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

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Sent electronically through email (hhoogervorst@ifrs.org)

21 December 2012

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

Dear Hans,

IFRS 9 Chapter 6 Hedge Accounting Review Draft

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 appreciate the opportunity to provide feedback on the Review Draft issued by the IASB regarding hedge accounting, proposed as amendments to IFRS 9 *Financial Instruments.*

Significant concern on the due process

In principle, we agree that the proposed amendments are an improvement over the current literature contained in IAS 39. However, some of our constituents expressed significant concerns on a specific amendment in Appendix B Application Guidance Para B6.5.5, which provides guidance on measuring hedge ineffectiveness using hypothetical derivatives. The paragraph was a surprise to us as it did not feature in the exposure draft, nor did it come up in the due process subsequent to that. It appears to us that not all of the required due process steps had been complied with by the IASB staff and we would be interested in knowing whether the IASB's Due Process Oversight Committee is satisfied with the way in which this draft document, which is intended to form an integral part of the Standard, has been dealt with by the IASB.

Specific issue on the treatment of cross currency basis spreads in foreign currency cash flow hedge

Paragraph B6.5.5. of the hedge accounting review draft incorporates a requirement that a hypothetical derivative, used to measure hedge effectiveness, does not include features in the value of the hedged item that only exist in the hedging instrument (but not the hedged item). We agree with this requirement. However, the paragraph goes on to note that this means that a hypothetical derivative cannot impute a charge for exchanging different currencies (often referred to as 'currency basis') even though actual derivatives might include such a charge. This implies that currency basis is not a component of the hedged item. We note that some commentators disagree with this implied fact. They believe that cash flow hedging for FX is built on the premise that - absent the hedging instrument - the entity would be required to exchange its own

functional currency for foreign currency in the future in order to settle the foreign currency exposure. It is this variability that is being hedged. Since this exchange of cash flows will occur in the future, those commentators would maintain that currency basis also exists in the hedged item. This treatment would be consistent with the accounting for FX embedded derivatives that are required to be separated from a host contract in accordance with former paragraph AG33(d) of IAS 39, which also is measured including currency basis.

Nevertheless, irrespective of which view one takes to the above theoretical arguments, we believe that the resulting accounting, which requires ineffectiveness to be recognised (with the resultant volatility in profit or loss), does not reflect the economics of the arrangement. In many cases the expected cash flows of the hedging instrument will perfectly offset the hedging instrument. While we accept that credit risk in the hedging instrument, for example, could lead to ineffectiveness in such a situation, we believe that this is a real risk that could result in the hedging instrument failing to offset variability in the hedged cash flows. This is not the case with currency basis, as it is a charge for exchanging currencies rather than a real risk that could lead to hedge failing to be effective. It should not, therefore, be taken into account when measuring effectiveness of the hedge relationship.

We also note that if one takes the view that currency basis is not present in the hedged item but instead represents a charge inherent in the hedging instrument for exchanging currencies in the future, we do not understand why this should be treated from other transaction costs and/or premiums associated with obtaining protection from risk. For example, the hedge accounting review draft proposes that initial time value of an option should be amortised over the period in which movements in the intrinsic value could affect profit or loss (for a time-period related hedge), with other changes in time value recognised in other comprehensive income. We believe that recognition of currency basis movements in profit or loss is inconsistent with such an approach. Indeed, we are of the view that including currency basis in the hypothetical derivative would have the same effect of recognising the initial charge (or credit) for exchanging currencies in profit or loss as the hedged item affects profit, and we therefore support this approach.

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We hope the IASB can address the above concern prior to the final standard being released.

If you would like to discuss any aspects of this letter in more detail, please do not hesitate to contact me at simonriley@hkicpa.org.hk.

Yours faithfully,

Simon Riley
Director, Standard Setting

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