



# Grant Thornton

International Accounting Standards Board  
30 Cannon Street  
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## **Exposure Draft *Hedge Accounting* (ED/2010/13)**

Grant Thornton International Ltd is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft *Hedge Accounting* (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions. We set out our main comments below. Our responses to the specific questions raised in the ED's Invitation to Comment section are set out in the Appendix.

### **Support for the project**

The existing requirements for hedge accounting in IAS 39 *Financial Instruments: Recognition and Measurement* have been widely criticised as being overly complex and rule-based. Numerous operational problems have been encountered when applying those requirements in practice. We welcome the Board's efforts to address these concerns by developing a model that is more principle-based and better reflects entities' risk management strategies.

We support the proposals that will broaden the circumstances in which hedge accounting is permitted and eliminate arbitrary distinctions and bright lines. A more flexible model should make it easier for entities that enter into economic hedging to apply hedge accounting.

We note that the ED proposes to retain IAS 39's principle that hedge ineffectiveness is measured and recognised in profit or loss. Measuring effectiveness is probably the most significant source of complexity for entities that apply hedge accounting. Accordingly, although the ED should simplify some aspects of hedge accounting, it will not make it simple. However, we believe this principle is an essential part of a credible hedge accounting model and therefore support its retention. This requirement is an important counter-balance to broadening the circumstances in which hedge accounting is permissible and should serve to mitigate concerns about increased potential for earnings management.

### **Main issues**

#### **Convergence**

Despite our support for a new approach to hedge accounting that would remove some of the complexity found in the current requirements, we are concerned that the proposals are not aligned with those of the Financial Accounting Standards Board (FASB). At present, IAS 39's requirements for hedge accounting are in fairly close alignment with those of US GAAP. While we wish to see the current requirements simplified, we do not want this to be at the expense of divergence with US GAAP. We therefore recommend that the Board work closely with its counterparts at the FASB so that a converged solution is reached.

#### Fair value hedge accounting

We are concerned that the costs to entities from having to change the way in which they present fair value hedges will exceed the benefits from the proposed change. The proposed changes would also result in divergence from US GAAP.

#### Designation of risk components as hedged items

We support the proposal that an entity should be able to designate a risk component as a hedged item provided that the component is separately identifiable and measurable. We believe however that the final Standard should stipulate that a risk component needs to be contractually specified to meet this proposed requirement.

#### Qualifying criteria and effectiveness

The ED proposes to eliminate or replace IAS 39's prospective and retrospective hedge effectiveness qualifying criteria. The ED proposes instead that the hedge must:

- meet the objective of the hedge effectiveness assessment (produce an unbiased result and minimise expected ineffectiveness); and
- be expected to achieve other than accidental offsetting.

We support the elimination of the retrospective 80/125% effectiveness criterion. This threshold is an arbitrary 'bright line' and can lead to mandatory discontinuation of hedges that are expected to be effective over their duration as a result of short-term fluctuations.

We are however concerned that the ED's proposed effectiveness criteria are not clear as expressed and may not be operational. Some of the terms used appear vague and could be susceptible to inconsistent application. Although we support modifying the existing effectiveness thresholds, we consider that a threshold should be retained in some form. In our view the FASB's proposal, in *Proposed Statement (Revised) Accounting for Hedging Activities—an amendment of FASB Statement No. 133* (the FASB proposal), for an expectation of "reasonable" effectiveness is a preferable starting point for developing a converged solution. We suggest that the effectiveness criteria should encapsulate the premise that there should be the expectation of a significant offset when entering into a hedging relationship.

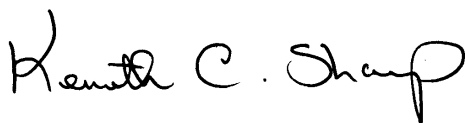
#### Effective date and transition

We agree with the Board's proposal for prospective application of the new approach. In line with our response to the Board's *Request for Views on Effective Dates and Transition Methods* however, we believe that the effective date for the Board's remaining major phases of the project to replace IAS 39 should be 1 January 2015.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@uk.gt.com or telephone + 44 207 391 9510).

Yours sincerely,



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## Invitation to comment 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?**

We support the Board in its wish to introduce an objective for hedge accounting. A robust objective should help make the Standard more principles-based and reduce the need for detailed rules. Ideally, entities should be able to refer to the objective to assist in addressing issues of interpretation in particular circumstances.

We suggest the proposed objective could be improved somewhat. The proposed phrasing implies that if an entity chooses not to apply hedge accounting, and instead follows the normal accounting for financial instruments, then its financial statements will not reflect its risk management activities. This would seem to imply that the normal accounting for financial instruments is somehow inappropriate. We suggest the objective should encompass the points that hedge accounting is:

- an alternative, voluntary accounting model
- portrays income statement effects of risk management activities in the same period to the extent they are effective in achieving offset.

### 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 support this proposal. Extending the range of eligible hedging instruments should make hedge accounting more flexible and align it more flexibly with entities' risk management strategies. Having said that, we are not aware of any significant demand among our client base for the increased use of cash instruments as hedging instruments.

We support the proposed approach of requiring non-derivative financial assets or liabilities to be designated in their entirety (with the exception of foreign currency risk components which are already identified under IAS 21). This will avoid the need for developing an approach to disaggregating such instruments, which could be problematic.

### 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. We understand that the proposal will enable some entities to better reflect their risk management strategy, where they manage different risk components independently.

#### 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?**

We agree that it should be possible for an entity to designate a risk component as a hedged item provided that that component is separately identifiable and measurable. Permitting risk components to be designated in this way will facilitate hedge accounting for those entities that enter into transactions that give rise to a combination of different risks, thus allowing them to more closely reflect their risk management practices.

We believe that the wording of the proposal, with its requirement for risk components to be 'separately identifiable and reliably measurable', is in keeping with a move towards a more principles-based Standard. We believe however that the final Standard should stipulate that a risk component needs to be explicitly specified in a contract in order to meet this requirement. Without this stipulation, questions of interpretation are bound to arise, as any component that could be inferred as being present in a non-financial item or transaction could qualify. No ineffectiveness would then arise because the price of the designated component will exactly match the derivative variable.

#### 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 support the proposal to permit an entity to designate a layer component of a nominal amount of an item as the hedged item. Doing so will eliminate issues for entities that manage layer components as part of their risk management strategies.

For the proposed change to be effective in practice, however, the new wording will need to be capable of being clearly interpreted. For instance, when a particular transaction occurs, it will need to be clearly evident whether the transaction which has occurred was the one that was being hedged or not. In relation to this, it may be useful to include a definition of a 'layer component' in the final Standard as well as including the guidance in B19-B23 of the ED.

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 for the reasons expressed in the Basis of Conclusions to the ED.

## 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 support the Board's efforts to make the requirements for hedge effectiveness more principles-based. In particular, we support removing the 80/125% retrospective test. We do however have some concerns over both the clarity and operability of the eligibility criteria proposed in the ED.

Overall, we suggest that the FASB's proposals, in *Proposed Statement (Revised) Accounting for Hedging Activities—an amendment of FASB Statement No. 133* (the FASB proposal) are a preferable starting point for developing a converged solution. These are that:

- an economic relationship exists between the hedging instrument and the hedged item or hedged forecasted transaction
- changes in fair value of the hedging instrument would be reasonably effective in offsetting changes in the hedged item's fair value or the variability in the hedged cash flows.

Our concerns with the ED's proposals are explained in more detail below.

### *Objective of the hedge effectiveness assessment*

We also have some concern over the concept of the "objective of the hedge effectiveness assessment" and the supporting guidance in paragraph B29. The need for an "unbiased result" seems to mean that the optimum hedge ratio must be used. The need to "minimise expected hedge ineffectiveness" implies that entities must identify and select the least ineffective of all possible designations - which could be broader than selecting the best hedge ratio and extend to all aspects of the hedge designation. Such an approach would not only be impractical given the extent of possible alternative designations but also inconsistent with the principle of alignment with an entity's risk management strategy.

We do agree that entities should not designate a hedge with the deliberate intention of creating ineffectiveness, although we are not convinced there is any motivation to do so.

If these optimisation concepts are retained we suggest that:

- the phrase "meets the objective of the hedge ineffectiveness assessment" should be replaced with terminology that reflects the Board's underlying intentions
- they should be subject to a reasonable endeavours threshold or something similar.

### *Other than accidental offsetting*

While we acknowledge that the requirement in paragraph 19(c) of the ED for a hedging relationship to be "expected to achieve other than accidental offsetting" is intended to be principles-based, we feel this concept is unclear and will lead to many interpretational questions in practice.

Our concerns are that:

- the terminology implies that "accidental" offset can be "expected" which we find questionable
- it is not clear whether any particular degree of "other than accidental offset" is inherent in the requirement. If a proposed designation includes any basis risk there will presumably be some "other than accidental" offset and some effects that will either be "accidental offsets" or non-offsets
- the guidance in paragraph B31 indicates that the Board has in mind the existence or otherwise of an economic relationship between the hedged item and hedging instrument. We agree that such a relationship should exist and note its inclusion in the FASB proposal. We would prefer that the main body of the final Standard expresses the criterion in similar terms
- however, B31 goes on to suggest that a statistical relationship is not sufficient to support an expectation of other than accidental offset. We question this assertion and suggest that a robust statistical analysis (indicating a high degree of correlation) is sometimes the only or most credible basis to assess whether an economic relationship exists.

#### 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 think that the concept of rebalancing a hedge relationship in certain circumstances is a useful one. We are concerned however, that the ED seems to lack a clear principle to determine when rebalancing is required. The ED proposes that rebalancing is required when:

- the risk management objective remains the same
- the relationship fails to meet the objective of the hedge effectiveness assessment (to produce an unbiased result and minimise ineffectiveness).

As explained in our response to Question 6, we are not convinced that the objective of the hedge effectiveness assessment is clear or operational as expressed. Consequently, we suggest that the circumstances in which rebalancing is required are also unclear.

One possible interpretation of the proposal is that entities must routinely assess whether the original hedge ratio continues to minimise ineffectiveness (and rebalance if not) at each reporting period. We do not believe this is the Board's intention as this would clearly increase complexity.

We therefore suggest that the final IFRS should have clearer principles to determine when the hedge ratio is assessed and (possibly) revised. We agree that rebalancing will be appropriate in circumstances where there is evidence of a systematic change in the nature of the economic relationship between the hedging instrument and hedged item (the example in B49 of a change in a currency peg is one such situation). We expect that such clear systematic changes will be rare however.

We therefore believe that the principles in the final IFRS will need to be capable of being applied to less clear-cut situations, for example where:

- the expected volume of a forecast transaction changes
- the entity chooses to improve the hedge relationship
- the entity receives new information indicating that its original hedge ratio is sub-optimal.

We can see arguments for and against rebalancing in such situations. Given that the concept of rebalancing a hedge relationship is a new one, we also suggest that:

- field testing could be useful in order to test the proposal
- further implementation guidance will be needed in order to ensure that it is properly understood and applied.

### 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 agree in principle subject to our concerns on the qualifying criteria. Should the project succeed in its overall aim of reducing the burden of applying hedge accounting, then it would appear reasonable for companies to be required to continue to apply hedge accounting where the qualifying criteria are still met.

We note however that inability to voluntarily de-designate a hedge relationship when the qualifying criteria are still met could lead to additional costs and complexity. A change in circumstances, such as revision to the timing of a forecast transaction, may result in the measurement of hedge (in-)effectiveness becoming more onerous part way through a hedge's duration. Prohibiting hedge de-designation in such circumstances might impose costs that exceed the benefits from simplifying the overall hedge accounting requirements. The inability to de-designate may also prove to be a limiting factor in the take up of the new approach. We recommend the Board considers these points when making their final conclusion.

Finally, if the wording in paragraph 23 of the ED is retained, the eventual Standard will need to be very clear on what will constitute a change in risk management objective and therefore result in discontinuation of the hedging relationship.

### 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?**

We have doubts over the merits of this proposal. Changing the way that fair value hedge accounting is accounted for and presented will increase the costs for those entities currently using this method of hedge accounting as they are forced to change their accounting entries. The benefits from this change are not immediately apparent to us. We also struggle to see a clear principle behind the proposed new treatment, which will result in divergence from the requirements of US GAAP.

**(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?**

We agree. Where fair value hedge accounting is applied to an instrument that would otherwise be accounted for at amortised cost, the current requirements of IAS 39 result in the hedged item being measured at a mixture of amortised cost and fair value. Such a measurement basis is difficult for users to understand. The ED's proposed approach of not adjusting the hedged item for the gain or loss on the risk being hedged, and instead presenting that gain or loss as a separate line item, should add transparency to the statement of financial position and make the financial statements more understandable to the user.

**(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?**

We do not support the use of a linked presentation for fair value hedges under which gross assets and liabilities related through a fair value hedge would be presented together on the same side of the statement of financial position. We feel that such a presentation would be confusing for the user of the financial statements and would make comparability between different sets of financial statements more difficult. We therefore feel that this information would be better presented 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?**

**(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?**

**(c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (ie the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?**



We agree that the current requirements of IAS 39, under which the undesignated time value of an option is treated as held for trading and is accounted for at fair value through profit or loss, do not necessarily reflect entities' risk management strategies and could be improved.

Having said this, we consider the ED's proposals in this area to be overly complex and unlikely to significantly reduce the administrative burden of applying hedge accounting for those companies that are affected by this proposed change. We would therefore encourage the Board to develop a simpler method of dealing with the time value component of an option. If the premium paid for a purchased option is viewed as an insurance premium it would be simpler to treat this amount as a prepayment and amortise it to profit or loss over the life of the cover period.

#### **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?**

We do not object to these proposals although we struggle to see a clear logic behind them, and question whether they will result in a more principles-based Standard. It will be easier to evaluate the Board's thinking in this area alongside its proposals on macro hedging once those proposals have been published.

#### **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?**

We agree with the proposals to present any hedging instrument gains or losses in a separate line for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement. To do so will avoid the artificial grossing up of gains or losses that would be necessary if all the affected line items were otherwise adjusted.

#### **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 support the objectives expressed in the ED relating to the disclosure of an entity's risk management structure and the effects of its hedging activities. We are concerned however that the disclosure requirements proposed in paragraphs 49 to 52 of the ED are overly prescriptive. While the information specified may well be useful, we feel that entities should be given greater freedom in deciding how much detail to disclose.

#### 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 support the Board's proposal that a commodity contract held for own use can be accounted for as a derivative in certain circumstances. Such an approach will remove an accounting mismatch by enabling those entities that manage their exposures to commodities contracts on a fair value basis to better reflect their risk management strategy.

#### 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 have no particular views or preferences on this matter.

#### Question 16

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

We agree with the proposed transition requirements but believe the proposed effective date should be later.

While we generally support full retrospective application of new IFRSs on the basis that it improves the comparability of financial statements between periods, we agree that on this occasion such an approach would be inappropriate. Retrospective application would be burdensome and is unlikely to be feasible without inappropriate use of hindsight.

We also support the Board in rejecting an approach of using prospective application of hedge accounting only for new hedging relationships. We agree that such an approach would be onerous as entities would need to maintain IAS 39's hedge accounting model for existing hedge relationships until those relationships are discontinued as well as applying the requirements of the new approach. We therefore support the Board in proposing prospective application of the ED's requirements for all hedging relationships.

In line with our response to the Board's *Request for Views on Effective Dates and Transition Methods* however, we believe that the effective date for the Board's remaining major phases of the project to replace IAS 39 should be 1 January 2015. This is because of the high overall impact of the changes proposed by these phases of the Board's financial instruments project. We believe that entities should be given a minimum period of three years from publication of the in-progress chapters of IFRS 9 to their effective date to allow for the modification of systems and collection of data that will be necessary to apply the new requirements.

Given the final version of IFRS 9 is not expected to be published before the second half of this year, and assuming the Board continues with its recent practice of setting most effective dates as either 1 January or 1 July, we therefore suggest 1 January 2015 should be the effective date.

We agree that early adoption should be permitted.

#### **Other comment**

As noted in our covering letter, the ED proposes to retain the principle that ineffectiveness is measured and recognised in profit or loss. We support this decision while also suggesting that this is one of the main sources of complexity for entities that choose to apply hedge accounting. The ED's proposals will therefore simplify some limited aspects of the current model but putting hedge accounting into practice will remain challenging for many entities.

We suggest that the Board, in its various communications surrounding this project, is careful to avoid creating a misleading impression that hedge accounting will become straightforward. It is important that entities continue to make a careful assessment of the advantages and disadvantages of applying hedge accounting.