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Dear Martin,

Thank you for the opportunity to respond to the IASB Exposure Draft on Hedge Accounting.

The Chartered Financial Analyst Society of the UK (CFA UK) represents more than 9,000 investment professionals working across the financial sector. For advocacy purposes, these members are represented by committees that consider proposals relating to Financial Reporting and Analysis Committee.

Response to Hedge Accounting Exposure Draft

High level issues

Most committee members support the principle-based approach, tying hedging to risk management and emphasising the economic rationale underlying hedge accounting. However, there is some concern that the principle is weak in that management's intentions are an insufficient basis for measurement. Those who are uneasy about the permissive nature of the ED have sympathy with the alternative view of John Smith, notably that some of the provisions lack rigour and that "the proposals would inappropriately expand the use of hedge accounting".

Support for the principle is based on a desire to see better explanations of and more transparency around risk management decisions. ***This is in line with the tenor of IFRS 9.*** It seems reasonable to remove some of the arbitrarily inflexible elements of IAS 39, such as the 80-125 effectiveness test. The focus should be on the risk management exercise and the way this is presented in the accounts should not influence behaviour.

The danger is that it is tempting for management to employ presentation techniques that offset and smooth the underlying numbers, which can mask risk. So the bar for hedge accounting – as for all types of offsetting – should remain high. As Mr Smith says: "the elimination of the condition that the hedge will be highly effective would unduly expand hedge accounting".

A further concern, in the wake of the financial crisis, follows from the degree of reliance on risk management models, which have proved fallible in the past. The impact on non-financial companies, which have often eschewed hedge accounting in the past, is also unclear. Those of us who have worked with accounts that do

not use HA have found considerable useful information (albeit non-GAAP) in the explanations and reconciliations of the difference between the statutory numbers and those put forward by the company as apparently reflecting the underlying economic reality.

The strongest support for the proposed changes to hedge accounting came from those who work for banks. They not only like the more liberal and flexible approach, but suggest that the logic of the "risk management" principle is that further concessions should be made eg in accounting for credit risk. They also look forward to further relaxation of the measurement criteria in the next phase dealing with portfolio hedging.

Those who support the ED believe that line-by-line presentation will help to identify the risks, and that the required disclosures would provide the explanations necessary to see the impact of the accounting treatment as well as the underlying risk being hedged.

On the issue of effectiveness, the latitude given to management by removing bright-line tests will give rise to more individual judgments by companies and increase scope for manipulation. The standard should give auditors a firm basis for challenging the judgments of management, so that the accounting treatment genuinely reflects the risk management and any changes are sound and transparent.

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, although some are concerned that the principle too permissive.

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. These could be part of a risk management strategy and the elements would seem to be separately identifiable and measurable. A high level of effectiveness should be expected.

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?

Mixed views because of potential misclassification of the risk in such aggregation.

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?

The criteria that the risk must be separately identifiable and measureable are very important. So is a high expectation of effectiveness. Only the strongest supporters of flexible HA believe that an approach can be found to credit risk that will satisfy these criteria.

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?

Yes, if it can be separately identified and reliably measured. But there was some confusion over this, including over the exclusion of the prepayment option from a hedged item. Is this because it is felt it cannot be reliably measured?

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?

The Committee supports the removal of the arbitrary 80-125 test. But the requirement that the relationship should "meet the objective of the hedge effectiveness assessment" seems rather circular. Other concerns are that minimising ineffectiveness is an obvious goal but does not sound like a test. And what does an "unbiased result" mean bearing in mind the preparer is producing this and will be keen for its hedges to qualify as being effective?

In the Basis for Conclusions BC 79 says: "the objective of the hedge effectiveness assessment should reflect that hedge accounting is based on the notion of offset." Yes but this must be limited to highly effective offsets and it is not clear that there is enough rigour on that. ***One suggestion is that the materiality concept should be applied: if the lack of effectiveness would create a materially different result, the hedging relationship does not stand.***

The view of the strong supporters is that the requirements create a separate set of objectives for effectiveness assessment that may not be part of the risk management strategies. That is, that the principle is not being followed.

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?

Mixed views. The positive one is: yes, so long as the rebalancing is transparent and clearly explained. The reservation is that it could allow ineffectiveness to be masked and perpetuated.

(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?

Ditto.

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, with the reservation that the qualifying criteria and the flexibility to rebalance may both be too premissive.

(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.

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?

There are mixed views on this. Some remain uneasy about extending the use of OCI, others believe it is a pragmatic way of presenting FV gains and losses on effective hedges.

(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.

(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?

There was some support for the linked presentation because this is an opportunity to show how assets and related liabilities are connected, and identify both the gross and net amounts. Not sure why the opposition of one industry should have blocked this.

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?

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?

This has some pragmatic appeal and paragraphs 34 a-c set some important eligibility criteria. The reservation is that aggregation coupled with a lack of rigour in hedge effectiveness measurement might lead to some risks being obscured.

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?

Separate line items would provide some transparency.

Question 13

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

In some previous responses the committee has said that the disclosure sections have been too detailed and prescriptive, In the case of hedge accounting, they need to be just that. So we welcome what is proposed in paragraphs 40 onwards. ***As well as reporting what it is doing, the entity should disclose prominently any change to risk policy and choice of instruments,***

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

40c may mean this, but it is useful in assessing the management of substantial exposures to volatile rates to be able to see not only what would have happened without hedge accounting but without hedging.

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?

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?

Yes*.

(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?

Question 16

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

**** The minority view on Q15 is that credit hedging should be allowed if it meets the separately identifiable and reliably measurable threshold.***

We hope that these comments have been useful and would be pleased to provide additional feedback in future.

Yours,

Jane Fuller, Chair Accounting Advocacy Committee

Will Goodhart, Chief Executive