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Mr. Steve Ong
Director, Standard Setting Department
Hong Kong Institute of Certified Public Accountants
37/F., Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

Dear Steve,

IASB Exposure Draft on Hedge Accounting ("Exposure Draft")

I refer to your letter to our Mr. Mark Dickens dated 17 December 2010 on the above which has been passed to me for my attention.

We have completed our review of the Exposure Draft and our views are set out below.

General

The Exposure Draft proposes to align hedge accounting more closely with a reporting entity's risk management activities with the objective of presenting more useful information to users of financial statements. The intent is a more objective-based approach to hedge accounting which the IASB hopes will make hedge accounting more accessible and applicable to a wider range of risk management activities.

We agree to the stated intent to provide more useful information in financial statements on risk management activities but we believe the proposals appear to be unduly complex and rule-based rather than principle-based. We are particularly concerned that the proposals do not appear to have been developed with a fresh look and an overall conceptual framework in mind on how all "risk management activities" should be reflected in financial statements. Rather the approach taken has been to revisit and consider the current requirements on "hedging" included in IAS 39 with the aim to rush a revised standard to meet an unrealistic June 2011 deadline.

We note that the approach taken in the Exposure Draft to deal with hedging activities is not comprehensive and we believe it is also conceptually flawed. Paragraph BC11 of the Exposure Draft states that hedge accounting is an exception to the normal recognition requirements in IFRS. We believe that by using this as a starting point in developing its proposals the IASB will undermine key accounting concepts and principles and this will

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lead to more rule-based accounting standards. We believe the IASB should work within fundamental basic principles and concepts. We believe a key issue to be dealt with by the IASB on hedging accounting is to set out the criteria where gains and losses arising on asset and liability measurement are allowed to be deferred. We believe that high quality financial information should show a faithful representation of the separate transactions undertaken by a reporting entity. Currently the focus of the revisions to accounting standards has been on the issue of regular re-measurement of assets and liabilities after initial recognition, and we believe this is the primary cause of complexity in accounting standards and financial reporting.

We believe that what constitutes risk management and hedging activities may be interpreted very widely. The Oxford Dictionary's definition of a "hedge" is "*to secure oneself against loss (on a bet, etc) by compensating transactions on the other side*". A hedge therefore involves two or more separate transactions.

We note that the proposals will allow hedges of risks relating to entire transactions, components or parts of transactions, as well as net portfolio positions and nil net positions. The proposals also permit changes in the risk management strategy and policy of a reporting entity. As a result, we believe that in effect, it will be possible for an entity to designate any number of transactions as having a hedging relationship and thus manage its reported results. For this reason we believe the approach is flawed and an alternative approach based on separate disclosure of transactions that are designated as having a hedging relationship will be a better approach to hedge accounting. A possible alternative approach is described further below, but we believe that some basic fundamental conceptual issues need to be addressed first.

What is hedging?

We believe that hedging is essentially a designation issue. A hedging relationship only exists where an entity chooses to make a designation that two (or perhaps more) separate transactions should be considered together as they are somehow linked. We believe that the designation of a hedging relationship should not normally lead to a change in the accounting policy adopted for the recognition and measurement of transactions. We are concerned with the proposals, first because the counterparties to the relevant transactions are normally with different parties, and second because the transactions would normally be made at different times. We believe transactions should normally be accounted for independently and hedging information should be regarded as disclosure of information given from a different perspective.

We believe the hedging transaction should be the latter transaction as its purpose is to reduce exposures created from an earlier transaction. Nevertheless, we would accept that if both transactions were intended to be and were entered into simultaneously, we believe it could be argued that the two transactions should be accounted for in substance as a single transaction. An example of this could be where an entity enters into a variable

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interest rate loan (i.e. the hedged item) that requires it to pay interest at a variable interest rate. The entity simultaneously enters into an interest rate swap (i.e. the hedging instrument) to convert the variable interest rate exposure to a fixed interest rate exposure. We believe that in these circumstances it could be argued that the entity should be able to account for the two transactions as being a fixed interest rate loan as that was the original intent and the two transactions were entered into at the same time.

Our further observations and concerns on the proposals are set out as questions and are discussed further below: -

(a) Is the scope of hedging activities in the Exposure Draft adequately and clearly defined?

The Exposure Draft in effect provides considerable freedom for entities to designate and undesignate hedging relationships for entire transactions, components of transactions as well as groups of transactions and the choices made could have a significant impact on an entity's reported results. We believe the proposals may facilitate the easier manipulation of reported results which is undesirable.

(b) Proposed separate line item in the statement of financial position – Is this not non-admission of a breach of basic accounting principles?

We are very concerned with the proposal in paragraph 26(b) of the Exposure Draft where gains or losses arising from fair valuing a hedged item shall be *“recognised and presented as a separate line item in the statement of financial position”*. We understand that although the gain or loss on the hedged item is arrived at by fair valuing the hedged item (in whole or in part), the carrying value of the hedged item shall be regarded as being stated at its original accounting policy, which may be, for example, at amortised cost. We believe this approach is conceptually flawed. If the resulting gain or loss shown as a separate line item in the statement of financial position does not form part of the carrying value of the hedged item (from which it has been determined), we believe it does not meet the criteria for recognition as an asset or a liability. The resulting question is what does the separate line item supposed to represent? The Exposure Draft's proposal appears to be an attempt to side-step the fact that there has been in fact a change in the basis of measurement for the hedged item (or a part thereof). Generally accepted accounting principles require similar assets and liabilities within a class to be accounted for in the same way (although unfortunately we note there are some other odd rule-based exceptions e.g. paragraph 53 of IAS 40), and the proposed treatment is a breach of this basic principle. We would add that a change in measurement would represent a change in accounting policy which would normally require a prior period adjustment to be made. Moreover, under the proposals some hedging effects will be reflected in “profit and loss” but others will be reflected in “other comprehensive income”. We believe the proposed disclosures will be difficult to understand to both professional and lay readers of financial statements, and will cause confusion.

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(c) Are “risk management activities” confined to hedging activities – Should there be a more holistic approach?

We believe that risk management is one function in managing a business and “hedging” can be implemented in many ways. For example, to manage an anticipated risk exposure arising from expected increases in the price of raw materials an entity could purchase additional quantities in excess of its normal production requirements to lock in its costs to the current unit price. The result is stocking of additional raw materials beyond the entity’s sales expectations and requirements for the coming year. Another entity may manage the same risk through the use of financial instruments. The question then is whether disclosures should be made for all “risk management activities” as entities may adopt different risk management strategies. The Exposure Draft is focused primarily on hedging through financial instruments and we believe that the issue of reflecting risk management activities should be addressed holistically so that disclosures on risk management activities disclosed in financial statements are complete, comparable and based on consistent conceptual principles.

A hedging financial instrument where used (which represents a separately identifiable transaction) entered into mitigate the risk associated with the hedged item (another separate transaction) forms an integral part of the business of a reporting entity. The final outcome of risk management activities however may turn out to be consistent with or inconsistent with management’s expectations and predictions, that is, the hedging transactions could be either effective or ineffective, but only the passage of time will tell. As risk management activities essentially represent the ordinary business of a reporting entity, we believe the impact of those activities should be fully reflected in the profit and loss statement as a measure of the true performance of the entity and its management.

(d) Why are not all gains/ losses arising from transactions designated as having a hedging relationship reflected in profit and loss?

As discussed in our letter to you dated 20 August 2010 in response to the IASB’s exposure draft on “Presentation of Items of Other Comprehensive Income (Proposed amendments to IAS 1)”, we raised concerns on the need for a conceptual basis for determining why and what type of gains/losses should be included in “profit or loss” vis-a-vis “other comprehensive income”. We believe that this conceptual issue has not been fully discussed or resolved and the proposals in the Exposure Draft add to the confusion of the purpose of the two statements. The conceptual rationale of recognising certain items under “other comprehensive income (“OCI”)” is not clear, although paragraphs 26, 29 and 31 of the Exposure Draft state that the intent of the proposals is to reflect the results of risk management activities in OCI. However, under the proposals, the gain or loss arising from the “ineffective” portion of a hedging relationship is transferred to “profit or loss” and the “effective” portion is retained in OCI. We believe this approach is conceptually flawed and both gains/ losses from the hedged item and the hedging instrument transactions should be reflected in profit and loss.

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(e) The proposals will not apply to “open portfolios”

The Exposure Draft only deals with hedging through financial instruments and does not cover other hedging activities. Moreover we understand its scope is intended to be restricted to “closed portfolio positions”. As we understand that open portfolio positions will be the norm rather than the exception, especially for financial institutions, the proposals will not meet the IASB’s objective of making hedge accounting more accessible.

(f) Are the terms used in the Exposure Draft clearly defined to ensure consistency in application?

We are concerned that the Exposure Draft appears incomplete. It does not discuss in any detail nor provide any definition of key terms used and does not indicate whether the terms have the same meaning as some similar terms used in IAS 39. The definitions mentioned in Appendix A to the Exposure Draft are not comprehensive of all the terms used.

Paragraph 1 of the Exposure Draft states that *“The objective of hedge accounting 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. This approach aims to convey the context of hedging instruments in order to allow insight into their purpose and effect”*. We believe that some risk management activities may be carried out without the use of financial instruments and thus the scope, meaning and objective of hedge accounting needs to be reassessed. We would also reiterate that under the proposals some hedging effects will be reflected in “other comprehensive income” rather than in “profit and loss”.

We believe that the Exposure Draft does not clearly distinguish between the transaction that results in a “hedged item” and the transaction that results in a “hedging instrument”. We believe that the hedged item should be a transaction that is entered into first; as it creates the exposure that leads to the need to enter into another subsequent transaction, namely, the hedging instrument. To illustrate, a buyer may wish to fix the exchange rate payable for the price of raw materials anticipated to be purchased in the future from an overseas supplier by entering into a forward foreign currency contract. As the forward contract has been entered into before the purchase of raw materials, the forward contract has created the exposure and not the raw materials purchases which has yet to be made. The foreign currency exposure will only be covered or matched if the future purchase of raw materials is made. If the future purchase of raw materials is not made, the exposure remains and will represent an unmatched or unhedged transaction. Possibly it may have been in substance a speculative foreign currency transaction. Paragraph 12 of the Exposure Draft which discusses hedged items appears to take the opposite view and regards the forward currency contract as the hedging instrument and the future purchase

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of raw materials (i.e. the firm commitment or a forecast transaction) as the hedged item. We believe the IASB should re-consider and refine the meaning of the terms “hedged item” and “hedging instrument”.

In summary, we would suggest that the IASB should revisit all the terms and definitions used in the Exposure Draft and indicate whether there have been any changes from IAS 39 and if so explain the reasons for the changes made. We believe precise terms are essential as unclear definitions will lead to inconsistency in interpretation and application.

(g) Is the distinction between “fair value hedges” and “cash flow hedges” clear and is the distinction meaningful to lay readers?

The Exposure Draft distinguishes “fair value hedges” from “cash flow hedges” which we believe is not meaningful, especially to lay readers of financial statements. We believe “true” hedges are carried out to manage risks relating to real cash inflows and outflows rather than fair value accounting changes. Accounting for fair value changes produces hypothetical results as no real transaction has occurred. We also believe that currently it is possible that some hedges may be entered into primarily because fair value accounting requires certain financial instruments to be re-measured at fair values with the resulting gains and losses being reflected in the profit and loss statement, OCI, or reserves.

We believe two fundamental conceptual issues require debate. First, the appropriate basis for measuring assets and liabilities on initial recognition and whether or not there should be subsequent re-measurement and if so how this should be reflected in the financial statements and second, whether a transaction can be accounted for differently simply because it is designated as having a hedging relationship.

We are concerned that the Exposure Draft proposals are extremely loose in that it will allow a different accounting treatment for a portion of a transaction (i.e. “components” and “layers” as described in the Exposure Draft) so long as the entity is able to justify a hedging relationship exists and that the amounts can be measured reliably. This will be permitted notwithstanding the fact that the component risk being hedged forms part of, and is intricately linked to, other risk elements of the same overall transaction, which are also subject to change.

As hedging accounting attempts to match a hedged item with a hedging instrument, hedge accounting raises the fundamental conceptual issue of what should be the “unit of account” when accounting for transactions. The conceptual question is when should “split accounting” of a transaction be permitted? Should a transaction be split and accounted for based on its component parts (that is, a smaller unit of account) and when should this be permitted or required? This leads to a further conceptual question of once an election has been made on the unit of account can this be changed subsequently. The Exposure Draft has not addressed these questions.

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(h) Will the proposals be consistent with the IASB's and FASB's other proposals on offsetting?

We note the IASB and the FASB issued a joint exposure draft in late January 2011 concerning the issue of offsetting of financial instruments. We understand the Boards have proposed that an entity should set-off a financial asset and a financial liability and the net amount must be presented in the balance sheet when (and only when) the entity:

- (a) has an unconditional and legally enforceable right to set-off the financial asset and financial liability; and
- (b) intends either to settle the financial asset and financial liability on a net basis, or to realize the financial asset and settle the financial liability simultaneously.

In particular, we note that under the proposals on offsetting, the realization of a financial asset and the settling of a financial liability are considered to be "simultaneous" only when they are settled at the same moment. Moreover, when offsetting is not permitted, financial assets and financial liabilities are presented separately from each other according to their nature as assets or liabilities.

Although hedge accounting is not directly related to the issue of offsetting, we believe there are similarities in the relevant issues and considerations and the IASB should ensure that the principles it introduces for offsetting are also consistent with its proposals on hedging.

(i) Is the "assessment of hedge effectiveness" practical, realistic and cost effective and is the issue of "rebalancing" relevant?

As stated above, we believe hedging is a matter of designation which should be determined at the time of entering and documenting the purpose of a transaction. Whether a hedge is effective or not can only be ascertained when the hedged item and hedging instrument are settled. Therefore, any effectiveness assessment before settlement of the two transactions is hypothetical in nature. We also believe any attempt to recognise effectiveness, and therefore also any ineffectiveness, before the settlement date may be seen as misrepresenting the facts as the reporting entity has no contractual obligation or intention to settle the hedged item and the hedging instrument on the earlier reporting date. Ultimately, the true test of effectiveness of a hedge of any risk or part of a hedged item will depend on the creditworthiness and ability of the counterparties to the transactions to honour their obligations.

We believe that "rebalancing" forms part of managing a business. Responsible risk management will involve monitoring whether the expected outcome of transactions to which a hedging relationship has been designated will produce the results as originally anticipated. If the hedged item and hedging instrument transactions cannot be

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immediately settled or extinguished or will not produce the original planned result, an entity sensibly would need to consider alternative courses of action, if any, it wishes to and can take. Whether or not further action is taken, the transactions giving rise to the hedged item and hedging instrument would need to be completed and settled in due course in accordance with their contractual terms.

Fundamental conceptual issue on the need for re-measurement of assets and liabilities

We believe that before the IASB proceeds with the Exposure Draft another key fundamental conceptual issue that needs to be revisited, and as a matter of priority, is why some accounting standards, such as those dealing with financial instruments, require subsequent re-measurement at each reporting period whereas some other accounting standards do not.

The current Conceptual Framework discusses the measurement of assets and liabilities and also the concepts of capital and capital maintenance. We would draw the IASB's attention to paragraphs 108 and 109 which appear below (underline is for emphasis).

“108 Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

109 Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.”

We understand that under paragraphs 108 and 109 of the Conceptual Framework the recognition of holding gains/ losses arising from changes in the price (and therefore value) of assets shall not be recognised under either the financial capital maintenance or the physical capital maintenance concepts. Despite this, such gains and losses are currently required to be recognised under some specific accounting standards (e.g. IAS 39, IAS 40 and IAS 41). We would urge the IASB to consider the conceptual aspects and in particular explain the conceptual basis for why changes in value of some assets such as

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financial instruments are required to be recognised at each reporting period end whereas similar rules do not apply to other assets.

As mentioned in our letter to you dated 31 January 2011, we believe that the wider use of fair value and the recognition of fair value changes in the profit and loss statement, statement of other comprehensive income, and directly in equity does not improve financial statements reliability and usefulness but in fact contributes to making financial statements less relevant and reliable, and we believe in some cases non-auditable. Recognition of fair values facilitates the easier manipulation of the financial position and performance of reporting entities which in turn may lead to financial instability which is not in the long term interests of investors, financial markets and economies as a whole.

We believe the IASB should revisit the Conceptual Framework as a matter of priority and it should seriously re-consider whether the focus of accounting should be to account for actual transactions that have occurred rather than adopting its current position which appears to be a focus on the re-measurement of assets and liabilities at their fair value subsequent to their initial recognition. The substance of fair value accounting is the recognition of hypothetical transactions with hypothetical parties and at hypothetical values at a periodic reporting end date. Although we believe that fair value information is useful, we believe a fair value gain or loss should not be recognised unless it is supported by an actual exchange or settlement of goods and services by the reporting entity with another party. Until an actual transaction has occurred, fair value information should only be provided by way of a note disclosure so that readers of financial statements can question management why certain actions have not been taken. We believe fair value re-measurement could be viewed as being similar to the recognition of a sale and buy-back transaction by the reporting entity (but an important distinction is that there is no counterparty to the transaction) and the key conceptual question to be addressed by the IASB is whether these should be recognised in financial statements.

Possible alternative approach to hedge accounting

If after public consultation and deliberation, the IASB considers that unrealised gains and losses arising from re-measurement of assets and liabilities is conceptually sound, we believe that a more appropriate and alternative approach to providing useful information on an entity's risk management activities would be to provide the information through narrative disclosures, separate from the primary financial statements. We believe the IASB should explore the possibility of adopting this approach rather than adopt the approach under the current proposals suggested in the Exposure Draft. Under this alternative approach the disclosures would be provided by way of a supplementary note to the financial statements and in essence the approach could be similar to the approach used in providing segmental information under IFRS 8, that is, presenting information provided in the financial statements but viewed from another perspective. We believe that the crux of the issue in hedge accounting is how to present information of "matched" transactions because two or more transactions are designated as being linked through a

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hedging designation. The other key issue to be addressed by the IASB is to clearly set out the criteria that must be met for justifying deferral of gains and losses. We believe that this alternative approach to hedge accounting would be simpler to apply in practice and the information produced would convey more meaningful and useful information about an entity's risk management activities.

We believe that the primary purpose of hedging transactions is to reduce the expected loss (e.g. to hedge against price risk and foreign currency risk) on an earlier transaction, but hedging may also be used to vary the terms of another transaction (e.g. to change a variable interest rate loan to a fixed interest rate loan). However, because the hedging relationship transactions are carried out with different parties and in most cases at different times, we believe that the asset or liability created by both the original transaction and the subsequent hedging transaction should normally be separately recognised.

The key issue to resolve in providing hedging information is whether and how the balances and related gains/ losses arising from the two separate transactions can be: -

- (a) matched; or
- (b) in the case where non-financial assets are involved, the gain or loss on a hedging instrument can be deferred and treated as forming part of the cost of an underlying asset (e.g. the cost of inventories acquired from an overseas supplier to include the cost of a foreign currency forward contract entered into with the intention to minimise a foreign currency exposure).

In exploring an alternative approach, the IASB will need to seriously re-consider the conceptual issue of what unrealised gains and/ losses or deferred gains/ losses should be allowed to be recognized and if so where they are presented.

Rather than adopt the current requirements where unrealised gains and losses are reflected in a mixture of profit and loss, OCI or reserves (and also specific and inconsistent rules on transfers between these accounts) we believe that all unrealised gross gains and losses should be recognised in a separately identified “deferred loss” and “deferred gain” account arising from transactions with a hedging relationship. These account balances should be presented under assets and liabilities respectively rather than under the present rules which require them to be ultimately reflected as part of equity. In this way, attention would be drawn to these accounts and management would need to justify and explain the reason for their origination and purpose, and that their carrying values will be recoverable. These “deferred loss” and “deferred gain” account balances could then be released as when the separate transactions designated as having a hedging relationships are contractually settled or completed.

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Under this approach, hedge accounting would primarily be a disclosure matter rather than the current proposed approach which leads to issues concerning whether there has been a change in accounting policy for the recognition and measurement of the transactions and their resulting assets and liabilities.

We believe the issue of deferral of gains and losses is a significant consideration in other accounting areas such as the treatment of foreign currency gains and losses on net investments in overseas subsidiaries and the revaluation of fixed assets such as land and buildings. However, we note that this issue has not been satisfactorily dealt with in the Exposure Draft or elsewhere. Current practice is that such gains/ losses are required to be reflected in reserves (i.e. as part of equity) and we believe the IASB should explore whether this is conceptually sound and should be allowed to be continued.

Disclosure

As mentioned above, we believe narrative disclosures supplemented by quantitative data on hedging activities shown separately from the primary financial statements would be more useful and understandable to readers. We would suggest the following information should be disclosed in a single note to the financial statements to present a comprehensive view of risk management and hedging activities carried out by the reporting entity:

- (a) the exposures or types of risks that the entity is facing and the entity's strategy to reduce such risks. Any changes in the risk management strategy or objectives should be disclosed;
- (b) how the entity has managed the risks and exposures through hedging activities, including the use of financial instruments;
- (c) the gross gains/ losses arising from re-measurement/ settlement of the hedged item and the hedging instrument transactions respectively, grouped under meaningful classes, together with the net gains/ losses;
- (d) the disclosures of hedges should separately show:-
 - (i) grouping and matching of account balances that have a designated hedging relationship;
 - (ii) accumulated and movements in balances of gross gains/ losses on re-measurement of hedged items and hedging instruments that have yet to be matched and settled; and
 - (iii) accumulated and movements in balances of deferred gains and losses arising from re-measurement of hedging relationship transactions that are held for later incorporation into the cost of acquisition of non-financial assets.

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- (e) narrative disclosure of whether in the opinion of the directors the risk management strategy has been effective including criteria used in the assessment.

Conclusion

We believe the Exposure Draft proposals in essence provide a free choice to change the measurement basis for assets and liabilities which should not be permitted as it will facilitate the manipulation of reported results and financial positions. We believe that transactions should normally be treated and accounted for separately as they are carried out between different parties and at different times. Risk management and hedging information can be better dealt with by separate disclosure of regrouping of information shown in the primary financial statements.

We believe that the IASB should address hedge accounting from a more comprehensive and holistic perspective and develop principles that can be applied universally rather than those specific to financial instruments. More importantly, there are more fundamental conceptual framework issues arising from the matters discussed in Exposure Draft which we believe the IASB needs to address first.

We hope that the above comments are helpful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited



Colin Chau
Senior Vice President
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c.c. Mr. Mark Dickens – Head of Listing