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30 Cannon Street
London EC4M 6XH
United Kingdom

Comments on the Exposure Draft, *Hedge Accounting*

To the Board Members:

The Japanese Institute of Certified Public Accountants (“we” and “our”) appreciates the continued efforts of the International Accounting Standards Board (IASB) on the financial crisis and welcomes the opportunity to comment on the Exposure Draft, *Hedge Accounting*.

We agree with the overall direction of the proposals of the Exposure Draft (ED) to change the requirements of hedge accounting from rule-based under IAS 39 *Financial Instruments: Recognition and Measurement* to principle-based, as this will enhance the usefulness and understandability of financial statements. We do have concerns, however - especially from an auditors’ perspective - that the requirements may be overly relaxed. To be more specific, the proposals in the ED assume that risk management activities, the basis for the accounting standard, are appropriately in place at every entity. Yet the proposals fail to clarify the level to which risk management activities should be in place, or what criteria should be met. Without clarification of these issues, we have strong concerns that differences may arise with regard to the appropriate level of risk management activities perceived by the preparers of financial statements and auditors. If this comes to be, it may lead to confusion in practice. To avoid this, we hope that the

IASB will clearly and appropriately deal with these matters through the development of further guidance or the issuance of appropriate educational documents based on thorough consideration of the actual status of the risk management activities the entities have in place, as revealed through various outreach activities.

Objective of hedge accounting

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?

Comment:

We support the overall direction of the proposals. We do not agree, however, with the proposal that prohibits the application of hedged accounting for investments in equity instruments designated as at fair value through other comprehensive income (FVTOCI).

We agree to confirm the proposed objective of hedge accounting, namely, to represent in the financial statements the effect of an entity's risk management activities. Yet an entity's risk management activities may set out to manage more than only exposures that could affect profit or loss. A limited focus on exposures that could affect profit or loss is not consistent with the objective of representing the effect of an entity's risk management activities in the financial statements. Although the proposed objective of hedge accounting only refers to an entity's risk management activities that use financial instruments to manage exposure arising from particular risks that could affect profit or loss, we believe that the Board should also include risk management activities that use financial instruments to manage the risk of value changes of equity investments designated as at FVTOCI.

We have considered the following concerns expressed in BC26, with regard to the application of hedge accounting for investments in equity instruments designated as at FVTOCI (to be designated as a hedged item in a hedging relationship).

- The exception contradicts the principle of not reclassifying changes in the value of equity investments at FVTOCI to profit or loss, or the principle of reclassifying ineffectiveness to profit or loss.
- Adding another exception (ie permitting equity investment as a hedged item) to the existing exception (ie the option to account for equity investments at fair value through other comprehensive income) will give rise to further complexity.

For the following reasons, however, we do not believe that these concerns alone would constitute sufficient grounds for prohibiting the application of hedge accounting for equity investments designated at FVTOCI.

- (1) Even if an entity is hedging its exposure to price volatilities and foreign currency risk by designating equity investments designated as at FVTOCI as a hedged item, and if, as a result of this proposal, the effect of that entity's hedging activities is not reflected in the financial statements, such proposal would not be consistent with the objective of hedge accounting, namely, to represent in the financial statements the effect of an entity's risk management activities. This treatment would also be counterintuitive.
- (2) We understand that the IASB's decision not to permit recycling for equity investments designated as at FVTOCI is based on the IASB's conviction that the statement of comprehensive income should reflect investment gains or losses only once, and hence, that it would be problematic to recognize gains or losses first in other comprehensive income, and then again in profit or loss. Yet under the proposed requirements for hedge accounting, the portion of gain or loss on the hedging instrument should be recognized in other comprehensive income and the ineffective portion should be reclassified to profit or loss. The IASB should first discuss and confirm the relationship between other comprehensive income and profit or loss in the context of the conceptual framework, and then discuss its recognition within the context of each standard. However, the IASB did not go through this process. Given the opacity of the concept of comprehensive income within the current IFRSs, we believe it would be unreasonable to prohibit hedge accounting based on an entity's risk management activities only on the grounds that the standard prohibits recognition of the gain or loss in profit or loss.
- (3) IFRS 9 *Financial Instruments* permits the designation of financial instruments as at FVTOCI under the measurement principles. We therefore believe that the equity investments designated as at FVTOCI should be permitted as hedged items if such equity investments are hedged within an entity's risk management activities. If, as discussed in IFRS 9, the recognition of gain or loss twice, first in other comprehensive income and then in profit or loss, is considered double counting, it can be solved by continuing the recognition of part of the ineffective portion (when

valuation gain or loss of the hedged item exceeds that of the hedging instrument) in other comprehensive income. If, on the other hand, the ineffective portion has to be recognized in profit or loss, the hedge ineffectiveness should be recognized in profit or loss even if the hedged item is an equity investment designated as at FVTOCI. The IASB should hold more hearings with constituents through various outreach activities to determine which method provides more useful information to the users of financial statements, and should enhance the conceptual framework to clarify what is to be recognized in other comprehensive income.

Instruments that qualify for designation as hedging instruments

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?

Comment:

We do not agree.

We are not aware of any need, in practice, to designate a non-derivate financial asset and non-derivative financial liability measured at fair value through profit or loss as hedging instruments at the moment. Rather, we recommend that the IASB conduct various outreach activities to clarify the practical needs of constituents and thereby identify the likely effects of such an expansion of the scope of hedging instruments.

Derivatives that qualify for designation as hedged items

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?

Comment:

We agree with the proposal, but believe that the accounting treatment should be clarified.

We agree with the ED proposal to permit the designation of aggregated exposure as a hedged item. This accounting treatment will eliminate artificial barriers on hedge accounting, and the effects of risk management activities will be reflected in the financial statements. Yet the ED does not clarify the measurement method for the

ineffective portion or the hedge accounting when an aggregated exposure is designated as a hedged item. We therefore believe that the accounting treatment should be clarified in the guidance.

Designation of risk components as hedged items

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?

Comment:

We agree with the proposal, but think that guidance should be provided.

We support the overall direction of ED which requires the designation of risk components of non-financial instrument as hedged risks. We believe that, however, for further guidance on the “separately identifiable and reliably measurable” criterion, in order to clarify the practical application of the requirement with regard to what relationship or which level of correlation is required in the context of the risk management policies of the entity.

Designation of layer component of the nominal amount

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?

Comment:

(a) We agree.

With regard to the context of net investments in a foreign operation, when designating spot rate changes as hedged risk and foreign currency asset and liability as hedging instruments in a hedge of net investments in a foreign operation, there may be situations

where an entity conducts hedge activities by designating a layer of the nominal amount of an item as a hedging instrument, rather than specifying individual hedging instruments (ie by designating a layer of the nominal amount of foreign currency funding (foreign currency deposits) as a hedging instrument, rather than separately designating Deposit A, Deposit B, and Deposit C as hedging instruments). This is based on the same concept as the strategy of replacing or rolling over a foreign currency asset and liability into another foreign currency asset and liability. Since the risks are even, this seems to be the case where it is very unlikely that specific problems will arise in hedge effectiveness assessment or discontinuation of hedge accounting, even if hedging instruments are not separately designated. If this is part of the entity's documented hedging strategy, since the hedged risk will be uniformity, we believe that the IASB should consider permitting the following at the final standard.

- Designation of a nominal component (ie specified amounts of certain types (not individual contracts) of foreign currency asset and liability) as a hedging instrument in a hedging relationship; and
- Continued application of hedge accounting unless foreign currency asset and liability which may be designated as a hedging instrument are below the nominal amount originally determined.

(b) The issue about a layer component including prepayment option has significant bearing on the discussion of the hedges of an open portfolio, an issue excluded from the scope of this ED. Thus, we believe this issue should be deliberated in the discussion of the hedges of open portfolios, in due consideration of the treatment in practice and of consistency with the risk management activities. Decisions on this issue should only come after such discussion.

Hedge effectiveness requirements to qualify for hedge accounting

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?

Comment:

We agree. It would be helpful, however, to clarify the following matters.

We support the elimination of the bright-line of 80-125 per cent for hedge effectiveness currently required by IAS 39. Likewise, we agree that the IASB determines a method

for effectiveness assessment in alignment with the entity's risk management policies. We also agree that a hedging relationship should meet the hedge effectiveness requirements to qualify for hedge accounting, and that the effectiveness assessment should be conducted on an ongoing basis.

The proposals state that a hedging relationship meets the hedge effectiveness requirements if it satisfies two conditions: (1) it meets the objective of hedge effectiveness assessment to ensure that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness (paragraph B19), and (2) it is expected to achieve other than accidental offsetting by analyzing the economic relationship (paragraph B31 and 19). Certain entities, however, may have risk management policies to maintain a certain level of risk exposure, not always minimizing it. If this is the case, the hedging relationship chosen under the entity's risk management activities might not ensure that the hedging relationship would minimize the expected hedge ineffectiveness. Therefore, it seems to be inconsistent between the objective of a proposal requiring alignment with the risk management activities and particular proposals that require rule-based requirements to restrict the application of hedge accounting. We believe that the final standard should further clarify whether or not the risk management objective and activity should be considered to determine whether the hedging relationship meets the objective of the hedge effectiveness assessment.

Rebalancing of a hedging relationship

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?

Comment:

We agree. We also have the following concerns, however, and would like to call for

several clarifications on the proposed requirements.

(a) We support the rebalancing of the hedging relationship and the accounting of the revised hedging relationship as a continuation of an existing hedge. These approaches would improve the excessively strict requirements under the current IAS 39. We also have the following concerns, however, and believe that the requirements should be clarified.

- The standard should clarify that the rebalancing is accounted for as a continuation of the hedging relationship only when risk management policy requires rebalancing for specified risk components, and that the rebalancing is conducted in accordance with that policy. In particular, phrases such as “Mandatory rebalancing of the hedging relationship” in the flow chart of paragraph B46 should be avoided, as this can be interpreted to mean that the standard requires physical execution of the transaction.
- If, for example, an entity adopts a risk management policy where the offset is required to be 90-100 per cent effective, the changes in the correlation of hedging relationship within this range would not lead to discontinuation of hedge accounting or rebalancing. If, on the other hand, an entity adopts a risk management policy that always requires 100 per cent effectiveness, a hedge relationship is accounted for as ineffective unless the 100 per cent offset is achieved. If the continuation or discontinuation of hedge accounting depends on the entity’s risk management objective and activities, differences in risk management objectives and activities from one entity to another may result in large discrepancies in the numbers presented in the financial statements even when the events are economically identical. To enhance usefulness and understandability of the financial statements, we recommend that entities be required to disclose the basis supporting their evaluations of the need for rebalancing, the adjustment methods which they apply when rebalancing and continuing hedge relationships, the ineffective portions recognized, and the items to be affected in financial statement.

(b) Permitting a proactive rebalancing of a designated hedging relationship when an entity expects that the hedging relationship might not meet the objective of the hedge effectiveness assessment in the future is aligned with the entity’s risk management activities. We therefore support the proposal to permit the proactive rebalancing of a hedge relationship and the accounting treatment of that relationship as a continuation of an existing hedge. To avoid arbitrary application, we propose that paragraph B59 should

disallow the continuation of an existing hedge when a risk management policy lacks explicit provisions on proactive rebalancing.

Discontinuing hedge accounting

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?

Comment:

We agree with both (a) and (b).

Accounting for fair value hedges

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?

Comment:

We agree, on the condition that the following matters be duly considered before the standard is finalized.

(a) We agree. The proposal will permit an entity not to recognize fair value changes of the hedged item in profit or loss, and, as with the accounting treatment for cash flow hedges, the hedge accounting will be considered an exception to the recognition of changes in fair value of the hedging instrument. Under normal circumstances, gains or losses arising from changes in the fair value of the hedged item should not be recognized when incurred. Their recognition in other comprehensive income, however, could be accepted as an exception in order to avoid volatility in other comprehensive income and equity.

The proposals should clearly state that with respect to the hedging of interest rate risks, the portion of gains or losses on the hedging instrument that corresponds to the interest income or interest expense of the hedged items recognized in profit or loss should be recognized in profit or loss.

(b) We support the proposal. It achieves the objective of the fair value hedge while precluding, at the same time, any exceptions to the measurement principles for hedged items in the presentation of the statement of financial position.

(c) We agree. Although the gross amounts would be presented in the statement of financial position, assets should be included in the total assets, and liabilities should be included in the total liabilities. But if, when applying the fair value hedge, the amounts of assets and liabilities are more volatile and the entity deems it appropriate to deduct the fair value of the hedging instrument from the total assets and total liabilities for the purpose of financial analysis, we believe it would be advantageous to disclose in the notes the linked presentation or the total assets and total liabilities (in cases where a linked presentation is used). Therefore, the IASB should add such requirement in the final standard.

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

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?

Comment:

(a) We agree because in this case, the time value of the option seems to be the transaction costs associated with the purchase or sale of the hedged item.

(b) We agree because in this case, the time value of the option is similar to an insurance premium for the hedged item.

(c) We support the proposal. The exception to recognize the time value of an option in other comprehensive income rather than in profit or loss seems justifiable to the extent it is only applied to the portion that relates to the hedged items.

Hedges of a group of items

Eligibility of a group of items as the hedged item

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?

Comment:

We do not agree with criterion (b).

As the proposal states, criterion (b) requires the items in the group to be managed together on a group basis for risk management purpose. However, the proposal also seems to assume that the managed risks (ie. the risks separately identifiable and reliably measurable when an entity manages specific risk components) are clearly identified and are common to the group. We believe that the IASB should explicitly state this as a criterion in the standard. While we can assume, as a matter of course, that the risks are clearly identified and common to the group, in the risk management, and further, that they may be matters to be considered in relation to the hedging instruments, we think that the standard should explicitly state that entities are required to apply risk management whose effects can be clearly presented in the financial statements.

Presentation

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?

Comment:

We agree.

For the hedging instrument gains or losses recognized in profit or loss, a hedged item is a group of items and not a separate item. On this basis, we support the proposal.

Disclosures

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?

Comment:

We support the proposal. The proposed disclosure requirements enhance the understandability of the effects of risk management activities and hedge accounting on the financial statements and will help the users of financial statements determine whether the objective of hedge accounting is met.

Accounting alternatives to hedge accounting

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

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?

Comment:

We agree with all parts of the proposal except the following.

Hedge accounting may be applied when an entity manages risks using derivatives to hedge fair value changes of the contracts that can be settled net in cash and that have 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. However, we also believe that the substance of the risk management for risks in a net position would be better represented when contracts of this type are accounted for as derivatives.

We are afraid that, in addition to the requirement that the business be managed on a fair value basis, the proposed provision in Appendix C, requiring that net exposure be

maintained close to nil, may not be consistent with the entity's risk management activities. The IASB should conduct various outreach activities to investigate whether the requirement is necessary, in the light of the substance of entity's risk management activities.

Accounting for credit risk using credit derivatives

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?

Comment:

We agree.

If the three alternatives considered by the Board in paragraphs BC226-BC246 are adopted, changes in the fair value of a hedged item attributable to a component other than credit risk hedged by credit derivatives will also be recognized in profit or loss. This would not be consistent with the risk management policy of the financial institutions that use credit derivatives. The designation as at fair value through profit or loss is an exception to the measurement principles. It would not be justifiable to introduce another exception to the requirement that an entity may, only at initial recognition, make an irrevocable election to designate as at fair value through profit or loss.

Effective date and transition

Question 16

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

Comment:

We support the proposal. At the same time, we believe that the IASB should establish a further requirement for first-time adopters of IFRS.

Since the hedging relationship will be designated after the standard is applied, there

should be no restatement, as a matter of course. We agree that the hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with the proposed criteria should be regarded as continuing hedge relationships. We also agree, in this case, that the final standard should be applied prospectively to all hedging relationships, as difficulties in understanding the financial statements may arise if multiple accounting treatments exist.

However, we recommend that the following requirement be added as a transitional provision for first-time adopters who elects early application of the standard.

Early application of the final standard is permitted in the ED, and in that case, all qualifying criteria must be met at the date of application as to apply hedge accounting from that date (paragraph 54). Normally, however, there is no “date of application” concept for first-time adopters. And according to the principles in IFRS 1 *First-time Adoption of IFRSs*, the final standard for hedge accounting would be adopted either from the date of transition to the IFRSs, or, if transitional provisions similar to those of IFRS 9 are implemented, from the beginning of the year of the first-time adoption of IFRS 9. The IASB should clarify the treatment in cases where the final standard is issued not as of the date of transition to the IFRSs, but as of the first IFRS reporting date. That is, the IASB should allow first-time adopters to apply new hedge accounting as of the specific date after the transition to IFRSs by also applying the “date of application” concept to first-time adopters, since the hedge accounting would only be applied when all qualifying criteria are met and the provisions prohibit retrospective application. In such case, the final standard should clarify that the previous GAAP will be applied before the date of application of the final standard for hedge accounting.

Yours faithfully,

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Executive Board Member—Accounting Practice (IFRS)

The Japanese Institute of Certified Public Accountants