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Hedge Accounting – Replacement of IAS 39
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Dear Mr Friedhoff

Exposure Draft ED/2010/13 Hedge Accounting

We would like to make the following overall points on the Exposure Draft, which are explained in more detail in the attached responses to the questions raised in that document.

We support the general direction of the Exposure Draft in so far as it seeks to better align hedge accounting with the risk management strategies adopted by reporting entities. In particular, emphasising principles rather than rules, and the removal of a “bright line” test with retrospective testing should simplify the on-going hedge accounting requirements, should better reflect the way entities deal with risks, and should be beneficial to preparers of accounts in helping to free up resources.

We note our specific points in the attachment below and believe that improvements to the proposals in the Exposure Draft could and should be made. We recognise that in themselves the proposals in the Exposure Draft are an improvement upon the convoluted requirements of IAS 39 and, by not just focussing on financial institutions, represent an improvement on the approach taken in IFRS 7. However, given the absence from the Exposure Draft of accounting for open portfolios and macro hedging, we would need to see the complete revised Exposure Draft in order to finalise our comments on the Draft, and to enable us to assess full impact in the context of a revised IFRS 7 and IFRS 9.

Given that the comment period ran from December to March, which for most corporates coincides with year end reporting requirements, it should not come as a surprise if many entities are unable to provide as detailed a response to the Exposure

Draft as might be hoped. For such an important area of accounting, more time is needed to consider all the implications, and the IASB should follow up the responses to the Exposure Draft with expert user focus groups and field testing exercises to ensure that all the implications of the proposals in a practical context are identified and understood.

There are several areas of the Exposure Draft which might require further work in terms of drafting the requirements, not least of which is the area of rebalancing. The Exposure Draft could be clearer on this topic and further thought is required to consider the practical implications.

Although the Exposure Draft is intended to be principle based, it could go further in this direction in removing some of the rule-based restrictions which are in the current version of the proposals:

- No adequate explanation is given for restrictions against hedging items in other comprehensive income, for example. If it is part of risk management to hedge against items in other comprehensive income or equity then hedge accounting should be available whether or not said items ultimately recycle to income or not.
- If there is an economic need to hedge internal transactions within a multi-national multi-currency group, and it is part of the risk management strategy to do so, then why are such transactions excluded from hedge accounting in these proposals (as they were in IAS 39)? While we would agree that should be no confusion between the purpose of hedging as an economic activity and the purpose of hedge accounting, it is desirable that hedge accounting should approximate the economic reality of why a hedge is needed.
- If it is part of an entity's risk management to voluntarily close out hedging positions which are still deemed hedges, why do the proposals forbid this? This appears to be an anti-abuse clause, which is inappropriate in what is supposed to be a principles-based standard, where application relies on the risk management policy followed by an entity's management.

A major concern with the Exposure Draft is that it imposes unnecessary and voluminous disclosures which may in certain circumstances be commercially sensitive, particularly when forecast information of sales and purchases is provided, and especially where an entity's disclosed forecast demand for raw materials might affect the price being charged in future, or the behaviour of competitors.

If the proposals of the Exposure Draft are principle based, why is there a set of mandatory disclosures? There should be disclosures of only what is necessary for explaining a given entity's risk management strategy and how it has affected the accounts, rather than a set of potentially meaningless and/or confusing disclosures imposed because the IASB is still taking a "once size fits all" approach to financial statements. There should not be issues of a lack of like for like comparability, but it should be appreciated that many companies in similar industries will face similar risks but address them in different ways, whereas companies in different industries will have different risks to face. Therefore attempting to force comparability through

standardised disclosures goes against the principle based approach, clutters the accounts, and attempts comparability which could be meaningless and of little or no use to users. Investors in particular will view an entity's approach to risk management (whether successful or not) in the context of its results and generally will have little interest in the mechanics of how this was achieved. The Exposure Draft could go further in terms of principles for narrative explanations of an entity's risk management policies. Users want to know that entities have identified risk, taken steps to mitigate risk (often in the context of delivery of results), and an explanation of the strategies used is required.

Arguably, it is counterproductive to have specific disclosures relating to hedged items if there are also "economic hedges" that fulfil the same function and are not disclosed, as they either do not qualify for hedge accounting or have not been designated as hedges (given that hedge accounting is not mandatory, nor should it be).

We hope that you find our comments useful and thank you for the opportunity to be able to comment on this matter.

Yours sincerely

A handwritten signature in black ink, appearing to read 'C Steyn', with a stylized flourish at the end.

C Steyn

Group Chief Accountant

Encs/

Exposure Draft 2010/13: 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?

In general we support the proposed objectives as they are more in line with business operations.

However, restricting hedge accounting to items that only affect profit and loss rather than other comprehensive income or equity is too limiting an approach as hedge accounting should encompass all of the risks that affect an entity.

In a similar context, we do not see why the proposals forbid the hedging of intercompany transactions (e.g. recharges) within a group where there is foreign exchange exposure between counterparties which have different functional currencies; while intercompany transactions eliminate on consolidation, the entity's results are affected depending on which exchange rate is used (e.g. spot or forward). This is perceived as a real foreign exchange risk in economic terms and therefore if part of an entity's risk management strategy, hedge accounting should be available.

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?

We agree with the above.

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?

We agree with the above but, although it is not a specific issue for us, the mandatory exclusion of inflation appears to be inconsistent with the principles of the Exposure Draft.

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 (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We agree with the above, but would expand this to include the designation of inflation as a risk component.

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?*

We agree with the above.

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?

We agree with the removal of the “bright line” 80/125 rule, and the removal of the need for retrospective testing. However we do have concerns over the continued need for prospective testing which seems unnecessary given that ineffectiveness is immediately recognised in profit and loss. In addition, B34 suggests that it might be possible in certain circumstances to avoid lengthy numeric testing, but the wording of this could be strengthened to make it clear that qualitative testing might be more the norm than quantitative testing.

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?*

We have concerns over the area of rebalancing, where the intentions of the IASB could be clearer in the Exposure Draft. Moreover, further thought is required to consider the practical implications and, for example, whether mandatory rebalancing as intended by the IASB would always reflect the underlying risk management or in fact is even consistent with a principles-based standard. Given that the comment period ran from December to March, which for most corporates coincides with year end reporting requirements, it should not come as a surprise if many entities are unable to provide as detailed a response to the Exposure Draft as might be hoped. For such an important area of accounting for financial instruments, more time is needed to consider all the implications and the IASB should follow up the responses to the Exposure Draft with expert user focus groups and field testing to ensure that all the implications of the proposals in a practical context are identified and understood.

Question 8:

- (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?*
- (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?*

We do not agree with these proposals. They seem to be anti-abuse provisions, which may often not achieve their aims, rather than principles which would reflect the risk management. If hedge accounting should match the entity's risk management strategy, then the accounting must allow for voluntary de-designation of hedging relationships and closing out of positions if that is part of the entity's risk management strategy.

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?*

While we agree that the conceptual basis of the current requirements can be criticised, the proposals as stated in the Exposure Draft could lead to unnecessary complexity and clutter in an entity's financial statements. We have a general concern over the trend to greater complexity in the primary statements, which can be detrimental to a clear understanding of the financial statements.

As regards Question 9(a), we do not agree. The current requirements are relatively well understood by users and preparers and are relatively simple to apply with the two parts of the hedging relationship netting off in profit and loss. We do not see the benefit from the approach suggested, which would only add confusion and complications for users and preparers.

As regards Questions 9(b) and (c), in order to show the impact of hedge accounting we believe that disclosures in the notes to the accounts are preferable to clutter in the primary statements. The proposals in the Exposure Draft to require a separate line

item in the balance sheet will in many cases show information of little use to users of the accounts and just clutter the primary statements. Disclosure in the primary statements or the notes is a choice which must be left to those preparing the financial statements, to be made in the light of their risk management policies and materiality. We do however agree with the point on linked presentation.

Question 10:

- (a) *Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. like a basis adjustment if 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 (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?*

While we generally agree with the proposals in the Exposure Draft, different approaches could lead to unnecessary complexity.

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?

In the absence of the proposed accounting for open portfolios, it is difficult to comment on the impact of the proposals in the Exposure Draft.

Question 12:

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

We agree with the proposals subject to all fair value changes being aggregated into one line in the income statement, with an appropriate level of detail provided in the notes to the accounts.

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?*

We accept that disclosure can be important in this area. However, it should be noted that mandatory disclosures according to a checklist, perhaps as an anti-abuse measure or a way of ensuring compliance with the hedging requirements, will lead to long, meaningless disclosures which will clutter up the financial statements. Unfortunately, in the current climate and with the way the Exposure Draft is drafted, preparers will inevitably gravitate towards a checklist mentality in order to avoid issues with auditors and regulators. The existing disclosure requirements of IFRS 7 reflect the activities of financial institutions rather than those of corporates and the proposed disclosures in the Exposure Draft add to this reporting burden for preparers of accounts. The additional information is likely to be voluminous and of questionable benefit to the users of the accounts

Additionally, these disclosures may in some circumstances be commercially sensitive, particularly when forecast information of sales and purchases is provided, and especially where an entity's disclosed forecast demand for raw materials might affect the price being charged, or the behaviours of competitors.

If the proposals of the Exposure Draft are principle based, why is there a set of mandatory disclosures? There should be disclosures of only what is necessary for explaining a given entity's risk management strategy and how it has affected the accounts, rather than a set of potentially meaningless and/or confusing disclosures imposed because the IASB is still taking a "once size fits all" approach to financial statements. This should not be a question of like for like comparability; most companies in similar industries will face similar risks but address them in different ways whereas companies in different industries will have different risks to face. Therefore attempting to force comparability through standardised disclosures goes against the principle based approach, clutters the accounts, and attempts comparability which could be meaningless and of little or no use to users.

The Exposure Draft could go further in terms of principles for narrative explanations of an entity's risk management policies. Users want to know that entities have identified risk, taken steps to mitigate risk (often in the context of delivery of results), and explanation of the strategies used is required.

Arguably, it is useless to have specific disclosures relating to hedged items if there are "economic hedges" that fulfil the same function either not qualifying for hedge accounting or not designated as hedges (given that hedge accounting is not mandatory, nor should it be).

At the very minimum, the proposed disclosures should be moved out of the standard and into the application guidance as illustrative examples of disclosures which could be given numerically.

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?

We have no comment on this proposal.

Question 15:

- (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?*
- (b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?*

We believe this to be more of an issue for financial institutions and so have no comment.

Question 16

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

The transition and implementation of this and other standards needs to be revisited given the large number of significant changes that the IASB is proposing. In this context, we would also note that the overall IASB package on financial instruments is yet to be seen, including the approach on open portfolio hedging. Prospective application from 1st January 2015 would seem an acceptable date given the amount of preparation that is likely to be required to implement these particular proposals. For example, taking the proposals in this Exposure Draft, software designed to work with the requirements of IAS 39 will require significant amendment or replacement in order to deal with the new rules.