

March 9, 2011

IFRS Foundation/IASB
30 Cannon Street
London EC4M 6XH
Company No: FC023235

Dear members of the International Accounting Standards Board,

The Korean Accounting Association (KAA) appreciates the opportunity to comment on the Exposure Draft of Hedge Accounting (ED).

We welcome the new principles for hedge accounting brought by the ED which are much more focused on actual risk management practices. We also agree with the Board in that the objective of hedge accounting proposed in the ED would lay the foundation for a more principle-based approach. However, there are a few areas in the ED that we believe do not faithfully follow the objective of hedge accounting. Specifically, the ED does not allow 'equity instruments designated at fair value through OCI' to be designated as a hedged item. The ED also does not adopt the Linked Presentation method, which becomes more important due to the removal of the 80-125% bright-line test.

Our comments on the specific questions in the ED are attached. We hope that they will be duly noted in the revision of the ED. We would be happy to further clarify any of our comments described in this letter should you so wish.

Sincerely yours,

Kim, Jee-Hong
President
Korean Accounting Association

Comments on the Exposure Draft of ‘Hedge Accounting’

By the Korean Accounting Association

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?

We agree with the Board in that the objective of hedge accounting proposed in the Exposure Draft (ED) would lay the foundation for a more principle-based approach.

However, there are a few paragraphs in the ED that we believe do not faithfully follow the objective of hedge accounting. For example, it does not allow ‘equity instruments designated at fair value through OCI (FVTOCI)’ to be designated as a hedged item, and also does not adopt the Linked Presentation method.

Another example is the hedging of the foreign currency risk of a firm commitment. Paragraph 22 of the ED allows a hedge of the foreign currency risk of a firm commitment to be accounted for as a fair value hedge or as a cash flow hedge. However, since paragraph 21 does not include a firm commitment in the definition of cash flow hedge, it cannot be accounted for as a cash flow hedge. Paragraph 22 does not seem to have a sound theoretical basis nor does it follow the principle-based approach of IFRS.

We will further explore these issues in the appropriate questions below.

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 ED concludes that ‘equity instruments designated at fair value through OCI (FVTOCI)’ is not subject to hedge accounting. This conclusion is based on that, as IASB explains, profits or losses recognized as OCI are not allowed to be reclassified into net income under IFRS 9. However, this conclusion might have a serious problem.

The problem is that it prevents an entity from applying hedge accounting to FVTOCI that has actually been hedged, and thus does not coincide with the objective of hedge accounting which is to reflect risk management activities.

In addition, not only does it distort the economic substance without a sound theoretical basis but also is inconsistent with the principle-based approach, a key aspect of IFRS.

Consequently, it seems that ED's conclusion was made for the mere sake of accounting.

The objective of hedge accounting can be achieved when it can be applied to all hedged assets and liabilities whose risk is identifiable and reliably measurable. One possible solution to avoid conflict with IFRS 9 and to appropriately present the effect of hedging in the financial statements would be to allow an entity to designate all hedged assets and liabilities including FVTOCI as a 'financial instrument designated as fair value through profit and loss.'

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?

We agree. We believe that hedge accounting should be applied as long as the hedged items' risk is identifiable and reliably measurable.

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?

We agree. The objective of hedge accounting can be achieved when it can be applied to all hedged assets and liabilities whose risks are identifiable and reliably measurable.

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?

We agree.

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?

We welcome removing the 80-125% bright-line test. However, it is our view that there needs to be more careful considerations on the practicality of applying the new standard.

First, one of the qualifying criteria for the hedge effectiveness requirement is that a hedge should “minimize expected hedge ineffectiveness.” But at the same time, the ED states that it does not need to be 100% nor the most effective hedging instrument, which makes it difficult to determine exactly how effective the hedge should be in order to be qualified for hedge accounting.

Second, the ED does not provide a definition of another qualifying criterion, “other than accidental offset.” In other words, the ED does not explain how much offset is “other than accidental offset,” which is especially troublesome when the degree of accidental offset needs to be proven quantitatively. For example, according to B31, a severe deterioration of the counterparty’s credit rating should be considered as an accidental offsetting in which case the entity can no longer apply hedge accounting. However, the ED does not explain how much deterioration needs to take place in order to claim it as ineffective or an accidental offset.

An entity will be involved in hedging activities when the risk from the hedging activities is much smaller than the risk that it wants to avoid. Therefore, whether or not an entity applies the hedge accounting is a matter of management’s decision making.

In this sense, the ED requires too much judgment and as a result, entities may end up with applying different judgments for the same hedging transaction. For example, under the current ED, an entity whose hedge has a minimum level of effectiveness can still apply hedge accounting since the 80-125% bright-line test has been eliminated.

Information users want to evaluate how effectively an entity has managed risks. Consequently, we believe that the presentation of hedge effectiveness on the face of the financial statements becomes extremely important. That is because information users should be able to see the differences in entities’ hedge effectiveness through financial statements. The Linked Presentation method can show hedge effectiveness on the face of the Statement of Financial Position, which makes LP even more useful under the current ED. Therefore, we propose the Linked Presentation method (which will be discussed later in Question 9).

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?

We agree. An entity does not have to withdraw from a hedging activity due to its ineffectiveness. The new proposal of allowing the rebalancing of a hedging relationship reflects the entity's risk management activities more efficiently in the financial reporting as well as makes hedge accounting easier.

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?

We agree. If an entity is permitted to discontinue hedge accounting for a hedging relationship by management decision and not by the qualifying criteria, it is possible for management to manipulate and distort the financial statements.

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?

(a)
The ED states that changes in the fair value of hedged items and hedging instruments, which were traditionally recognized as profits and losses, are to be recognized at the OCI. This change is in the right direction for two reasons: (1) it is an effort to integrate fair value hedge

accounting and cash flow hedge accounting into a single model, and (2) it conforms to the concept of OCI which is ‘the change in an entity’s wealth not to be realized in the near future.’ However, we have a couple of comments on this issue.

First, the balance of OCI from fair value hedge accounting is always ‘0’ whose meaning is difficult to understand.

Second, the IASB must provide the definition of OCI. Currently, the definition of OCI is not available in any IFRS standards. As mentioned above, the general understanding is that OCI refers to the change in an entity’s wealth not to be realized in the near future. Nevertheless, the ED does not seem to strictly follow this general understanding of OCI. For example, even though it is highly probable that the change in the fair value of short-term hedged assets and liabilities will be realized in the near future, hedge accounting allows it to be recognized at the OCI. Since the current IFRS is not clear about the difference between net income and OCI and thus, confuse users, we believe that the IASB should provide more specific guidelines on OCI.

(b)

It is our understanding that the Korea Shipbuilder’s Association sent you a comment letter on why the Linked Presentation method is a better presentation method for hedge accounting. We have many reasons to believe that the Separate Presentation method has many serious problems as stated below.

Hedged assets and liabilities have fundamentally different characteristics from general assets and liabilities. In the case of general assets and liabilities, their gross cash flows reflect their economic substance. On the other hand, net cash flow best describes the true nature of hedged assets and liabilities because an entity intends to offset the cash flows from hedged assets and liabilities and pay the net amount, not the gross amount, at settlement.

The Separate Presentation method is an appropriate method for presenting the gross cash flow generated from general assets and liabilities but not for presenting the net cash flow from hedged assets and liabilities. In this sense, the Separate Presentation method does not accurately present an entity’s risk management activities through hedging on the financial statements. Only the Linked Presentation method can properly present the true economic substance of hedged assets and liabilities.

In addition, if the Separate Presentation method is used instead of the Linked Presentation method for hedged assets and liabilities, the following problems may occur

- The volatility of hedged assets and liabilities will be shown much larger on the Statement of Financial Position than it actually is, and the risk of entities with hedged assets will be appeared to be magnified.
- In regards to the volatility of hedged assets and liabilities, entities with hedged assets will appear to be riskier than entities without hedged assets. In other words, entities who have hedged assets will look much riskier than entities that have not hedged their assets and are in open position to full speculation.

- As a result, management will avoid being involved in any hedging activities, driving the entity to be fully exposed to risks. This is an example of accounting information misleading (or forcing) management to make the wrong decisions.

Some argue that these issues are limited to certain industries. But these problems occur for most of fair value hedge accounting, although their impact on the financial statements would not be the same. The reason why these problems are not conspicuous in other fields is that the sheer size of hedged items and the fluctuation of FX rate are not big enough to have significant impact on the financial statements. Since there is always a chance that the size of hedged assets can increase and/or the fluctuation of FX rate can become volatile, the problems are potentially important issues for any industry in any country.

Even though the proponents of the Separate Presentation method acknowledge its potential problems, many of them argue that it does not interfere with users' decision making. The reasoning is that users will modify accounting information to fit their needs. Then, for the same reason, we would like to argue that the Linked Presentation method should be used, because users would modify accounting information to meet their needs. The reason why we support the Linked Presentation method is that the Linked Presentation method is a more appropriate way of presenting hedge accounting because it better reflects the true economic substance and the risk management objective of an entity's hedging activities. To put it differently, selecting a method that properly presents the economic substance of an entity's management activities is far more important than the preference of information users.

(c)

The ED does not seem to pay enough attention to the Statement of Financial Position. Nowadays, the Statement of Financial Position is as important as or more important than the Income Statement. The unnecessary fluctuations on the Statement of Financial Position can misguide many naive accounting information users.

The purpose of hedging is to reduce the uncertainty about future cash flow. The Linked Presentation method clearly shows how much an entity is exposed to uncertainty in the future cash flow of hedged assets and liabilities (i.e., hedge adjustment), and by how much an entity can reduce uncertainty through hedging activities (i.e., hedging instrument). The ED releases the qualifying criteria of hedge effectiveness requirement by eliminating the 80-125% bright-line test. Therefore, it becomes more important to provide not only the gross risks associated with hedging activities (i.e., hedge adjustment and hedging instrument) but also the hedge effectiveness (i.e., difference between hedge adjustment and hedging instrument) on the face of the Statement of Financial Position. Clearly, only the Linked Presentation method does possess the feature of presenting entities' hedge effectiveness on the face of financial statements, and should be at least allowed as an alternative to the Separate Presentation method for entities with hedging activities.

The proponents of the Separate Presentation method oppose to the Linked Presentation method because of significant counterparty risks. However, a hedging activity is not normally associated with significant counterparty risks. If so, an entity would not be involved in the hedging activity at all. It is unusual and/or infrequent that counterparty risks become

significant enough to be presented in the financial statements.

The Linked Presentation method assumes the usual situation where the counterparty risk is not significant. Naturally, it is appropriate to represent the Statement of Financial Position by using the Linked Presentation method for hedging relationships. Only when an unusual and infrequent situation where counterparty risk is significant occurs, information users will restate the financial statements. However, if the IASB allows only the Separate Presentation method, information users will almost always restate the Statement of Financial Position because SP assumes the abnormal situation where counterparty risk is significant.

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?

We agree.

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.

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?

We agree

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?

We agree. However, many disclosure requirements could be simplified if the Linked Presentation method is allowed.

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.

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?

It is difficult to identify and measure the credit risk component of a financial item. Therefore, we agree with the Board that we should discuss about an alternative accounting treatment for hedges of credit risk later when enough research is conducted on it.

Question 16

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

We agree.