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Dear Sir/Madam

## **EXPOSURE DRAFT – HEDGE ACCOUNTING**

Thank you for providing us with the opportunity to comment on the proposals set out in the recently issued exposure draft (“ED”) on hedge accounting.

We welcome the work the Board is doing to improve the accounting for financial instruments and hedge accounting in particular. We agree with the Board that the current accounting requirements are in need of improvement.

We support the overall direction of the Board’s proposals to align hedge accounting more closely with risk management, establish an objective-based approach and address inconsistencies in the existing hedge accounting model.

However, we do have a number of concerns.

- **Hedge effectiveness requirements to qualify for hedge accounting**

We are concerned that the objective of an unbiased result and minimising expected hedge ineffectiveness sets the test at too high a level, or may be interpreted as doing so. We believe it would be helpful to provide further guidance and example(s) around paragraph B29 and in particular the final sentence, which states it is not necessary to have an expectation of perfect effectiveness to qualify for hedge accounting.

- **Rebalancing of a hedging relationship**

We do not agree with the proposal that rebalancing should be mandatory where a hedge relationship no longer meets the objective of the hedge effectiveness assessment. We believe these requirements add an unnecessary burden to entities. There is a risk that corporate treasury functions will be required to invest time continually making relatively small rebalancing adjustments to the hedge in order to comply with the criteria, in a way that is not of value to the commercial activities of the entity. Commercially, an entity may decide not to adjust the hedge every time there is a movement in the hedging relationship away from the original effectiveness assessment. In line with the objective of aligning hedge accounting more closely with risk management, entities should not be required to make such adjustments solely to achieve hedge accounting.

- **Discontinuing hedge accounting**

We do not agree with proposals to prohibit voluntary de-designation of hedge accounting relationships. We believe this takes a narrow and over-simplified approach to entities' risk management activities. In practice entities often determine that de-designation is the most appropriate approach operationally.

- **Accounting for fair value hedges**

We do not agree with the proposals to recognise gross fair value hedge adjustments in other comprehensive income (OCI) and to show the adjusted hedge balance as a separate line on the balance sheet. We believe this approach adds clutter to both primary statements which is unhelpful to users. This information can best be dealt with in a more focused way with explanation in the notes to the accounts together with other financial instrument disclosures.

- **Disclosures**

We are very concerned about the required detail of some disclosures. Disclosure requirements under IFRS are already significant, particularly in the area of financial instruments, and it is becoming widely acknowledged that the increasing level of disclosure is adding such complexity to financial statements that they become more difficult to understand and therefore less useful. We have identified particular concerns in our response to question 13.

- **Effective date and transition**

We believe the Board should defer the implementation date to take account of the complexity of the proposals and the requirement in some jurisdictions for endorsement prior to adoption. This is particularly important where entities report in more than one jurisdiction, one of which requires full IFRS and another IFRS as endorsed by that jurisdiction, as is the case for EU listed companies which are also listed in the US. We believe the application date should be no earlier than accounting periods beginning on or after 1 January 2015.

We have provided answers to the individual questions below. We hope you find these comments helpful in reaching your conclusions.

Yours sincerely,

**Andy Agg**  
**Chief Accountant**

**Objective of hedge accounting****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?***

**Comments**

We agree with the overall proposed objective of hedge accounting. We believe this represents a significant improvement on the current accounting requirements under IAS 39, and supports the intention to reflect the hedging strategies more clearly in the financial statements. We agree that hedge accounting should be a choice and not mandatory for the reporting entity.

To improve the representation of an entity's risk management activities in financial statements, we believe the Board should further explore allowing hedge accounting for equity instruments at fair value through OCI. Also, we do not believe that hedge accounting should be restricted only to those items which affect profit or loss, where similar principles should be applied to items which affect other comprehensive income. We do, however, acknowledge the Board's view that such an approach creates additional complexity.

To achieve the proposed objective, we believe the Board should undertake further consultation to bridge the gap between the accounting concepts of hedging and those actually recognised by risk managers. For example, the classification of hedges as fair value, cash flow or net investment appears to be used by accountants to identify separate accounting treatments. Risk managers do not necessarily view hedges in that way, but are required to align their risk management decisions with the accounting concepts so that hedge accounting is achieved.

**Instruments that qualify for designation as hedging instruments****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?***

**Comments**

We agree with the proposals.

**Derivatives that qualify for designation as hedged items****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?***

**Comments**

We agree with the Board's proposals on derivatives that qualify for designation as hedged items. This will allow greater access to hedge accounting and align with risk management strategies of economically hedging transactions with more than one risk. It is assumed that this would be available for both fair value and cashflow hedge accounting relationships.

**Designation of risk components as hedged items****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 (i.e. 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?***

**Comments**

We welcome the proposal to permit designation of a risk component as a hedged item in non-financial items and hence permit hedge accounting for significant economic exposures such as commodity cost risk components within a contractual arrangement. Further clarity should be provided on defining 'identifiable and reliably measurable'.

**Designation of a layer component of the nominal amount****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?***

**Comments**

We agree with the Board's proposals on designation of a layer component of the nominal amount.

## Hedge effectiveness requirements to qualify for hedge accounting

### 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?***

### Comments

We welcome the proposed removal of the 80-125% bright line tests for hedge accounting qualification, and the move to prospective assessment only. The current requirements of IAS 39 frequently result in anomalies as valid risk management hedge relationships do not meet the hedge accounting criteria. In addition, the proposal to permit qualitative assessment in certain cases would alleviate some of the administrative and operational overhead of hedge accounting.

We note the Board's comments, set out in paragraph BC 81, on the importance of having a hedge effectiveness assessment objective which is sufficiently rigorous to prevent the designation of hedge relationships which give rise to systematic hedge ineffectiveness. We are concerned, however, that the objective of an unbiased result and minimising expected hedge ineffectiveness sets the test at too high a level, or may be interpreted as doing so.

The criteria to minimise hedge ineffectiveness may imply that reporters should at all times consider alternative hedges and if any they identify would reduce hedge ineffectiveness further, the objective of minimising hedge ineffectiveness fails and therefore hedge accounting is not permitted, even though the intention of the proposals is that it should be.

We believe the criteria should be that, on initial designation there is no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item.

We believe it would be helpful to provide further guidance and example(s) around paragraph B29 and in particular the final sentence, which states it is not necessary to have an expectation of perfect effectiveness to qualify for hedge accounting. For example, ineffectiveness may be expected due to the credit risk in the hedging instrument.

We also ask the Board to consider the two specific examples set out below.

An entity may designate a derivative as a hedging instrument part way through the derivative's life. Typically, the fair value of the derivative at the designation date would therefore not be zero. At the end of the derivative's term the fair value would be zero. The change in the fair value of the derivative from the date of designation to the end of its term is therefore fixed. We assume that this scenario would not be interpreted as a biased result for assessing hedge effectiveness under the proposals. Rather, for the purpose of considering bias, we assume that it is appropriate only to consider scenarios where changes in the fair value of the hedging instrument systematically exceed or are less than changes in the hedged item (as set out in paragraph B29).

The ED proposes that the time value of money should be taken into account when measuring hedge effectiveness (B43). Many entities document and measure the hedge of foreign currency risk on an undiscounted basis. We assume this would continue to be permitted under the proposals in accordance with paragraph B34. Otherwise entities would

be required to carry out unnecessary present value calculations even though the hedge is obviously effective.

## Rebalancing of a hedging relationship

### 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?***

### Comments

We do not agree with the proposal that rebalancing should be mandatory where a hedge relationship no longer meets the objective of the hedge effectiveness assessment.

We believe these requirements add an unnecessary burden to entities. There is a risk that corporate treasury functions will be required to invest time continually making relatively small rebalancing adjustments to the hedge in order to comply with the criteria, in a way that is not of value to the commercial activities of the entity. Commercially, an entity may decide not to adjust the hedge every time there is a movement in the hedging relationship away from the original effectiveness assessment. In line with the objective of aligning hedge accounting more closely with risk management, entities should not be required to make such adjustments solely to achieve hedge accounting.

Subsequent to designation we believe entities should have the option of rebalancing or recognising any ineffectiveness in accordance with their own risk management activities.

## Discontinuing hedge accounting

### Question 8

***(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?***

***(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?***

### Comments

We do not agree with the proposal to prohibit voluntary de-designation of hedge accounting relationships. The proposal takes a narrow and over-simplified approach to entities' risk management activities. In practice entities often determine that de-designation is the most appropriate approach operationally. For example, the de-designated instrument may offset another financial instrument or the originally designated hedging instrument may no longer be the most optimal one.

If, however, the Board is to pursue its proposed approach, we believe some clarification is required. For example, we are unclear whether, for this purpose, the risk management strategy should be considered at the level of each individual hedging relationship or at a more general strategic level; or whether the entity has the option to determine which is more appropriate according to its own objectives.

For example, an entity may have a strategy of maintaining its fixed interest rate borrowings within a range of 55% to 60%. In implementing that policy, it may enter into a number of floating to fixed interest rate swaps, to swap variable interest rate borrowings to fixed rate.

For commercial reasons, the entity may decide to terminate the hedge of a particular variable rate borrowing by overlaying the swap which hedges that borrowing with a fixed to floating swap, whilst still remaining within its target range of 55% to 60% fixed. This activity could be repeated several times for a long term borrowing.

If for the purposes of these proposals, the risk management strategy should be considered at the more general strategic level, then the risk management strategy (a range of 55% to 60% fixed) has not changed. Under the proposals, hedge accounting would therefore not be discontinued. An accounting mismatch would arise as changes in the fair value of the new fixed to floating swap would be reported in profit and loss.

If for the purpose of these proposals, the risk management strategy should be considered at the level of the individual hedged item and hedging instrument, the risk management strategy has changed, in that it is no longer intended to hedge the variable cash flow risk of the individual borrowing. Hedge accounting would be discontinued. Changes in the fair value of the original floating to fixed swap and the new fixed to floating swap would be reported in profit and loss and would therefore offset.



Based on our reading of paragraph 19(b), we believe that the second approach is in accordance with the proposals, as documentation relates to specific hedging instruments and hedged items. We believe the second approach also meets the objective of the proposals to represent the effect of an entity's risk management activities.

## Accounting for fair value hedges

### 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?***

***(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?***

***(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?***

### Comments

We do not agree with these proposals in (9a) and (9b). Whilst the information may well be useful it is best dealt with in the disclosures. Users can then address it in a focused way. Including this data in the primary statements adds clutter and complexity and is therefore unhelpful to users.

Analysts have suggested there is existing confusion in the distinction between fair value and cash flow hedges. The proposals may add to this confusion, with the gross amount of gains and losses of both the hedging instrument and the hedged items in a fair value hedge relationship flowing through OCI with ineffectiveness being transferred to profit and loss (net nil impact), whilst the effective portions of a cash flow hedge relationship are reported in OCI.

We agree that linked presentation should not be allowed for fair value hedges, as the hedges are for specific risks within financial and non-financial items, and disclosures within the financial risks may better convey the use of varying asset and liability instruments and the hedged risk components.



**Accounting for the time value of options for cash flow and fair value hedges****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 (i.e. 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?***

**Comments**

We 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 using the basis adjustment if capitalised or into profit and loss at the same time as the profit and loss impact from the hedged item. We agree that the premium is viewed as a cost of hedging (mitigating risk) by risk managers and therefore should be associated with the hedged item rather than a source of hedge ineffectiveness.

The proposals to transfer the aligned time value from OCI to profit and loss on a rational basis (interpreted as including straight line amortisation) and only to the extent the time value relates to the hedged item appear reasonable. The introduction of the alignment of time value between the hedging instrument and hedged item does introduce increasing complexity, and we would query the benefit of this aspect, specifically the calculation to obtain the appropriate aligned value. However, the ability to minimise volatility from changes in fair value of the aligned time value element will be welcomed where options are a significant hedging tool for entities.

**Hedges of a group of items****Eligibility of a group of items as 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?***

**Comments**

We welcome the proposal to permit groups of items as a hedged item for an accounting hedge designation purpose and thus providing greater flexibility than the existing IAS39 rules.

However, we believe that some of the restrictions with respect to net positions undermine the purpose of aligning the accounting with risk management practices and are unnecessary. Thus, we do not agree with the cash flow hedge accounting requirement of net positions with offsetting cash flows that profit and loss must be affected in the same reporting period (34c). This proposed approach results in a different accounting result if the individual transactions are hedged from the one that arises if they are hedged on a net basis. Consequently entities are being asked to take a decision on the structure of a hedge transaction, solely with the purpose of achieving the accounting. We therefore believe that paragraph 34c should be reconsidered.

If the net position hedge accounting was prohibited, as the hedged items impacted profit and loss in different reporting periods, we would assume that designation of a percentage of the eligible gross position would be allowed.

**Presentation****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?***

**Comments**

As noted in our answer to question 11 above, the commercial effect of hedging net is the same as if each item in a group were hedged separately. We are therefore concerned at the lack of comparability in the proposed accounting between hedging net and gross. This approach requires the entity to hedge the gross positions, if it wishes the hedging impact to be reflected in the respective line items.

When entities are hedging net and the conditions in 34 (a) and 34(b) are met, an option should be available for the hedge gain or loss to be grossed up and allocated to the different line items being hedged. These amounts can be disclosed and quantified as arising from net hedged positions.

## Disclosures

### **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?***

### **Comments**

As the ED seeks to align the accounting more closely with an entity's risk management strategy, we agree that it is appropriate to include disclosures on that strategy.

We are, however, very concerned about the required volume and detail of some disclosures. Disclosure requirements under IFRS are already significant, particularly in the area of financial instruments, and it is becoming widely acknowledged that the increasing level of prescriptive disclosure is adding such complexity to financial statements that they become more difficult to understand and therefore less useful.

We believe that the disclosures required in paragraph 46 should not be for each subsequent period that the hedging relationship is expected to affect profit or loss. This could represent a lot of data and is unduly onerous. Current IFRS 7 disclosures already provide sensitivity to key risks. Perhaps the prescriptive nature of these disclosures could be considered in the context of the new ED, rather than new and additional requirements.

We also believe it is not necessary to analyse all disclosures into fair value hedge, cash flow hedge and net investment hedge type. This terminology appears to be used by accountants so different accounting treatments can be identified. It would seem that treasury functions do not recognise these concepts. Therefore providing such an analysis in all cases is either, not useful or inappropriate information. In particular, we believe little is gained by analysing the disclosures in paragraph 49 into the accounting definitions of hedges, as well as by category of risk.

Paragraph 50b refers to cash flow hedges and net investment hedges although the subparagraphs refer only to the cash flow hedge reserve. This follows from paragraph 32, which suggests that gains or losses on net investment hedging instruments should be accumulated in the cash flow hedge reserve. We believe such gains or losses should be accumulated in a translation reserve, offsetting gains or losses on the net investment being hedged.

**Accounting alternatives to hedge accounting**

**Accounting for a contract for a non-financial item that can be settled net in cash as a derivative**

**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?***

**Comments**

We believe it would be helpful to further clarify what is meant by “a fair value-based risk management strategy” and the “entire business” in appendix C.

If an entity uses derivatives to hedge fair value changes in own use purchase contracts, we believe that entity should have the option to fair value the purchase contracts. This both reflects the risk management activities of the entity and resolves an accounting mismatch. However, an entity should not be required to fair value the purchase contracts. This approach would then be consistent with hedge accounting, which is optional.

**Accounting for credit risk using credit derivatives****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?***

**Comments**

We have no specific comments to make in regard to this area.

**Effective date and transition****Question 16**

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

**Comments**

We are very concerned about the required date of implementation for the proposed standard.

We believe it is important to give companies a long lead time in order to be able to implement the required system changes and fully analyse the appropriate changes to their portfolios. The Board could consider an option for a grandfathering mechanism, where appropriate, for existing hedge documentation and relationships under IAS 39

Further, we believe the Board should also take account of the fact that, like National Grid, some companies are permitted to adopt an IFRS in their local jurisdictions only when endorsed by the relevant authority (e.g. the European Union), but are required to file accounts for US listings in accordance with full IFRS. The burden on such companies will be very significant when the accounting requirements in such a complex area are not aligned.

We believe the Board should therefore defer the required implementation date to allow a reasonable time for any local endorsement process, with early adoption permitted. The application date should be no earlier than for accounting periods beginning on or after 1 January 2015.

We agree with the other proposed transition arrangements.