March 9, 2011
The International Accounting Standards Board
30 Cannon Street
London, United Kingdom
EC4M 6XH

IASB Exposure Draft Hedge Accounting

The Committee on Corporate Reporting (CCR) of Financial Executives International Canada (FEI Canada) is writing to provide its response to the International Accounting Standards Board (IASB) Exposure Draft (ED) Hedge Accounting.

FEI Canada is the all-industry professional membership association for senior financial executives. With eleven chapters across Canada and more than 2,000 members, FEI Canada provides professional development, thought leadership and advocacy services to its members. The association membership, which consists of Chief Financial Officers, Audit Committee Directors and senior executives in the Finance, Controller, Treasury and Taxation functions, represents a significant number of Canada's leading and most influential corporations.

CCR is one of two national advocacy committees of FEI Canada. CCR is devoted to improving the awareness and educational implications of the issues it addresses, and is focused on continually improving the standards and regulations impacting corporate reporting.

We welcome the opportunity for financial statement presentation to better reflect risk management strategy and believe these principle-based standards are an improvement over existing standards. We are concerned, however, that the ED does not provide sufficient application guidance to permit financial statement preparers to determine the appropriate accounting for some transactions. Our responses to the specific questions include examples where we believe additional clarification is needed.

We do not agree with the proposal to remove or significantly limit an entity's ability to voluntarily discontinue hedging relationships. Risk management is dynamic and fluid and, as a result, a designated hedge could meet the qualifying criteria for effectiveness without remaining optimal for a specific risk management strategy. In these situations, rebalancing of the hedge ratio may not be optimal. Rather the discontinuation of the existing hedge and commencement of a new hedge might better optimize the risk management strategy.

Finally, we are concerned that several significant technical items within this ED differ from the FASB's Financial Instrument ED issued in May 2010. We encourage both the IFRS Foundation and the IASB to work with the US FASB in converging IFRS and US GAAP in order to promote comparability of financial statements.

Thank you for the opportunity to provide input to the IASB's deliberations on hedge accounting. We believe that additional application guidance and clarification is needed and therefore we recommend that the Board consider re-exposing the standard concurrent with the proposals for

macro hedging rather than rush towards a June 30th deadline. Appendix 1 includes our responses to the specific ED questions.

Yours very truly,

Tyrone Cotie
Chair
Committee on Corporate Reporting
FEI Canada

Appendix 1
Answers to Specific Questions

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 agree with the proposed objective of hedge accounting. We recognize the difficulty in creating a standard for hedge accounting without reference to quantitative guidance. As financial statement preparers, we recognize that most hedging programs are not designed to address enterprise-wide risks but rather specific risks such as fluctuating interest rates, foreign currencies or commodity prices. While laudable in theory we believe that this ED may not fulfill the objective of presenting an entity's risk management objectives if the standard abjures its responsibility of presenting rules to address specific transactions. In the absence of such clarification management may be subject to challenge from external parties such as auditors, regulators and investors as various entities prepare financial statements based on divergent assumptions.

We believe it is unclear from the ED what constitutes a closed vs. open portfolio. The addition of a scope section with definitions and examples (including examples of non-financial hedging arrangements) could provide more clarity of the Board's intended distinction between open and closed portfolio hedges. The basis for conclusions should clarify that open or macro portfolio hedging is a term utilized in the current IAS 39 standard that relates to fair value hedge accounting for a portfolio of interest rate risk hedging, and the forthcoming macro hedge accounting ED will also encompass a variety of dynamic hedging activities including non-financial hedge relationships. In addition, we believe both open and closed portfolios should be addressed within the same standard or ED in order for hedge accounting to holistically reflect an entity's risk management strategy and aid preparers in analyzing all accounting requirements.

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 with the proposals and believe that the ED will expand the range of transactions that may be accounted for with hedge accounting and better align accounting treatment with an entity's risk management strategy.

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?

We agree with the proposals and believe that the ED will expand the range of transactions that may be accounted for with hedge accounting and better align accounting treatment with an entity's risk management strategy.

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 (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We agree with the proposals and believe that the ED will expand the range of transactions that may be accounted for with hedge accounting and better align accounting treatment with an entity's risk management strategy.

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 that an entity should be allowed to designate, as a hedge, a layer of the nominal amount as there are situations where a layer approach would better reflect the entity's risk management activities.

The layering approach is typically used by financial institutions for cash flow hedge relationships. It should also be noted that the risk management strategies of financial institutions are generally open portfolio strategies. Therefore, our comments on the proposals in this ED will also depend on the hedge accounting project relating to macro hedging. It is difficult to fully comment on the proposals contained in this ED without a clear and complete view of all proposals relating to hedge accounting.

Commodity producers also use a layering approach for designating cash flow hedges of commodity prices. As daily production volumes can fluctuate, this makes designations based on percentages impractical.

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 disagree with this proposal as it restricts hedge accounting for the management of interest rate risk. Specific interest rate management examples that appear to be disallowed under the ED include:

- Mortgage agreements in Canada may include prepayment options that allow borrowers the option to prepay a portion of their mortgage annually without penalties. Exercising a prepayment option is not correlated to market behaviors on interest rates.
- Entities may issue debt that contains provisions for early repayment subject to "make whole" payments. The existence of the ability to make early repayments does not impact interest rate volatility, and therefore should not preclude hedge accounting as long as the debt remains outstanding.

We believe that a principle-based standard should not restrict hedge accounting simply because an instrument includes a prepayment option.

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 agree with the proposed hedge effectiveness criteria in paragraph 19 of the ED. The elimination of the 80-125% "bright line" requirements for assessing hedge effectiveness allows companies to hedge in accordance with their risk management objectives which may not have been possible under the current rules. This change will require modification to hedge documentation, systems and procedures. However, although we support the shift to a principle-based standard, we believe that additional clarification is required to assist entities in determining appropriate measures of hedge effectiveness and ineffectiveness.

The ED focuses on using a hedge ratio to minimize expected ineffectiveness. The exposure draft does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements, including determination of the hedge ratio. Although we agree that an entity should use a method that captures the relevant characteristics of the hedging relationship we feel that additional guidance and examples should be provided in the ED, particularly for non-financial hedging relationships where critical terms are not closely aligned and the ratio is other than 1:1. Difficulties may arise in application of the hedge ratio concept to non-financial hedging relationships. We support the concept in theory but require further clarification on the level where the hedge ratio is applied, for example is it on the entire group portfolio, each layer of that portfolio, or based on each individual hedge? Based on discussions with IASB staff, this appears dependant on the hedge strategy and accordingly could be at the portfolio level, at each layer or individual hedge.

We disagree with the requirement to assess whether the hedge effectiveness requirements are met using a quantitative analysis on an ongoing basis or, at a minimum, at each reporting date. We believe the frequency of hedge effectiveness assessment should only be at inception unless there is a significant change in circumstances. As hedge accounting would be aligned with risk management objectives, qualitative analysis at each reporting date would be sufficient in assessing hedge effectiveness.

We question whether it is necessary to require entities to minimize hedge ineffectiveness as long as they meet their documented risk management objectives. The ED is unclear as to whether an entity is permitted to use a hedging instrument that doesn't provide the best possible offset to the hedged item and therefore the least amount of ineffectiveness. In some cases, particularly in non-financial hedging relationships, the instrument that provides the best offset is not always available due to market illiquidity and/or cost effectiveness. We would suggest that a better approach may be to permit entities to use the hedging instrument that aligns with their risk management policies, but also meets business objectives such as being cost effective, regardless if the instrument provides the best possible offset to the hedged item.

The ED implies that an entity can rebalance at a date other than the reporting period end if there is a significant change in circumstance affecting the hedge effectiveness requirements. It would be useful to clarify what constitutes a significant change in circumstance affecting the hedge effectiveness requirements. For example, would increased price volatility in a commodity market

be a significant change? Under the current standard, increased volatility may result in failed regression analysis, which would imply a discontinuation of hedge treatment. However our interpretation of the ED is that hedge accounting can continue as long as the risk management objective is unchanged. Would failed regression analysis that includes a significant change in the hedge relationship result in a change in the hedge ratio and therefore a rebalance of the hedge but not a discontinuation? Another concern is whether audit firms would accept continued hedge treatment in a scenario where regressions show that correlations have weakened, but the entity's risk management objectives are still met by the hedge relationship.

We agree that the hedge effectiveness assessment should be prospective and support the removal of the retrospective assessment.

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 hedge relationship remains the same? Why or why not? If not, what changes do you recommend and why?

We support the proposal regarding rebalancing the hedging relationship, provided that the risk management objective for a hedge relationship remains the same. Clarity should be provided on what constitutes a hedge relationship failure and when rebalancing is mandatory or voluntary. We believe that there would be significant challenges for the preparers and audit firms in determining when and how to rebalance.

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 agree that there are circumstances where components of a hedging relationship might be affected by market conditions but these changes are not significant enough to modify the risk management strategy. In these situations, the rebalancing (i.e. adjusting the hedge ratio) would be appropriate. Therefore, when an entity expects that a designated hedging relationship might fail to meet the objective of the risk management strategy in the future, proactive rebalancing would be appropriate.

Question 8(a) – Do you agree than 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?

See our response in question 8(b).

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 strongly disagree with this proposal. This restrictive rule appears to contradict the principle-based approach of the ED.

Hedge accounting is a choice, not a requirement, and management should have the ability to discontinue hedge accounting at any time as long as that change is consistent with the entity's risk management objective. We believe there may be situations where voluntary de-designation could occur, consistent with the risk management strategy of an entity.

Typically, risk management is dynamic. Therefore, a designated hedge could meet the qualifying criteria of effectiveness without being optimal for the specific strategy. In these situations, rebalancing that hedge relationship might not be the best solution for risk managers. Instead, the risk manager could decide to enter into a new hedge in order to optimize the risk management strategy and designate the original instrument in a new relationship. We believe the proposal is too restrictive and potentially may not align with risk management strategies.

An entity may also determine that the cost of maintaining evidence to support the assessment of ongoing hedge effectiveness may outweigh the benefits gained from the accounting treatment and entities should have the ability to discontinue hedge accounting in this instance.

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 recognized in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?

We agree with the proposal as it will expand the opportunity for an entity's accounting treatment to coincide with its risk management strategy. In current practice, fair value hedge accounting is rarely used as the accounting treatment does not recognize the risk management strategy equivalently to cash flow hedges. This proposal rectifies this inconsistency.

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?

While we agree that this gain or loss provides information useful to financial statement users, we believe this information is generally best disclosed in the notes rather than adding detail and complexity to the balance sheet. IAS 1 currently requires this information to be presented in the statement of financial position if an entity's primary business activities are hedging or it concludes that this information is highly valuable for its users.

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?

We believe that linked presentation in the notes should be permitted as offsetting exposures on the balance sheet appears to be too aggressive given the offsetting exposures may be with different counterparties. However, using linked presentation in a note provides meaningful information on the true exposure.

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 (e.g. like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss? Why or why not? If not, what changes do you recommend and why?

We agree with the principle that the time value of an option should be accumulated in other comprehensive income (OCI) and then reclassified to the initial measurement of the non-financial asset or into profit or loss when the hedged transaction affects profit or loss. However, we disagree with the ED's proposal that this treatment should only be available when the initial measurement of the option includes a transaction cost. Commodity sales are frequently hedged with what are commonly referred to as "costless collars", which are offsetting put and call options on the sale and purchase of the commodity and have a combined zero net cost at inception. However, immediately after inception, the collars have value, as commodity prices fluctuate. Time value within the collar will never be realized, and requiring this time value to be recognized in profit and loss, only to be reversed later, provides misleading information to the financial statement user. We believe that the time value of options of this nature should also be deferred in OCI until the hedged transaction is realized, not just time value for options that include time value as an initial transaction cost.

Question 10(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?

We have no comment.

Question 10(c) – Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (i.e. the "aligned time value" determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

We have no comment.

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 that the requirements for qualifying groups of items for hedge accounting should be similar to individual hedged items since both approaches are similar in concept and more aligned with the entity's risk management strategies than the current IAS39 requirements.

In addition, we support the proposal to apply hedge accounting to net positions as this further aligns hedge activities with an entity's risk management practices.

We also noted that financial institution risk management strategies are open portfolio strategies and our comments on this question will also depend on the accounting project relating to macro hedging.

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 (e.g. in a net position hedge), any hedging instrument gains or losses recognized in a profit or loss should be presented in a separate line from those affected by the hedged item? Why or why not? If not, what changes do you recommend and why?

We generally support the proposal as grossing up the net amount will present gains or losses that do not exist. The proposal will accurately represent the economic substance of the transaction. However we do not believe that presenting this information on a separate line of the basic statements is useful to financial statement users. If the amounts are significant (under the requirements of IAS 1), separate note disclosure may be useful.

Question 13(a) – Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

We do not agree that the new disclosure requirements are appropriate for all entities. We feel that financial statement users are burdened with disclosure related to derivatives and hedging strategies that provide limited useful information to most financial statement users who are not risk management experts. Specifically, we recommend that:

- Providing disclosure as stated in ED paragraphs 45 and 46 would be inappropriate. Providing the monetary amount or other quantity to which the entity is exposed for each particular risk may represent competitively sensitive information and mandatory disclosure may influence an entity's decision to apply hedge accounting.

- The disclosure described in paragraphs 47 through 51 be optional and included when they provide useful information for the entity. We do not believe these disclosure requirements are relevant for all entities and other ways of communication may be more effective and easier for users to understand for certain hedging strategies. We question the universal decision usefulness of this information.

- The ED align with the requirements of IFRS7 to ensure consistency among the various phases of the Financial Instrument project and ensure the disclosure requirements provide information that enables users to evaluate the nature and extent of risks arising from financial instrument and hedging activities when viewed as a whole.

Question 13(b) – What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

No additional disclosure recommended. We would like to reiterate that mandated disclosures should provide decision useful information for financial statement users and it is important not to require complex derivative and hedge accounting information in the financial statements which may be difficult to interpret.

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 disagree with this proposal to account for 'own use' contracts as derivatives only if it is in accordance with the entity's fair value-based risk management strategy. Instead we suggest that the Board allows flexibility to permit dynamic risk management strategies that permit an entity to elect 'own use' contracts to be accounted for as derivatives if an entity can sufficiently demonstrate that the election eliminates or significantly reduces accounting mismatch in accordance with the entity's risk management strategy. We also feel it is important that the proposal allow for flexibility and permits a portion of 'own use' contracts, such as commodity purchase and sale contracts, to be treated as financial instruments to eliminate accounting mismatches that could occur if only a portion of the exposure was economically hedged but the entire 'own use' portfolio was treated as a financial instrument.

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?

We agree that the alternative accounting treatments proposed for accounting for credit risk using credit derivatives add unnecessary complexity in accounting for financial items.

Question 15(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?

Consistent with our response to question 15(a), we do not believe that any of the three alternatives mentioned above should be considered.

Question 16 – Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We agree with prospective application but do not agree with the proposed transition timing. We recommend that all changes to the financial instruments standards be implemented at the same

time as the sections are interconnected. Given the significance of these changes for many entities and the connection with other significant revisions to insurance and revenue recognition standards, as provided in our comment letter on IASB's ED Effective Dates and Transition Method, we recommend that these changes be effective no earlier than January 1, 2015.