



# ICGN

International Corporate Governance Network

By web submission: [www.ifrs.org](http://www.ifrs.org)

Sir David Tweedie, Chairman  
International Accounting Standards Board  
30 Cannon Street  
London, EC4M 6XH  
United Kingdom

17 March 2011

Dear Sir David,

**Re: ED/2010/13 Hedge Accounting**

We are writing on behalf of the International Corporate Governance Network (ICGN). The ICGN is a global membership organisation of institutional and private investors, corporations and advisors from 50 countries. Our investor members are responsible for global assets of US \$12 trillion.

The ICGN's mission is to raise standards of corporate governance worldwide. In doing so, the ICGN encourages cross-border dialogue at conferences and influences corporate governance public policy through ICGN Committees. We promote best practice guidance, encourage leadership development and keep our members informed on emerging issues in corporate governance through publications and the ICGN website. Information about the ICGN, its members, and its activities is available on our website: [www.icgn.org](http://www.icgn.org).

The purpose of the Accounting and Auditing Practices Committee (A&A Practices Committee) is to address and comment on accounting and auditing practices from an international investor and shareowner perspective. The Committee through collective comment and engagement strives to ensure the quality and integrity of financial reporting around the world.  
[http://www.icgn.org/policy\\_committees/accounting-and-auditing-practices-committee/](http://www.icgn.org/policy_committees/accounting-and-auditing-practices-committee/)

The ICGN applauds the proposed new accounting standard on hedge accounting. The proposed standard represents a principles based approach. It will allow entities to report the results of their management strategies with reasonable efforts. We trust that reporting entities will make use of this opportunity to provide more relevant and reliable information to the users of financial statements.

We are mindful, nevertheless, of the risk of too much flexibility allowing scope for unwanted accounting arbitrage. We have particularly noted the alternative views recorded from IASB board member, John Smith. We have not been able to judge how significant the risks are, compared to the existing standard (that was also not immune to earnings management). It would have helped if the Board could have provided more extensive worked examples of the impact of its proposals.

Our responses to the specific questions follow.

### **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 the ICGN supports the proposed objective of hedge accounting. If an entity acquires an instrument to mitigate a risk exposure, the effects should be represented in the financial statements. There should be a principles based approach to standard setting which should ensure transparency so that there is comparability between financial statements to facilitate decision making by investors. From the investors' perspective the overarching objective should be to ensure that the accounting reflects the economics of the business activities and the risk mitigation strategies that are employed. This is a broader scope than that in the ED which may be too narrow in restricting it to the management of exposures that affect only "profit and loss."

### **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?**

The ICGN agrees that non-derivative financial assets and liabilities should in principle be eligible hedging instruments.

### **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?**

The ICGN agrees that an aggregated exposure that is a combination of another exposure and a derivative may in principle be designated as a hedged item if this is consistent with the entity's risk management approach.

### **Question 4**

**Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?**

The ICGN agrees that a risk component may in principle be designated as a hedged item if this is consistent with the entity's risk management approach. The ED does not permit inflation to be designated as a risk component of a financial instrument, unless it is contractually specified, on the grounds that inflation is not separately identifiable and reliably measureable. Given that hedging of inflation risk is, and is likely to remain, a widespread objective, efforts should be made to provide a basis for this to be eligible for hedge accounting.

### **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?

The ICGN agrees that a layer of the nominal amount of an item may in principle be designated as a hedged item if this is consistent with the entity's risk management approach. The ICGN also supports the exception for contracts with prepayment options.

### **Question 6**

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

The ICGN supports the proposed hedge effectiveness requirement. In many cases it should be easy to establish whether an instrument will mitigate risk in accordance with risk management objectives. Quantitative approaches should only be necessary in special, more complex cases. The key requirement should be for all hedge ineffectiveness, expected or unexpected, to be reflected in the primary statements as it arises.

### 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 ICGN supports the rebalancing requirements but considers more guidance is needed as this is a new concept.

### 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?

The ICGN supports the requirement to continue hedge accounting as long as the relationship meets risk management objectives and qualifying criteria. Hedge accounting is the preferred accounting principle and arbitrarily changing to another principle would violate consistency principles and provide opportunities for earnings management.



### 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?

The ICGN supports the proposed accounting for fair value hedges. For users it is important that the reported effects of risk management are properly understood. This requires disclosure at disaggregated levels either as separate line items in the statement of financial position, or, in a footnote.

### 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?

The ICGN considers it right to seek an acceptable accounting basis to reflect the use made of options for hedging purposes. The proposals appear complex, and we are not fully convinced of the rationales. Some, but not all, our members find the insurance premium analogy attractive.

Rather than distinguishing the concepts of time value and intrinsic value it may be better to focus on the emerging pay-offs of the option strategy and ensure that the accounting reflects genuine impairment of the original cost of the option. We agree that gains and losses otherwise during the option period will then be best recognized in OCI.

### **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?

ICGN agrees that it should be possible to hedge groups of items if this is consistent with firms' risk management strategies, which it often would be. The criteria for eligibility are properly restrictive.

### **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?

The ICGN believes that users sometimes analyse financial statements on a line item basis; return on financial assets are analyzed separately from cost of financial liabilities. Reporting hedging instrument gains and losses net then presents a problem. On the other hand grossing up is not necessarily the solution. Rather reporting entities should report their risk management strategies in sufficient detail to enable analysts to understand the effect on individual line items.

### **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?

The ICGN supports disclosure requirements that enable users to understand the effects of risk management strategies.

The ICGN believes that this section should start with a statement of objectives that focus on users. This might be accomplished by referring to users' needs for information of various kinds in paragraph 40. Satisfying these broad ranging needs is the objective of disclosure. It is important that entities have this objective in mind when deciding the level of disclosure.

Secondly, the ICGN believes that in paragraph 44 an entity should be required to describe its risk management strategy whether hedge accounting is used or not; an entity that uses hedge accounting should not have to provide more detailed disclosures. (It seems clear that paragraphs 45-46 are more general in these respects.) One solution would be to rewrite Paragraphs 49-52 to also require entities that hedge, but do not use hedge accounting, to provide the same information; i.e. the numbers that would have been reported if hedge accounting had been used.

Finally, the ICGN believes that many analysts consider OCI a nuisance. These users will want to move some OCI items to profit and loss and others to assets or liabilities. In particular gains and losses on hedging instruments used to hedge cash flows will often be moved to assets or liabilities. The footnote disclosures must be detailed enough to allow for this. Paragraphs 50 – 52 will provide sufficient information, but it is important that the level of detail is not reduced. In particular information must be provided separately by category of risk. It should also be made clear that foreign exchange risks may consist of several categories of risk. At a minimum, information should be reported separately for foreign exchange risks that are financial or operational in nature.

#### **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?

The ICGN supports "a fair value option" for commodity contracts. However, it is not clear what "a fair value based risk management strategy" means in the context of commodities that are intended for the entity's own use. This issue should be clarified to avoid misuse of any fair value option.

## 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?

According to the objectives of the proposed standard, hedge accounting should be allowed for credit derivatives. The ICGN would encourage the IASB to continue their efforts to develop methods that would enable entities to reflect their hedging of credit risk in financial statements.

If you would like to discuss any of these points, please do not hesitate to contact Carl Rosén, our Executive Director, at +44 (0) 207 612 7098 or [carl.rosen@icgn.org](mailto:carl.rosen@icgn.org). Thank you for your attention and we look forward to your response on the points above.

Yours sincerely,



Lou Moret  
Co-Chair, ICGN Accounting and  
Auditing Practices Committee



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Cc: ICGN Board Members  
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