives can be hedged items, hedging strategies that include written options and net written options should not be precluded from being hedging instruments.
35. We note that under IFRS 9 an entity may designate a financial liability at fair value through profit or loss but record the change in fair value relating to own credit in OCI. We assume such an instrument is still permitted to be an eligible hedging instrument but the final standard should clarify this. In addition, consideration should be given to whether insurance liabilities measured in accordance with IFRS 4 are eligible as hedging instruments.

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?

36. We agree that an aggregated exposure that is a combination of another exposure and a derivative (ie, a synthetic exposure) may be designated as a hedged item. Doing so again enables entities better to align their accounting with their risk management objectives.
37. We assume that it is the intention that the same derivative may be used as a hedging instrument or as part of the aggregated hedged exposure depending on the hedging strategy and the related hedge documentation. For example, where a foreign currency fixed rate loan

initially has a floating local currency swap as the hedging instrument and at a later stage the hedging strategy changes so that a second swap is executed to swap from local currency floating to fixed, we assume that the original local currency floating swap, which was the hedging instrument, now becomes part of the hedged exposure. It may be helpful for the final standard to clarify this point.

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?

38. We agree with the proposals that would allow an entity to designate as a hedged item those risk components that are separately identifiable and reasonably measurable, regardless of whether they are contractually specified or not. Doing so aligns the eligibility of risk components for both financial and non-financial items and recognises that many entities already manage risk components in this way. Once again this enables entities better to align their accounting with their risk management objectives.
39. We believe that **all** risk components should be eligible hedged items provided that they are separately identifiable and reliably measurable. In our view, any specific exclusion from this principle is unwarranted as it would prohibit hedge accounting for some valid risk management strategies. This is in keeping with developing a principles-based, rather than rules based, standard. Therefore:
 - We do not agree with paragraph B18 which 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'. In our view, inflationary risk should be treated in the same way as any other risk component ie, if an entity can demonstrate that it is separately identifiable and reliably measurable, it should be eligible to be designated as a hedged item.
 - We do not agree with paragraph BC225 which states that 'to accommodate hedge accounting for hedges of credit risk, a different hedge accounting requirement... would have to be developed'. As with inflationary risk, we believe that credit risk should be treated in the same way as any other risk rather than creating a rule that prevents it being a hedged item. Although we accept that it may be difficult to measure reliably this risk component in practice, we believe that there are situations where it is possible to do so. See also our reply to question 15 below.
 - We do not agree with paragraph B23 which states that 'a layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk'. As with inflationary risk and credit risk, we believe that prepayment risk should be treated in the same way as any other risk rather than creating a rule that prevents it being a hedged item. See also our reply to question 5(b) below.
40. We agree with the conclusions reached in paragraphs BC61-64 regarding designation of 'one-sided' risk components and designation of a percentage component of a nominal amount.
41. We note that the proposals carry over from IAS 39 the requirement that a hedged component of the cash flows of a financial asset or a financial liability must be less than, or equal to, the total cash flows of the asset or the liability. We believe that in some cases it is possible for a risk component of a hedged item (for both financial and non-financial items) to exist that is greater than the total cash flows of the item. For example, in instances where a negative risk component (or negative spread) behaves independently to the other risk components. This could arise when two or more offsetting risks are bundled together as part of a single

transaction. For deposit taking institutions this could arise on bank accounts that bundle together the offering of banking services with deposit taking, for example a customer deposit could be subject to LIBOR risk despite the overall rate of interest payable on the account being less than LIBOR.

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?

42. We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item. This will allow entities who manage risk in this way to apply hedge accounting, once again enabling them better to align their accounting with their risk management objectives. We believe that layering is critical for the macro hedge accounting model, and we are likely to have further comments when we see these proposals.

Question 5 (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?

43. We do not believe that this is a valid restriction. We believe that layer components that include prepayment options should be eligible hedged items. As noted above, we believe that **all** risk components should be eligible hedged items provided that they are separately identifiable and reliably measurable.
44. This is a more significant issue in the context of macro hedging. Further consideration needs to be given to whether this restriction makes sense in the context of portfolios, particularly as the Board develops its proposals for macro hedge accounting.
45. It does not seem unreasonable that an entity should wish to hedge the bottom layer of prepayable items, knowing that there is little or no risk of prepayment in the layer because all prepayments will occur from the top layer. Vanilla interest rate swaps may well be an effective hedge of this bottom layer and such an approach is widely used in practice. We encourage the Board to further investigate such risk management practices and to consider how best they can be reflected in hedge accounting to reflect not only the risk management but the economic behaviour of the portfolio.

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?

46. We welcome the removal of 80-125% bright line on hedge effectiveness as in practice it is seen as arbitrary, onerous and difficult to apply. Moreover, it can create a disconnect between risk management objectives and hedge accounting. We also welcome the elimination of retrospective hedge effectiveness testing.
47. We note that entities are expected to assess at inception and on an ongoing basis, at each reporting date, whether a hedging relationship meets the effectiveness requirements. We suggest that the work involved in this ongoing test should be consistent with the method for determining hedge effectiveness. Where a simple qualitative approach is applied, it may be sufficient to review for indications that the hedge is no longer effective. This may be along the lines of the impairment testing under IAS 36 for property, plant and equipment. Where a more complex quantitative approach is applied, then the rigour of the ongoing test will be greater.

48. We welcome the introduction of an objective-based assessment to determining which hedging relationships qualify for hedge accounting. However, we are concerned with the notion that the objective of the hedge effectiveness assessment is defined as ensuring the hedging relationship 'will produce an unbiased result and minimise expected hedge ineffectiveness'. While we appreciate what the Board is looking to achieve here, we nonetheless believe that this wording could be improved significantly. Some of our concerns and recommendations are expanded upon below.
49. We are concerned that 'produce an unbiased result' is not clearly explained in the main body of the standard. Paragraph BC29 explains that this means that there should be 'no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in the value of the hedged item' and that there should therefore be no 'deliberate' mismatch in the weightings of the hedged item and of the hedging instrument. In other words, there should be no deliberate under or over hedging. We believe that this should be spelt out more clearly in order to avoid any doubt about what is meant. For example, there may be situations when the entity has no choice but to enter into hedge relationships that will result in consistent over or under hedging, such as when interest rates are expected to increase in future or where there is expected to be "pull to par" ineffectiveness as a result of the timing of the start of the hedge relationship. We assume it is not the intention to prevent hedge accounting in such circumstances and the wording in the final standard should make this clear.
50. We are concerned that 'minimise expected hedge ineffectiveness' could be interpreted to mean that all hedging arrangements should be 100% effective. While we appreciate that this is not the Board's intention, the current wording is ambiguous and could easily be misinterpreted. We would therefore recommend the Board expands upon what is meant by this expression by explaining that 'ineffectiveness' should be minimised in a manner consistent with the entity's risk management strategy and limits.
51. We believe that it would be useful if management were required to disclose what level of ineffectiveness their risk management strategies will tolerate for each category of hedged risk. Further, we believe that management should be required to reconsider an existing hedging arrangement if this level of tolerance is breached. We do not believe that management should be forced to discontinue hedge accounting or rebalance the hedging relationship in such circumstances. Any hedge ineffectiveness will be recorded in profit or loss anyway and changes in economic circumstances may result in changes in management's tolerance and adaptations to the risk management strategy.

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?

52. In principle, we agree with the notion of 'rebalancing' as it enables entities to reflect changes made to the hedge ratio for risk management purposes in their accounting. By introducing a more flexible approach, the need frequently to discontinue and restart hedging relationships is reduced and the dynamic nature of risk management is better reflected in the accounting. Rebalancing may be particularly useful if it not only involves changing the hedge ratio but also if the overall size of the hedge can be reduced. Nonetheless we feel the proposals are overly complex to apply with many different layers of hedge relationships having to be tracked over time.

53. We also have a number of concerns about mandatory rebalancing of hedging relationships.

- We do not believe an entity should be required to rebalance a hedging relationship if doing so is not a part of its risk management strategy. This is inconsistent with the aim of better aligning accounting with risk management objectives.
- In some circumstances it may not even be possible to rebalance, for example where the hedge is of a very specific risk and the entity is not be able to contract further hedging instruments. If rebalancing is not possible and the hedge accounting is still consistent with the risk management objective, it is not clear how the requirement could be met.
- It is a matter of judgement whether the risk management objective has changed or not, meaning there will be no 'right answer' when it comes to deciding whether rebalancing should take place or the hedging relationship should be discontinued.
- Some entities may interpret the proposals as implying that the hedging relationship must be 100% effective at all times, meaning they would feel the need to constantly rebalance in order to continue applying hedge accounting. This would greatly increase the complications of tracking and managing the different layers of hedge accounting.
- If rebalancing requires additional market transactions rather than merely changing the designation of proportions if the hedging instrument, the additional costs would made this unattractive.

54. We believe that rebalancing should be optional. When the concerns set out above are addressed, rebalancing may be an appropriate methodology in certain circumstances but it may not be the best methodology in all cases to ensure that hedge accounting is consistent with the overall risk management objectives for a particular risk, as set out in paragraph 63 below.

55. As noted in our reply to question 6 above, we believe that even if the hedge ineffectiveness is outside of management's normal tolerance levels for an individual hedge there should be no mandatory requirement to rebalance.

56. We also note that the proposals do not explain the consequences of failing to comply with these requirements ie, what are the implications if a hedging relationship fails to meet the objective of the hedge effectiveness assessment and the risk management objective remains the same yet the entity does not rebalance? Presumably the entity would have to discontinue hedge accounting. But is this not effectively the same as allowing voluntary de-designation in such circumstances, even though elsewhere in the proposals it says that this is no longer permitted?

Question 7 (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?

57. As noted above, in principle we agree with the notion of 'rebalancing' as one strategy to manage hedge relationships. While we do not support mandatory rebalancing, we are in favour of allowing entities to proactively rebalance if doing so reflects their expectations of future changes in the hedge ratio.

Question 8 (a)

Do you agree that the 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?

58. We do not agree. Where an entity has a risk management policy which is supplemented with a clearly documented use of hedge accounting designations and de-designations as a rebalancing mechanism to minimise potential income statement volatility arising from the underlying risk management policy, the ability to voluntarily de-designate a hedging relationship is as important as the ability to voluntarily designate a hedging relationship.
59. Voluntary de-designation is currently permitted by IAS 39 and in our opinion should continue to be permitted. Since the future cannot be predicted, we do not believe that it is practicable to discontinue hedge accounting to achieve a particular accounting result.
60. An example where such a strategy may be used would be where an entity has a portfolio of fixed rate debt which is swapped to floating rates using interest rate swaps. On a rolling basis, the entity also decides to fix the first few years of its exposure to floating interest rates by entering into floating to fixed interest rate swaps (ie, the entity fixes the rates for the short term on its 'synthetic' floating rate debt). Whilst the fixed to floating swaps can be fair value hedge accounted, under IAS 39 the floating to fixed swaps are unable to get hedge accounting (as a derivative on a derivative) and these swaps would create income statement volatility when fair valued at the end of each accounting period.
61. By electing not to designate a portion of its fixed to floating derivatives as fair value hedges, it is possible for the entity to reduce income statement volatility arising from parallel yield curve shifts (where the weighted duration of the floating to fixed swaps has been balanced with the weighted duration of the un-designated fixed to floating swaps, a parallel yield curve shift should create broadly offsetting gains and losses from these two groups of swaps). If an event changes the weighted duration of either portfolio of swaps (for example, maturities, new swaps), the entity may want to further designate, or de-designate some of its fixed to floating swaps as fair value hedges to bring duration matching back into balance.
62. The proposals would introduce the ability to hedge the combination of a financial liability and a derivative, which is welcomed and will be applicable to a number of situations. However the approach outlined above would continue to permit the flexibility required when using a portfolio approach similar to the one described.

Question 8 (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 hedging accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

63. We believe that hedge accounting should always be optional for those entities meeting the qualifying criteria. We also believe that entities should be allowed to stop hedge accounting at their discretion regardless of whether or not the conditions that allowed them to opt in to hedge accounting in the first place continue to apply. In other words, if an entity can opt in to hedge accounting they should equally be able to opt out at any time. This is not only because risk management objectives can change as economic conditions make risk management strategies more or less cost effective or even possible. Even where the overall risk management objective for a particular risk type does not change, the methodology for best achieving that objective at the micro level of each individual hedge may need to change. In our view, hedge accounting will have a better chance of reflecting risk management and therefore of being explainable and understandable where there is sufficient flexibility in the detailed accounting

requirements. The overall hedge accounting should be consistent with the stated risk management objectives as set by and as reported to senior management. At this overall level, we agree that hedge accounting should not be discontinued if there is not a change in risk management strategy but individual hedges may need to be discontinued (or rebalanced) at the micro level to achieve this. These proposals are unclear in this respect and therefore we do not support the proposals as drafted.

64. As noted in our reply to question 8(a) above, voluntary de-designation may be part of an entity's risk management strategy. Not allowing this to be reflected in the financial statements is inconsistent with the aim of aligning accounting with risk management objectives.
65. Even if voluntary de-designation were prohibited as proposed, it would often be possible to create the same result by taking out an opposite hedging arrangement. Therefore, we feel that the aim of the proposals would be difficult to enforce in practice.

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?

66. We do not agree with the proposals. Taking all gains and losses on the hedged item and hedging instrument to OCI and then immediately transferring any ineffectiveness to profit or loss ultimately creates the same outcome as is currently required by IAS 39. Therefore, we do not see that there is any merit to the additional entries in the primary financial statements since there will be a net nil in OCI. We would continue to recognise fair value movements (and ineffectiveness) in profit or loss.
67. We note that paragraph 29 requires that all hedge ineffectiveness is immediately recognised in profit or loss for cash flow hedges. This appears inconsistent with the proposed approach for fair value hedges.

Question 9 (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?

68. In principle we 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. In our view, this has two clear advantages.
- It removes the problem of having assets in the statement of financial position at hybrid values where only part of the asset is hedged; and
 - It provides an indicative measure of the extent to which the asset's cash flows have been altered by hedging activities.
69. We accept that where any entity has a limited amount of hedge activity, it may be useful to show the valuation adjustments as separate line items adjacent to the line item that includes the relevant hedged asset or liability. However, the usefulness of this information decreases the more hedge accounting an entity uses as the face of the statement of financial position will inevitably become cluttered with additional line items, many of which will be aggregations of many individual hedges.
70. Therefore, we would recommend that all valuation adjustments are aggregated into single lines on the face of the statement of financial position for assets and for liabilities, with more detailed information on asset and liability classes and risks relegated to the notes.

71. We also note the proposals for a 'split presentation' when any entity is hedging a net position. We do not support these proposals as they will not be representative of the risk management approach.

Question 9 (c)

Do you agree that the 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?

72. We do not support the use of the linked presentation for fair value hedges or any other hedging arrangements. We believe such a presentation would impair comparability between entities and would be difficult to achieve in practice. We believe an understanding of an entity's overall risk management strategy is better achieved through appropriate narrative and numerical disclosures in the notes to the financial statements.

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?

73. Where an entity elects to designate only the intrinsic value of the option as the hedging instrument under IAS 39, the time value of the option is classified as held for trading and is therefore measured at fair value through profit or loss. We accept that doing so can give rise to significant volatility in profit or loss and that this accounting treatment is disconnected from the entity's risk management strategies. Nonetheless, given the complexity of the alternative proposed within the exposure draft, we feel that entities that wish to continue with the existing IAS 39 approach should be allowed to do so. In other words we would not mandate the proposed change but include it as an alternative to the existing IAS 39 approach.
74. We believe that the proposed approach, while theoretically sound, is complex in practice and would support efforts to reduce the complexity, recognising that the notion of the time value of an option that perfectly matches the hedged item is not dissimilar to a hypothetical derivative. It may be that the perceived complexity of the approach can be reduced by building on the existing practice for hypothetical derivatives.
75. We believe that a single approach to reclassification should be developed. We believe that in all instances the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in a manner consistent with the underlying hedged item.

Question 10 (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?

76. We believe that a single approach to reclassification should be developed. We believe that in all instances the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in a manner consistent with the underlying hedged item.

Question 10 (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?

77. We believe that a single approach to reclassification should be developed. We believe that in all instances the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in a manner consistent with the underlying 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?

78. In our view the proposals relating to hedging groups of items and net positions together with the concept of hedging layers suggest the Board is heading in the right direction when it comes to hedges of portfolios. However, we cannot comment fully until we have seen the Board's proposals on macro hedging.
79. Currently, it is not possible to hedge net positions. Instead, an entity can hedge a portion of a gross position. This results in the designated hedged item being different from the true economics behind the hedge which creates complications for the entity and for users trying to understand the hedging strategy and disclosures. We believe that hedges of net positions should be allowed where management hedges on a net basis for risk management purposes.
80. However, we are concerned that the proposed eligibility criteria are too restrictive.
- For a net position to be eligible for hedging, the proposals require each individual item to be individually eligible for hedge accounting. This will involve identifying the corresponding gross amounts. This is likely to be inconsistent with internal risk management strategies and will therefore require additional documentation to be created in order to meet the criteria for hedging. We believe this is unnecessary. It is also not clear whether this is consistent with the ability to include derivatives in the aggregate exposure as set out in paragraph 15.
 - For cash flow hedges, the proposals only allow offsetting where the corresponding cash flows affect profit or loss in their entirety in the same reporting period. We believe that this restriction is unnecessary. Further, we believe that it will disadvantage those who report more frequently as they will have a shorter window to achieve offset as compared to less frequent reporters.

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?

81. The proposals regarding the presentation in profit or loss of the effects of hedge accounting for net positions is a solution as it avoids the problem of artificially grossing up gains or losses. However, since the same economic result can be achieved if the positions are designated on a gross basis, we believe further consideration should be given to allowing the hedged position of individual income statement lines to be presented. This will reduce the need for businesses to provide non-GAAP measures to explain their results.

Question 13 (a)

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

82. By moving to a principles-based approach, the proposals will introduce significantly more judgement than was the case under IAS 39. In particular the 80-125% rule on hedge effectiveness will be replaced with an objectives-based assessment. We are supportive of this change, although it will mean that hedge accounting will be available for the first time to some entities, even where their hedging strategies could be considered aggressive or result in more ineffectiveness than other potential risk management strategies. Because of this we agree that more focussed disclosures are necessary so that users of the financial statements can better understand the nature and effectiveness of an entity's risk management strategies and how they impact upon the financial statements.
83. We believe the overall aim of the disclosure requirements should be to enable users of the financial statements to understand the nature and effectiveness of an entity's risk management strategies and how they impact upon the financial statements. Therefore we broadly agree with the proposed disclosure objectives in paragraph 40. However, we do not believe these objectives will necessarily be met by simply requiring entities to comply with the list of disclosures that follow in paragraphs 44-52. The inclusion of such a detailed, prescriptive list of disclosures is likely to encourage a 'checklist' approach to complying with the requirements, possibly resulting in vast amounts of micro level detail at the expense of the macro level information that is of interest to most users. Furthermore, the disclosures already required by IFRS 7 should be borne in mind. Duplication should be avoided as should any attempt to increase the scope of risk disclosures to risks not included in IFRS 7.
84. We believe that entities should be required to consider the level of detail necessary to satisfy the disclosure requirements and how much emphasis to place on each of these requirements as this would allow some flexibility and ease the reporting burden in many cases. We would recommend that the Board should remove the word 'shall' from many of the proposed disclosure requirements and clearly state that all of the disclosures listed should not be regarded as mandatory in all situations.
85. We further believe that the proposed disclosures may be operationally onerous in practice and that entities may need to generate information purely for financial reporting purposes even though it does not form part of their risk management strategy. Moreover, under the proposals entities could potentially be required to disclose proprietary information such as strike prices at which hedges apply, the current hedge coverage, roll dates etc. This could disadvantage entities when they next go to the market. This is a further reason why the disclosures should be focussed at a sufficiently high level to explain the risk management strategy and its overall effectiveness and impact on the financial statements without requiring details of individual accounting hedges.

Question 13 (b)

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

86. Consistent with IFRS 7, it would be helpful to clearly align the disclosures to the information presented to senior management. In addition, we understand that the intention is for the disclosures to be limited to risks that are subject to hedge accounting; not all risks undertaken by the entity or all of a particular risk type where not all of that risk type is subject to hedge accounting. However, paragraph 42 and paragraph 45 taken together could be read as requiring, for example, forward looking disclosure of all the commodity price risk to which an entity is exposed when it hedges only some transactions or assets. This should be clarified by bringing BC 193, which confines the disclosure "only to those risks that an entity has decided to hedge and for which hedge accounting is applied". While we agree with this restriction, in further developing the proposals for management commentary, the IASB may like to consider

whether management commentary should include a more complete description of the overall risk management strategy, including where the entity has chosen not to apply hedge accounting.

87. As noted in our reply to question 6 above, we believe that it would be useful if management were required to disclose what level of ineffectiveness their risk management strategies will tolerate for each category of hedged risk.
88. We do not have any other specific additional disclosures that we would like the Board to include in the final standard. As noted above, we believe that the required disclosures should be flexed to each entity's circumstances and that a long list of mandatory disclosures is not the best way to achieve the disclosure objectives.

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?

89. We support the proposals for limiting the 'own use' scope exception that currently exists as part of IAS 39. It builds on notion of 'business model' developed in IFRS 9, which we think could be better articulated in the drafting. Nevertheless, it may be of assistance to some entities in better reflecting their risk management practices in the financial statements. We note that another way of achieving similar ends would be to extend the fair value option to such contracts where this would reduce an accounting mismatch.

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?

90. As noted in our reply to question 4 above, we do not agree that a separate approach is necessarily needed for hedges of credit risk. While accepting that there are inherent difficulties in doing so in practice, we believe that the normal hedge accounting rules should be permitted provided that credit risk can be separately identified and reliably measured.
91. We are not supportive of developing a separate hedge accounting model specifically for situations where entities hedge credit risk using credit derivatives. We believe all hedging arrangements should be accommodated within either the general hedged accounting model or the macro hedge accounting model.
92. We believe that all of the options included in paragraph BC226 would add unnecessary complexity to accounting for financial instruments.
93. Many entities who hedge credit risk using credit derivatives do so at a macro level. Therefore, we would encourage the Board to return to this issue when developing its macro hedging model.

Question 15 (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?

94. As noted in our reply to question 15(a) above, we are not supportive of developing a separate hedge accounting model specifically for situations where entities hedge credit risk using credit derivatives. However, if pressed, our preferred choice would be alternative 3.

Question 16

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

95. We agree that the proposed requirements for hedge accounting should be applied prospectively.
96. See our separate representation letter in response to your *Request for Views on Effective Dates and Transition Methods* for our overall views on effective dates.

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