

03 March 2011

Via website posting: <http://www.iasb.org/>

Dear Sir / Madam,

UPP Group Ltd ("UPP") are pleased to comment on Exposure Draft: Hedge Accounting (ED/2010/13). In addition to the specific questions, we have also provided comments on certain matters, particularly around the treatment of hedging RPI linked income / expenditure streams.

In principal we are in agreement with the approach that the IASB are taking with hedge accounting, however, we feel that more could have been done within this exposure draft to address the hedging of inflation. We have commented at length with regard to the treatment of inflation risk within our response to Question 4.

**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?*

UPP agree that by introducing an objective linking an entities risk management activities to hedge accounting rules is a sensible approach. Outlining an objective that describes the alignment of risk management activities to accounting processes is an improvement on existing guidance. It is agreed that the objective is helpful 'in setting the scene' for hedge accounting.

In addition we wish to emphasise that a principals based approach as opposed to the existing rules based approach feels like a far better fit with the realities of the commercial world.

**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?*

It is agreed that allowing non-derivative financial liabilities and assets measured at fair value through the profit or loss would be appropriate under the proposed principals based approach.

**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?*

It is agreed that allowing aggregated exposures that are a combination of another exposure and a derivative should be able to be designated as a hedged item as this reflects how entities will manage risks in practice.

**Question 4:**

*Do you agree that an entity should be allowed to designate as a hedged 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?*

Referring back to the overlying objective set out by the IASB for hedge accounting, it is agreed that this change that this change is not only appropriate but that it corrects the anomaly in IAS 39 in the different treatment of financial and non financial items. Many entities identify risks within transactions that do not involve financial instruments. These risks are identified within risk management activities, however, existing rules would not allow for the application of hedge accounting to these items without significant effort.

It is further agreed that the requirement to be able to separately identify and reliably measure is an appropriate safeguard to prevent against widespread and inappropriate use of these hedge accounting rules.

We feel that these rules could be further expanded to more explicitly address the risk of movements in inflation as opposed to the guidance contained within paragraph B18 that specifically excludes inflation as a separately identifiable and reliably measurable risk. Many entities will have contracted deliverables that are tied to movements in inflation. They will identify this risk as part of risk management procedures and put in place hedging instruments to mitigate this risk. Under existing IAS 39 this would not qualify as an allowable hedging relationship. It would appear that by allowing identifiable and measurable risks transactions of this nature could be accounted for under the proposed hedge accounting rules however paragraph B18 does cast some doubt over whether such transactions could be hedge accounted for.

Movements in inflation is a real risk that many entities face. There are risk management solutions that entities use to mitigate these risks. Restricting the application of hedge accounting rules to these transactions means that entities are forced to operate in a way that is not commensurate with commercial practice because application of the accounting rules would result in profit and loss volatility. Entities should be free to manage their risks as they see fit, as opposed to having to manage risks being mindful of the accounting implications of the transactions they are entering into.

The treatment of inflation within hedge accounting, however is still rather vague in reading the exposure draft, we therefore feel further guidance would be of benefit to preparers of accounting information using this proposed standard.

**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?*
- (a) UPP agree that the designation of a layer of the nominal amount of an item is appropriate under principals based hedge accounting rules. Again, this would be an example where entities will be more freely able to hedge based on commercial sense as opposed to a mere compliance with accounting rules.
- (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?*
- (b) UPP agree with the conclusion contained within paragraph B23.

**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?*

It is agreed that the proposed rules for the need for hedge relationships to be effective to qualify for hedge accounting are an improvement on the rules in the exiting IAS 39.

**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?*
- (a) It is agreed that where hedging relationships begin to fail the hedge effectiveness assessment and entity should re balance the hedging relationship only where the risk management objectives of the entity have not changed.
- (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?*
- (b) It is agreed that by allowing the proactive rebalancing of hedging relationships that appear likely to fail the hedge effectiveness criteria in the future is allowing entities to effectively manage their risks in the moment as opposed to having to manage their risks to comply with accounting rules.

**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?*
- (a) It is agreed that an entity should only be permitted to discontinue hedge accounting when the hedging relationship ceases to meet the qualifying criteria. This should only occur after an entity has attempted to rebalance the hedge relationship where there has been no change in the entities risk management procedures. As far as possible the accounting for hedging instruments should mirror the risk management objectives of the entity.
- (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 still meets the requirements*
- (b) It is agreed that an entity should not be permitted to discontinue hedge accounting whilst all qualifying criteria remain in place. The overall objective is for hedge accounting to match the risk management of the entity. There is a risk that by allowing entities to discontinue hedge accounting there is an opportunity to manipulate the use of derivatives to create a desired accounting position.

**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 the profit and loss? Why or why not? If not, what changes would you recommend?*
- (a) UPP are of the opinion that having a consistent treatment for both types of hedge instruments will lead to accounts that are more readily understood.
- (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?*
- (b) UPP agree with the principal of disclosing the gain or loss on the hedged item separately, though it is of concern that this may create confusion and unnecessary information on the statement of financial position. This additional information about movements on the hedged item may be better contained within the note, as opposed to the face of the primary statement.
- (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?*
- (c) It is agreed that linked presentation should not be allowed. We are in agreement with the rationale detailed in BC 128.

#### **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?*

It would appear that the introduction of these rules with regard to the time value of money will create confusion and unclear accounting results if time value is only considered for options. We are of the opinion that time value should be considered for all instruments or none at all.

#### **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 agree with the eligibility requirements for groups of items to be treated as the hedged item.

#### **Question 12**

*Do you agree that for a hedge of a group of items with offsetting risk position that affect different line items in the income statement (eg in a the 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 agree with this proposal.

#### **Question 13**

- (a) *Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes would you recommend?*
- (a) In principal we agree with the proposed disclosure requirements however, in paragraph 43 the proposed standard allows entities to determine how much detail to disclose. In the interest of consistent disclosures across all entities applying the standard, we suggest minimum requirements should be put in place.

### **Question 13 (continued)**

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

We do not believe that additional disclosures other than those already suggested would be of benefit. An ideal balance needs to be met where users are getting useful information, but are not being overloaded with cumbersome and unnecessary disclosures.

### **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 agree with these proposals.

### **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?*

As our entity do not envisage ever holding credit derivatives we have chosen not to respond to this question.

### **Question 16**

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

We agree with the proposed transitional requirements. We are also in agreement in allowing for early adoption of these requirements where IFRS 9 has been adopted in full.

**Additional comments**

We are of the opinion that these changes will be a marked improvement on the existing rules within IAS 39. By aligning risk management and accounting entities should be able to manage their risks effectively without any unexpected or unwanted adverse accounting results.

With this in mind, we do feel that additional consideration needs to be given to the guidance around the treatment of inflation risk. If these changes are truly to align risk management procedures to the accounting treatment care needs to be taken to not scope out certain instruments or risks as the resultant standard will not result in achieving the desired result.

Once again, we thank the IASB for the opportunity to comment on this exposure draft.

Sincerely,

A handwritten signature in blue ink, appearing to be 'BS' with a stylized flourish.

Belinda Solohub CA  
Group Corporate Accountant