

THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND



Response from
The Institute of Chartered Accountants of Scotland to
the International Accounting Standards Board
Exposure Draft 2010/13: Hedge Accounting

9 March 2011

INTRODUCTION AND KEY ISSUES

The Institute's Accounting Standards Committee has considered exposure draft 2010/13 "Hedge Accounting" and is pleased to forward its comments to the IASB.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Accounting Standards Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Overall we believe that these proposals represent a significant improvement over the current hedge accounting model in IAS 39. The focus on the entity's risk management activities is important in simplifying the accounting and in allowing entities to reflect their economic hedging activities in their financial statements. The proposals should be helpful for operational businesses that use hedging to protect their core business activities by allowing them to apply hedge accounting more easily. The exposure draft retains a number of restrictions, such as not permitting hedging of items that affect other comprehensive income, which we believe will limit the effectiveness of the proposed standard.

There are aspects of the proposals that may cause complexity, such as the notion of rebalancing. Before this standard is finalised, the IASB should undertake field-testing of the proposals with a range of entities in different sectors. We do not have a clear picture of whether entities that currently do not apply hedge accounting would be persuaded to do so by these proposals – field-testing may be helpful in clarifying this.

Any enquiries should be addressed to Amy Hutchinson, Assistant Director, Accounting and Auditing and Secretary to the Accounting Standards Committee.

ANNEX: RESPONSES TO SPECIFIC QUESTIONS

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?

Response:

We agree with the proposed objective, and believe that the explicit link to an entity's risk management activities will help ensure that hedge accounting is a better reflection of the underlying economic reality. The objective refers specifically to 'particular risks that could affect profit or loss.' We do not agree with this restriction as we believe that it will limit the usefulness of hedge accounting for entities who may hedge items that affect other comprehensive income. We would encourage the IASB to consider further whether hedge accounting could be extended to cover items that affect other comprehensive income.

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?

Response:

We 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. This is a sensible approach which introduces greater flexibility and will allow entities that use these types of assets and liabilities for economic hedging to reflect this in their financial statements.

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?

Response:

We agree that an aggregated exposure may be designated as a hedged item. This again removes a restriction and makes it easier for entities to align hedge accounting with their risk management activities.

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?

Response:

We agree that an entity should be allowed to designate a risk component as a hedged item. This allows entities that manage their risks in this way to represent this accurately through hedge accounting. However, we are unsure why, in a principles-based standard, there is a specific exception for non-contractually specified inflation risk. We are aware that certain types of entities do hedge inflation risk; therefore it would be helpful if they were able to reflect this through hedge accounting. We do not believe that the Board has adequately justified this exclusion and would like to see further discussion of this area.

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?

Response:

- (a) We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item, as hedge accounting should be capable of reflecting the risk management activities of an entity that hedges layer components.
- (b) We agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. We agree with the justification provided in BC69.

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?

Response:

In principle, we agree with the proposed hedge effectiveness requirements. We support the removal of the 80 to 125 per cent bright line test from IAS 39, and the removal of the requirement for retrospective assessment of hedge effectiveness. This removes unnecessary rigidity and complexity that may currently discourage entities from applying hedge accounting. The new hedge effectiveness requirements enable entities to make their assessment based on management information used for decision-making purposes which is a positive development as it links external reporting more closely to the way an entity manages its business.

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?

Response:

We agree that in theory re-balancing is a sensible approach that will make it easier for entities to continue to apply hedge accounting. However the concept is not well-understood and we believe that field-testing is required to determine how the proposals can be operationalised.

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?

Response:

We 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. We also 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. Our only concern is that it may be difficult to enforce these proposals, for example, within an entity which has extensive hedging activities.

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?

Response:

We 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 transferred to profit or loss. We do not 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. Such an item does not meet the definition of an asset or liability and therefore should not be separately presented. We do not support linked presentation as we do not believe that this would aid understandability or comparability.

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?

Response:

We support the development of an approach to address the problems of using options as hedging instruments in IAS 39. It would be preferable if there was a single approach to the reclassification of the time value component from other comprehensive income to profit and loss to avoid increased 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?

Response:

We cannot comment fully on the proposals for groups of items until the Board's proposals for macro-hedging have been established. We are concerned that the approach here may be restrictive – for example, all items in the group must individually be eligible hedged items, although this may not be the way that an entity actually manages its hedging activities.

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?

Response:

We agree that the hedging instrument gain or loss recognised in profit or loss should be presented in a separate line for the hedge of a group of items. However the question does not address presentation in the statement of financial position i.e. the hedging gain or loss is presented as a separate line item, which we disagree with, as stated in our response to Question 9 above.

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?

Response:

We agree with the general principles for disclosure set out in paragraphs 40 to 44. However the detailed requirements that follow seem to be at odds with these principles as they are highly prescriptive and may engender a tick-box mentality. It would be preferable if the detailed requirements were optional i.e. 'an entity may' rather than 'an entity shall.' The disclosures will also have to be considered alongside the risk disclosures required by IFRS 7 before they are finalised to ensure they are compatible and not duplicative.

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?

Response:

This appears to be a very industry-specific issue, and we are unsure why this needs to be addressed in the exposure draft.

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?

Response:

We agree that the three alternatives to accounting for hedges of credit risk using credit derivatives would add complexity to accounting for financial instruments. The Board should work with entities that undertake this type of hedging to identify if there are other solutions to this issue.

Question 16

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

Response:

We agree with prospective application. The likely implementation date is dependent on the date of finalisation of the standard since there must be sufficient time for entities to prepare for transition. We believe that the June 2011 deadline for completion of this and other major projects is no longer relevant – it is far more important for the Board to ensure that the projects are completed to the highest possible standard.