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International Accounting Standards Board

30 Cannon Street

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Dear Colleagues:

Exposure Draft 2010/13: *Hedge Accounting*

We are grateful for the opportunity to comment on Exposure Draft 2010/13 *Hedge Accounting*. Our responses are set out in the attached appendix.

We commend the efforts of the Board and the project staff in engaging with constituents on the challenges raised by accounting for hedging activities in formulating the proposals contained in the Exposure Draft.

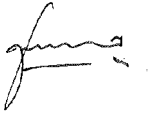
The proposals acknowledge the fact that hedging activities are no longer exceptional and that they should be more fairly reflected in financial statements if readers are to obtain a better understanding of their economic effects.

We are, however, unable to support all the Exposure Draft's proposals. Our concerns are set out in the Appendix, and are summarised below:

- a) Hedge effectiveness testing: We are concerned that the hedge effectiveness testing requirements remain onerous and could be a disincentive to greater application of hedge accounting. In our view, an approach to effectiveness testing that follows the impairment indicator (trigger) approach in IAS 36 *Impairment of Assets* would be sufficient.
- b) Hedge accounting: We note that the proposals seem overly mechanistic and could be further simplified without affecting the quality of the financial information presented.
- c) Disclosures: The proposals require some disclosures for an entire category of risk even if only some of that risk is hedge accounted for. In our view such proposals are overly burdensome and necessary.

Please do not hesitate to contact us if you have any questions about our responses.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Paul A. Morshuis'.

Paul, A. Morshuis.

Paul Morshuis

Vice President Accounting and Reporting

APPENDIX

Question 1: Objective of hedge accounting

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We agree that the objective of hedge accounting as proposed best articulates the principle-based approach that is needed if hedge accounting is to best serve readers of financial statements.

We note that the proposed objective limits hedge accounting to exposures that affect profit or loss, i.e. it precludes hedge accounting for exposures that also affect other comprehensive income. At first glance, this exclusion appears to be a rule rather than a principle, however, we do not think hedge accounting for such exposures would be of benefit to users and we therefore support this restriction.

Question 2: Instruments that qualify for designation as hedging instruments

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?

In our view, the current restrictions in IAS 39 are arbitrary and unhelpful for both users and preparers; we therefore support the proposal.

Question 3: Derivatives that qualify for designation as hedged items

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 proposed approach better reflects the economics underlying certain hedging activities than is currently the case under IAS 39; we therefore support the proposal.

Question 4: Designation of risk components as hedged items

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 support the principle underlying this proposal for the reasons set out in the Basis for Conclusions. However, we are not convinced there is a need to add a rule to the underlying principle in this proposal that prohibits hedging accounting for inflation risk. If, as is asserted in paragraph B18, inflation risk cannot be reliably measured, it will anyway not qualify for hedge accounting. Furthermore, in instances where inflation risk can be demonstrated to be measured reliably, we do not see the need for it to be excluded from hedge accounting.

Question 5: Designation of a layer component of the nominal amount

- (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?**

These proposals appear consistent with the proposed objective of hedge accounting, which we support. Accordingly, we also support these proposals.

Question 6: Hedge effectiveness requirements to qualify for hedge accounting

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 welcome the principle-based approach proposed in respect of hedge effectiveness requirements to qualify for hedge accounting. It removes a significant administrative obstacle that was arbitrarily rules-based.

We are, however, concerned that the Board did not reconsider in more depth the timing and frequency of hedge effectiveness assessments. Having documented the hedging relationship, the proposal to require assessment of future effectiveness at each reporting date seems unnecessary to us, given that ineffectiveness is anyway measured and accounted for.

We favour an approach that is more closely aligned with that applied to property, plant and equipment, and in particular impairments, for a number of reasons:

- (a) Under the proposals, a hedge relationship can only be designated as such if it meets the entity's risk management strategy; assuming the strategy does not change, there is in our view no need to additionally review the effectiveness of the relationship unless circumstances indicate otherwise. This is analogous with the treatment of property, plant and equipment, which is recognised if it meets the recognition criteria and tested for impairment when there are triggering indicators.
- (b) Once designated, the hedge relationship will be periodically reviewed to ensure it continues to be aligned with the entity's risk management strategy, regardless of any requirements in the final standard, simply because risk management is an ongoing process. To additionally require period-end assessments seems to us an unnecessary duplication. This is analogous with the requirement to review estimates such as useful economic lives only annually rather than at each interim reporting date.
- (c) At each reporting date, hedge effectiveness and ineffectiveness must be measured and accounted for; it seems to us that if, at this point, hedge ineffectiveness is identified as being or becoming significant such that rebalancing will not be appropriate, this should be the trigger for reviewing whether, overall, the hedge relationship is expected to be effective. This is analogous to the impairment indicator (trigger) approach under IAS 36 *Impairment of Assets*.

If one of the aims of the Board is to encourage greater use of hedge accounting (which we presume is the case, given the proposed objective of hedge accounting), we fear that many preparers will continue to

view the administrative burden of applying hedge accounting as being prohibitive. We therefore request that the Board reconsider its approach to effectiveness testing as we feel further improvements through reducing the administrative burden of applying hedge accounting can be made.

Question 7: Rebalancing of a hedging relationship

- (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?**

These proposals appear consistent with the proposed objective of hedge accounting, which we support. Accordingly, we also support these proposals.

Question 8: Discontinuing hedge accounting

- (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?**

Given the overall objective of hedge accounting outlined in the Exposure Draft, together with the proposals concerning rebalancing, both of which we support, we agree it is consistent and logical to prohibit voluntary discontinuation of hedging relationships.

Question 9: Accounting for fair value hedges

- (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?**

In principle, aligning the mechanics of fair value hedge accounting with those applied to cash flow hedging relationships would appear to be a positive move towards removing the complications surrounding how hedge accounting is applied. We also welcome the general principle of separating the presentation of ineffectiveness (in profit or loss) from effectiveness (in other comprehensive income).

We do, however, have some reservations about the detail in the proposals:

- (a) The two-step approach proposed for the recognition of all fair value gains and losses on the hedged item and hedging instrument in other comprehensive income, followed by a transfer to profit or loss of ineffectiveness, seems to us to be overly mechanistic and likely to add (yet) more detail to financial statements without adding to the quality of information provided about hedging relationships. In our view, a single-step approach that simply presents the amounts of ineffectiveness and effectiveness in the relevant statements (or notes thereto) has the advantage of greater clarity.
- (b) The proposals in paragraphs 27 and 28 to require basis adjustments for hedges of firm commitments, but not for hedges of recognised assets and liabilities, seem to us to be inconsistent and fail to reduce complexity. We do not, however, think there is necessarily a simple solution to the question of presentation of hedged gains and losses (which is exacerbated by proposal to permit hedge accounting for net and combined exposures). Our feeling is that there is scope for pragmatism here, given the comprehensive disclosure proposals. We recommend the Board carries out further research on this, if appropriate with field testing of the proposals.

Question 10: Accounting for the time value of options for cash flow and fair value hedges

- (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 current reporting requirements in respect of the time value of options that are designated in hedging relationships currently add volatility to financial performance reporting and have no information value. We therefore support the proposals.

Question 11: Hedges of a group of items

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?

The proposals better reflect common hedging practices and are aligned with the objective of hedge accounting; accordingly we support them.

Question 12: Presentation

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?

Ideally, hedged transactions would be recognised at the hedged rate (e.g. the hedged exchange rate rather than the spot rate for foreign currency transactions), since this would best reflect the underlying economic motivation for hedges of net positions. However, we appreciate the difficulties of achieving this, especially when hedges are not 100% effective, and we agree that grossing up transactions for the effects of hedging for the purposes of presentation is undesirable. The solution proposed does have the advantage of being relatively simple to apply and, in the absence of a better alternative, we therefore support it.

With respect to balance sheet presentation, we do not feel there is a need to require separate presentation of hedging balances according to those that are in asset and liability positions, as proposed in paragraph 38, and recommend that the Board considers permitting net presentation for these items, with the requisite analysis provided in the notes.

It is not clear to us whether or not the presentation proposals intend that all hedging effects be presented on the face of the primary statements, as is suggested in paragraph 26(b), for example. We believe that if the primary statements become too cluttered with hedging-related adjustments and sub-totals, the goal of improving the understanding among readers of an entity's hedging activities may not be achieved. We therefore recommend the Board allows a more pragmatic approach that reflects the relative significance of the items concerned, permitting presentation in the notes if this provides greater clarity.

Question 13: Disclosures

- (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?**

We do not agree with all the proposed disclosure requirements.

We are concerned by the proposed requirements in paragraphs 42 and 45 that disclosure be provided of how the entity's hedging activities may affect the amount, timing and uncertainty of future cash flows for all categories of hedged risk to which *some* hedge accounting has been applied. For example, suppose that an entity is exposed to commodity price risk, which it hedges but for which only some transactions or assets are hedge accounted for. Our reading of the proposals is that the forward looking disclosures are required for the entire risk category, rather than just those that are hedge accounted for. It is not clear from the Basis for Conclusions if this was intended or not, and implementation guidance on this is not offered. We therefore assume – and hope – this was an oversight and that the Board intended such disclosures to be required only for those items for which hedge accounting has been applied. If, however, the Board did intend this interpretation, we would advise against it; for many entities, obtaining the information on such a scale would be prohibitively expensive and would discourage them

from applying any hedge accounting, which runs counter to the Board's aim. In our view, disclosure should be restricted to those risks (rather than risk categories) to which hedge accounting has been applied.

We also have a more general concern about that the proposals to require disclosure of the amounts (values, volumes or other quantities) that make up the risks that have been hedged. In our view, quantification of these items is of little information value because in most instances, many items will have been hedged, with different maturities and risk profiles. We therefore urge the Board to reconsider this proposal.

Accounting alternatives to hedge accounting

Question 14: Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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 proposal should help remove some of the accounting mismatches that arise in connection with these types of transaction, particularly where they are hedged, would facilitate a better presentation of the overall economic effects of entering into and hedging such transactions without requiring hedge accounting; we therefore support the proposal.

Question 15: Accounting for credit risk using credit derivatives

- (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 have no views on this matter.

Question 16: Effective date and transition

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

We agree that the proposed transition requirement successfully balance the information needs of users (particularly with respect to comparability) and the cost of implementation, and we therefore support them.