Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

9 March 2011

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

Dear Sirs,

IASB Exposure Draft of *Hedge Accounting*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your Exposure Draft are set out in the Appendix for your consideration.

We acknowledge that the global financial crisis highlighted that users of general purpose financial statements require better information to understand an entity's hedge accounting activities, how they reflect an entity's risk management activities and the extent to which those activities are successful in meeting an entity's risk management objective. We support the IASB's decision to undertake a comprehensive review of the hedge accounting requirements to develop a principles-based approach that provides more meaningful information.

The hedge accounting model proposed in the ED provides a number of significant improvements that will make hedge accounting more accessible. We agree with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of the entity's risk management activities. We believe that this approach has the benefit of being consistent with the role of the business model in the classification of financial instruments.

The proposals remove a number of the restrictions to hedge accounting in IAS 39 *Financial Instruments: Recognition and Measurement*. In our view, there are important improvements relating to the removal of the effectiveness test based on bright-lines (80% to 125%), the possibility to designate derivatives, risk components and net positions as hedged items, and the possibilities to apply hedge accounting to components of non-financial items. These proposals make the hedge accounting less rigid and enable an entity to align its hedge accounting closer to its risk management objectives.

However, we are concerned that there are key application issues that must be addressed by the Board in order for the proposals in the ED to be operational:

- *Risk management* – The ED relies heavily on an entity's risk management as a basis for hedge accounting. We believe that further guidance should be provided on how to link the accounting to the objective of the risk management strategy and how comprehensive the documentation of the risk management

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strategy is required to make the proposal operational. Further, we understand that risk management strategies may be set at various levels, e.g. entity-wide, business unit, geographic area, portfolios, or individual items. As each entity's risk management strategy is different depending on the specific facts and circumstance, we recommend the Board clarify how the concept of risk management strategy is intended to be applied.

- *Effectiveness testing*: We are pleased that qualitative effectiveness testing will be permitted. However, we have concerns with the current wording in the ED that would require a hedging relationship to produce an unbiased result, as this is overly restrictive and the requirement to minimize expected hedge ineffectiveness could be inconsistent with an entity's risk management strategy. Furthermore, as the ED does not specify a particular method for performing hedge effectiveness assessment, we believe that there will be more a need for guidance to assist preparers to implement the requirements, in particular for those in emerging markets and for entities elsewhere that have not applied hedge accounting previously.

- *Rebalancing*: We support the notion but the ED is unclear as to the criteria that must be applied in order to decide whether there is a need to rebalance the hedge. A significant degree of judgment would be required in determining whether a new trend is emerging, or whether there are fluctuations around a long term trend. Further, the mandatory rebalancing may require frequent revision of the hedge ratio in order to maintain the hedge effectiveness objective, which could significantly increase the operational burden of hedge accounting.

- In our view, the Board should adopt a more principles-based approach in determining the eligibility of hedging. We do not understand why the objective of hedge accounting focuses solely on one part of the single performance statement. That is, "risks that could affect profit or loss". As the overall objective is "to represent in the financial statements the effect of an entity's risk management activities that use financial instruments", it seems illogical to preclude the management of risks that affect another part of the single performance statement, "other comprehensive income (OCI)". This restriction to just those risks that affect profit or loss and some other proposals in the ED could create inconsistencies with risk management practices and need, in our view, to be further considered by the IASB such as

  - Restriction of eligible hedged items to risks that could affect profit or loss prohibits hedge accounting for equity securities classified as fair value through OCI.

  - Restriction to the eligibility of specific components such as inflation and credit risk is considered to be inconsistent with the proposed objective of the hedge accounting of representing the effect of an entity's risk management activities if these components can be separately identifiable and reliably measurable.

  - To extend the eligible hedging instruments to non-financial items.

Based on our observation at the IASB outreach meetings in Hong Kong, it was noted that the interpretation of some of the requirements in the exposure draft, such as the hedge effectiveness requirements and situations which would require rebalancing, is not consistent between the constituents and the staff of the IASB, we are concerned that diversity in practice may result were the exposure draft to proceed without suitable clarifications. We recommend that the IASB review the current wordings in the exposure draft to ensure they reflect what the IASB intends.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/jn

Encl.

Comments on the IASB Exposure Draft of *Hedge Accounting*

Objective of hedge accounting

<u>Question 1</u>

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

We generally support the proposed objective to align hedge accounting more closely with risk management activiites. However, we believe that another important objective of hedge accounting is to mitigate the recognition and measurement mismatch that may arise from the normal accounting requirements applicable to hedging instruments and hedged items. We, therefore, believe that a hedge accounting objective should reflect the following:

a) a link between an entity's risk management activity and its financial reporting; and

b) how hedge accounting mitigates the recognition and measurement anomalies between the accounting for hedging instruments and the accounting for hedged items.

Specifically, we recommend the Board to use the objectives set out in paragraph BC14 accompanying the ED.

We urge the Board to provide guidance to clarify the context of the level at which risk management strategies should be applied for hedge accounting. For instance, risk management strategies would imply a high level management approach, such as “no more than 40% of the entity’s borrowings should be at a variable rate”. Nevertheless, the application of such strategies or objectives would be at a much lower level so that there is a one to one relationship between each strategy or objective and each hedge accounting relationship. As each entity’s risk management strategy is different depending on the specific facts and circumstance, we recommend the Board clarify how the concept of risk management strategy is intended to be applied.

While we agree with the broad outline of the proposed objective, we do not understand why the objective of hedge accounting focuses solely on one part of the single performance statement. That is, “risks that could affect profit or loss”. As the overall objective is “to represent in the financial statements the effect of an entity’s risk management activities that use financial instruments”, it seems illogical to preclude the management of risks that affect another part of the single performance statement, “other comprehensive income (OCI)”. Therefore, we would like the IASB to consider permitting hedge accounting of risks that affect OCI e.g. investments in equity investment at fair value through OCI and pensions. We understand that entities do manage risks of equity investments that are strategic in nature. For instance, a common risk management strategy would be for entities to hedge the foreign currency exposure on a strategic foreign currency equity investments designated as fair value through OCI. In our view, hedge accounting should be permitted provided that the hedging relationship meets the general requirements for qualification and is consistent with the risk management activities.

Instruments that qualify for designation as hedging instruments

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

We welcome the extension of the range of eligible hedging instruments to include non-derivative financial instruments, because it enables an entity to align its hedge accounting closer to its risk management objectives.

However, we consider that the Board should extend the eligible hedging instruments to non-financial items such as gold bullion. It is common for entity to use gold bullion to hedge against the forecasted jewellery sale. We believe that as long as the management believes that such hedge accounting is consistent with their risk management policy, they should be allowed to apply hedge accounting to reflect this.

We note that paragraph 5 of the ED states that a financial asset or a financial liability measured at fair value through profit or loss may be designated as a hedging instrument. However, according to IFRS 9, an entity can only elect to adopt a fair value option provided that the use of fair value eliminates or significantly reduces an accounting mismatch. Therefore, there may be situations where the designation of a financial instrument measured at fair value through profit or loss as the hedged instrument would contradict with its original purpose of eliminating accounting mismatch. Therefore, we believe that financial assets or financial liabilities that are designated as fair value through profit or loss should not be allowed to be designated as eligible hedging instruments.

In addition, we note that paragraph 17 of the ED only allows the foreign currency risk of an intragroup monetary item to be qualified as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation but it does not allow the intragroup monetary items to be eligible hedging instruments. We are not convinced by the explanation in paragraph BC47 accompanying the ED that the issue is not addressed in the ED because the consideration of intragroup monetary items for eligibility as hedging instruments would require a review of the requirements in IAS 21 at the same time. In our view, the Board should adopt a more principles-based approach in determining the eligibility of hedging.

The ED continues to disallow the use of written option as a hedging instrument provided that a written option is designated as an offset to a purchased option. We consider that it is rather rule-based and a written option should be allowed for hedge accounting if it can be proved to be consistent with the risk management strategy. Should the Board decide not to allow a written option be assigned as hedging instrument, we would recommend the Board to provide a clarification of when is the assessment of a written option should be made e.g. at inception or when hedge accounting is applied.

Derivatives that qualify for designation as hedged items

<u>Question 3</u>

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?

In principle, we support the proposal that a synthetic exposure may be designated as a hedged item and that a hedged item may consist of a combination of a derivative and a non-derivative instrument. However, it would be helpful if the final standards can clarify the applicability of such "synthetic accounting" on fair value hedge accounting as its gains and losses on the hedged item would already be recognized in profit or loss.

In operational perspective, we recommend the Board to provide more comprehensive guidance regarding the documentation and effectiveness testing of such aggregated exposures. Take the illustrative example as stated in B9(b) of the ED, an entity enters into a 10-year fixed-to-floating cross currency interest rate swap that swaps the fixed rate foreign currency debt into a variable rate domestic currency exposure. This is then overlaid with a 2-year domestic interest rate swap that, on the basis of the domestic currency, swaps variable rate debt into fixed rate debt. Based on the ED, it is unclear whether both the 10-year and 2-year interest rate swaps in the illustrative examples are required to be proved effective to qualify for hedge accounting or only the net exposure can be assessed for effectiveness. We are concerned that without clear guidance, preparers may be confused and that this will result in a diversity in practice emerging.

Designation of risk components as hedged items

<u>Question 4</u>

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We welcome the decision to permit the designation of cash flows or fair values of an item attributable to a specific risk or risks as hedged items irrespective of whether the item that includes the risk component is a financial or non-financial item. We believe that this will eliminate a significant issue for those companies that manage individual risk components separately and enables closer alignment of risks management practices to the accounting treatment.

Paragraph B18 of the ED asserts that "inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified." We appreciate the difficulties that exist in identifying and measuring reliably non-contractual inflation components. However, 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.

In addition, we believe that to make the standards operational, the Board should provide clear guidance on what is meant by "separately identifiable and can be reliably measurable" as required in the ED, particularly for those risk components that are non-contractually specified. We believe that further guidance should be developed to aid preparers in identifying the risk components such as liquidity risk, inflation risk, credit risk and interest rate risk, etc., especially in situations where such risks are not explicitly identified in the hedged item. For example, under the ED, an entity may choose to fair value hedge the interest component of payments for a non-cancelable executor contract. However, the interest rate component is not often explicitly identified in an executor contract.

Designation of a layer component of the nominal amount

<u>Question 5</u>

(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 with the decision to permit the designation of a layer component as hedged item. However, we consider that the definition of a layer component as defined in B21 is not clear. It states that "a layer component may be specified from a defined, but open, population". We find it is difficult to understand how a component can satisfy both the criteria of "defined" and "open". We suggest removing the word "open" to prevent confusion and to remove potential conflict with the hedging of an "open portfolio" that we expect will be considered in the ”macro hedging” proposals.

(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 do not have a firm response to this question. We understand that the interest rate risks on certain layer components of a contact can be isolated from the prepayment risk at a portfolio level. However, we also understand the complications that prepayments occur for many reasons which are not directly linked to interest rate risks, such as mortgages prepayable when the borrower relocates, passes away or refinances from another bank, which are behavioral considerations that are factored by financial institutions into their risk management strategies. We would like the Board to further consider this issue as part of the “macro hedging” proposals.

Hedge effectiveness requirements to qualify for hedge accounting

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We welcome the removal of the 80 to 125 per cent bright line test for assessing and measuring hedge effectiveness. It is a significant step towards introducing flexibility and abolishing unnecessarily restrictive requirements that currently discourage entities from applying hedge accounting. However, since all ineffectiveness is recognized in profit or loss, we suggest the Board reconsiders whether the qualifying criteria for hedge accounting are really necessary. In our view, entities should perform a qualitative assessment at the inception of the hedging relationship that demonstrates the existence of an economic relationship between the hedged risk and the hedging instruments, and achieves the company's risk management strategy.

We have concerns with the current wording in the ED that indicates a hedge relationship must produce an "unbiased" result, as this is overly restrictive as it seems to indicate that all bias should be eliminated both at inception and on subsequent designations. Without flexibility, the ED would be more restrictive with a higher operational burden than currently required by IAS 39. We believe that it is not the intention of the Board.

In addition, we have concerns regarding the proposed effectiveness criteria that the hedge relationship minimizes expected hedge ineffectiveness. We believe that the objective of risk management of an entity is not always to minimize expected hedge ineffectiveness. In many cases, an entity may decide that a hedge that is substantially less than 100% effective may meet that entity's particular risk tolerance, given the costs of hedging and other factors. Based on our observation at the IASB outreach meetings in Hong Kong, we understand the Board does not intend that a completely perfect degree of precision is required and that entities are permitted to apply judgment as to their own degree of tolerance. It is unclear how a requirement to minimize is consistent with a principles based standard intended to align hedge accounting with risk management practices.

We are concerned that a requirement to minimize hedge ineffectiveness in connection with the other principles of assessing effectiveness may require an entity to search for the hedging instrument that most significantly reduces ineffectiveness regardless of whether it is economically advantageous or consistent with the entity's risk management strategy and those hedging instruments that make operational sense for the entity to utilize. For example, an entity could seek to develop a bespoke hedging instrument that minimizes ineffectiveness or use an exchange traded instrument that, while not minimizing ineffectiveness, provides an effective economic offset for which hedge accounting should be attributed.

We acknowledge that the Board noted in the Basis for Conclusions that "… many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of basis risk that the entity accepts in order to achieve a cost-effective hedging relationship. Consequently, when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item." There is a difference between something that cannot be eliminated at all and something that cannot be cost effectively eliminated. While the Board appears to be acknowledging that some trade off between hedge effectiveness and cost effectiveness is part of an entity's risk management strategy, it remains unclear where that boundary lies, particularly in view of the mandate to minimize hedge ineffectiveness.

We believe that a qualitative threshold such as reasonably effective should be adopted in connection with the broader proposed hedge accounting principles, as it would provide a necessary measurement basis against which to assess the competing objectives of minimizing hedge effectiveness and achieving cost effectiveness. It would also allow for more qualitative hedge assessments, which would reduce the need for onerous quantitative effectiveness testing. This would be consistent with the FASB's proposal in its exposure draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* and result in a better matching of hedge accounting with an entity's risk management objectives.

The IASB's proposed model relies heavily on an entity's risk management as a basis for hedge accounting, however, it is noted that this linkage is not continued consistently throughout the ED. For example, the qualifying criteria for hedge accounting in the ED do not explicitly state that a hedging relationship needs to be aligned with the entity's risk management objectives. We believe that the Board should articulate better the link between risk management and hedge accounting.

Rebalancing of a hedging relationship

Question 7

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

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

We agree with the notion of "rebalancing" hedge relationship, because this enables an entity to reflect changes that occur in a hedging relationship from a risk management perspective. In this way, accounting would reflect the development of the risk management activities. We consider that the introduction of the rebalancing notion is an improvement as it avoids frequent discontinuation and restarting of hedge relationships when the risk management objective remains the same. However, we have a number of concerns and points for clarification, as detailed below.

We believe the ED is unclear as to the criteria that must be applied in order to determine whether there is a need to rebalance the hedge or not. According to paragraph 23 of the ED, the need to consider rebalancing arises when the objective of hedge effectiveness assessment are no longer met, e.g. there is bias or an expectation that ineffectiveness will not be minimized by the current hedge designation. The ED requires that ineffectiveness will not always be minimized such that it is expected to be zero. However, the requirement to "eliminate any bias" indicates an expectation that no bias is acceptable. This interpretation could lead to requirements for frequent rebalancing as the ED seems to indicate that frequent rebalancing is <u>required</u> in order to maintain the hedge effectiveness objective and result in significant operational burden to preparers. Further, a significant degree of judgment must be applied by management to consider whether the bias is temporary or indicative of a trend away from the designated hedge ratio. We would recommend that the Board provides additional clarity. We believe that rebalancing should be <u>permitted, but not required</u> and the ED should be clearer that judgment is permitted in deciding whether to rebalance, not solely based on the sources of ineffectiveness and whether the additional ineffectiveness is a trend, but also on the level bias that is acceptable over the life of the hedge. Under our proposed model, if an entity chooses not to rebalance, hedge accounting will be discontinued because the entity effectively changes its risk management strategy when it realized that the hedge is no longer effective, at which point, the entity will either dispose of the hedging instrument or hold the hedging instrument for trading purposes.

The guidance in the ED on rebalancing focuses on the requirement on the change in volume of the existing hedged item or hedging derivative. However, we believe that there will be other situations where rebalancing may be appropriate such as changes in expected timing of hedged item and change in basis risk. We would recommend the Board further consider whether such changes to hedge relationships are situations which would require rebalancing.

Discontinuing hedge accounting

<u>Question 8</u>

(a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?

We agree 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 as it allows hedge accounting to be more closely aligned with actual risk management practices.

(b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

We agree with the proposal in principle to avoid entities abusing the ability to discontinue hedging for accounting purposes but continue for risk management purposes. However, given that entities could just close out a hedging derivative and transact new one or just change their risk management strategy to achieve the same effect as voluntarily de-designation, the requirements may not be as effective as in avoiding such abuses as intended.

In addition, it would be helpful if the Board can clarify the appropriate level to be considered on the assessment of changes in the risk management objective (transaction level, entity / group risk management).

Accounting for fair value hedges

<u>Question 9</u>

(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?

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

We do not support the proposed accounting approach for fair value hedges.

Specifically, the proposal requires entities to take the following two steps:

(i) Step 1: Gains or losses on hedging instruments and hedged items are recognized in other comprehensive income (OCI) when they are incurred; and

(ii) Step 2: Any ineffectiveness is reclassified from other comprehensive income to profit or loss in the period when it arises.

On Step 1, there are a number of fundamental issues the Board needs to address before concluding that gains or losses on hedging instruments and hedged items in a fair value hedge should not be recognized in profit or loss. For example, what is meant by OCI classification? What are the principles that differentiate items of OCI from items of profit or loss?

Until the Board deals with the above fundamental issues, we do not believe that it is appropriate for the Board to conclude that gains or losses on hedging instruments and hedged items should be recognized in other comprehensive income. We do not believe that the OCI classification is a “dumping ground” for contentious items.

In addition, we do not believe that the proposed fair value hedge accounting mechanism would provide useful information to users of financial statements. Nor do we believe that the proposed fair value hedge accounting mechanism would reduce complexity. Specifically, under the proposal preparers need to quantify the amount of ineffectiveness in order to determine the amount of gains or losses to be reclassified to profit or loss whilst the existing fair value hedge accounting mechanism in IAS 39 does not require preparers to quantify the amount of hedge ineffectiveness, as this automatically achieved, nor does IFRS 7 require its disclosure.

In view of the above, we find it difficult to see why the proposed fair value hedge accounting mechanism is preferable, or more understandable than the fair value hedge accounting mechanism set out in IAS 39.

However, should the Board believe that gains or losses should be recognized in OCI (despite of the above fundamental issues associated with OCI), we support the Board's proposal of replacing the fair value hedge accounting mechanics with the cash flow hedge accounting mechanics. We believe that such an approach would reduce complexities (e.g. those associated with the distinction between fair value hedges and cash flow hedges).

Moreover, we do not agree with the proposal's 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 as the primary financial statements will be cluttered, depending on the number of hedge relationships entered into by an entity. If required, we would support that the information be reflected in a separate note to the financial statements.

(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 that linked presentation is not an appropriate tool to report on the link that the entity's risk management strategy establishes through hedge accounting between different assets and liabilities. We believe that the risk management strategy of an entity should be explained in the notes to the financial statements. Showing linkage on the face of the statement of financial position would create confusion and impair comparability between entities.

Accounting for the time value of options for cash flow and fair value hedges

<u>Question 10</u>

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?

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

We welcome the proposals which address the issue of ineffectiveness due to the time value components in options. We note that the proposals in the ED are similar to the treatment of options in US GAAP Derivatives Implementation Group (DIG) G20 but the proposals in the ED extend the requirement to all fair value and cash flow hedges.

We acknowledge that the proposals have the potential to introduce additional complexity as entities that use options as part of their hedging strategy will need to obtain detailed information to calculate "aligned time value". We propose that to reduce confusion of preparers, the wording of the proposal should be refined and make clear that if the underlying of the option is not exactly the same as the hedged item, the actual time value has to be compared with that of a hypothetical option that perfectly matches the hedged item (e.g. with the same notional amount, life and underlying).

The ED proposes to account for the time value of options in a hedge accounting relationship by making a distinction between transaction-related hedged items and time period related hedged items. However, we note that the ED does not explain clearly the definition of these two types of hedged items. We suggest that illustrative examples should be provided for easy understanding.

In addition, we note that the ED proposes that for transaction-related hedged items (e.g. the forecast purchase of a commodity), the cumulative change in fair value of the option's time value would initially be accumulated in OCI and then the amount is removed from OCI and included in the initial cost or other carrying amount of the hedged item. We consider the proposed accounting treatment may not be consistent with the measurement of assets in other standards such as IAS 2 *Inventory* and IAS 16 *Property, Plant and Equipment* where the finance cost is not included in the initial cost of asset unless it meets the criteria for capitalisation of borrowing costs. We would like the IASB to address this apparent inconsistency by explaining why the cost of time value option is allowed to be included in the initial cost of asset under hedge accounting.

In addition, we believe that, if the proposed accounting for time value of options is finally adopted, it should also be applied to forward contracts where entities separate the interest element and the spot price of a forward contract for hedge accounting purposes.

Hedges of a group of items and Eligibility of a group of items as the hedged item

<u>Question 11</u>

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?

A hedge of an overall net position does not qualify for hedge accounting under IAS 39. We welcome the proposal in the ED that allow a group of items to comprise a net position that can be an eligible hedged item under certain criteria. We understand that these proposals represent an intermediate step towards the development of an accounting model for hedges of open portfolios (i.e. macro hedges). However, we observe that some restrictions will be maintained in the general hedging model for closed groups of hedged items and the rationale for these restrictions is not clear and needs clarification.

(a) Paragraph B73 of the ED states: "When a group of items that constitute a net position is designated as a hedged item, an entity shall designate the overall group of items that includes the items that can make up the net position. An entity is not permitted to designate a non-specific abstract amount of a net position." We find the reference to non-specific abstract amount to be particularly unclear. The ED provides an example of net firm commitments that off-set in different time periods as representing a non-specific abstract amount. However, the fair value of the commitments would offset with the exception of time value. The underlying principle is simply not clear and the example serves to increase the confusion.

(b) For the purpose of cash flow hedge accounting, the ED specifies an additional criterion to allow a group of net positions as a hedged item. That is, any offsetting cash flows in the group of hedged items, exposed to the hedged risk, must affect profit or loss in the same reporting period (including interim reporting periods). This criterion may be a significant constraint for many entities. This may be because risk management is based on the timing of cash flows rather than the timing of profit or loss impact. Forecast sales and purchases with the same payment dates often do not affect profit or loss in the same period (since there is, typically, a stock turnover period on the items purchased). Also, this restriction will have differing effects for entities that report on yearly, half-yearly or a quarterly basis, with the greatest effect being on the latter, where it may mean that such entities cannot hedge at all.

Presentation

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognized 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 are concerned about the inconsistency between the proposals in the ED in relation to the presentation of the effect of hedge accounting for group of items in the statement of financial position and the profit or loss. The ED proposes that when an entity designates as a hedged item a group of items (including a net position) in a fair value hedge, the cumulative change in fair value of the hedged risk from each of the items is required to be presented on a gross basis adjacent to the related assets and liabilities in a separate line item. However, the ED proposes that the gains or losses from the hedging instrument, when it is designated in a hedging relationship of a net position of offsetting items that affect different lines of that statement, should be present on a net basis in a separate line item in profit or loss.

We understand the rationale for the net presentation is to prevent grossed-up adjustments of all the affected line items in the income statement that would result in the recognition of gross gains or losses that do not exist. However, this may not be the desired outcome for some entities, for example, when forecast sales and purchases are an eligible hedged net position, their corresponding line items in the profit or loss ("sales" and "cost of goods sold") will still be recorded at spot rate and will not reflect the effect of the hedge (which is to be shown on a separate line), therefore, volatility will still occur in gross line items in profit or loss. Since different industries may desire for different types of presentation (i.e. gross/net) to suit their purpose, we would suggest the Board to allow preparers to present the hedging instruments' gains or losses in the income statement either in gross or net amount provided that there is comprehensive disclosure in the notes of the financial statements about the rationale of presentation and the policy should be carried out consistently.

Disclosures

<u>Question 13</u>

(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?

We are supportive of the objectives of the disclosure requirements. However, we would encourage the Board to consider how the proposed disclosures will interact with the existing hedge accounting disclosures in IFRS 7 *Financial Instruments: Disclosures* and the Basel III disclosure requirements to ensure that the proposed IFRS disclosures are not duplicative or inconsistent with the Basel accords.

In general, we agree with the proposed disclosure requirements but have certain substantive comments:

- Paragraph 45 requires an entity to disclose how it manages each category of risk exposure. We consider the scope of the requirement is far too extensive as it may include the hedged risks and other operational risks such as legal and tax risks etc. We suggest that the disclosure should be limited to those risk exposures for which an entity has applied hedge accounting, which would be consistent with the requirement in paragraph 44.

- Paragraph 46(c) requires an entity to disclose in quantitative terms how hedging changes the exposure. For example, entities would be required to disclose foreign currency denominated purchases or sales over the next three years if hedge accounting is applied to any portion of those cash flows. We are concerned that this requirement may involve the disclosure of information that is absolute, forward looking and commercially sensitivity. We consider that if the objective of the Board is to enable users to understand the extent of risk exposures that have been hedged, the Board can consider revising the requirement to "disclose a qualitative indication of the extent of risk exposure that is hedged by an entity that is highly probable."

- The Board should provide more guidance on the specific disclosures that should be included in the financial statements.

Accounting alternatives to hedge accounting

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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?

The ED proposes that contracts that would meet the "own use" scope exception would be required to be accounted for as derivative instruments, if that is in accordance with the entity's fair value-based risk management strategy. We agree that the "own-use" scope exception of IAS 39 is complex and difficult to apply and the proposals of the ED are a step in the right direction. However, we do not support the proposed change which could require many commodity contracts that are not currently accounted for as derivatives to be recognized on balance sheet and recorded at fair value. Moreover, the reference to underlying business model is unclear as to whether the entire business must be managed on a fair value basis or not. We encourage the Board to apply a similar approach to US GAAP where the normal purchase and normal sale exemption is an election which permits entities to not account for own use contracts at fair value without regard to an entity's risk management strategy.

As the issue of "own use" scope exception is not directly related to hedge accounting and we consider that the current proposals do not address all concerns of preparers, we suggest that the Board should address this issue as part of a separate project.

Accounting for credit risk using credit derivatives

Question 15

(a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?

(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

We disagree with the Board's decision to preclude hedge accounting for hedges of credit risk using credit derivatives and we found that none of the three alternative accounting treatment proposed by the Board is satisfactory.

We believe that, considering the objective of the hedge accounting (i.e. to represent the effect of an entity's risk management activities), the requirements should provide entities with the tools to capture their risk management practices in the financial statements.

Paragraph BC 219 to BC 246 assert that credit risk is not an eligible risk component, as the Board considers it cannot be identified separately and measured reliably. We have identified contradictions between this assertion and the requirements in other standards or projects, such as reporting for changes in own credit risk for financial liabilities under IFRS 9 and assessing future credit losses in the ED of Financial Instruments – Amortised Cost and Impairment, where credit risk is required to be assessed in isolation.

We acknowledge that the spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements and it is difficult in practice to isolate and measure the changes in fair value that are attributable only to change in credit risk. However, we note that the methodology prescribed in IFRSs 7 and 9 may deduce an approximate measure of the impact of credit risk. That the measurement is not exactly precise is not a concern since the lack of precision would be recognized in profit or loss as part of ineffectiveness. We consider that the Board should develop a principle-based standard without adding rules to restrict specific components as hedged items. Therefore, we believe that, where the hedged item is credit risk, hedge accounting should be permitted provided that the hedging relationship meets the general requirements for qualification, that is reasonable hedge effectiveness can be expected, and is consistent with an entity's risk management activities.

However, If the Board decides to explore further the three alternatives as proposed in the ED, we would prefer Alternative #3 which would permit fair value through P&L to be elected at initial recognition or subsequently, with the difference between the then carrying amount and fair value of the hedged item being amortised or deferred. To not permit an election subsequent to initial recognition (as is the case in Alternative #1) would be inconsistent with many risk management strategies whereby an entity obtains credit protection for exposure at some point after initial recognition, when perhaps the credit profile of the instrument has changed.

We believe that the immediate recognition in P&L of gains or losses related to the difference between fair value and carrying amount at the date of election as set out in Alternative #2 would involve immediately recognising in P&L changes in fair value that are not related to credit risk.

Effective date and transition

<u>Question 16</u>

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

We support the requirement for prospective application; however, we consider that limited retrospective application should also be allowed for those entities which have early adopted the first phase of IFRS 9 (classification and measurement) provided that information is available without the use of hindsight.

Given that the proposals in the ED will require entities to undertake a fundamental review of their hedging strategies, hedge documentation and associated accounting. In addition, all existing hedge relationships will need to be reviewed to ensure that they continue to qualify for hedge accounting at transition. In this respect, we encourage the

Board to include more transitional guidance, for example, on how outstanding IAS 39 hedging relationships should be accounted for as of transition date. We believe an effective date of 1 January 2015 would be more appropriate. This view is consistent with our response to the IASB's Request for Views on Effective Dates and Transition Methods.

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~ End ~