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March 2011

Hedge Accounting

International Accounting Standards Board  
30 Cannon Street, London EC4M 6XH  
United Kingdom

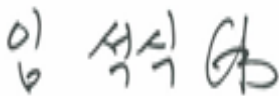
Dear Sir or Madam:

The Korea Accounting Standards Board (KASB) has finalized its comments on the exposure draft of hedge accounting.

The comments prepared by the KASB have been prepared after extensive due process and deliberation.

Please do not hesitate to contact us if you have any inquiries regarding our comments. You may direct your inquiries either to me (suklim@kasb.or.kr) or to Ms. Minyoung Jean([myjean@kasb.or.kr](mailto:myjean@kasb.or.kr)), researcher of KASB.

Yours sincerely,

A handwritten signature in black ink, appearing to read '임 석식' (Lim Seok-sik) followed by a stylized monogram.

Dr. Suk-Sig Lim  
Chairman, Korea Accounting Standards Board

Cc: Sungsoo Kwon, Director of Research Department

We are pleased to comment on the exposure draft of hedge accounting. Our comments include views from a public hearing and responses collected from the various associations. We finalized the comment letter through the due process established in KASB.

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**Exposure Draft ED/2010/13**  
**Hedge Accounting**

**General comments**

The KASB believes that the direction of this ED is correct in that an entity's risk management activities and management's intentions are linked with the hedge accounting and are presented in financial statements.

However, we believe adequate application guidelines and illustrations in order to not impair the comparability of companies are needed. For example, we welcome introducing rebalancing concept but believe it will be better to refer to guidelines or illustrations provided by the IASB instead of wholly depending on the entities' judgment.

Additionally we think some explanations which can cause interpretative problems need to be reworded.

**Specific Comments**

**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 disagree.

The KASB suggests that the objective of hedge accounting represents the effect of hedged items, hedging instruments, and hedging activities more comprehensively. First, the scope of hedged items is too restrictive. In this exposure draft, it is required for qualifying hedged items to be exposed to particular risks affecting profit or loss. However, considering the purpose of this hedge accounting project which is to reflect the risk management purpose and strategy, it would be more consistent to expand the scope of qualifying hedged items to include the items that are exposed to particular risks affecting other comprehensive income and the items in the statement of financial

position (i.e. asset or liability). For example, the exposure draft excludes equity instruments designated at fair value through OCI because of the fact that the profit and loss classified as OCI is not to be reclassified as net income. Namely the requirement in ED prevents a company from applying hedge accounting even though a company hedges equity instruments. Above statement is not consistent with the principle that 'hedge accounting should apply the hedge activities.'

Second, the proposed objective should clarify that 'the effects of risk management activities' is not only related to recognition and measurement but also to presentation and disclosure. Since the risk management activities can have an impact on future cash flows and the extent of particular risk exposure as well as on profit or loss, the financial statements should be able to properly show not only the individual effect of the hedged items and hedging instrument but also the relationship between them.

Lastly, paragraph 5 of this exposure draft mentions only financial instruments as hedging instruments. However, because a contract for a non-financial item that can be settled net in cash can satisfy the definition of derivatives, the requirements related to hedging instruments needs to be modified to include this type of derivatives.

### 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?**

We agree

### 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?**

- ◆ For hedging the aggregated exposure, it has possibility of misunderstanding as synthetic accounting which does not separately account the derivatives within aggregated exposure but only account for the aggregated exposure. We believe allowing the aforementioned method is not the original intention of the ED. There needs to be clarification on this matter.
- ◆ There is lack of application guidance related to documentation and designation of combination hedge. For example, on application guidance B9(b), the final hedged

item's combination risk can be considered as cash flow risk due to change in interest rate and this can be viewed as 'top relationship.' Each risk which composes the combination hedge is interest rate risk and foreign currency risk and these two risks can be viewed as 'bottom relationship.' In this case, whether the bottom relationship which composes the combination hedge should satisfy the effective hedge relationship requirements first is unclear.

Before considering satisfying the requirements for top relationship, the bottom relationship must satisfy the hedging requirements first. It is clear on that the derivatives which compose the combination hedge should be measured in fair value, however, it is unclear in how to account for the profit and loss due to change in fair value. Consequently, there needs detailed guideline related to above statement.

- ♦ It is unclear whether the exposure draft allows designating the specific risks among aggregated exposure as hedged items. In other words, for the derivatives included in hedged items, whether the portion of change in fair value due to specific risk are designated as hedged items and recognized in profit or loss and the portion of change in fair value due to other risks can be presented as profit or loss are unclear. For examples, in the case below, whether only the interest rate risk can only be designated as hedged item or among the change in fair value of derivatives, the changed portion due to FX risk can be recognized in profit or loss are unclear.

	Non derivative financial instrument	+	derivative	=	Hedged item
item:	(JPY floating rate foreign currency debt)		(JPY floating rate - USD fixed rate CRS)		(USD fixed rate foreign currency debt)
risk:	FX, interest rate		FX, interest rate		FX, interest rate

### Question 3 (other comments)

If complied with the management's objective and economic substances, the derivatives should be designated as hedged items and hedge accounting should be applied. For example, when it is economically more beneficial to enter into new derivatives as hedging instruments and to designate existing derivatives as hedged items, the volatility of profit or loss will be increased if hedge accounting is not applied.

**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 basically agree with the proposals of ED. However, we'd like to ask considering the following which are raised by Korea companies and related parties.

There needs to be guidelines on what kind of relevance there is in 'relevant facts and circumstances' required in ED in identifying the risk components. In other words, in order to designate specific risks that are not mentioned on contracts as hedged items, there needs to be detailed guidelines such as application scope and etc.

**(wording)** The ED requires valuation of the 'relevant facts and circumstances' in order to separately identify the risk components. We believe this valuation is required only when separately identifying specific risk that are not mentioned in contract but it is not clearly mentioned so that this requirements may be interpreted as if it should always be applied when identifying risk components as hedged items. Thus we would like to modify the expression not to be misunderstood.

**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?**

We agree

**Question 5**

**(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 basically agree with the ED.

However, we'd like to ask considering the followings which are raised by Korea companies and supervisory organization.

- ◆ It is unclear on that whether the change in cash flow of cash flow hedged items in order to measure the effectiveness signifies the present value. On the ED, it is required as discounted present value when ineffectiveness is measured. Whether effectiveness test can be measured using the change in variable cash flow method which current IAS 39 does not recognize.
- ◆ When forward contract is to be designated as hedging instrument and spot risk only is designated as hedged item, when calculating the fair value due to change in spot risk (when measuring the hedge effectiveness) whether to discount is unclear.
- ◆ When measuring the hedge effectiveness and ineffectiveness, the ED allows both fair value hedge and cash flow hedge to be applied on hypothetical derivatives (Current IAS 39 only allows to apply on cash flow hedge) According to the ED, since hypothetical derivatives replicated hedged items, the method of hypothetical derivatives can only be used if the result when hypothetical derivatives are not used is the same.

However, these two requirements contract to each other. For example, for fair value hedge accounting which used IRS, if hypothetical derivatives are used, ineffectiveness which may occur from the first fixed interest of cash flow due to interest rate change (residual cash flow after hedge) is not measured, but if basic method is used the ineffectiveness can be measured. Thus the results of these two methods are different so that cannot be used on fair value hedge accounting. ED's contents that hypothetical derivatives are applied to fair value hedge accounting cause contradiction.

- ◆ ED requires measuring effectiveness when 'significant change in circumstances' occurs. However, since mostly deciding significant change circumstances depend on subjectivity, thus we suggest providing operational guidelines.

- ♦ In order to improve the understanding of the users of financial information, we suggest presenting the standards and method used when measuring the effectiveness as a footnote.

**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?**

We agree.

**Question 7**

**(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 disagree

If the hedge relationship fails to meet the objective of the hedge effective assessment in the future, requiring the entities to rebalance is appropriate from the perspective of maintaining the comparability between companies.

However, supervisory organisation agrees with the ED.

**Question 7 (other comments)**

We think the scope of rebalancing is not clear. According to the ED, it's clear that change in 'size' can viewed as rebalancing as proposed by the B54 of ED but it's ambiguous whether entrance and exit of hedged items and hedging instrument can be viewed as rebalancing.

In order to make a decision if companies need revaluation, par. 50 of the ED requests companies to judge whether hedge relationship still meets the objective of the hedge effectiveness assessment (in order words, whether the hedge ratio still ensures that the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness). We believe that guideline on how to apply the judgment should be suggested in order to not be abused and not impair comparability.

**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?**

We agree

However, there needs guideline related to risk management objective since the hedge accounting can be discontinued due to the change of risk management objective.

**Question 8**

**(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.

**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?**

We basically agree with the ED.

However, financial institutions raised concerns about recognizing the change of fair value as OCI. They say that recognizing the fair value change in OCI makes the hedge accounting difficult to understand and to apply. Also they argue that it contrasts the basic objective of this ED which seeks the easier and principal-based accounting.

**Question 9**

**(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?**



We basically agree with the ED.

However, financial institutions raised concerns about creating separate line items. They say when a company applies fair value hedge accounting on various assets or liabilities, if separate items are presented for each asset and liability, the financial statement becomes excessively complex. For companies such as financial institutions, who have many hedged items, the financial statements can become unnecessarily complex and this may deteriorate accessibility of users of financial information.

### Question 9

**(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? <sup>1</sup>**

The purpose of hedge accounting is to present effects of hedge activities of the managements on financial statements and the purpose of financial statements is to provide useful information which is relevant and faithfully present what it purports to represent.

Given the fact that the management's intention of hedging the firm commitment is to create stable net cash flows, presenting the future realizable net cash flows on the statement of financial position provides useful information to the users and presents effects of hedge activities on financial statements as well.

However, according to the current IFRS and proposals of the ED, on the income statement, the hedge effect is appropriately presented however on statement of financial position, it is not appropriately presented. Moreover, when the exchange rate rapidly changes, the volatility of statement of financial position may increase. As a result in order to appropriately apply the intention of managements and provide useful information to the users, there needs to be improvements in presenting the fair value hedge accounting of the firm commitment.

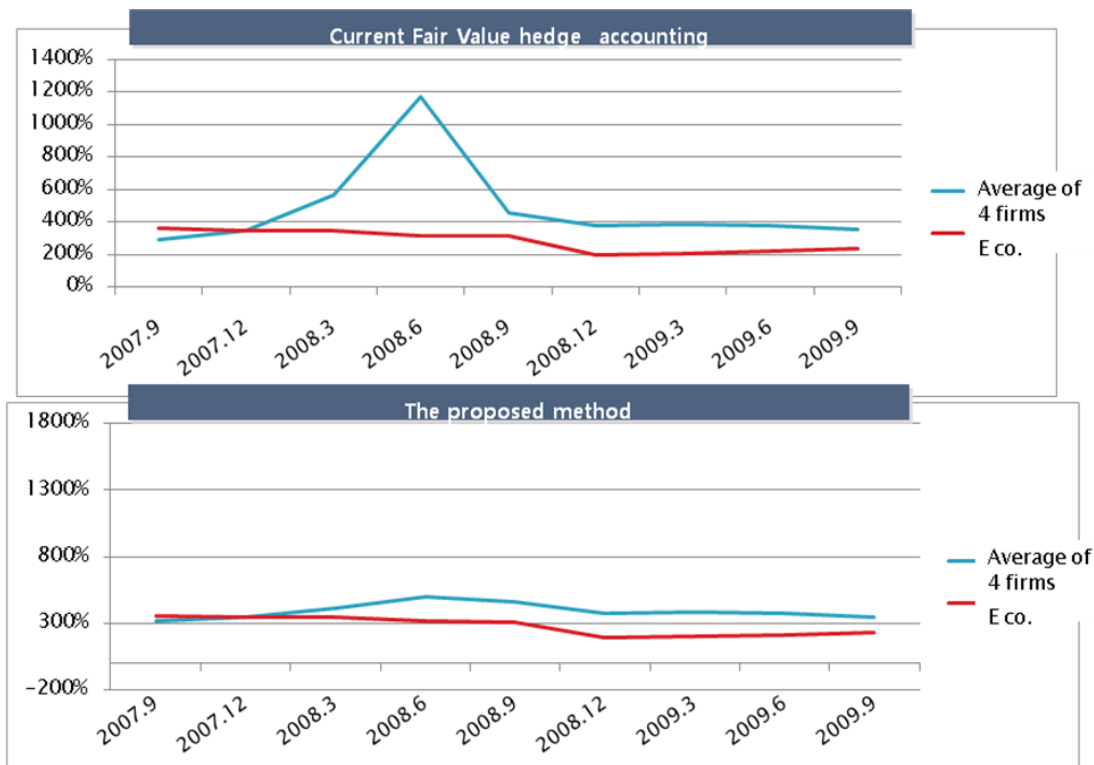
The KASB would like to suggest the linked presentation as a method to properly present the effect of fair value hedge accounting on firm commitments. The linked presentation presents the linkage of hedged items and hedging instruments and simultaneously gives the information on both total amount and net amount to the users. In addition, when exchange rate fluctuates, the linked presentation reduces volatilities of the statement of financial position and reflects the intention of management. Please refer

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<sup>1</sup> Please refer to Appendix A for details.

to the below illustration which compares the effect of linked presentation with that of the requirement of the ED.

	IASB ED	LP	Not APPLY HA
	Company S	Company S	Company S
<b>Asset</b>			
<b>I. Assets related to derivatives</b>	4,204,090,099	242,692,722	-
Assets related to derivatives	1,369,608,004	(2,591,789,373)	-
Hedge adjustments	2,834,482,095	2,834,482,095	-
<b>II. Current assets</b>	<b>8,807,061,501</b>	<b>8,807,061,501</b>	<b>8,807,061,501</b>
Current assets	8,807,061,501	8,807,061,501	8,807,061,501
<b>III. Non-current assets</b>	<b>5,099,110,662</b>	<b>5,099,110,662</b>	<b>5,099,110,662</b>
Non-current assets	5,099,110,662	5,099,110,662	5,099,110,662
<b>Total assets</b>	<b>18,110,262,261</b>	<b>14,148,864,884</b>	<b>13,906,172,163</b>
<b>Liabilities</b>			
<b>I. Liabilities related to derivatives</b>	<b>4,116,568,781</b>	<b>155,171,404</b>	<b>-</b>
Liabilities related to derivatives	2,591,789,373	(1,369,608,004)	-
Hedge adjustments	1,524,779,407	1,524,779,407	-
<b>I. Current liabilities</b>	<b>8,862,455,766</b>	<b>8,862,455,766</b>	<b>8,862,455,766</b>
Current liabilities	8,862,455,766	8,862,455,766	8,862,455,766
<b>II. Non-current liabilities</b>	<b>1,650,376,515</b>	<b>1,650,376,515</b>	<b>1,650,376,515</b>
Non-current liabilities	1,650,376,515	1,650,376,515	1,650,376,515
<b>Total liabilities</b>	<b>14,629,401,062</b>	<b>10,668,003,685</b>	<b>10,512,832,281</b>
<b>Equity</b>			
<b>I. Capital stock paid-up</b>	<b>1,154,951,155</b>	<b>1,154,951,155</b>	<b>1,154,951,155</b>
<b>II. Capital surplus</b>	<b>499,150,044</b>	<b>499,150,044</b>	<b>499,150,044</b>
<b>III. Capital adjustments</b>	<b>(663,872,515)</b>	<b>(663,872,515)</b>	<b>(663,872,515)</b>
<b>IV. Other Comprehensive income</b>	<b>132,993,707</b>	<b>132,993,707</b>	<b>139,207,940</b>
Losses on valuation of derivatives	(6,214,233)	(6,214,233)	-
Others	139,207,940	139,207,940	139,207,940
<b>V. Retained earnings</b>	<b>2,357,638,807</b>	<b>2,357,638,807</b>	<b>2,263,903,257</b>
<b>Total equities</b>	<b>3,480,861,199</b>	<b>3,480,861,199</b>	<b>3,393,339,881</b>
	-	-	-
<b>Ratio</b>			
Debt to equity ratio	420.28%	306.48%	309.81%

Financial Effect of the proposed method on debt to equity ratio

We believe that the reservations related to the linked presentation can be solved by adding the followings on disclosures

Disclosing the amount of hedged items, hedging instruments and hedge adjustments and net exposures per hedged risk which was reduced due to the result of hedge activities as a table should be allowed. This table should be disclosed irrelevant to whether linked presentation is allowed. (Refer to the disclosure requirement proposed in IASB's ED 'Offsetting financial assets and financial liabilities')

Disclosing both total assets and liabilities before and after applying linked presentation as footnote

**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?**

- ♦ The ED wishes to amend the accounting on time value of options majorly due to volatility in profit or loss. We believe amending the ED considering a method which currency rate change effect can be applied even when interest rate components of the future contract are distinguished and its fair value change are recognized in profit or loss is suggested from the point of maintaining the consistency in accounting.

Furthermore, if the accounting approach of option's time value is applied to long-term liability that is denominated in foreign currency, appropriately amortizing profit and loss valued in exchange of foreign currency over the existing period of liability after deferring will be a way to maintain consistency.

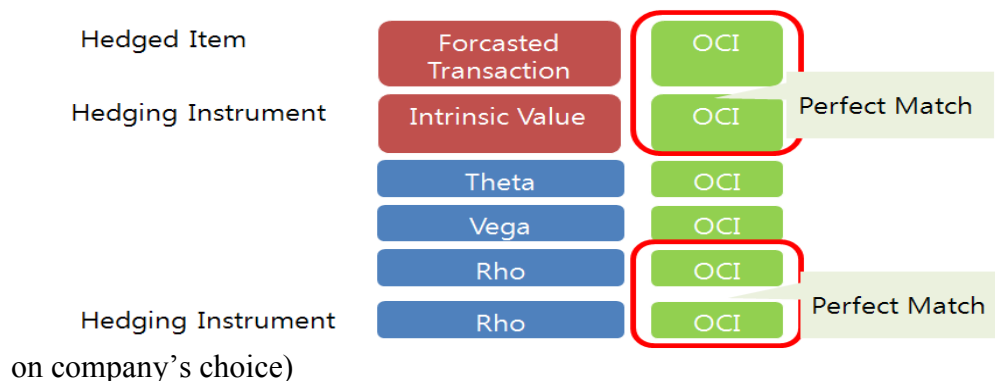
- ♦ The IASB amended hedge accounting on time value of option due to the main reason of increased volatility in profit or loss due to change in fair value of time value when option's intrinsic value is designated as hedging instrument. However, generally, the companies who do not mostly hedge using options will not have great volatility in profit or loss due to change in fair value of option time value. Therefore, requiring the accounting method proposed in the ED for these kinds of companies will be a great burden.

If the company is concerned about the volatility of fair value due to change in time value of option, the company will follow the proposals in the ED. However, for those companies who are not concerned about the above matter, there needs to be a simpler accounting method suggested.

Regarding this, not classifying the time value of option into real time value and aligned time value, adding the time value designated to the given premium (real time value) into the OCI and amortizing over the hedging period can be considered as an alternative.

- ♦ For banks, when intrinsic value of options are only designated as hedging instrument, in order to hedge a part (e.g. Rho) among time value,, new hedging instrument is used. According to the IAS 39, time value of option and changes in fair value of derivatives are all recognized as P/L so that separate hedge accounting

is not needed. However, because according to the ED, the time value of option is forced to be recognized in OCI, in order to recognize the hedging effect, a company should designate a risk among the risk components of time value as hedged item. Moreover, under the ED it is unclear whether the risk among risks which compose time value of option can be separately designated as hedged items. Consequently, when intrinsic value of option is designated as hedging instrument, the current accounting which requires recognizing time value as OCI makes difficult to apply the hedge accounting than current IAS 39. Thus, for time value, we suggest allowing to recognize as OCI depending on each item (in other words, depending



### 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?**

The disclosure proposed in the ED may be viewed as improvements from the point that it shows risk managing strategy and hedging activities of entities.

However, whether this disclosure can be applied in real operation from the writers' of financial statements perspectives and whether the users of financial statements do not face difficulties in understanding and interpreting the contents should be analyzed through the field test.

#### **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?**

If hedged risk is credit risk, we agree with the IASB's effort in improving the applicability of hedge accounting of this. However, we believe it is not appropriate to pursue the improvement in direction of allowing matters those are not consistent with the existing model of fair value option. For existing fair value option, this is not consistent with not retrospectively allowing withdrawal but Designating as profit or loss item at up to the extent of the initial recognition point for the all financial instruments.

If fair value option is revised to be applied limitedly for loans or loan contracts, there may be questions raised on why other items or other risks that fair value hedge accounting is applied is not allowed.

The IASB mentioned that it is not possible to apply the hedge accounting on the credit risks because the credit risk is difficult to reliably measure and separately distinguish as a background of considering the above alternative.

However, the companies practically use credit default swap as one of hedge activities in order to properly manage the credit risk. In order to accomplish the purpose of amendment which is to improve accounting standards consistently with companies' purpose and strategy of hedging activities, new model development should be pursued which can be applied in real operation and that is also consistent with the accounting model of hedge accounting and fair value option.

As a part of the new model development, we suggest in searching for a direction to match with the hedge accounting model through lessening the restrictions of fair value of fair value option (designation point, cancellation of designation, designation on part of the components).

### **Question 16**

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

- ◆ We believe 2016 as required effective date rather than 2013 is more appropriate. Setting the required effective date as 5 years after can provide sufficient preparation period. Thus, the companies can accomplish stable accounting system. Sufficient time also positively affects in improving the international comparability of companies.
- ◆ The meaning of prospective application is ambiguous when calculating the separate component of equity associated with the hedged item which is applied by cash flow hedge accounting. If inception of the hedging relationship begins under the IAS 39 and then IFRS 9 is applied, what is the standard time to calculate the separate component of equity associated with the hedged item? Is it the real inception of the hedging relationship or the application time of the IFRS 9?

### **Other comments**

- ◆ **(KASB)** Risk components of the non-financial items are not included in the scope of financial instruments. In other words, the IFRS 9 is standards related to financial instruments. However, hedge accounting includes not only financial instruments

but also non-financial instruments. Therefore, establishing separate standard related to hedge accounting is suggested rather than including standards related to hedge accounting in IFRS 9.

- ♦ **(open portfolio issue raised by banks)** The following contents of ED provided realized foundation of open portfolio

The standard to measure effectiveness of hedge is not limited to 80~125% but to comply to hedging purpose

When risk components are distinguishable and measurable, it is allowed to designate as hedged items.

Our suggestions regarding open portfolio is followed below.

Hedge purpose of open portfolio is to maintain the greeks square. The greeks can distinguish and measure. Thus, if the hedge purpose is effective to maintain greeks square, the hedge accounting without de-designation and restarting should be permitted under open portfolio. However considering risk management objective, the daily tracking requirements is needed for the hedged items and hedging instruments of open portfolio.

By comparing the accumulated OCI from the whole hedged items of portfolio and the total accumulated OCI from the whole hedging instruments of portfolio, the ineffective portion may be classified as P/L daily (For P/L, proportionally distributing on each composed items or presenting as separate items may be considered.)

- ♦ **(the issue raised by insurance companies)** When cash flow hedge accounting is applied on the foreign currency debt measured by amortized cost, we suggest in allowing derivatives that are hedging instruments to be measured as amortized cost. The hedged item is measured as amortized cost so that it is not exposed to risk of interest rate change. However for currency swap, foreign currency interest rate change and Won-currency interest rate change are presented on financial statements. Thus, in order for economic effect to be sufficiently applied on financial statements, we suggest in allowing amortized cost measurement of currency swap which is used as hedging instrument