

March 9, 2011

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

Dear International Accounting Standards Board,

Regarding the request for Comment Letters on the Exposure Draft (Hedge Accounting) by March 9<sup>th</sup> 2011, the Korea Shipbuilder's Association (KOSHIPA) has compiled the views of its members and has completed the review of the Exposure Draft with appropriate consultation and input from various interested parties.

Although we broadly agree with the outline of the Exposure Draft, we do have some recommendations to propose, especially in relation to the separate presentation method and the linked presentation method. While we appreciate the efforts of the IASB to adopt the principle based approach, our view is that the draft should pay more consideration on the fundamental purpose and characteristics of hedging transactions, and the magnitude of their implications on the shipbuilding industry.

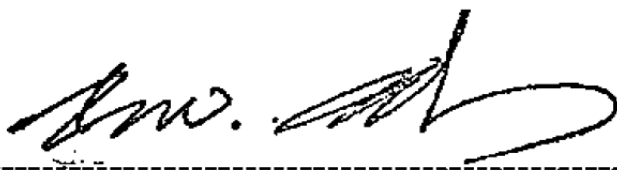
This Comment Letter consists of five parts:

- Part 1: Illustrations of Separate line presentation(SP) and Linked presentation(LP)
- Part 2: Why do we need Linked Presentation for fair value hedge accounting?
- Part 3: Problems caused by applying SP to fair value hedge accounting
- Part 4: Fallacy of counterarguments against LP
- Part 5: Conclusion

We hereby provide detailed examples to illustrate our views on the Exposure Draft followed by logical explanations supporting our arguments. It is our hope that they will be duly noted in the revision of the Exposure Draft.

Respectfully yours,

The Korea Shipbuilders' Association

A handwritten signature in black ink, appearing to read 'Oh Byung-Wook', written over a horizontal dashed line.

Oh Byung-Wook  
Chairman

## **Part 1: Illustrations of Separate line presentation (SP) and Linked presentation (LP)**

The purpose of this illustration is to explain the drawbacks of the Separate Line presentation method described in the Exposure Draft on Hedge Accounting (hereinafter, SP) while describing the positive role of the Linked presentation method (hereinafter, LP) by demonstrating how risk management activities through hedge are presented in the Statement of Financial Position in those two different presentation methods.

For this purpose, this illustration analyzes 3 cases (1 (when the asset is not hedged) and 2 (when SP is used for the hedged asset and when LP is used for the hedged asset)), assuming a situation where an entity has a foreign currency asset (or firm commitment) and experiences a gain on the foreign currency asset (or firm commitment) due to the upturn in the FX rate.

### **1. Illustration for Foreign Currency Asset**

In this analysis, we assume a situation where the entity has a foreign currency asset.

When the foreign currency asset is not hedged	(Case A) Statement of Financial Position			
	(Hedged) item      100			
	Change in fair value 10			
	When SP is used		When LP is used	
When the foreign currency asset is hedged	(Case B-SP) Statement of Financial Position		(Case B-LP) Statement of Financial Position	
	Hedged item      100	Hedging instrument 8	Hedged item      100	
	Hedge adjustment    10		Hedge adjustment    10	
			Hedging instrument    (8)	
			Ineffectiveness      2	

#### **a. When SP is used for presentation (Cases A and B-SP)**

Case A appropriately shows the FX risk exposure of the foreign currency asset, because the change in the fair value of the asset due to the variation of the FX rate (CU10) is shown in the Statement of Financial Position.

The purpose of the hedge is to reduce the FX risk which is the fluctuation of future cash flow from the foreign currency asset. In case B-SP, another type of FX risk (hedging instrument, CU8) is added to the FX risk exposure of the foreign currency asset (hedge adjustment, CU10) on the liability side of the Statement. Therefore, SP makes the hedging-entity (Case B-SP) look like it is being exposed to the additional FX risk, and look riskier than a non-hedging entity (Case A). In this regard, Case B-SP has a serious problem in that it enlarges the risk of the entity involved in hedging activities. SP reflects the risk management activity of an entity in the opposite direction on the Statement of Financial Position, distorting accounting information.

b. When LP is used for presentation (Cases A and B-LP)

SP (Case B-SP) distorts the entity's risk management activity by newly adding the hedging instrument account to the liability side of the Statements. On the other hand, LP (Case B-LP) appropriately shows the degree of the entity's exposure to the FX risk. The hedge adjustment (CU10) represents the risk of uncertain future cash flow from the asset, and the hedging instrument (CU8) shows the reduction of the uncertainty in the future cash flow from the hedging activity. By presenting both the hedge adjustment and the hedging instrument on the same side of the Statement of Financial Position, LP shows the fact that (1) the entity has a foreign currency asset exposed to FX risk, but (2) is able to reduce the FX risk by hedging the asset. In other words, LP explicitly shows that the inherent FX risk of the foreign currency asset (i.e., the hedge adjustment) has been reduced by the hedging activity (i.e., the hedging instrument). Thus, LP is a more accurate presentation of the entity's risk management activity than SP.

Another advantage of LP is that it shows the risk that has not been removed from the hedging transaction. Stated differently, the difference between the hedge adjustment and hedging instrument, referred to as the ineffective portion of hedging (CU2), is shown on the Statement of Financial Position. LP provides more useful information about future cash flow than SP.

## 2. Illustration for Firm commitments

In this analysis, we assume a situation where the entity has a firm commitment. As explained below, the problems of SP described above get worse for firm commitment.

When the firm commitment is not hedged	(Case C) Statement of Financial Position			
	-		-	
	When SP is used		When LP is used	
When the firm commitment is hedged	(Case D-SP) Statement of Financial Position		(Case D-LP) Statement of Financial Position	
	Hedge adjustment 10	Hedging instrument 8	Hedge adjustment 10	Hedging instrument (8)
			Ineffectiveness 2	

a. When SP is used for presentation (Cases C and D-SP)

The Statement of Financial Position of Case C distorts the financial status of the entity because it does not show the FX risk of the entity at all, even when the entity is fully exposed to the FX risk by not hedging the firm commitment. This problem, which exists only for firm commitments not for foreign currency assets, occurs because non-hedged firm commitment is not recognized in the financial statements.

The problem associated with Case B-SP is much more severe in Case D-SP. Compared to Case A, Case B-SP has only one additional risk on the liability side (hedging instrument). However, compared to Case C, Case D-SP adds two extra risks (hedge adjustment on the asset side and hedging instrument on the liability side). So despite the fact that an entity has reduced its FX risks, its financial presentation shows two additional risks giving the impression that the entity's risk has much more increased. Therefore, under such circumstances, an entity is perceived to be much riskier when it is involved in hedging activities (Case D-SP) than when it is not (Case C).

b. When LP is used for presentation (Cases C and D-LP)

In Case D-SP, SP makes the entity look much riskier by newly adding the two new risks and inappropriately presents the entity's risk management activity. As explained in Case B-LP, LP could be a good solution to the problem demonstrated in Case D-SP. By presenting both the hedge adjustment and the hedging instrument on the same side of the Statement of Financial Position, LP shows the fact that (1) the entity has a foreign currency asset exposed to FX risk (CU10), but (2) is able to reduce the FX risk (CU8) by hedging the asset.

LP also shows that hedging activities reduces risk but it does not eliminate all risks. For all that, if LP is applied, the remaining risk being the difference (CU2) between hedge adjustment and hedging instrument is shown on the Statement. This ineffective portion of hedging is not apparent when SP is used.

Case D-LP better reflects the effects of the entity's risk management activities than Case D-SP. In other words, LP explicitly shows that the inherent FX risk of the firm commitment (i.e., the hedge adjustment) has been reduced by the hedging activity (i.e., the hedging instrument), showing that the entity is in control of the FX risk through the hedging activity.

c. Cases B-SP/LP and Cases D-SP/LP

These are the cases where the entity hedges the asset for FX risk.

In such cases, the impact of the fluctuation in the FX rate is shown greater on the Statement of Financial Position of the entity with firm commitment (Case D-SP/LP) than that of the entity with foreign currency asset (Case B-SP/LP). This is because the hedged foreign currency asset is shown on the Statement of Financial Position whereas the hedged firm commitment is not. Therefore, the risk of an entity with the hedged firm commitment is magnified.

## **Part 2: Why do we need Linked Presentation for fair value hedge accounting?**

Until now, we have examined some illustrative examples showing the practical implications of both SP and LP. From this point on, we would like to give our theoretical explanations and logical reasoning on why the drawbacks of SP occur and LP is a better alternative.

Hedged assets (e.g., hedge item) and liabilities (e.g., hedging instrument) are different from general (non-hedged) assets and liabilities in their nature. General assets and liabilities generate a gross cash flow, because the cash flow from general assets is detached from the cash flow from general liabilities. Thus, for general assets and liabilities, their gross cash flows reflect their true economic substance.

On the other hand, hedged assets and liabilities produce a net cash flow because an entity intends to realize the financial asset and settle the financial liability simultaneously. Consequently, for hedged assets and liabilities, the net cash flow, not the gross cash flow, represents their true economic substance.

If SP is applied to hedged assets/liabilities (Cases B-SP and D-SP), despite the fact that the purpose of hedging is to reduce the fluctuation of future cash flow, the FX risk of the original hedged item remains on one side, while the FX risk of the hedging instrument is additionally shown on the opposite side of the Statement of Financial Position. This results in the following unexpected drawbacks.

Entities engaged in hedging activities (Cases B-SP and D-SP) will show a higher exposure to the risk than entities that are not involved in hedging activities (Cases A and C). This is due to the fact that the additional fluctuation from hedging instrument is only shown on the Statement of Financial Position of entities engaged in hedging activities.

Since SP adds the fluctuation of the hedging instrument, i.e., additional risk (compare Cases A and B-SP, or Cases C and D-SP), it shows the opposite effect of an entity's risk management activities on the Statement of Financial Position. SP ignores the underlying economic substance of hedging activities and distorts the extent and effect of the entity's risk management activities in the financial reporting.

The major reason for the problems described above is because SP is faithful to the "gross concept" of the Statement of Financial Position. On the other hand, hedging is based on the "net concept," as explained above. Therefore, SP is an appropriate presentation method for the cash flow of only the general assets and liabilities, not that of the hedged assets and liabilities.

The purpose of fair value hedging is to reduce risks by minimizing the fluctuations in future cash flow, and hedging actually (economically) reduces risks from future cash flow. However, SP could present neither the extent and effect of such an entity's important risk management activity nor the economic substance of hedging activities in the Statement of Financial Position, whereas LP could.

LP is a way to introduce the net concept into the Statement of Financial Position. LP acknowledges the net concept by offsetting the impact of hedging activities. Since LP represents the net concept, which is the true economic substance of hedging activity, LP is appropriate for hedged assets and liabilities. LP allows a more transparent and consistent representation of the entity's risk management activities and future cash flow than SP. In a hedging transaction, first, the cash flow of the hedged asset and liability will eventually be offsetted and second, it will be offsetted at the same time. Only LP can provide users with such additional accounting information, which is why LP is considered to be a better accounting presentation method for hedging activities than SP.

As stated in the Framework for Preparation and Presentation of Financial Statement, one of the most important qualitative characteristics of financial reporting is "predictive value," and the predictive value of financial reporting could be enhanced by the manner in which information is displayed. LP is a presentation method that has greater predictive value on future cash flow than SP. That is because LP shows the future cash flows from hedging activities more accurately than SP does. In this regard, we also believe that LP represents more faithfully the hedging transactions. Therefore, LP should be adopted in order to better present the effects of an entity's risk management activities on the Statement of Financial Position.

In the future, there probably will be a need to further use the concept of net cash flow not only for hedging activities but also for other types of management activities. LP can be a suitable solution for such accounting demands. In other words, LP is not an issue limited to hedge accounting but a broad issue that could be widely used in other fields. Therefore, allowing LP for hedge accounting is a good start for future application of the net cash flow concept to the Statement of Financial Position.

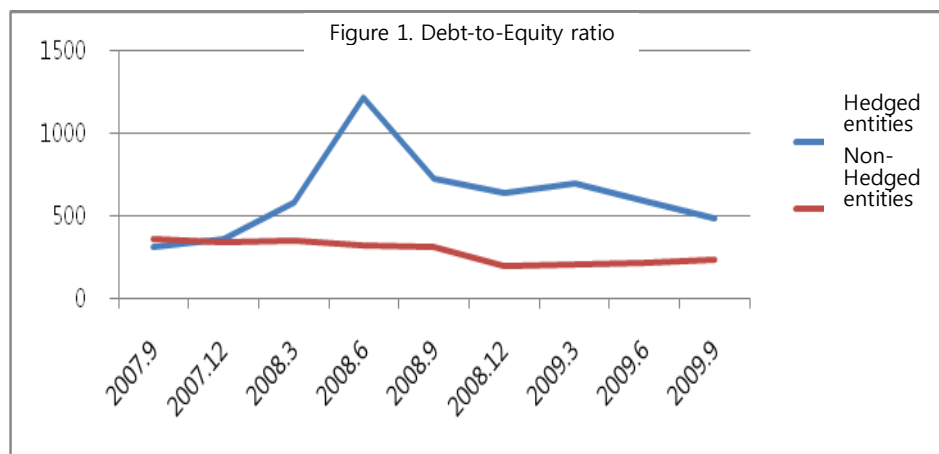
The Income Statement does not have this issue because the Income Statement offsets gains and losses from hedging instruments and hedge adjustment, showing the accurate effects of fair value hedging stemming from the net concept of the Income Statement. SP shows inaccurate effects of hedging on the Statement of Financial Position by not allowing the net concept.

### **Part3: Problems caused by applying SP to fair value hedge accounting**

1. SP ignores the characteristics of hedging activities as described above, causing the following three problems.

Firstly, even though the volatility of cash flow of hedged assets and liabilities is small, it is magnified in the Statement of Financial Position when SP is applied. SP does not consider the fact that cash flow from hedging activities is interconnected and the net cash flow from the hedged assets and the related liabilities represents its true economic substance. Therefore, if SP is used for hedging activities, the risk of an entity will be overstated in the financial statements.

The second problem of SP is that it distorts comparability. First, Figure 1 shows the debt-to-equity ratio of the hedged and the non-hedged entities in Korean shipbuilding industry when they both use SP. As shown in Figure 1, the value of assets and liabilities of an entity which is involved in hedging activities becomes more vulnerable to the change in FX rate than those of an entity which is not. Therefore, SP makes an entity who has eliminated FX risk through hedging activities look riskier than an entity who is fully exposed to FX risk by not being involved in any hedging activity. This phenomenon is a serious problem because SP distorts the economic substance of an entity engaged in hedging activities.



Thirdly, SP has a problem in that it misleads management's decision making. Under the current Exposure Draft, the only way to avoid vulnerability (i.e. overstated risk) in the assets and liabilities due to the change in FX rate is for an entity not to hedge their FX risk. For example, assume a situation where the change in FX rate has a possibility of increasing the debt-to-equity ratio to a level higher than what is required by a debt covenant. SP will induce management to make the wrong decision of not being involved in hedging activity and let the entity be fully exposed itself to FX risks, which could not only adversely affect the entity's real business activities but also distort the information user's decision making.

2. The problem described below is not a problem of SP itself. Instead, it is the problem caused by paragraph 26(b) of the Exposure Draft, which states, "the separate line item shall be presented next to the line item that includes the hedged asset or liability."

It is an improvement in that this statement enables an entity to show the linkage between the two items, and that it could avoid mixed measurement<sup>1</sup>. However, the very same statement causes an inconsistency in their presentation in the Statement of Financial Position. As shown in the table<sup>2</sup> below, the entity's hedging activities are presented in the form of SP in Case 1, while in the form of LP in Case 2. This inconsistency is problematic because it is caused by the gains or losses of the hedged item (e.g., the change in FX rate) without any systematic theoretical basis.

Case 1. Gain on hedged item (e.g., FX rate goes up)			Case 2. Loss on hedged item (e.g., FX rate goes down)		
Statement of Financial Position			Statement of Financial Position		
Hedged item	XXX	Hedging instrument	YYY	Hedged item	XXX
Hedge adjustment	YYY			Hedge adjustment	YYY
				Hedging instrument	(YYY)

This inconsistency in presentation could cause a problem in comparability as well as the computation of financial ratios such as debt-to-equity ratio. Moreover, it should once again be noted that Case 2 is in the form of LP, which implies that LP is already allowed in the current Exposure Draft. For improving the comparability of financial statement, we believe, LP should be allowed in all cases.

<sup>1</sup> Presenting gains and losses from a hedged item as a separate line item is another important improvement in that it distinguishes the change in fair value from the amortized cost.

<sup>2</sup> The Statements of Financial Position presented in the table assume two cases where an entity hedges a foreign currency asset for FX risk. Case 1 assumes a gain (i.e., the FX rate goes up) and Case 2 assumes a loss (i.e., the FX rate goes down) on the hedged item.



## **Part 4: Fallacy of counterarguments against LP**

### **1. Counterparty risks associated with the change in FX rate**

The Exposure Draft opposes to LP because, “LP does not differentiate between the types of risks covered by that relationship and those that are not.” This statement is definitely based on the improper assumption that the change in FX rate influences all risks related with the hedge. FX risk, the change in the value of hedged assets and liabilities, is determined by FX rate which is totally irrelevant to the counterparty credit risk. Once again, other risks such as counterparty credit risk are not associated with FX risk. Hedging activities are not associated with counterparty credit risk.

### **2. Counterparty risks associated with credit risk**

B31 of the Exposure Draft states that hedging instruments may not be used if the credit standing of the counterparty severely deteriorates. This statement can be interpreted as, if there is not much counterparty credit risk, entities may engage themselves in hedging activities. So the sheer fact that an entity is involved in a hedging activity implies that the credit risk of the counterparty is minimal. The purpose of hedging firm commitments is to reduce risks, and hedging actually (economically) reduces risks. If the counterparty credit risk, an important element supporting SP in the Exposure Draft, is significant in the actual business, there is no reason for an entity to be involved in hedging activities. Therefore, an entity would engage in a hedging activity with a financial institution with very low credit risk. In such cases where there is minimal counterparty credit risk involved, LP is a better method reflecting the economic substance of the transaction.

According to BC128, SP needs to be used for hedge transactions because of counterparty risk. But as already explained, counterparty risk does not exist in most hedging activities. Then, it is questionable whether SP still needs to be applied or LP can be used instead for the case where there is remote or no counterparty risk involved. It is evident that there is a need for a clear guideline which presentation method should be used for the case. Also, if SP is the only method that should be used for the case, there needs to be a clear explanation on its basis of the conclusion.

Some people argue, “The recent financial crisis has shown how third party credit risks that were perceived by many highly intelligent professionals as being “remote” or even “trivial” could rapidly create massive losses.” This argument is not wrong. However, every transaction involves risk, and it is general accounting rule that the remote risk is not presented in the financial statements if the possibility of the risk is remote. Also, third party credit risk is quite stable over the hedging period, because the usual hedging period is no longer than a couple of years. Consequently, such argument should not be an issue of discussion.

### **3. LP, an issue of a specific industry?**

Some experts argue that LP should not be allowed because LP is an issue of specific industries. However, this is a common issue of all industries as long as entities possess hedged foreign assets and liabilities and thus, has the hedge adjustment and hedging instrument in their financial statements.

The only reason why the issue of LP is not raised in other industries is because the amount of assets and liabilities from hedging activities is not dominant in their financial statements. In other words, the overall size of their hedging activities and the fluctuation of their foreign currency rate are relatively minimal. In this regard, if the amount of hedged assets and liabilities grows, then the SP's misrepresentation of risk management activities will become an important problematic issue for any entity in any industry.

## **Part 5: Conclusion**

The purpose of hedge is to reduce the risk which is the fluctuation of future cash flow. However, SP distorts this entity's risk management activity through hedge in its presentation in the Statement of Financial Position. By newly adding the hedging instrument account to the opposite side of the hedged item in the Statement of Financial Position, SP makes the hedging-entity look like it is being exposed to the additional risk and look riskier than a non-hedging entity. This problem is much more severe when the hedged item is a firm commitment.

LP appropriately shows the degree of an entity's exposure to the risk. The hedge adjustment represents the risk of uncertain future cash flow, and the hedging instrument shows the reduction of the uncertainty in the future cash flow from the hedging activity. By presenting both the hedge adjustment and the hedging instrument on the same side of the Statement of Financial Position, LP shows the fact that (1) the entity has an asset/liability exposed to a risk, but (2) is able to reduce the risk by hedging the asset/liability. Thus, LP is a more accurate presentation of the entity's risk management activity than SP. Moreover, LP shows how much risk has not been removed from the hedging activity, by presenting the difference between the hedge adjustment and hedging instrument on the Statement of Financial Position.

We believe that the anomalies of SP pointed out in this letter are not consistent with the intention of the Exposure Draft, which contemplates that the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities. We once again believe that accounting's role should be to provide financial information about business activities, not to direct business activities.