



EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

Sir David Tweedie
Chairman
IASB – International Accounting Standards Board
IFRS – International Financial Reporting Standard
30 Cannon Street
London EC4M 6XH

Great Britain

Mainzer Landstrasse 47a
DE – 60329 Frankfurt am Main

Contact: Claudia Stinnes
Direct number: +49 69 26 4848 300
Fax number: +49 69 26 4848 335
Email: Claudia.Stinnes@effas.com
Internet: www.effas.com

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Exposure Draft ED/2010/13 Hedge Accounting

Comments by the European Federation of Financial Analysts Societies (EFFAS) Financial Accounting Commission - FAC

Dear Madam, dear Sir,

The European Federation of Financial Analysts Societies is the European umbrella organization of national analysts' societies. It comprises 26 members, representing more than 14,000 investment professionals in the areas of equity and bond research, asset management as well as investment advice. The European Federation of Financial Analysts' Societies through its Commission on Financial Accounting has reviewed the ED/2010/13, *Hedge Accounting*.

The Commission supports the IASB's efforts on the close alignment of the accounting with an entity's risk management activities and improving the ability of investors (and other users, i.e., analysts) to understand the entity's risk management activities and to assess the amounts, timing and uncertainty of future cash flows represented in its financial statements. We believe that this move is of utmost importance to enable users of financial information to understand the company's risk management and risk mitigating techniques applied as well as its risk appetite.

We are pleased to provide some comments to your questions as follows:

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?

Our response

Yes, we agree. We support hedge accounting as an accounting model that reflects properly the decisions taken by risk management. The fact that the new proposal introduces more flexibility brings hedge accounting more in line with common risk

management. In other words, the new accounting model allows increasing convergence of an entity's accounting and risk management view. We do believe that the proposed application of the new hedge accounting model is more logical and more transparent. Moreover, we believe that it is easier to understand for users as it reflects actual decisions taken by the company. As hedging is a well-established risk management practice there is a need to show actual effects in the financial statements. We also support the proposal for enhanced presentation and new disclosure requirements.

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?

Our response

Yes, we agree. It is our understanding that a company's risk management has always assigned assets to certain liabilities (also non-derivatives) to mitigate a particular risk. We, as users, are particularly interested in learning about the company's risk management in general and prefer that the accounts properly reflect the actual decisions taken and the strategy chosen by risk management. As we are in particular interested in financial reports that reflect economic reality we question whether the limitation set for hedging instruments measured at fair value through profit and loss is precluding some hedging transactions.

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?

Our response

Yes, we agree. We believe that it allows a better reflection of market reality.

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 (i.e., 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?

Our response

Yes, we agree and welcome the proposal. Some risk components are identifiable and measurable. The elimination of the restrictions previously imposed on non-financial items closes a gap between actual risk management and accounting view.

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?

Our response

5 a) and b) We agree. It closes or at least reduces the gap between the economic and the accounting viewpoint.

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?

Our response

Although we support the elimination of the 80 – 125 percent range as a rule to be adhered to for the application of hedge accounting we question whether the guidelines in the standards are sufficiently rigorous on the *ex-ante* definition of hedge effectiveness. We expect that an objective based assessment will enhance the link between an accounting point of view and an entity's risk management and as such will improve the usefulness of financial statements. However we would like to emphasize the importance of management's and auditor's responsibility in assuring the proper application of the standard principles and true effectiveness of the hedges.

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?

Our response

We agree.

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?

Our response

We agree with both a) and b).

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 recognized 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?

Our response

We agree with 9a).

On 9b) and 9c) we do not have a firm opinion. Nevertheless we believe that there is no need for additional line separation.

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 (e.g., 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 (i.e., 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?

Our response

We do not object to your proposals.

Question 11: Eligibility of a group of items as the hedged item

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?

Our response

Yes, we agree. As many industries apply hedge accounting of open portfolios and macro hedges we suggest that the Board presents its proposals for the second phase of the hedge accounting project as early as possible.

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 (e.g., 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?

Our response

Yes, we agree. We would, however, draw your attention to the fact that many European industries have to report according to presentation formats established by their relevant regulators such as EBA and ESMA. A close coordination with the newly established regulators at the European level is proposed. By and large it would be preferable to have presentation matters included in the disclosures.

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?

Our response

We support your proposals for disclosure, although we would like to stress that simplicity is advisable in contrast with the example in BC, page 82 IE-3.

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?

Our response

We do not have a firm opinion.

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?

Our response

We question why CDS (credit default swaps) which are commonly used to hedge credit spread risk should not be an eligible hedging technique. We are of the belief that excluding those instruments from hedge accounting results in a rule based standard leading to financial statements that do not reflect economic reality and risk management decisions taken.

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?

Our response

As we have commented earlier we are not in favour of a piecemeal approach and would therefore prefer IAS 39 to be replaced by IFRS 9 in its entirety.

Other comments**Our response**

The Commission would like to emphasize that for users the only reason for changes is that the new standards provide the homogeneity, comparability and, as much as possible, simplicity needed to analyse companies across their sector and across constituencies.

The commission is willing to provide additional comments, as necessary.

Yours sincerely,

Javier de Frutos
Chair, Commission on
Financial Accounting

EFFAS Financial Accounting Commission

EFFAS was established in 1962 as an association for nationally-based investment professionals in Europe. Hheadquartered in Frankfurt am Main, EFFAS comprises 26 member organisations representing more than 14,000 investment professionals. The Commission on Financial Accounting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint.

FAC members are Javier de Frutos (Chairman, Spain), I Jacques de Greling (Vice-Chairman, SFAF France), Friedrich Spandl (OVFA, Austria), Henning Strom (NFF, Norway), Ivano Mattei (AIAF, Italy), Taras Koval (USFA, Ukraine), Jérôme Vial (SFAA, Switzerland) and Rolf Rundfelt (SFF, Sweden).
