

March 8, 2011

IFRS Foundation www.ifrs.org

Hedge Accounting, ED/2010/13, December 2010.
Comment on cash flow hedge accounting on forecast commodity contracts.

Dear IFRS Foundation:

The Exposure Draft addresses issues resulting from cash flow hedges of forecast commodity transactions adding complexity to hedge accounting. Derivatives accounting only is more transparent.

Further, the accounting can be used to deflect attention from speculative transactions.

Derivatives and Risk Management in the Petroleum, Natural Gas, and Electricity Industries, Report SR-SMG/2002-01, October 2002, United States Energy Information Agency (EIA)
<http://www.eia.doe.gov/oiaf/servicerpt/derivative/chapter7.html>

Cash Flow Hedges, Chapter 7, *Accounting for Derivatives*, states in part as follows:


With a cash flow hedge, it is the cash flow from an expected future transaction that is being hedged, and so there is no balance sheet entry for the hedged item.

Without further refinement of the accounting guidelines, only changes in the value of the derivative would be recognized in current earnings in a cash flow hedge. If this were in fact the case, there would be no benefit to hedge accounting for cash flow hedges. The accounting would be the same as the accounting for non-hedge (speculative) holdings of derivatives. Yet the company hedging the cash flow of an expected transaction is not seeking to profit from price movements but rather to stabilize future cash flows. (Underlines added.)

Application of business models by commodity producers and users to “stabilize future cash flows” of expected transactions by using cash flow hedges needs substantiation. For example, do budgets reflect plans for significant net gains from commodity contracts? Are frequent changes in forecasts in effect supporting speculation to try to produce those expected net gains? Intent is hard to prove.

I believe that cash flow hedge accounting on forecast commodity contracts should be terminated.

Thank you for the opportunity to comment.


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Appendix

Source: *Hedge Accounting* and *Hedge Accounting, Basis for Conclusions and Illustrative Examples*, ED/2010/13, December 2010. (Underlines were added primarily to emphasize issues or complexity.)

Accounting for qualifying hedges

20 An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 19 (which include the entity's decision to designate the hedging relationship).

(b) cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and could affect profit or loss.

IN44 The Board believes that hedge accounting does not necessarily provide appropriate accounting for hedging relationships that include commodity contracts. Consequently, the Board proposes to amend the scope of IAS 39 to allow a commodity contract to be accounted for as a derivative in appropriate circumstances. The Board believes that this approach combines the purpose for a contract that can be settled net to buy or sell non-financial items (normally commodities) that are 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 and also how they are managed. This better reflects the contract's effect on the entity's financial performance and provides more useful information.

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?

Comment: Yes, if net settlement without physical receipt or delivery is analyzed over time to help detect speculative activity (eg gross and net volume, amounts and average price). I believe that a fair value-based risk management strategy can accommodate a reasonable level of net settlement in cash if an industry practice. Net settlement can be an efficient means of settling contracts under certain conditions and consistent with a normal practice of physical receipt or delivery. Upward trend or high level of net settlement may be an indicator of trading that is most safely left to the specialized providers of market liquidity.

BC131 For cash flow hedges, recognising in profit or loss gains and losses arising on the hedged item in excess of the gains and losses on the hedging instrument is problematic because many hedged items of cash flow hedges are highly probable forecast transactions. Those hedged items do not yet exist although they are expected to occur in the future. Hence, recognising gains and losses on these items in excess of the gains and losses on the hedging instrument is tantamount to recognising gains and losses on items that do not yet exist (instead of a deferral of the gain or loss on the hedging instrument). The Board noted that this would be conceptually questionable as well as a counter-intuitive outcome.

N39 For cash flow hedges of groups of items with offsetting risk positions (eg net positions) the hedged items may affect different income statement line items. Consequently, a cash flow hedge of such a group creates a presentation problem when amounts are reclassified from other comprehensive income to profit or loss. This is because the reclassified amounts would need to be grossed up to offset the hedged items effectively. The Board concluded that if it proposed to adjust (gross up) all the affected line items in the income statement the result would be the recognition of gross (partially offsetting) gains or losses that do not exist. This is not consistent with basic accounting principles. Consequently, the exposure draft proposes that amounts that are reclassified from other comprehensive income to profit or loss should be presented in a separate line item in the income statement for cash flow hedges of a net position. The Board believes that this avoids the problem of distorting gains or losses with amounts that do not exist.

Cash flow hedges

29 While a cash flow hedge meets the qualifying criteria in paragraph 19, it shall be accounted for as follows:

- (i) If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability. This is not a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence it does not affect other comprehensive income.
- (ii) For cash flow hedges other than those covered by (i) that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss

30 When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 24 and 25) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 29(a) as follows:

- (a) If the hedged future cash flows are still expected to occur, that amount shall remain in the cash flow hedge reserve until the future cash flows occur.
- (b) If the hedged future cash flows are no longer expected to occur, that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1). A hedged future cash flow that is no longer highly probable of occurring may still be expected to occur.

Eligibility of a group of items as the hedged item

34 A group of items ... is an eligible hedged item only if ...

- (c) for the purpose of cash flow hedge accounting only, any offsetting cash flows in the group of hedged items, exposed to the hedged risk, affect profit or loss in the same and only in that reporting period (including interim periods as defined in IAS 34 *Interim Financial Reporting*).