



The Corporate Reporting Users' Forum

4 April 2011

Via Email: Martin Friedhoff
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Re: IASB ED/2010/13 - Hedge Accounting

Dear IASB Board Members,

General comments

1. IAS 39 'Financial Instruments: Recognition and Measurement' has legitimately been criticised as limiting the ability of companies to faithfully report their performance and financial position. We welcome the efforts of the IASB to develop hedge accounting proposals that have the flexibility necessary to properly and fairly reflect the undertaking of economically rational hedging activity.
2. Hedge accounting is an approach to financial reporting that aims to enable entities to report their business activities, including the economic effects of their hedging strategy, more faithfully in their financial statements than would otherwise be the case.
3. Hedge accounting is a necessary exception to the normal recognition and measurement principles that should facilitate better communication with the users of an entity's financial reports with regards to its risk management activities. Hedge accounting should only be used when the application of the normal recognition and measurement principles would potentially confuse users and/or provide a less meaningful explanation of the impact of risk management activities.
4. If the normal recognition and measurement principles result in accounting that is aligned with the entity's risk management activities then hedge accounting is unnecessary and inappropriate. We also identify in our detailed comments that there may be circumstances when hedge accounting ceases to be necessary or appropriate although the hedging relationship (and risk management strategy) remains in place.
5. There is, accordingly, a legitimate requirement for hedge accounting, and we consider that the IASB is right to facilitate this though without at this stage making its application compulsory. This is a practical and pragmatic response to a genuine accounting problem and the need to achieve coherence in the presentation of information to users. We do not think that it is possible at this time to develop a hedge accounting standard that could be made mandatory and thereby achieve the consistency and comparability that investors seek. However, this should not preclude further thought at a future time as to whether progress could be made in this direction.
6. We welcome the emphasis given in the Exposure Draft and the Basis of Conclusions to the fact that this is designed to apply principles-based accounting but it is disappointing that these principles are not as clearly articulated as they might be and the principles are often limited by specific rules within the proposals. Hence, the intention of the IASB to closer align risk management and accounting will be achieved only to a limited extent.



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7. Additionally, it seems the ED is based on a risk management approach for mainly individual transactions. This will not work well in large financial institutions, where risk management is determined at a portfolio level. We await the proposals of the Board on macro-hedging and open portfolios. Appropriate accounting solutions here are important and without progress in this regard it is difficult to draw clear conclusions regarding the whole project.
8. We consider that the overarching rationale should be to achieve aligned treatment of hedged item and hedging instrument as regards recognition and measurement in the financial statements. The impact of all hedging activity, whether effective or ineffective, should then impact profit and loss once its impact has flowed through. This means that it will often be right to make use of Other Comprehensive Income (OCI) for initial recognition of gains and losses on hedging instruments.
9. Alignment with the business model concept as applied in the rest of financial instrument accounting is a helpful feature of the ED's proposals. It is vital that the impact of risk mitigation activity should drive the accounting rather than the accounting consequences of alternative strategies driving decisions as to what hedging activities, if any, to employ.
10. We agree with the abolition of the arbitrary 80/125 effectiveness test. We also agree with deletion of the backward facing effectiveness test. Provided that the impact of hedging ineffectiveness is recognised promptly in Profit or Loss we see no useful purpose from applying an ex-post safeguard of this type.
11. We are mindful, nevertheless, of the risks of too much flexibility giving scope for accounting arbitrage. We have particularly noted the alternative views recorded from IASB board member, John Smith. We have not been able to judge how significant the risks are and it would have helped if the Board could have provided much more extensive worked examples of the impact of its proposals.
12. The use of options to achieve asymmetric hedging of adverse price movements whilst retaining the upside from favourable price changes is a legitimate risk mitigation strategy but it creates significant challenges regarding the appropriate accounting. We comment at greater length in the specific consultation question and we note that significant thought has been given by the Board and staff to what is a difficult topic. However we would observe that the proposed approach is complex.
13. The proposals on hedging must be viewed in the wider context of the overall project on accounting for financial instruments. We have previously expressed disappointment that it has not been possible to achieve a convergence of approach with FASB. That observation is clearly applicable here also. Indeed, without converged accounting for financial instruments the credibility of the overall convergence project is very significantly reduced.



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Questions for Consultation

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 welcome the attempt to provide a definition of the objective of hedge accounting. We note, however, the somewhat limited scope relating only to risks that affect Profit or Loss. It would be preferable, we think, to try to achieve a more principle-based definition.

The IASB proposals as presented will prevent hedge accounting of risks that would otherwise be recognised in OCI not Profit or Loss. This is the case where, as under IFRS 9 'Financial Instruments' 5.7., an entity opts to present in OCI subsequent changes in the fair value of an investment in an equity instrument that is not held for trading. The apparent reason is that the Board cannot find a conceptually satisfactory basis for how to recognize hedge ineffectiveness. We do not consider this satisfactory. If OCI gains and losses are economically meaningful it is rational to seek to mitigate them and the accounting should reflect the consequences of such actions in a meaningful way. The hedge ineffectiveness problem could be resolved by requiring over-effectiveness to be taken to Profit or Loss and under-effectiveness to OCI.

The difficulties in dealing with OCI items again draws attention to the unresolved conceptual debate as to the purpose of OCI and the criteria for recognition of gains and losses here rather than within profit or loss. It is evidently unsatisfactory to allow or prohibit hedge accounting based on arbitrary accounting demarcation rules rather than the nature of the real-world economic nature of the risks that the entity faces and wishes to mitigate.

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 that these should be eligible hedging instruments.

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 as this could well reflect a legitimate hedging 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?

Yes we think this is appropriate as the hedging of components of an overall risk will often be the reason why an entity will wish to hedge.



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We note that the ED will not permit inflation be designated as a risk component of a financial instrument unless it is contractually specified on the grounds (as per Paragraph B18 of the ED) that inflation is not separately identifiable and reliably measurable. Given that hedging of inflation risk is, and is likely to remain, a widespread objective we think that efforts should be made to provide a basis for this to be eligible for hedge accounting. To the extent that there are technical challenges in this area they will be relevant whether or not inflation is contractually specified in the hedged item and we do not think therefore that this should be relevant to eligibility. In addition, it is not clear to us why paragraph B18 of the ED only applies to financial instruments, but not to non-financial instruments. We believe that the IASB should develop a stronger conceptual basis for deciding which non-contractual inflation components may be designated as hedged items.

The proposed hedge accounting requirements continue to diverge in important respects from risk management practices in the banking sector, as in respect of the sub-LIBOR where the IASB intends to retain the existing restrictions in IAS 39. We comment specifically on the prohibition of hedge accounting of credit risk in answer to Question 15. Restrictions of this kind are at odds with a principles-based approach.

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?

We agree with the eligibility of a layer of the nominal amount of an item as the hedged item as this could constitute a valid hedging strategy. If a prepayment option changes the nature of the hedged risk the accounting needs to reflect this and therefore restrictions on eligibility could be necessary. However we disagree with the ED's proposal which would specifically inhibit hedge accounting in respect of prepayment options. We think it inappropriate for carve outs of this type which is unhelpful in achieving a principles-based standard.

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 removal of the arbitrary 80/125 per cent expected effectiveness test and with the deletion of the retrospective effectiveness test. The key requirement should be for all hedge ineffectiveness, expected or unexpected, to be reflected in the primary statements as it arises.

Question 7

(a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?

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

It is not entirely clear what the ED intends here. Where the effectiveness of the hedging relationship changes the accounting needs to change to reflect this, consistent with the need for hedge ineffectiveness to be recognised as it arises. It is logical for an entity to seek to rebalance the hedge in the light of evidence that its strategy over- or under-compensates for changes in the hedged item and the accounting needs to reflect this. However, it does not follow that the entity should be expected always to do so or that access to hedge accounting should be dependent on rebalancing actually taking place. The accounting consequences of a



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decision not to rebalance should simply be a recognition of excess movements on the hedging instruments in Profit or Loss as appropriate and under-effectiveness as a reduction in the proportion of the nominally hedged item as subject to the hedge.

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?

The ED proposes that hedge accounting should be voluntary but that once invoked, and so long as the hedged item exists or is expected to occur and the hedging instrument is held, the entity cannot elect to discontinue it. We note that continued exposure to both hedged item and hedging instrument does provide a strong prima facie indication that the hedging strategy remains in place. Some CRUF members consider, accordingly, that the ED's restriction is sound. Others believe that a company should be able to choose hedge accounting when it believes doing so provides better information but that there might, similarly, be circumstances in which at a future point to continue to hedge account would result in poor information even if the hedge position (and the risk management strategy) remain in place.

The ED's requirements as presented will, in any event, not provide an economically rational treatment in all cases, especially where there is a change in the nature and accounting treatment of the hedged item account within an on-going hedging relationship. There is a danger of the ED's requirements in this area resulting in accounting driving risk management rather than revealing it. The following example illustrates what we have in mind:

1. GBPCo takes order to supply kit in 14 months time to a USD customer and agrees a USD price. GBPCo takes out a GBP/USD forward to hedge this exposure and lock in the GBP value of the sale. Hedge accounting is necessary prior to the sale being booked to faithfully represent GBPCo's risk management strategy.
2. GBPCo ships the kit prior to the year end, invoices the customer in USD, and books a receivable and revenue as a result. The forward continues to be held to hedge the eventual cash receipt. The hedged item (the receivable) will be marked-to-market in FX terms through the P&L and so it would be desirable to see the derivative also affecting P&L from this point onwards. Under the ED's proposals this does not appear to be possible.
3. At the y/e the receivable will be adjusted for FX movements with the change taken to P&L. If USD is falling against GBP then an FX loss will arise on the receivable (reflecting the smaller amount of cash that will eventually be received). The forward provides economic protection against this loss but if hedge accounting is continued then the hedging gain will be taken to OCI so the P&L will not show the offset.
4. When the cash is eventually received the hedge will be closed and the cumulative hedging gains (or losses) will be recycled through the P&L (under the ED's current proposals). At this point the economic impact of the hedge will show up correctly – in overall P&L terms.

If hedge accounting had been 'turned off' at Stage 2, then the gains would have been recycled from OCI into Profit or Loss and any further changes would go direct to Profit or loss, offsetting the FX movements on the receivable and giving a more sensible view at the year-end (Stage 3). The same would be true for the following period and until the cash was received and the hedge was closed out. There is no need for an entity to continue



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the hedge accounting documentation and testing process when gains and losses will naturally match in profit or loss.

As has been raised in comment letters from the Association of Corporate Treasurers (among others) the ED's prohibition is easy to get around but doing so would impose unnecessary costs on shareholders. Entities may, for example, wish when terminating a hedge, to purchase a new offsetting instrument rather than to close out the existing derivative. However the ED appears to prevent the first of these being given an economically meaningful accounting treatment. We would prefer the lower cost alternative of a change to the ED.

We also consider that flexibility would be necessary where there are genuine changes of hedging strategy, for example to use the hedging instrument for a different purpose, for example to hedge an unrelated item in, perhaps, a quite different segment of the entity's business operations. Again, we believe that a more principle-based approach rather than an inflexible rules-based approach would be more likely to permit the accounting to reflect the economics, the effectiveness of the risk management strategy and development in the entity's business model.

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?

We agree with the recognition of hedging gains and losses in OCI although this could be more simply done net of the reporting of the ineffective portion in Profit or Loss.

On balance we agree with the proposed line item presentation in the statement of financial position. This would facilitate user understanding of the position of the issuer where the balance sheet numbers both before and after the effects of hedge accounting are of obvious interest. However, concerns exist that this is being only being achieved through additional complexity on the face of the statement when presentation in the Notes might prove more effective.

We are unconvinced at this stage of the merits of linked presentation. It would be helpful if this could be reconsidered in a broader context, within either the financial statement presentation or the conceptual framework projects.

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?

(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?



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(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?

The use of options for risk management presents real accounting challenges. The proposed treatment involving potentially different treatment of intrinsic value and time value is complex though other approaches would likely be also. Although conceptually distinct, demarcation of intrinsic and time value for accounting purposes over the life of a hedge is of questionable appropriateness given the continuous changes that take place over the option life. Time value will have a tendency to change into intrinsic value over the duration but there is also the possibility of movement in the opposite direction over shorter periods during the option life.

The two suggested ways of conceptualising the option premium (or part of it) at the outset viz as either an element of a transaction cost or else as a payment analogous to an insurance premium are each problematic. It is not evident that the value of the underlying item that might be the subject of a hedge should be thought in any way to depend upon whether a decision is taken to hedge out both upside and downside, not to hedge it or to take out an option to hedge one side of the risk.

On balance, we think that amortisation of the time value through Profit or Loss would be a pragmatic but acceptable approach. Although simply taking all gains and losses on the instrument to OCI over the duration of the holding period could be justifiable there will be times when hedging via a purchased option will be unambiguously inferior to either a strategy of full hedging or no hedging. It is difficult to believe that an impairment of the option and its time value would not sometimes therefore need to be recognised.

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?

This is a complex area that poses significant challenges for accounting as well as the nature of corporate risk management though in principle we would wish sensible hedging strategies to be facilitated. However, the mechanics of what is proposed seem unnecessarily restrictive and the presentation is complex.

It is also difficult to comment in the absence of proposals relating to macro hedging. It should be possible for an entity to hedge net positions if that is how it manages risk but currently this is not permitted. The proposed eligibility criteria are, however, too restrictive. For cash flow hedges it seems logical to allow offsetting where the corresponding cash flows affect profit or loss in the same and only in that accounting period (paragraph 34(c)). This is too restrictive for entities that frequently report who would struggle to achieve this in shorter periods.

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 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 that a full measure of disclosure is necessary in this case to allow a proper understanding but we are concerned that the proliferation of line item presentation may be excessive and not optimise practical transparency. Consistent with our answer to Question 13 users are concerned to understand the gross position on hedges and the proposed accounting treatment may obscure this.



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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?

A vital attribute of hedge accounting is that it is supported by appropriate and sufficient disclosures to enable users to gain a proper understanding of the hedging and risk management activities and how they have impacted the figures presented in the primary statements. However, a fair balance must be struck in this regard. It will be counterproductive if the additional disclosure requirements deter entities from using hedge accounting whether because of the compliance burden or because to comply will lead to disclosure of commercially confidential information that would not be required to be disclosed if hedge accounting is not adopted. Neither of those scenarios is in the interests of investors.

The proposals will introduce significantly more judgment than was the case under IAS 39 resulting from, for example, the removal of the 80-125% rule on hedge effectiveness. Overall the aim of the disclosure requirements should be to enable users of the financial statements to understand the nature and effectiveness of an entity's risk management strategies and how they impact upon the financial statements. The proposed disclosure objectives in paragraph 40 would on the face of it satisfy the needs of users. However, there is concern that these objectives will not necessarily be met by requiring entities to comply with the list of disclosures in paragraphs 44-52. Entities should be permitted to consider the level of detail necessary to satisfy the disclosure objectives. In addition to increase transparency and comparability, disclosures should allow users to understand results of both the hedged and un-hedged positions where an entity could have applied hedge accounting but elected not to do so.

Users of accounts would benefit from disclosures that show the hedged value of their sales and costs. Current accounting treatment requires preparers to book revenues at the spot rate and show the hedging gain/loss separately making it difficult to assess the hedged margin.

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?

Yes, we do not consider that the cash settlement of the derivatives held as a hedging instrument should be a constraint on eligibility for accounting that reflects the underlying economics and business model.

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?

Use of credit derivatives seems an economically rational strategy to pursue for risk mitigation purposes. It is evident, though, that the use of credit derivatives for managing credit risks poses significant challenges in the accounting. Market developments may, indeed in the opinion of some already do now, allow credit risk to be



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separately identified and reliably measured. We do not agree that the standard should rule it out. Rather, further work is needed in achieving a workable regime that will avoid excess volatility and also command the confidence of users. Part of the solution will, we suggest, be to require entities to explain, in the notes to the financial statements, how they have applied the principles of the standard to the accounting for their efforts to hedge this risk.

We consider that hedging credit risk has implications for the IASB's project on impairment of financial assets and that it should also be considered in connection with that project.

Question 16

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

We commented earlier this year on the principles that should apply in our response to the IASB's - Request for Views on Effective Dates and Transition Methods. In the context of the current consultation, it would not be practicable to restate the past if the current proposals had been in operation for completed transactions. It is for preparers to decide whether existing hedges at the beginning of the comparative period would comply with the new IFRS and explain the effects of its application in the financial statements.

It is important that an undue compliance burden on preparers is avoided and this argues for both a sufficiently long planning and transition period and also flexibility as to treatment of existing hedging transactions. The proposed 2013 implementation date could prove unduly challenging if preparers that wish to implement hedge accounting under the new standard are to have time to make the necessary system changes.

About the Corporate Reporting Users' Forum (CRUF)

The CRUF came together in 2005 as a discussion forum to help its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of accounting standard setters such as the IASB and FASB.

CRUF participants come from all around the world, including individuals from both buy- and sell-side institutions, and from both equity and fixed income markets.

The CRUF is a discussion forum. Different individuals take leadership in discussions on different topics and in the initial drafting of representations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media. It would not be correct to assume that those individuals who do not participate in a given initiative disagree with that initiative.

We sign this letter in our individual capacity as participants of the Corporate Reporting Users' Forum (www.CRUF.com) and not as representatives of our respective organizations. The views expressed are those of individual CRUF participants and do not necessarily reflect the views of the respective organizations where we are employed.

The participants in the Forum that have specifically endorsed this response are listed below.

Michael McKersie
Assistant Director, Capital Markets
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