

07 March 2011

IFRS Foundation
30 Cannon Street
London EC4M 6XHH
United Kingdom

Re: Exposure Draft ED/2010/13 Hedge Accounting

Dear IFRS Foundation:

Chatham Financial (“Chatham”) is pleased to comment on the International Accounting Standards Board’s (the “IASB” or the “Board”) proposed hedge accounting amendments to IAS 39 *Financial Instruments: Recognition and Measurement* (the “Exposure Draft”). Chatham serves as a hedging advisor to over 1,000 companies globally in many different industries. More than 400 of our clients apply the hedge accounting provisions of either IAS 39 or ASC 815 and will be impacted by the new hedge accounting provisions. Chatham assists companies with the implementation of IAS 39 and ASC 815 on a daily basis for thousands of derivative transactions, including providing assistance with hedge designation memos, effectiveness testing, derivative valuations, journal entries, and footnote disclosures for many different types of hedging relationships. Given our role, we believe that we are well-positioned to understand the impact and ramifications of the proposed guidance on a broad spectrum of derivative end users and share the following comments and recommendations from that perspective.

Overall Comments

Positive Aspects of the Proposed Hedge Accounting Model

Aligning hedge accounting with risk management activities

Chatham is supportive of the IASB’s efforts to align hedge accounting more closely with an entity’s risk management activities, and we believe many of the proposed changes will provide investors with more decision-useful information than under the existing model. We also appreciate the IASB’s efforts to reduce the complexity of hedge accounting in certain areas and address inconsistencies and weaknesses in the existing hedge accounting model.

Permitting specific risk components of non-financial items to be hedged

In addition, and perhaps most significantly, we strongly agree with the proposed guidance that would permit an entity to hedge a specific risk component of either a financial or non-financial item, provided that the specified risk component is “separately identifiable and reliably measurable.” We agree that financial and non-financial items should be treated similarly and believe this proposed change will align the accounting treatment for entities hedging components of non-financial items with their associated risk management practices. In our view, the existing model that creates distinctions between financial and non-financial items is arbitrary, confusing, and unnecessary. Indeed, many companies have exposure to changes in the price of commodities and prudently mitigate these exposures through the use of derivative instruments,

similar to the mitigation of interest rate or foreign currency risk in financial items. We further believe that the threshold of requiring that the specified risk component be “separately identifiable and reliably measurable” is appropriate to provide for a robust application of hedge accounting in practice.

Permitting designations of a layer component of the nominal amount of a hedged item

Chatham also agrees with the proposal to allow entities to designate a layer component of the nominal amount of an item as the hedged item. We believe this will simplify the hedge accounting model for various risk management strategies and appropriately recognises the level of uncertainty that may surround the hedged item. However, we do not believe that a blanket prohibition against designating a layer component of a contract that contains a prepayment option if the option’s fair value is affected by changes in the hedged risk is the right approach and we question the theoretical basis for that type of prohibition, as discussed in our response to Question 5 in the Appendix.

Improvements in the accounting for the time value of options

In general, we believe that the Board’s proposed approach for recognising the time value component of options is much more reasonable and appropriate than the existing guidance under IAS 39, and we appreciate the Board’s recognition that the existing accounting treatment is not aligned with the risk management activities of most entities. We view this as a significant improvement and also appreciate that the accounting for options will be more closely aligned with U.S. GAAP. However, as noted below, we believe the proposed guidance in this area requires additional clarification and could be further simplified.

Areas of Concern with the Proposed Hedge Accounting Model

Lack of clarity with several of the proposed changes

One of our principal concerns with the Exposure Draft relates to the lack of clarity with several of the proposed changes, particularly with respect to the qualifying criteria for hedge accounting, required rebalancing, and accounting for the time value of options.

In particular, phrases like “other than accidental offsetting” are unclear and confusing, as are the requirements that the hedging relationship “produce an unbiased result and minimise expected hedge ineffectiveness.” **Without further clarification, we are very concerned that such language could be misinterpreted and taken to extremes in practice by auditors and regulators, which may (1) actually raise the threshold to qualify for hedge accounting beyond what is currently required and (2) significantly increase the cost of hedging.** For example, we worry that an auditor or regulator could require an entity to go to great lengths to “minimise” ineffectiveness—to the point that the marginal cost of creating a slightly more effective hedge far exceeds the marginal benefit of further mitigating a particular risk. Accordingly, we strongly recommend that the Board clarify that entities are permitted to manage ineffectiveness within reasonable parameters that are consistent with the entity’s risk management strategies and that are defined at the inception of the hedging relationship. This is critical to provide clarity and context for phrases such as “other than accidental offset” and “unbiased result” and “minimise ineffectiveness” that are used in the proposed guidance.

Additional clarity is also needed for entities to effectively apply the proposed guidance when mandatory rebalancing is required (see our response below to Question 7 in the Appendix) and for accounting for the time value of options. Regarding the time value of options, for example, additional clarity is needed to help entities differentiate between what will be treated as a “transaction related” hedged item and a “period related” hedged item, as each category has a different outcome for recognising the time value component of the original premium paid in profit or loss. Furthermore, we recommend that the Board further clarify what it means by “rational basis” for amortisation of the option premium. (See our detailed comments in response to Question 10 in the Appendix below.)

Prohibitions against voluntarily discontinuing a hedging relationship

We believe that restricting an entity’s ability to voluntarily discontinue a hedging relationship is a major step in the wrong direction and will create a host of practice issues and problems. We believe this area was working very well in practice and that a “fix” was completely unnecessary. Accordingly, we are deeply concerned that the proposed guidance in this area will (1) add significant complexity to the hedge accounting model, rather than simplifying it, and (2) restrict a number of appropriate risk management activities, as further discussed in our response to Question 8 in the Appendix.

Changes to the mechanics of fair value hedge accounting

The change in the mechanics of how fair value hedging relationships will be accounted for and presented in the financial statements represents a substantial increase in complexity, in our view, with little or no apparent benefit over the existing approach. The existing approach in this area is (1) simple to understand and apply, (2) consistent with U.S. GAAP, and (3) well understood by both users and preparers of the financial statements. We strongly question the need for fair value hedging relationships to create *separate* line items in the statement of financial position (further cluttering the primary financial statements) or to “gross up” other comprehensive income. We believe this is tantamount to creating meaningless extra steps (eg tracking and accounting for gains and losses first through OCI) with the same ultimate impact on profit or loss. We further believe that the transparency of the financial statements will be reduced as OCI becomes increasingly confusing to understand.

Further divergence from U.S. GAAP

The hedge accounting model being proposed by the IASB creates additional differences with U.S. GAAP in a critically important and complicated area of accounting. We urge both Boards to consider opportunities to significantly (and hopefully completely) converge their hedge accounting models before final guidance is issued.

Additional Opportunities to Improve the Hedge Accounting Model

We believe the Exposure Draft provides an ideal opportunity to significantly improve the existing hedge accounting model. We feel very strongly that a few additional modifications will (1) result in greater convergence between IRFS and U.S. GAAP, (2) resolve significant practice issues and inconsistencies in the guidance, and (3) significantly simplify the accounting for hedging activities.

Key recommendations for improvement that we urge the IASB to consider include two practical accommodations proposed by the FASB in its Exposure Draft of Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the “proposed ASU”), as follows:

- We believe that the guidance in paragraphs 118 and 126 of the FASB’s proposed ASU will simplify the hedge accounting model for cash flow hedging relationships with slight timing mismatches between the hedging instrument and hedged forecast transactions. The use of a single hypothetical derivative for purposes of assessing effectiveness and measuring ineffectiveness in those situations is a reasonable and appropriate practical accommodation in our view.
- Similarly, we strongly recommend that the IASB adopt guidance similar to paragraph 124 of the FASB’s proposed ASU regarding use of the same credit risk adjustment on the hypothetical derivative as that used in calculating the fair value of the actual hedging derivative. We believe very strongly that the hypothetical derivative logically should be based on a “real” derivative transaction that could be executed by the entity in the marketplace. More specifically, we believe it is entirely appropriate and reasonable to assume that the same counterparties apply to both the actual derivative and the hypothetical derivative (rather than assuming, for example, that the hypothetical derivative is executed between parties with zero credit risk, or otherwise misaligning the actual and hypothetical derivatives with respect to the adjustment for credit risk).

From our perspective, both of those proposals by the FASB are very reasonable accommodations that will resolve lingering practice issues and simplify the application of hedge accounting, and we urge the IASB to consider those provisions during its redeliberations and convergence efforts.

Our responses to the specific questions posed by the IASB are included in the Appendix below, including several suggested clarifications and recommendations for the IASB to consider for inclusion in the final standard.

We thank the Board for its consideration of our comments and recommendations and would be pleased to discuss these issues in more detail with the Board or staff at your convenience. Please do not hesitate to contact me at 001.484.731.0228 or at dgentzel@chathamfinancial.com should you have any questions or desire further clarification on any of the topics discussed in this letter.

Sincerely,

/s/ Daniel S. Gentzel

Director of Accounting Policy
Chatham Financial

APPENDIX

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 are supportive of the proposed objective of hedge accounting, which is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. At a more granular level, however, we continue to be concerned with how the provisions will be applied in practice, and therefore recommend several modifications to the proposed hedge accounting model, as described above and in our responses to the questions below, that we believe will improve the model by making it clearer, more consistent with the stated objectives, and more practical to apply.

In addition, although we strongly support the objective of better aligning an entity's risk management activities with its financial reporting, we believe that risk management activities are much broader than only those items that affect profit and loss, and we question the theoretical basis and rationale for precluding as eligible hedged items instruments measured at fair value through other comprehensive income. Finally, we note that the Exposure Draft continues to focus primarily on "micro" hedging, and we look forward to the Board's future hedge accounting proposals with respect to open portfolios and "macro" hedging.

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?

Although we do not believe it will be widely applied in practice, we support the idea of permitting non-derivative financial assets and non-derivative financial liabilities that are measured at fair value through profit or loss to be considered eligible hedging instruments. For entities that use these instruments in practice as part of their risk management activities, we believe it makes sense to permit them to apply hedge accounting when such instruments are being used for risk management purposes.

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 support permitting an aggregated exposure that is a combination of another exposure and a derivative to be designated as a hedged item. We believe it would be useful in certain situations, such as those described in paragraphs B9 (a) and (b) of the Exposure Draft, as it provide entities with more flexibility in applying hedge accounting.

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 strongly support permitting a broader range of risk components to be designated as the hedge risk in a hedging relationship as proposed in the Exposure Draft. We believe this will make applying hedge accounting more practical in certain situations, primarily hedges involving commodities and other non-financial items. As noted above, we also believe that the threshold of requiring that the specified risk component be “separately identifiable and reliable measurable” is appropriate to provide for a robust application of hedge accounting in practice.

In particular, with respect to non-financial items for which such designations are prohibited under the existing guidance, we do believe such hedges oftentimes provide clear and identifiable offset to changes in the price of the specified components of the non-financial items. One example would be an entity entering into an aluminium forward purchase contract to hedge the major component cost of an aluminium-based manufactured product. Based on our experience, basis differences and sources of ineffectiveness between the aluminium forward contract and the aluminium component of the hedged item oftentimes can be clearly identified and measured in such hedging strategies. Under the existing guidance, however, the entity would have to assess the effectiveness of the hedge by evaluating the degree of offset between the cash flows on the aluminium forward contract and the *overall variability* in all cash flows on the entire manufactured product – which generally includes other ingredients and components. Ultimately, such a straightforward strategy may not qualify as an effective hedge. If it does qualify for hedge accounting treatment under the existing guidance, it generally will still result in significant volatility in profit or loss related to the unhedged components. Accordingly, we strongly support the IASB’s efforts to expand the hedge accounting model to accommodate hedges of specific risk components in both financial and non-financial items.

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 strongly support the proposal to allow entities to designate a layer component of the nominal amount of an item as the hedged item. We believe this will simplify the hedge accounting model for various risk management strategies and appropriately recognises the level of uncertainty that may surround the hedged item.

However, we do not believe that a blanket prohibition against designating a layer component of a contract that contains a prepayment option if the option’s fair value is affected by changes in the

hedged risk is the right approach, and we question the theoretical basis for that type of prohibition. Instead, we believe it would be much more consistent and appropriate to require that for such hedging relationships, the hedging instrument and hedged item contain offsetting (mirror-image) prepayment options, such that the prepayment option that is impacted by the hedged risk is included in the hedge effectiveness assessments and measurements.

- For example, assume that a bank desires to designate a fair value hedge of the EURIBOR benchmark interest rate risk of \$20 million of a \$25 million fixed-rate issuance of brokered CDs. The brokered CD issuance is callable by the bank and generally hedged by a callable/cancelable swap. The values of those prepayment options are directly affected by changes in the designated EURIBOR benchmark interest rate. However, due to prepayments related to the death or adjudication of incompetence of the CD holder, often referred to as “death puts” (which are unrelated to changes in the benchmark interest rate), the nominal amount of the hedged item generally changes over its life. It seems reasonable that a bank would be able to designate the “bottom” \$20 million layer of the \$25 million nominal amount of the brokered CD issuance, even though the contract includes a prepayment option (the CDs are callable by the bank as specified in the contract).

From our perspective, as long as (1) the hedging instrument (a cancelable swap in this example) contains a mirror-image prepayment option to the prepayment option included in the hedged item, and (2) those fair value changes are included in the assessments and measurements of hedge effectiveness, that type of designation and strategy should be permitted. In those types of hedging strategies, we believe the risk component is separately identifiable and reliably measurable. We urge the Board to reconsider its decision on this issue, as we believe that permitting such strategies *with our proposed guardrails* would not lessen the robustness of the hedge accounting model.

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 concept in paragraph B28 that when designating a hedging relationship and on an ongoing basis, an entity shall analyse the sources of ineffectiveness that are expected to affect the hedging relationship. However, we disagree with the objective of the hedge effectiveness assessment being to produce an unbiased result and minimise expected hedge ineffectiveness described in paragraph B29. Rather than use absolute terms like “unbiased result” and “minimise” expected hedge ineffectiveness, which imply there can be zero bias and only minimal ineffectiveness, we believe it would be more reasonable to require an entity to establish in its overall risk management policy an “acceptable range” (ie an acceptable or tolerable amount) of expected bias or ineffectiveness given the sources of ineffectiveness identified at the inception of the hedging relationship and then to manage the relationship within that range. If the assessment of effectiveness demonstrates that the amount of ineffectiveness is within the acceptable range, the objective of the hedging relationship would be achieved and hedge accounting would be applied, but if it were outside the acceptable range the objective would not be achieved and hedge accounting would not be applied. If there are no sources of

ineffectiveness identified, then a qualitative assessment would be acceptable for satisfying the objectives of the hedge effectiveness assessment. In either case, hedge ineffectiveness would always be measured using the proper hedged item or hedged transactions and would be recognised in profit or loss appropriately. We provide an example of how this could be applied in our response to question 7(a) below.

We also feel that managing the hedging relationship to an appropriate hedge ratio that minimises hedge ineffectiveness could lead to increased volatility in profit or loss and result in the recognition of fair value changes in profit or loss under IFRS 9, whereas under the same scenario under IAS 39 there would be no recognition in profit or loss. As a high level example, assume an entity is hedging a forecast 5-year fixed rate debt issuance expected to occur 6 months in the future. The entity hedges its interest rate risk on the expected fixed rate debt issuance by entering into a 5-year pay fixed interest rate swap that starts in 6 months to coincide with the expected debt issuance. Three months after entering into the hedging instrument, the entity's expectations for when it expects to issue fixed rate debt are now 6 months after the originally expected issuance date. Under IAS 39, we will assume for this illustration that the hedging relationship is highly effective, but the effectiveness ratio is 90%. The hedging relationship is an underhedged cash flow hedge and, as a result, no hedge ineffectiveness will be recognised in profit or loss and the full change in fair value of the hedging instrument will be recorded in OCI. Under the guidance in the Exposure Draft, it seems the entity would need to consider whether it has an appropriate hedge ratio designated and potentially rebalance the designated amount of the derivative to 90% in this case. If the entity rebalances to a hedge ratio of 90%, going forward 10% of the change in fair value of the hedging instrument would be recognised in profit or loss and 90% would be recorded in OCI, whereas under IAS 39 the hedging relationship would still be underhedged and no ineffectiveness would be recognised in profit or loss. Depending on the fair value of the hedging instrument, the difference could be material.

Continuing the example, with respect to minimising hedge ineffectiveness in paragraph B29 of the Exposure Draft, we feel the IASB should clarify whether it means (1) "minimise the amount of hedge ineffectiveness recognised in profit or loss" or (2) "minimise the difference in the offsetting changes in fair value between the hedging instrument and the hedged item or forecast transaction." These two conditions could each be construed as determining the amount of hedge ineffectiveness, but may produce very different results in profit or loss. The first condition considers the fact that cash flow hedges that are underhedged produce no ineffectiveness that is recognised in profit or loss whilst the second condition does not. Taking our previous example further, it could be inferred that ineffectiveness is minimised at the point where the cash flow hedging relationship was less than 100% effective, ie an underhedge situation. Since no ineffectiveness is recognised at any point the hedging relationship is underhedged, then any underhedge situation theoretically produces the minimal amount of hedge ineffectiveness (ie zero ineffectiveness). Taking the view in the first condition would seem to indicate that cash flow hedging relationships with even very minimal dollar offset that also produce an underhedge result would satisfy the hedge effectiveness objective to minimise ineffectiveness. However, under the second condition, a cash flow hedging relationship with a very minimal amount of dollar offset that also produces an underhedge result would likely not satisfy the hedge

effectiveness objective to minimise ineffectiveness. We recommend the Board provide clarifying language on this matter to avoid confusion in practice.

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?

The IASB has stated in the Exposure Draft that the new objective of the hedge effectiveness assessment is to:

1. ensure the hedging relationship will produce an unbiased result and
2. minimise hedge ineffectiveness

The Exposure Draft states that rebalancing can either be done proactively if the entity believes the objectives will not be met or is mandatory when the hedging relationship no longer achieves “other than accidental” offsetting. We are concerned that the rebalancing provisions proposed by the Exposure Draft are not sufficiently clear to enable users to apply the concept of rebalancing, as further discussed below:

The Exposure Draft indicates that management can proactively rebalance a hedging relationship because it is expected to fail the objective of the hedge effectiveness test. We see several practical implications to applying this concept including:

- There is no guidance in the Exposure Draft indicating what, if anything, management must do to substantiate why it believes a proactive rebalancing is necessary, which may lead to inconsistent application and confusion;
- There is no mention that management must be correct in its assessment of the need to proactively rebalance a hedging relationship;
- There is no guidance on what action should be taken if management was incorrect in its assumption that the objective of hedge effectiveness would no longer be satisfied (eg if management was incorrect, should it then be required to undo the proactive rebalancing?);
- Given the lack of guidance, it seems management could simply indicate that it believes it will fail to satisfy the objective without actually substantiating it; and
- A lack of consistency in applying the rebalancing concept among entities could result in a lack of comparability across entities’ financial statements.

In addition, we noted that mandatory rebalancing is required when the hedging relationship no longer achieves “other than accidental” offsetting. We feel there is currently insufficient

guidance in the Exposure Draft to indicate what constitutes accidental offset. This also could result in a lack of consistency and comparability among entities.

The Exposure Draft discusses addressing the hedge ratio (paragraph B48), which indicates that adjusting the hedge ratio allows an entity to respond to changes in the relationship between the hedging instrument and the hedged item arising from its underlyings or risk variables. We have several concerns with simply looking at the hedge ratio in a given hedging relationship. It seems to only address “volume” related differences when adjusting the notional amount designated as hedged would be effective in reducing the ineffectiveness whilst it ignores other sources of ineffectiveness, including timing differences and basis differences (eg location differences, quality differences, or tenor of interest rate differences). Therefore, the Exposure Draft does not provide sufficient guidance to address situations where other than volume related ineffectiveness is present and is likely to lead to confusion and inconsistency in practice. Also, failing to consider these areas could result in forcing companies to rebalance hedge ratios inappropriately.

We do support the idea of permitting companies (with appropriate rebalancing) to continue original hedging relationships despite encountering situations that cause the amount of hedge ineffectiveness to change beyond a “minimal” amount.

To address the shortcomings of the proposed rebalancing guidance (regardless of the source of ineffectiveness), we offer an alternative view to the guidance proposed by the Board whereby the Board could essentially extend the requirements of paragraph B28 of the Exposure Draft and require an entity to quantify in its overall risk management policy an acceptable range of ineffectiveness that could arise from the various sources of ineffectiveness that could exist in a particular hedging relationship. As part of its documentation for each individual hedging relationship, an entity would need to identify the sources of ineffectiveness in the hedging relationship, and if the actual amount of ineffectiveness quantified at a subsequent measurement date approaches the thresholds of the estimated range, the entity could voluntarily rebalance. If the amount exceeded the thresholds, the entity would be required to rebalance. After a rebalancing occurs, if amounts removed from the hedging relationship would no longer cause the amount of ineffectiveness to be outside of the entity’s original forecast expectations for ineffectiveness, then such amounts again could be included in the original hedging relationship (on a prospective basis) without requiring them to be redesignated off-market. We feel this approach would be much easier to apply in practice than the approach recommended by the Board in the Exposure Draft.

As an example of how this approach would work in practice, an entity would be required to:

- Establish in its overall risk management policy acceptable amounts of hedge ineffectiveness for the different types of hedging relationships and strategies used to manage risk.
- At inception of each individual hedging relationship, identify the expected sources of ineffectiveness in the hedging relationship, if any, and establish a quantitative set of expectations around how much ineffectiveness could arise over the life of the hedging relationship.

- At subsequent measurement dates, if the measured ineffectiveness is:
 - Within the acceptable range, then no rebalancing is required.
 - Outside the acceptable range, then rebalancing would be required.
 - Within a predefined percentage (established in the entity's overall risk management policy) of either end of the range, the entity could proactively rebalance.
- If an amount is removed from the hedging relationship because such amount was outside the established parameters, but at a subsequent date was within the parameters, that portion could be redesignated in the original hedging relationship (ie without redesignating it off-market in a new hedging relationship).
- In all cases, hedge ineffectiveness would be measured using the proper hedged item or hedged transaction and recognized in profit or loss.

Taking this approach requires an entity to identify and quantify potential sources of ineffectiveness (ie items that could cause it not to achieve its risk management objective) and set parameters in its risk management policy around when it would, would not, or could rebalance. Those parameters could not be changed without establishing a new hedging relationship. This approach allows management to determine what it considers to be an acceptable range of ineffectiveness, would require less ongoing administrative burden, and would be easier to monitor and apply.

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?

As the Exposure Draft is currently written, we do not support the requirement for an entity to discontinue hedge accounting only when the hedging relationship ceases to meet the qualifying criteria. We believe that restricting an entity's ability to voluntarily discontinue an effective hedging relationship after it has been established is a major step in the wrong direction and will create a host of practice issues and problems. We foresee numerous operational concerns with this modification to the guidance, including a substantial increase in cost and complexity, and are equally concerned with the negative unintended consequences that will inevitably result from this prohibition.

We work with hundreds of companies in a wide variety of industries and have not seen—and are not aware of—any abuse in this area, which makes the proposed modification particularly perplexing. Nor do we believe that auditors, regulators, or users have identified this as an area of concern. As such, this proposed restriction appears to be an attempted “fix” to an area that is not broken in our view. If an isolated abuse does in fact exist in practice, we believe a much more surgical response is warranted (for example, enhanced disclosure of whatever specific concerns prompted the proposed change). From our perspective, however, a sweeping prohibition that completely eliminates an entity's ability to remove the designation of an effective hedge would be very unfortunate and does not pass the most basic cost-benefit analysis.

Many prudent and legitimate hedging strategies involve discontinuing the hedging relationship at some point. A few examples include:

(1) Cash flow hedges of a floating rate liability or asset with an interest rate cap or floor for a period of time, after which the entity may desire to remove the hedge designation of the original option so that a new “at-market” option can be designated in its place (for example, assume that an entity capped its EURIBOR-based debt a few years ago at 6% when interest rates were high; now, in today’s interest rate environment after interest rates have fallen substantially, the entity may desire to remove the designation of the “worthless” 6% cap and designate a new 1% cap in its place);

(2) Cash flow hedges of foreign-currency-denominated sales/purchases and desired discontinuation of the hedging relationship upon recognition of the resulting foreign currency receivables/payables—a particularly common strategy for entities seeking to hedge foreign currency risk (given the natural offset achieved by simultaneously recording changes in the fair value of the hedging instruments and the IAS 21 translation gains/losses on the recognized foreign currency receivables/payables in profit or loss); and

(3) “Delta-hedging” strategies and dynamic portfolio hedging strategies with pools of hedged items.

Given entities’ fundamental need to voluntarily discontinue effective hedging relationships in these types of situations and as the mix of assets and liabilities (and their measurement attributes) on the balance sheet changes, etc., we urge the Board to reconsider this proposed modification to the existing guidance.

Further, given that applying hedge accounting is voluntary and can be voluntarily elected to be applied at any point after a trade is executed (ie hedge accounting does not have to be applied from the trade date of the hedging instrument, it can be elected to be applied at any point after the trade is executed), we fail to understand why voluntarily discontinuing to apply hedge accounting is problematic or confusing.

Question 8: (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 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. As we discuss under our response to question 8(a) above, we strongly support voluntary dedesignation of hedging relationships. Our view is that so long as an entity sufficiently discloses the nature and extent of its hedging activities in its financial statements, including the effect on the financial statements, requiring it to maintain a hedging relationship in a situation in

which the entity otherwise would elect not to maintain it, is illogical and unreasonable. We feel that dedesignations could be better addressed by requiring disclosures in the financial statements regarding the reasons why such hedging relationships were discontinued and the associated quantitative impact on the financial statements.

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?

No, we do not agree with changing the recognition provisions for fair value hedges. As noted above, we feel that recognising in profit or loss both the change in the fair value of derivatives designated in fair value hedging relationships as well as the change in fair value of the hedged items due to the risk being hedged is a solution that is currently well understood and is working well in practice. We feel that requiring such a change to the mechanics of fair value hedging relationships adds no value to the financial statements and instead adds unnecessary complexity and cost due to the operational changes it will require.

Question 9: (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?

No, 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. We feel that the gain or loss on the hedged item attributable to the hedged risk should continue to be presented as part of the item being hedged. Presenting gains and losses in line with the Exposure Draft will lead to negative amounts being presented on the asset side of the balance sheet and positive amounts on the liability side of the balance sheet in some cases, which adds clutter and complexity and may be confusing to many users. We feel a more effective way to present such information would be through requiring disclosure of these adjustments in the notes to the financial statements.

Question 9: (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 agree that linked presentation should not be allowed for fair value hedges. We also agree with the Board's conclusions in BC128 that disclosures about hedging would be a better alternative to provide information about the relationship between hedged items and hedging instruments that allows users of financial instruments to assess the relevance of the information for their own analysis.

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?

In general, we believe that the Board's proposed approach for recognising the time value component of options is much more reasonable and appropriate than the existing guidance under IAS 39. However, we believe additional clarity is needed for entities to effectively apply the proposed guidance, primarily as it relates to the difference between what will be treated as a "transaction related" and "period related" hedged item, as each category has a different outcome for recognising the time value component of the original premium paid in profit or loss.

In reading BC149 of the Exposure Draft, we infer that the Board's view is for forecast transactions to be treated as transaction related hedged items and hedges of existing assets or liabilities to be treated as period related hedged items. However, the classification for many common strategies continues to be ambiguous. For example, the guidance does not address situations in which interest rate risk is hedged with an option, for example, a purchased interest rate cap, floor, or collar. A common situation involving an interest rate cap involves hedging the exposure to the variable cash flows of an existing liability that are based on a particular index (eg EURIBOR) for changes in cash flows above the strike rate of the interest rate cap. In this case one may reasonably conclude that the hedged items are transaction related (ie forecast interest payments) and that the amounts would be reclassified out of OCI in the same periods during which the hedged expected future cash flows affect profit or loss. However, the guidance seems sufficiently ambiguous that a reasonable interpretation of the guidance may also lead to a conclusion that the variable-rate liability is being hedged for a given time period and that this example fits into the category of a "period related" hedged item. For these common hedging strategies involving interest rate caps, floors and collars, it is not clear to us how the Board intends for option time value to be reclassified/amortised to profit or loss over the life of the hedge, including whether straight-line amortization would be permitted or whether an amortisation approach similar to the methodology described in FASB ASC 815-30-35-36 (DIG Issue G20), in which allocated fair value amounts are reclassified from other comprehensive income to profit or loss when the associated hedged forecast transactions affect profit or loss would be permitted or required. Conceptually, we believe that the guidance provided in DIG Issue G20 is the most theoretically sound and should be required for those types of hedging relationships, but our primary concern is that additional clarity is needed in this area to achieve a

fair and consistent application in practice. Along those lines, we believe that a detailed example illustrating how the time value component of a purchased interest rate option may be reclassified/amortised from OCI to profit or loss should be included in the final standard, particularly since this concept is new under IFRS.

In addition, we recommend as a practical expedient that the Board permit entities to reclassify the total option premium paid rather than just the time value component of the option. It is quite possible that the original option premium includes an intrinsic value component rather than just a time value component. The total option premium at inception can be allocated over the life of the hedging relationship on a rational basis using the caplet method, which has been applied under ASC 815 since DIG G20 became effective. We would be happy to provide the Board with an example of how this is applied in practice.

Finally, we think the complexities created by introducing the concept of “aligned time value” (including the required “lower of” tests) do not justify the perceived marginal benefit to users of the financial statements, which benefit we believe would be minimal. Accordingly, we recommend that the accounting for the time value component of an option should be consistent even if the critical terms of the option do not exactly match the hedged item.

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 support the criteria for the eligibility of groups of items as hedged items presented in paragraphs 34(a) and (b), but envision issues in practice with the requirements imposed by paragraph 34(c) to require that any offsetting cash flows in a cash flow hedging relationship must affect profit or loss in the same and only that reporting period. We can foresee situations where entities originally expect that such items will affect profit or loss in the same period yet the actual results vary from the original forecast. We have concerns over how this latter issue will be applied in practice. For example, if an entity at time of hedging expects to satisfy all of the criteria in paragraph 34, but ultimately fails to satisfy the criteria in paragraph 34(c) for 10% of the designated amount of the hedging instrument, do they (1) not apply hedge accounting at all to that portion of the hedging instrument, or (2) reclassify from OCI into profit or loss the amount corresponding to the 10% that will not satisfy the criteria? When should this be performed and how much should be reclassified – (a) the full change in fair value related to 10% of the notional from inception of the hedging relationship or (b) the full change in fair value related to 10% of the notional from the date they no longer expect to satisfy all of the criteria? We feel additional clarity around this point is needed to avoid confusion in practice.

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 support the idea of presenting in a separate line in the income statement the gains and losses from a hedging instrument that hedges a net position that affects different lines in the income statement. However, we feel such presentation should be within the same section of the income statement as would occur if a net position was not hedged. For example, if an entity hedged its net foreign currency exposure in a particular currency in which it had both sales and expenses, we would expect the separate line item to be presented within the gross margin section of the income statement as this would be the case if the entity elected to simply hedge its foreign revenues or foreign expenses. As a result, we feel paragraph 37 should be expanded to address this concern.

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?

In general, we support the Board's proposed disclosure requirements as the disclosures would be more consistent with the existing requirements in ASC 815 and are a step towards convergence with the FASB. However, there are a few remaining differences between the existing ASC 815 disclosure requirements and those in the Exposure Draft which may be useful to users of financial statements prepared using IFRS. One area in particular is disclosure around credit-risk-related contingent features that exist in hedging instruments. Such information could provide useful insight into the liquidity of the entity in the event the contingent credit-risk-related features were triggered.

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 proposal to require derivative accounting to be applied 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. We feel this will help entities in certain situations eliminate accounting mismatches that arise, particularly related to commodities contracts.

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 agree that all of the three alternative accounting treatments would add unnecessary complexity to the accounting for financial instruments. In addition, expanding the use of the fair value option to account for hedges of credit risk using credit derivatives is likely to lead to significant volatility in profit or loss from unhedged components. Instead, we would prefer to see a solution for hedges of credit risk within the construct of the main hedge accounting model.

Question 16: Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We support the proposed transition requirements. However, we feel that clarifying guidance will be needed in the final hedge accounting standard to address the requirement in paragraph 55 of the Exposure Draft regarding how to present and disclose hedging relationships in the financial statements that will have differing treatments under IFRS 9 compared to IAS 39 but are regarded as “continuing hedging relationships.”