

IASB
30 Cannon Street
London EC4M 6XH
UK
Paris, March 9, 2011

Exposure Draft ED/2010/13 Hedge Accounting

Dear Sir David,

We thank you for the opportunity to provide comments on the ED dealing with Hedge Accounting. We strongly support the IASB's intent to align risk management and accounting by proposing a more principle-based approach for hedge accounting. As regularly mentioned in our comment letters we support accounting in substance and welcome all steps toward a better recording in the financial statements of the performance of a company. In the energy industry the present ED will help to report the economic characteristics of the business more adequately and thus improve the information presented in the financial statements. We also welcome the continuation of the IASB's discussions with regard to macro hedges in a later phase of the project. Nevertheless, we think that the present exposure draft is an important step in improving the presentation of the business models and risk management strategies in the financial statements of the entities so that we strongly support the IASB's intent to issue the new requirements for hedge accounting even without having finished the deliberations on macro hedging if this is not possible in the short term.

Beyond this general approval, we do not understand why the IASB has not achieved a 100% principle-based approach and has kept some oddments of the rule-based IAS 39. We would like to raise some pending issues that are of a high importance for the preparers of the financial statements. In that perspective, we have emphasised the following main improvement areas:

- as a general statement, we believe that all economic hedge strategies should be eligible to hedge accounting on the basis of an adequate documentation. We have noticed that some items/instruments, even if deemed to be economic hedges, do not qualify for hedge accounting (e.g. instruments designated at FVTOCI under IFRS 9 are not eligible hedged items, written options are not eligible hedging instruments);
- regarding the application of fair value accounting on "own use" contracts, we think that the issue is not adequately solved and requires that the following should be considered:
 - o derivative accounting should enable the entity to adequately report the economic characteristics of its business; and
 - o it should be considered that a contract may be composed of two or more separate contracts for the purpose of the ED under certain conditions.

Furthermore, we have proposed additional guidance to the IASB to clarify some principles that were not clearly explained in the Exposure Draft. These clarifications concern the following areas:

- even if we welcome the removal of the 80%-125% bright line, we think that “achieving other than accidental offsetting” and “minimising expected hedge ineffectiveness” should be clarified;
- even if we feel that the rebalancing principle is intended to reduce complexity in applying hedge accounting, we think that this principle should be clarified.

Finally, GDF SUEZ is part of an industry association called IEAF (International Energy Accounting Forum). To be synthetic, our answers are focused on principles that should be followed with respect to hedge accounting but most of them are not illustrated by any examples. Nevertheless, we refer systematically to the IEAF illustrative examples that we fully support. On that perspective, we encourage the IASB to consider these examples as guidance testing that is deemed to measure whether the principles set out in this Exposure Draft are robust enough.

Should you like to discuss any of these matters, please do not hesitate to contact us at pascale.mourvillier@gdfsuez.com or +33 1 44 22 42 89.

Best regards

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Appendix 1: Answers to the specific questions raised in the invitation for comments on the ED Hedge Accounting

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?

We strongly support the intent of the IASB to align risk management and accounting by proposing a more principle-based approach for hedge accounting.

The purpose of financial statements is to provide useful information to their users, in particular to investors and financial analysts. Their interests lie in recurring income and real cash flows, not one-off issues. IFRS are also used by the management to monitor the business.

Both investors and management are interested in the economic view (or “risk management view”) of a company and therefore accounting entries usually labelled as “artificial” volatility should be removed from the statement of comprehensive income when analysing a company’s performance.

As a consequence, we consider that this ED represents a significant positive step forward to achieve hedge accounting, especially on the following matters:

- (a) eligibility of hedged items and hedging instruments, a.o.:
 - a. designation of specific risk components in a non-financial item;
 - b. designation of a combination of an exposure and a derivative as a hedged item.
- (b) groups of items and net positions, i.e. permitting hedge accounting for relationships other than between a single hedging instrument and a single hedged item.

To the extent that macro hedging is part of the risk management and the risk mandates (and to the extent it is documented as such, i.e. these strategies are risk-reducing), we welcome the continuation of the IASB’s discussions with regard to these issues, but – as indicated in our cover letter – we also support the IASB’s intent to issue new requirements for hedge accounting even without having finished the deliberations on macro hedging (see below our specific point on macro hedging).

- (c) Effectiveness qualification, i.e.:
 - a. no retrospective test anymore;
 - b. no “80% -125%” bright line anymore;
 - c. strong link made with risk management
- (d) Accounting for the time value of an option that qualifies for hedge accounting: accounting treatment will avoid non-economically profit or loss volatility.

Although the proposed approach is principle-based and should align accounting and risk management activities, some strategies still cannot be accounted for as hedging instruments (some written options – see our dedicated point below). We propose to

include a general statement that all economic hedging strategies on the basis of an adequate risk management documentation should be eligible to hedge accounting.

In that perspective, we are concerned about the objective of hedge accounting set out in the Exposure Draft. Indeed, according to the ED, the objective is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks **that could affect profit or loss**.

There are numerous examples where the risk management purpose is to hedge one or more risks attributable to equity instruments that will be (through IFRS 9) designated at fair value through other comprehensive income and that will therefore no longer affect profit or loss (except for dividends). The following examples would not be eligible to hedge accounting in the proposed guidance while they do represent economic hedges. We therefore believe that the intent of the IASB to make a link between risk management policy and hedge accounting is not fully reached.

On that perspective especially, the Board wrote that *"extending eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems and be inconsistent with its decision not to allow hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income"* (IN 15).

Especially, we feel that the arguments in the Basis for Conclusions are not strong enough to disable equity instruments designated at fair value through OCI (under IFRS 9) to be eligible hedged items.

Among others, BC25 refers to ineffectiveness: *"Conversely, if the hedge ineffectiveness were recognised in profit or loss it would:*

- (a) be consistent with the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss; but*
- (b) contradict the prohibition of reclassifying from other comprehensive income to profit or loss gains or losses on investments in equity instruments accounted for as at fair value through other comprehensive income".*

We believe that hedge ineffectiveness cannot be considered as a gain or loss on investments in equity instruments accounted for as at fair value through other comprehensive income (if it relates to a CFH relationship) but rather as a gain or loss on an instrument that is a hedging instrument. It is a characteristic of hedge accounting to deviate from the "normal" accounting principles.

As a consequence, we ask the IASB to reconsider the objective of hedge accounting so that it fits to all economic hedge strategies, i.e. not only those that manage exposures arising from particular risks that could affect profit or loss.

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?

Yes, we agree.

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?

Yes, we agree and again strongly support the intent of the IASB to align risk management and accounting by removing inconsistent rule-based measures from IAS 39.

Nevertheless, we do not know how the IASB intends to deal with derivatives that are embedded in a host contract. In particular, we would like to ask the IASB to clarify the accounting treatment of the following example:

- IFRS 9 phase I has retained the IAS 39 guidance on the embedded derivatives on non-financial items;
- An entity is selling electricity at floating price. The indexation is based on both coal and gas. The assessment of the entity is that the contract contains an embedded derivative that should be accounted for at fair value through profit or loss, separately from the host contract;
- The risk management objective is to hedge the coal/gas exposure by concluding swaps. The exposure is then composed of a highly probable transaction and a derivative (embedded derivative more precisely). This combination should be eligible to hedge accounting according to the ED ;
- What would be the accounting treatment of such a situation since in IAS 39, a zero net P&L effect is achieved (the change in fair value of the embedded derivative perfectly offsets the change in fair value of the economic hedging instrument)?

On that matter, we would appreciate if the IASB could handle this issue with respect to the risk component (we refer to Q4) so that the accounting treatment proposed would be appropriate under all aspects.

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?

Yes, we strongly agree.

We strongly support the intent of the IASB to align hedge accounting requirements for both financial and non-financial items.

As we have explained in the past, it is important to have a close match between the operational hedging strategy of an entity and its financial reporting. That is why we think that hedge accounting should be applicable where hedging is economically justified and adequate documentation is provided.

Designation of a 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?*

(a) designation of a layer of the nominal amount

Yes, we agree since this improvement ensures that risk management policy will be adequately translated into accounting.

(b) restriction in a layer component that includes a prepayment option

We are concerned that although the IASB intends to apply a principle-based approach it has nevertheless introduced new restrictions in its proposed guidance. And particularly, arguments used in BC69 are similar to those used to exclude specific risk components in a non-financial item in IAS 39.

BC69: "(...) The Board noted that if the prepayment option's fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how hedge effectiveness would be measured)".

We would rather propose a positive principle-based approach explaining that a layer component including a prepayment option is eligible to hedge accounting only to the extent that the risk component can be separately identifiable and meets all the requirements to be accounted for as such.

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?

We welcome the removal of the 80%-125% bright line test to assess whether the hedging relationship qualifies for hedge accounting.

We support the IASB's view to link risk management objectives with hedging documentation in par. 19 of the ED:

Furthermore, the ED requires that the hedging relationship should meet the objective of the hedge effectiveness assessment and **is expected to achieve other than accidental offsetting**. The objective of the hedge effectiveness assessment is to ensure that the hedging relationship will produce an unbiased result and **minimise expected hedge ineffectiveness**.

1. Achieving other than accidental offsetting

On that topic, there needs to be some sort of high-level conceptual requirement for statistical support when not hedging the exact forecasted item (that is when we use proxy hedging instruments). While we all agree that the 80-125 bright line test should be removed, the ED is not strong enough to lead to an appropriate interpretation of that criterion.

2. Minimising expected hedge ineffectiveness

On that topic and subject to our first point expressed above, we believe that the IASB should clarify that since the entity should rely on its risk management to determine the hedging instrument, the hedging instrument will not necessarily be the most effective but could be an alternative instrument¹ (because it will be traded in a more liquid market or that is less expensive). Otherwise, some could believe that minimising ineffectiveness is not achieved if other more effective instruments exist on the market.

The fundamental objective of any risk management policy is **risk reduction**, as it is not always possible to know 'ex-ante' whether hedging strategies adopted by the risk management will actually succeed in minimising expected hedge ineffectiveness. Therefore, minimising hedge ineffectiveness as well as achieving other than accidental offsetting should be presumed when the transaction is part of the risk management strategy.

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

¹ Often referred as a proxy

hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

- (b) *Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?*

We strongly support the IASB in its efforts to align risk management objectives with hedge accounting and therefore agree with the proposed approach subject to what follows.

Accounting consequences of rebalancing

Even if we feel that the rebalancing principle is intended to reduce complexity in applying hedge accounting, we ask the IASB to clarify this principle with respect to the application guidance that is provided in B46-60 and that should follow the way we interpret it.

On that topic, we refer to question 7 and appendix 2 of the IEAF comment letter that GDF SUEZ fully supports.

Regarding the risk management objectives

We strongly support the link made between risk management objectives and accounting.

We have noted that concepts such as risk management policy/objective or change in risk management policy/objective are not defined in the Exposure Draft. Since we believe that entities should use judgment to assess whether the risk management objective does remain or not the same for the hedging relationship and should rely on strong internal controls to make sure that (**and how**) risk management objectives are put in place, we ask the IASB to confirm that this assessment is subject to judgment.

According to us, a change in the external/internal environment (change in prices, demand, production capacity...) will trigger an assessment of whether the entity's risk management objective has changed but will not automatically lead to a change in the risk management strategy.

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?*

(a) Discontinuance of hedge accounting when hedging criteria are no longer met

Yes, we agree that an entity should discontinue hedge accounting when the hedging relationship ceases to meet the qualifying criteria.

(b) Discontinuance of hedge accounting when hedging criteria are still met

We do only agree on that principle **if and only if** all economic hedging strategies were eligible to hedge accounting on the basis of an adequate documentation (which is not totally the case in this Exposure Draft). Please refer to answer to Q1.

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?*

As a general comment, we strongly support the intent of the IASB to retain a dedicated accounting treatment for fair value hedges. Indeed, we believe that the underlying fundamentals of fair value hedges are quite different from cash flow hedges since:

- cash flow hedges are related to highly probable transactions that are not yet accounted for;
- while fair value hedge accounting (except for unrecognised firm commitments – for which we agree that this represents a “strange animal”), applies to items that are already recognised in the statement of financial position.

Furthermore, alignment to one single hedge accounting model (no revaluation of the hedged item):

- would really have made it difficult to identify the type of risk management strategy applied by the entity;
- would have led to volatility in other comprehensive income.

(a) fair value hedge mechanics

We believe that the introduction of a two-step approach (recognising all changes in fair value of both hedged items and hedging instruments in other comprehensive income and then recycling immediately ineffectiveness into profit or loss) does not add any value. Furthermore:

- there is no rationale/principle that supports the recognition of the gain or loss of the hedged items and hedging instruments in other comprehensive income;
- the immediate reclassification of ineffectiveness from other comprehensive income to profit or loss is in substance not a change compared to IAS 39 which already requires ineffectiveness to be recognised in profit or loss.

We furthermore do not believe that the proposed approach has eliminated the mixed measurement for the hedged item since the total amount that would be accounted for according to the ED (hedged item + the gain or loss on the hedged item attributable to the hedged risk) is not different from the amount recognised under IAS 39.

As a consequence, we ask the IASB to reconsider the cost-benefit of this measure that does not depart significantly from IAS 39 (we believe that IAS 39 mechanics should remain) and that would not reduce complexity in applying hedge accounting.

(b) presentation of the gain or loss of the hedged item on a separate line

Even if we agree that the proposal intends to avoid a measurement attribute that is neither at amortised cost nor at fair value, we however ask the IASB to reconsider the use of a separate line for the following reasons:

- we fear that most of these separate assets and liabilities (those related to the gain or loss on the hedged items attributable to the hedged risk) would not meet the definition of an asset or liability according to the framework in themselves but should rather be related to another asset or liability;
- this information in itself (i.e. in the statement of financial position) is not necessary to understand the risk management policy of an entity since it is redundant with the information provided in the disclosures. On the contrary, in the case of an entity that uses hedge accounting for several asset and liability items, it would lead to a huge number of additional line items which would make the statement of financial position look complex and confusing.

(c) linked presentation

Yes, we agree. Linked presentation would not reduce complexity in preparing financial statements when risk policy is complex and would be redundant with the information provided in the disclosures.

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?*

As a general comment, we strongly support the IASB in its intent to align efficient business decisions with accounting. Indeed, the accounting treatment of time value under IAS 39 has often led the entities to avoid the use of option derivatives for the benefit of derivatives such as forward contracts or swaps that were often considered less optimal economically (giving away upside as well as protecting downside risk), but more optimal from an accounting perspective.

However, we feel that the proposed accounting treatment is sometimes complex (see our comments below) and we would propose the IASB to eventually reconsider it with respect to DIG issue G20 in US GAAP that actually deals with options very well and that could be used as a framework.

Furthermore, we have understood from our meeting with Board Member Philippe Danjou and Bob Garnett that the guidance applicable to the time value of an option will also be applicable for the time value of a forward contract (interest element). However we believe that this clarification is needed in the final draft. Therefore, we propose that the guidance related to the accounting treatment of time value of an option should be applied by analogy to the interest element of a forward contract.

(a) transaction related hedged items

Yes, we agree with the proposed approach since the accounting treatment related to time value in IAS 39 was disconnected from risk management. Indeed, risk management typically considers the time value of an option as a cost of hedging. As the Board has noted in BC144, *"it is a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes"*.

Furthermore, reclassification as a basis adjustment (in case of a recognition of a non-financial asset) or in profit or loss when the hedged item affects profit or loss, ensures a matching principle.

(b) period related hedged items

Yes, we agree with the proposed approach. Such as for the transaction-related hedge relationship, this accounting treatment avoids volatility in profit or loss and ensures a coherent matching principle that was otherwise not reached in IAS 39.

(c) align time value issue

Even if we understand the underlying economics of such an accounting treatment, we are concerned that this would (usually) add unnecessary complexity when applying hedge accounting.

Actual time value larger than aligned time value

On the particular case of actual time value larger than the aligned time value, we believe that this will have few impacts in reality since the risk management is not likely to conclude a hedging instrument with a premium that is larger than the premium that would have been paid with another existing hedging instrument. We also suggest that the IASB clarified that this would only be the case if the alternative instrument (with aligned time value) can be reliably measured.

Actual time value smaller than aligned time value

On the particular case of actual time value smaller than the aligned time value, we ask the Board to reduce complexity of accounting treatment so that the “lower of cumulative variation” principle (as it is explained in the ED) applies in such a way that if the actual time value of the hedging instrument is lower than the time value of the aligned instrument, all the change in the MtM of the time value would be recognised in other comprehensive income.

Hedges of a group of items (1)

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?

Yes, we agree and strongly support the overall proposal of the IASB to extend hedge accounting to groups of items and net positions.

Furthermore, to the extent that macro hedging is part of the risk management and the risk mandates (and to the extent it is documented as such, i.e. these strategies are risk-reducing), we welcome the continuation of the IASB’s discussions with regard to these issues, but – as indicated in our cover letter – we also support the IASB’s intent to issue new requirements for hedge accounting even without having finished the deliberations on macro hedging.

Furthermore, we are concerned about the fact that the IASB – while it has intended to fully align risk management and hedge accounting – continues to pursue an accounting approach

based on individual items. We believe that interpretation of this guidance will lead to diversity in practice. Indeed:

according to BC178 of the ED, “The Board considered how an entity that applies net position hedge accounting should identify the hedged item. The Board concluded that an entity would need to designate a combination of gross positions if it were to apply the hedge accounting mechanics to the hedged position. Consequently, the Board decided that an entity could not designate a merely abstract net position (ie without specifying the items that form the gross positions from which the net position arises) as the hedged item”.

We instead believe that an entity will designate **a net position**. But for internal control purposes, it would need to know the items that constitute this net position. Indeed, designating the net position will avoid confusion.

Hedges of a group of items (2)

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?

Yes, we agree with the proposal to present on a net basis in a separate line the gains or losses attributable to the hedging instruments. That would indeed avoid artificial grossing up of gains or losses.

We are however concerned that this principle does not apply to fair value hedges where the proposal requires that the gain or loss shall be presented on a gross basis next to each line item that includes the related asset or liability. Since the disclosures provide the users with sufficient information about the risk management policy (and its consequences in the financial statements), we believe and ask the IASB that the change in fair value should be aggregated into a single line in the statement of financial position.

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?*

Yes, we agree that the disclosures play a fundamental role in understanding the risk management policy of an entity. We also support the IASB that intends to require more judgment compared to IAS 39 (paragraph 40-43).

On that perspective, we would like to draw the attention of the IASB on the importance of use of judgment and therefore would like that these points are emphasised:

- leaving the disclosures “up to” the judgment of the entity is crucial since disclosing all existing information directly or indirectly linked to hedge accounting would “drown” the users of financial statements especially in a situation when the entity has many and often complex activities;
- using judgment will also enable the entity to make a trade-off between existing disclosures already foreseen in its reference document (that includes consolidated financial statements but also – due to regulatory reasons – disclosures on risk management) so that some information do not become redundant because of a rule-based approach on disclosures;
- at last, judgmental approach will ensure that a trade-off is made for confidentiality purposes. In this respect, we are concerned that the disclosure requirements will lead to the publication of sensitive information about the entities’ business strategies. This is in particular true with regard to the provisions concerning the amount, timing and uncertainty of future cash flows, which require to disclose detailed quantitative information about the risk exposures of the entities.

In addition, we would emphasise the entity should consider the level of detail necessary to satisfy the general objectives and how much emphasis to place on each of the requirements. This would avoid rule-based interpretation of the requirements (paragraphs 44-52 being understood as a checklist to be fully filled in by each entity) and would rather enable the entity to prepare a relevant information to the users of financial statements.

At last, we are concerned about the wording used by the IASB and which reinforces this “checklist” approach, i.e. the wording “shall” is used instead of “may or may not”.

Accounting alternatives to hedge accounting (1)

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?

Again, we strongly support the intent of the IASB to align risk management and accounting by proposing a more principle-based approach to report the economic characteristics of the entity’s business.

In that perspective, we appreciate that – while this Exposure Draft mainly deals with hedge accounting – the IASB tries to improve own use exception.

Indeed, referring to the position paper² that the IFAF has sent to you end of 2009, we believe that reflecting the economic characteristics of the entity’s business will be achieved by

² IAS 39 IFAF Position Paper on Financial Instruments, September 2009

improving not only the current hedge accounting model but also the own use accounting model.

As a reminder, the following points related to own use application have been raised in the IEAF position paper:

1. accrual accounting for contracts to buy or sell a non-financial item:

- a) application of accrual accounting should be possible if net settlement is due to operational or market constraints;
- b) if an entity has similar contracts with different business purposes, the entity should irrevocably confirm their purpose through designation at inception as “at fair value through profit and loss” or as “in accrual accounting” in accordance with the entity’s expected purchase, sale or usage requirements;
- c) composed contracts can be considered as two or more separate contracts for the purpose of IAS 39 under certain conditions.

2. written options:

- a) application of accrual accounting should be possible if the written option concerns a volume flexibility in response to changes in demand resulting from operational or market constraints;
- b) for the “closely related” concept, we would like to add extra examples related to commodity contracts, in order to provide clear application guidance for commodity contracts as well as for financial items.

Coming back to the IASB’s proposal and especially IN 44 and appendix C, we appreciate that the IASB has rightly noticed that current IAS 39 framework was not totally appropriate for own use contracts. However, we feel that the issue is unclearly defined (what would IAS 32.8 definitely look like?) and does not take all business aspects into account.

Therefore, since this topic is very crucial for the industry, we propose an alternative to the IASB to solve the own use issues in a better way.

1. Confirmation that accounting treatment should be based on management purposes

We agree that if an entity has similar contracts with different business purposes, the entity should confirm their purpose through designation as “at fair value through profit or loss” or as “in accrual accounting”.

Indeed, for most utilities in the energy market the use of energy commodity contracts is mainly twofold:

- 1) To provide a physical contract to sell expected generation and purchase for retail demand in the energy market. Those contracts are intended for physical delivery and are not net settled for the purpose of short-term profit making (type 1).
- 2) To optimize its “assets” (power plants, storage capacities, long term contracts...) (type 2).

In that perspective, we support the intent of the IASB to demonstrate that “own use” contracts and “fair value managed” contracts are dissimilar. This dissimilarity by different business purpose can indeed be demonstrated through the use of appropriate organizational and portfolio structures, risk management policies and procedures.

2. Need of more adequate “unit of account” of a contract

In our opinion, this issue is not adequately solved since it results from the proposal that fair value accounting would apply mandatorily to any own use contract that is managed on a fair value basis.

As an alternative, we believe that this issue would be more adequately solved if:

- (a) derivative accounting should enable the entity to adequately report the economic characteristics of its business; **and**
- (b) if it can be considered that contracts may be composed of two or more separate contracts for the purpose of the ED under certain conditions.

(a) Derivative accounting to report economic characteristics of a business

Applying derivative accounting for contracts that otherwise meet all requirements for application of the “own use” exception should only be allowed when it is deemed to adequately report the economic characteristics of the entity’s business. This application would avoid volatility in profit and loss in some situations. This is especially occurring when contracts are managed together with assets that are not in the scope of IAS 39 and are not fair valued (example: power plant accounted for according to IAS 16).

On the other hand, there are cases where it can make sense to apply the same accounting treatment to all contracts within a portfolio. This could be the case when for example electricity or gas supply contracts have to be fair valued because part of the volume is economically managed by using derivatives. In this case, it could be appropriate to fair value physical supply contracts to end-customers that actually qualify for own use accounting under IAS 39 at fair value as well in order to avoid accounting mismatches.

As a consequence, we propose that fair value accounting is applied to own use contracts for the purpose of avoiding accounting mismatches. This principle would be similar to the fair value options for financial assets and financial liabilities as governed by IFRS 9 par. 4.1.5 and 4.2.2.

(b) Composed contracts issue

Furthermore, commodity contracts often contain some volume flexibilities, and in some circumstances³ it would be appropriate to consider them separately from the rest of the contract. For long term commodity purchase or sales contracts, it can also be appropriate to consider different blocks of volumes within one single contract.

³ This separation should be analysed on case-by-case basis since volume flexibilities can fit with different management strategies, i.e. one being made for “own use” purposes and others being concluded for optimization purposes (and managed therefore based on its fair value).

The separate treatment can be adequate because of a different business purposes, e.g. physical delivery for own use purposes of a fixed quantity and profit-taking activities for an additional optional volume (so that accrual accounting for one part and fair value accounting for another part is possible), or because of a different hedging strategy that will be applied to the different components of a contract.

We have noted that the IFRIC received in January 2010 a (quite similar) request to add an item to its agenda on providing guidance on whether a contract can be seen as two separate contracts for the purpose of applying paragraphs 5-7 of IAS 39. At that time, the IFRIC decided not to add this issue to its agenda arguing that the IASB would answer it through its project to replace IAS 39. This request has not been taken into account in the ED proposal.

As a consequence, we propose that the following would be added to paragraph 8 of IAS 32 and would replace the ED proposal:

For the purpose of this Standard, a composed contract to buy or sell a non-financial item can be considered as two (or more) separate contracts under the following conditions:

- a) the contract has two (or more) components that could have been the subject of two (or more) separate contracts, which together would have had exactly the same impact as the composed contract*
- b) the cash flows and the risks of the separate components can be clearly identified and measured*

The choice to consider such a contract as two (or more) separate contracts has to be made at inception and cannot be revised afterwards.

Accounting alternatives to hedge accounting (2)

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?*

We believe that prohibiting hedge accounting for credit risk is a rule-based measure that does not fit to the objectives followed by the IASB. Rather, we would propose that hedge accounting should be applied if all criteria are otherwise met (i.e. eligibility of hedged item, consistency with risk management...).

However, we acknowledge that it may be difficult to achieve hedge accounting in practice for the reasons raised in the ED (hedge item cannot be reliably identified and measured). Therefore, we support the IASB in its efforts to investigate further in the development of the proposed alternatives.

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?

No, we do not agree with the proposal.

We instead propose to the Board to ask for an elective transition (either prospective or retrospective) that will enable the entity to

- either prospectively adopt requirements of hedge accounting.

Rationale behind this decision is coming from the significant change induced by the proposal;

- or to retrospectively adopt requirements of hedge accounting.

We believe that the argument in BC249 (“(...). *However, in accordance with the proposals, a hedge accounting relationship can be designated only prospectively. Consequently, retrospective application is not applicable*”) is not appropriate. Rather we believe that retrospective application of the standard enables the entity to come-back at inception of the hedge and therefore allows it to prospectively designate hedging relationship. As far as retrospective application is practicable, only retrospective application will achieve an understanding of the performance and the risk management strategy of the entity at first application of the ED (see following example).

We think that an entity should generally apply the new requirements for hedge accounting prospectively, unless retrospective application would be practicable and allow for a better representation of the entity's business model in the financial statements, i.e. when the retrospective application would directly reinforce the link between risk management policy and (hedge) accounting.

At last, we believe that transition requirements are moreover not clear enough and we are not sure to understand how the following example should be treated (simplistic assumptions have been taken).

Example:

Let us assume that the entity has a forecast transaction to purchase gas at a floating price (the gas will be delivered at 31/12/N+2). According to its risk management policy, the entity decides to protect itself against the exposure to changes in the variable price associated with this forecast transaction by concluding a swap to fix the price (01/01/N). The hedged price is 20 CU.

Following dates are considered in this example:

31/12/N = closing date where IAS 39 criteria are applied

31/12/N' = restatement of 31/12/N according to IFRS 9 principles

01/01/N+1 = effective date of IFRS 9

31/12/N+1 = first closing date after IFRS 9 is applied

31/12/N+2 = settlement of both hedged item and hedging instruments

(a) prospective application

Since the entity is hedging only one component of the pricing formula, it cannot apply hedge accounting under IAS 39 (while all other criteria are met) so that the economic hedging instrument is accounted for at fair value through profit or loss.

At the application date of the ED (01/01/N+1), the risk being economically hedged can be designated in a hedging relationship. It is considered that the hedging instrument is designated in a CFH relationship as of that date.

| | 31/12/N | 31/12/N+1 | 31/12/N+2 |
|---|---------|-----------|-----------|
| Market price of underlying | 25 | 30 | 30 |
| Change in FV of hedged item | <5> | <10> | <10> |
| Change in FV of hedging instrument | 5 | 10 | 10 |
| "+" = gain ; "-" = loss | | | |
| <u>Statement of financial position</u> | | | |
| Derivative | 5 | 10 | 0 |
| Cash | 0 | 0 | 20 |
| Retained earnings | <5> | <5> | <20> |
| Accumulated OCI | 0 | <5> | 0 |
| <u>Income statement</u> | | | |
| Sales | 0 | 0 | 0 |
| Purchases | 0 | 0 | 30 |
| Recycling of hedging instruments | 0 | 0 | <10> |
| Current operating income | 0 | 0 | 20 |
| Mark-to-Market on commodity contracts | <5> | 0 | 5 |
| Net income | <5> | 0 | 25 |
| "+" = debit ; "-" = credit | | | |

GDFS comment:
Either recycling from OCI or reclassification from "Mark-to-Market on commodity contracts" P&L line

At 31/12/N+2 (date of settlement of both hedged item and hedging instrument), we observe that the net profit or loss impact (25 CU) does not correspond to the "hedged price" (20 CU in this illustrative example).

b) retrospective application

Allowing retrospective application would result in accounting for a "net purchase" of 20 CU which is the hedged price:

| | 31/12/N ¹ | 31/12/N+1 | 31/12/N+2 |
|--|----------------------|-----------|-----------|
| Market price of underlying | 25 | 30 | 30 |
| Change in FV of hedged item | <5> | <10> | <10> |
| Change in FV of hedging instrument | 5 | 10 | 10 |
| "+" = gain ; "-" = loss | | | |
| Statement of financial position | | | |
| Derivative | 5 | 10 | 0 |
| Cash | 0 | 0 | 20 |
| Retained earnings | 0 | 0 | <20> |
| Accumulated OCI | <5> | <10> | 0 |
| Income statement | | | |
| Sales | 0 | 0 | 0 |
| Purchases | 0 | 0 | 30 |
| Recycling of hedging instruments | 0 | 0 | <10> |
| <i>Current operating income</i> | 0 | 0 | 20 |
| Mark-to-Market on commodity contracts | 0 | 0 | 0 |
| Net income | 0 | 0 | 20 |
| "+" = debit ; "-" = credit | | | |

GDFS comment:
Either recycling from OCI or reclassification from "Mark-to-Market on commodity contracts" P&L line

As a conclusion, not allowing fully retrospective application would necessarily pollute the financial statements (and more particularly the net result) for a quite long time (the time necessary for the non-designated hedging instruments to settle).

Our other concerns

1. Written options

a. use of written option as hedging instrument

We believe that written options should also qualify as hedging instruments if they are designated as an offset to purchased options or to owned assets that have similar characteristics.

Power generating assets, such as gas-fired power plants, represent real options for the owner of the plant because of the flexibility to let them run or not, based on the prevailing market prices. The embedded option in a gas fired-power plant can be referred to as a Clean Spark Spread Option⁴. Therefore, the revenues generated from a gas fired power plant can be characterized as a portfolio of clean spark spread call options.

It is customary to identify different economic hedging strategies that will achieve a risk-reward level consistent with the owner's risk aversion:

1. Fixed-price electricity and natural gas contracts such as forward contracts and swaps.

⁴ The annotation 'Clean' refers to the inclusion of costs for CO2 into the plants economic value calculation.

These hedging strategies will usually meet the criteria to be accounted for as hedging instruments in a cash flow hedge relationship.

2. Tolling agreements⁵

These tolling agreements are often favoured by risk-averse entities who prefer to lock-in the capacity revenues. These are usually options with characteristics very similar to that of the power plant and are best described as “**synthetic power plant**”. This economic hedging instrument is rarely in the scope of IAS 39 and is therefore accounted for on an accrual basis.

We believe this accounting treatment is also appropriate.

3. Financial spark spread options, call/put options on electricity and on natural gas

The entity may have the market view that the electricity and natural gas prices will diverge, resulting in high natural gas prices and low electricity prices. That means an increase in the spark spread risk for the power plant. In this case, the entity will choose to sell electricity call options that pay out to the buyer when prices rise above the contracted strike power price. The entity can then use a portion of the sales proceed to purchase natural gas call options to protect against a rise in fuel costs.

This sale of options may not achieve hedge accounting in all circumstances, neither in IAS 39 nor in the ED.

Since all strategies are entered into to reduce entity's risk (even if using different ways) and are considered as economic hedges by risk management, we believe that all should be eligible to hedge accounting.

b. Guidance on written options is not clear

As it has sometimes led to issues when applying hedge accounting to certain (not net) written options, we would appreciate if the IASB clearly clarifies that a written option can qualify as hedging instrument if it aims to offset a purchase option (and when the combination does not constitute a net written option). Indeed we believe that paragraph 11 of the ED is misleading and is not clarified by any application guidance so far:

- *“However, a derivative instrument that combines a written option and a purchased option (eg an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option*
- *Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only **if none of them** is a written option or a net written option.”*

We also suggest that judgment should be applied to assess whether a combination of a purchased option and a written option in substance constitutes a net written option. Compared to application guidance F.1.3. of IAS 39 and since hedge accounting has been sometimes

⁵ A tolling contract is essentially an option, whereby Party A sells to Party B the right to ‘call’ power from Party A in exchange of cash and gas and EUAs (CO2 allowances) delivered by Party B to Party A on the expiry date.

difficult to apply (while economically justified), we believe that the most relevant factors in this assessment would be the following:

- except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date).
- the notional amount of the written option component is not greater than the notional amount of the purchased option component.

Indeed, we believe that the “net premium paid” criterion is highly subject to discussions and sometimes leads to disqualification of hedge accounting while the structure is economically hedging a risk. Furthermore, it would be appropriate to consider this criterion of net premium as the net cost of hedging so that accounting is aligned with risk management.

2. Net position not allowed under this ED

Again, to the extent that macro hedging is part of the risk management and the risk mandates (and to the extent it is documented as such, i.e. these strategies are risk-reducing), we welcome the continuation of the IASB’s discussions with regard to these issues, but – as indicated in our cover letter – we also support the IASB’s intent to issue new requirements for hedge accounting even without having finished the deliberations on macro hedging.

We are also concerned that the arguments used to disallow hedge accounting for a net position in which the hedged items affect profit or loss in different periods are not robust enough. Among others, we point out BC169-173 explaining that allowing hedge accounting – and therefore deferring recycling of part of the MtM recognised in OCI – would be a “*significant departure from general IFRSs regarding the items that result from the forecast transactions*”. We believe instead that the issue has not been explored sufficiently and that the reasoning behind this decision requires a better explanation.

Moreover, as an alternative, we believe that in some situations hedge accounting should still be achieved (as it was in IAS 39):

Example

An entity has a net position of FC50 consisting of forecast purchases of FC150 in 12 months’ time and forecast sales of FC100 in 20 months’ time. This could be hedged for 12 months using a forward foreign exchange contract under which the entity receives FC50 and pays CU25 (i.e. a 2:1 forward exchange rate).

Even if the net position consists of transactions that do not impact the profit and loss at the same reporting period, the entity will correctly argue the following:

- risk management is to hedge FC50 purchases out of FC150 in a 12 months period in accordance with par. 35 of the ED (designation of a component of a nominal amount);
- risk management is to leave at that moment the remaining position unhedged (i.e. remaining FC100 purchases and FC100 sales);

As a conclusion, hedging FC50 purchases should be still possible in that case since this transaction corresponds to the risk management policy that intends to achieve optimal offsetting and minimise ineffectiveness.

We ask then to the IASB to clarify accounting treatment in such a case.

3. Hedges of a net investment in a foreign operation

We are concerned about the lack of clarity of this ED with respect to the improvements made to hedge accounting and that are closely linked to net investment hedges. Especially, we would appreciate that the IASB clarifies that the following also applies to NIH.

According to paragraph 15, the Board has decided that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item (see also question 3).

There are some situations where the hedging instrument in a NIH relationship is also the hedged item in a CFH relationship. We believe that the principle-based approach set out for cash flow and fair value hedging should also be applied for net investment hedge.

4. Sub-libor issue

We are concerned about the restriction that mentioned in B24 that if a component of the cash flows of a financial asset or financial liability is designated as the hedged item, that component must be less than or equal to the total cash flows of the asset or liability (e.g sub-libor example).

We think that this restriction is rule-based. Our industry would only be impacted by such a rule when commodity transactions become financial assets or liabilities (this is the case when an own use transaction does no longer qualify for own use, e.g. because of practice of net settlement). On that discrepancy especially, we believe that two contradictory accounting models should not remain and since we think that this restriction is rule-based, we would like to ask the IASB to remove it.

5. Hedging a forecast transaction to acquire a business

We have listed the following paragraphs available in the ED regarding transaction to acquire a business:

B7 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.

BC118 The Board did not consider new designations of any hedging relationships of the acquiree in the consolidated financial statements of the acquirer following a

business combination. The Board noted that this is a requirement of IFRS 3 Business Combinations and hence not within the scope of its project on hedge accounting.

We are concerned about the fact that some could interpret these paragraphs as a restriction to apply hedge accounting when an entity decides to protect itself against the exposure to changes in the foreign exchange rate associated with the forecast transaction to acquire a business.

Even if we agree that the highly probable criterion would not be met in some cases, we however think that there is no rational basis to exclude a transaction from hedge accounting through a rule-based approach to the extent that all criteria in the ED are met (being especially highly probable forecast transaction and consistency with risk management policy).