

International Accounting Standards Board
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Your Ref: Comment letter on Exposure Draft ED/2010/13 Hedge Accounting

Dear Sir.

Thank you for giving us the opportunity to comment on your exposure draft Hedge Accounting. Current hedge accounting under IAS 39 is overly rules-based, mandates an arbitrary “bright line” test of hedge effectiveness, and promotes “accounting-economic” mismatches, with preparers very often unable to apply hedge accounting to genuine hedges that form part of a rational, economic risk management strategy. This is unacceptable. I therefore support the principles-based approach which you have taken here with regards to the main objective, which is to align hedge accounting with an entity’s risk management activities. In particular I support the following sensible proposals:

- certain risk components would be eligible hedged items
- certain aggregated exposures that are a combination of another exposure and a derivative would be eligible hedged items
- certain layer components of defined nominal amounts would be eligible hedged items
- certain groups of individually eligible items representing a gross or net position would be eligible hedged items
- hedges would be rebalanced rather than restarted
- voluntarily discontinuing would be prohibited
- the time value component of purchased options would be accounted for in other comprehensive income

I also support the approach that you have taken with regards to the disclosure requirements. Disclosure arguably plays a more important role when complementing a principles-based standard compared with a rules-based one. I believe that the proposed disclosure requirements are reasonably sufficient and complete, and will provide users with more

meaningful information about how an entity's hedge accounting relates to its risk management activities, and how effective its hedging activities are with respect to its risk management objectives.

Accounting for the time value of purchased options

In general, I support the board's interpretation in paragraph BC147 of time value as the insurance premium that an entity pays for obtaining "insurance" protection against risk. I also support that the change in time value should be accounted for in other comprehensive income. However I would recommend that the board should propose a single consistent approach for the reclassification of amounts from equity to profit or loss, rather than the dual approach, depending on the hedged item, currently proposed.

Differences between the IASB and the FASB

I am not happy with the inconsistencies and differences between the IASB and the FASB, in particular concerning the effectiveness assessment, rebalancing and hedging layer components. This will lead to incomparable reporting between the regimes. I would recommend that the IASB and FASB should work more closely together in order to develop a set of global accounting standards in line with their commitments.

Answers to specific questions raised by the IASB

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?

Yes. I agree with the proposed objective of aligning hedge accounting with an entity's risk management activities. This is a natural linking of accounting with risk management, in order to capture the actual economic impact in financial statements of using hedge instruments to mitigate financial and business risks. This objective should be the conceptual basis behind all of the principles and rules proposed in the exposure draft.

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?

Yes. I welcome the board's decision to widen the scope of instruments that are eligible as hedging instruments by including non-derivative financial instruments measured at fair value through profit or loss. This will better promote the alignment of hedge accounting with risk management, which is our main objective. However, I believe that there is more that we can do here. I disagree with paragraph BC39: I can see no rationale for excluding non-derivative financial instruments that are not measured at fair value through profit or loss from scope. I would recommend that the board give more consideration to their inclusion going forward.

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?

Yes, I agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item. For the purposes of risk management, entities very often consider combinations of exposures, in aggregate, as synthetic exposures. Therefore this proposal would be conducive to better aligning an entity's hedge accounting with its risk management activities in practice.

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?

Yes. I strongly agree with this proposal, which would allow entities greater flexibility in applying, and aligning, hedge accounting to their risk management activities. I also agree with the provision that the risk component should be separately identifiable and reliably measurable.

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?

Yes. I agree that an entity should be allowed to designate a layer of the nominal amount, however identified, of an item as the hedged item, as this would promote the alignment of hedge accounting with the entity's risk management activities.

- (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?

Yes. If the prepayment option's fair value is affected by changes in the hedged risk, then the layer component would not be separately identifiable, which is a requirement for designating a risk component as a hedged item.

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?

Yes, I agree that a hedging relationship should meet the objective of the hedge effectiveness assessment (i.e. to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness), and should be expected to achieve other than accidental offsetting, in order to qualify for hedge accounting. I also support the elimination of the 80-125% bright line test, and the retrospective hedge effectiveness requirements, under IAS 39, in favour of the more principles-based prospective hedge effectiveness assessment proposed here. Furthermore, I welcome the guidance that a hedging relationship does not have to be expected to be perfectly effective in order to qualify for hedge accounting (see paragraph B29), as this would otherwise limit the scope of hedge accounting in practice, and would therefore not align hedge accounting with an entity's actual risk management activities.

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?

Yes. In terms of its application of hedge accounting, I 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. Hedging is usually a dynamic process, and this proposal is a vast improvement over IAS 39. The proposal is more flexible, and would allow an entity to account for a change in hedging relationship which results from the application of its actual risk management objectives, procedures and processes.

- (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?

Yes. In terms of its application of hedge accounting, the concept of rebalancing should also be applied proactively, where an entity rebalances a hedge resulting from the application of its actual risk management objectives, procedures and processes.

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?

Yes. An entity should not be able to arbitrarily discontinue hedge accounting prospectively when the hedging relationship continues to meet the qualifying criteria.

- (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?

Yes. An entity should not be permitted to arbitrarily 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. This is an improvement over IAS 39, which allowed an entity to arbitrarily revoke a hedging relationship.¹

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?

Yes, I 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. This has the advantage of presenting the extent of offsetting achieved for fair value hedges in the statement of comprehensive income, and also maintains the reporting of all hedge ineffectiveness in profit or loss.

- (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?

Yes, I 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. This will eliminate mixed measurement for the hedged item.

- (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?

Yes, linked presentation should not be allowed for fair value hedges. I believe this would reduce comparability between entities, and would not provide meaningful information to users.

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?

Yes, partly. I recommend that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be transferred to profit or loss on a rational basis.

¹ See IAS 39, paragraphs 91(c), 101(d).

- (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?

Yes, I 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.

- (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?

Yes, I 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). I understand that this would increase complexity in accounting for the time value of purchased options, but it is a sensible solution. An entity would need to determine which features of the option are critical. This determination requires considerable judgement, which introduces some subjectivity here. I have no problem with this, as long as the judgement is applied consistently, and follows a well-documented procedure.

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?

Yes, I agree with the criteria outlined in paragraph 34 concerning the eligibility of groups of items as a hedged item. I support that a group of items could qualify as a hedged item if this is consistent with the entity's risk management strategy. I also agree with paragraph B70 that this must be a matter of fact, rather than just assertion or documentation. I also strongly support that the proposals would permit net position hedging, which is much more consistent with general risk management practice, and would therefore more closely align an entity's hedge accounting with its risk management 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 (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?

Yes, I agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement, 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. I concur with the reasoning presented in paragraph BC175.

I do not support that, for a fair value hedge of a group of items, the gross amounts of gains or losses associated with each asset or liability should be presented in separate line items in the statement of financial position. Although this is consistent with the designation of the hedged item being the group of items, it could lead to inappropriate grossing up (of assets and liabilities), which was specifically avoided for affected income statement line items elsewhere. I would rather recommend that such information should be disclosed, preferably 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?

Yes. The proposed disclosures would provide meaningful information to users. Given the principles-based nature of this exposure draft, I agree with paragraph 33 that an entity should determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and what additional information would be required to satisfy the disclosure objectives. I further agree that information disclosed should be usefully separated by risk category, as users predominantly analyse hedging activities by type of risk, and that an entity should determine each category of risk on the basis of the risk exposures it decides to hedge and for which hedge accounting is applied. I also support that an entity should provide a reconciliation of accumulated other comprehensive income in accordance with IAS 1.

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

Paragraph 40(a) states that the disclosures should provide information about an entity's risk management strategy and how it is applied to manage risk. For completeness I would suggest that the disclosure requirements should include hedge-related transactions undertaken as part of an entity's risk management strategy and activities, even if the transaction does not qualify for hedge accounting. This would provide more complete and useful information to users.

See also my response to question 12.

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?

I strongly support this proposal. It would provide welcome relief to preparers, mitigating the current accounting mismatch for commodity contracts that are currently excluded from the scope of IAS 39, and would provide more meaningful information to users.

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?

The problem with credit risk is that there is no generally accepted method of isolating and measuring credit risk from the spread between risk free rates and market interest rates.² I agree that the three alternative approaches outlined in paragraph BC226 all have merits, however I would not support their further development as doing so would introduce an arbitrary accounting model within the principles-based hedge accounting model proposed here. I also agree that each of the three alternative accounting treatments would add unnecessary complexity to accounting for financial instruments.

- (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?

Please see my response to question 15 (a).

Question 16

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

Yes. I agree that an entity should apply the proposed requirements prospectively, and that existing hedging relationships that have qualified for hedge accounting under IAS 39 should be subject to the proposed requirements from the date of transition. I would also support earlier application only if all existing IFRS 9 requirements are adopted at the same time or have already been adopted.

² There are many ways to analyse this spread including empirical approaches, structural models of implied default probabilities and default risk premia, intensity based models of implied default probabilities and default risk premia, and demand and supply based models and market microstructure models. None of these approaches could be described as "generally accepted".

Summary of my main recommendations to the board:

- **Adopt a single approach to reclassifying the time value of a purchased option from accumulated other comprehensive income to profit or loss – preferably on a rational basis (see my response to question 10)**
- **Propose that information about the gross amounts of gains or losses for fair value hedges should be disclosed, preferably in the notes (see my response to question 12)**
- **Propose the disclosure of hedge-related transactions undertaken as part of an entity's risk management strategy and activities, which do not qualify for hedge accounting (see my response to question 13)**

Yours faithfully

C.R. Barnard

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