

9 March 2011

International Accounting Standard Board
30 Cannon Street
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United Kingdom

Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON EXPOSURE DRAFT ON *HEDGE ACCOUNTING*

In response to your request for comments on the IASB's exposure draft on *Hedge Accounting*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

GENERAL COMMENTS

We support the International Accounting Standards Board (IASB and Board) in seeking to improve and, more importantly, simplify the hedge accounting requirements so that the financial statements better reflect the way in which the entity manages its financial risks. We generally agree and support the proposals contained in the exposure draft, ED/2010/13, *Hedge Accounting* (ED).

However, some of our constituents (a minority) raised concerns around the lack of comparability created by the ED (and its predecessor IAS 39 – *Financial Instruments: Recognition and Measurement* (IAS 39)) in particular noting that hedge accounting is a voluntary designation on a transaction-by-transaction basis. These constituents believe that the ED will allow similar risk exposures and risk management strategies to be accounted for differently between entities, different transaction types within an entity, and across like transactions within an entity. For example, an entity may hedge account larger capital expenditure purchases and not other bulk working capital related purchases even though both are economically hedged.

We do have concerns regarding the approach taken by the Board in issuing this ED prior to the issuance of its proposals regarding portfolio or macro hedge accounting. We understand that the Board is seeking to finalise the issuance of this phase of the replacement of IAS 39 with IFRS 9 – *Financial Instruments* (IFRS 9) by 30 June 2011. We believe that it would have been more efficient for the IASB to finalise its hedge accounting proposals into a single document and then to seek input from its constituents. This is especially so since, whilst this ED does not explicitly cover portfolio/macro hedge accounting, we do note that it does inherently contain components of such a model, being in areas such as the designation of layers of cash flows, designation of net and nil net hedged positions and the rebalancing of a hedging relationship's hedging instruments and hedged items. Accordingly, we would like to point out that our comments contained in this document may well change based on the proposals that the Board issues on portfolio/macro hedge accounting.

Based on our reading of the ED, we believe that the Board has in some respects continued to rely on IAS 39's existing hedge accounting requirements and rules in developing this ED rather than performing a fundamental review of the basis on which hedge accounting should be permitted. Whilst we have outlined our comments in detail below, we make reference to examples such as only requiring hedge accounting where the hedged risk affects profit or loss; not permitting certain written options to qualify as hedging instruments; the reference to the interest element of a forward contract; disallowing intra group foreign denominated monetary items from being designated as hedging instruments; and permitting inflation risk to be a qualifying hedged risk. We believe that the Board should re-consider a number of the fundamental areas of hedge accounting, such as those noted in the aforementioned sentence, so as to result in the financial statements better reflecting the economic risk management practices of the entity.

SPECIFIC COMMENTS

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 have separately considered this question under each of the following sub-headings:

- the entity's risk management activities; and
- the hedged risk could affect profit or loss

The entity's risk management activities

We support the principle that the objective of hedge accounting should be aligned with an entity's risk management activities. In terms of the ED, an entity's risk management plays a key role in a number of areas, for example, the manner in which the entity discloses its hedge accounting activities, i.e. reference to both the entity's *risk management strategy* and *hedging activities* [ED paragraph 40]; whether an identified risk (or component) qualifies for hedge accounting, i.e. reference to an entity's *risk management objective and strategy* [ED paragraph 19]; and the determination of whether an entity discontinues hedge accounting, i.e. reference to *risk management objective* [ED paragraph B46].

As a consequence of the emphasis placed on an entity's risk management *activities/objective/strategy*, we request that the Board consider providing additional guidance on what constitutes an entity's *risk management activities/objective/strategy*, including:

- whether an entity's risk management strategy and its risk management objective are separate concepts, and if so, what the distinguishing characteristics of each term are;
- what level of the entity's management should be involved in setting an entity's risk management strategy/objective, for example, should an entity's risk management strategy be determined by the entity's key management personnel;
- at what level an entity's risk management activities/strategy/objective should be determined, i.e. on an entity-wide, portfolio/business unit, a transaction level, or an appropriate combination of these; and
- whether an entity's risk management activities/strategies/objectives may extend to one-off transactions. In addition, does a one-off hedge require the involvement of an appropriate level of the entity's key management personnel to qualify for hedge accounting?

The hedge risk could affect profit or loss

We do not believe that hedge accounting should be limited to where an entity may '*... manage exposures arising from particular risks that could affect profit or loss.*' [ED paragraph 1]. This is because entities may hedge particular risk exposures which ultimately may never impact profit or loss. The decision to hedge a particular business risk is not driven by how or where the gains and losses on the transaction might be reported within an entity's financial statements; rather management of the entity determines whether it is appropriate for the entity to be exposed to a given risk or mitigate the risk exposure.

By requiring that the particular risk(s) could affect profit or loss, a number of economic hedges will not be allowed to be reflected from an accounting perspective in accordance with the entity's risk management activities and hence an entity's financial statements may not achieve the objective of hedge accounting, i.e. because the financial statements do not

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represent an entity's risk management activities that use financial instruments to manage exposures from particular risks. For example, an entity may wish to hedge the market price risk inherent in an equity instrument, which on acquisition a number of years ago, it elected to designate at fair value through other comprehensive income (FVTOCI) in terms of IFRS 9. Due to a change in its business model, the entity decides to dispose of its investment, but wishes to secure a minimum price through the purchase of a put option over the equity instrument. The entity wishes to reflect the link between the equity instrument and the put option in its financial statements, but it is precluded from doing so by paragraph 4 of the ED, which does not allow hedge accounting to be applied to equity instruments classified as FVTOCI. In addition, paragraph 5.4.4 of IFRS 9 states that the election of FVTOCI is irrevocable, therefore the fair value movements on the underlying equity instrument remain within 'other comprehensive income' (OCI) and the fair value movements on the put option within profit or loss.

We also note that the requirement for the particular risk to affect profit or loss would prohibit the following economic hedges from being accounted for in accordance with the ED:

- a hedge of the variable interest rate risk inherent in a preference share dividend where the dividend is based on a variable interest rate benchmark (the preference share is classified as an equity instrument); and
- a hedge of foreign exchange risk of a forecasted dividend to be declared in foreign currency before the date of recognition of the dividend within the financial statements, i.e. before a financial liability is raised.

We therefore recommend that the Board consider the removal of the ED's requirement that the hedged item could affect profit or loss.

Further to our recommendation above we recommend that the Board permit an entity to apply hedge accounting to FVTOCI instruments where the entity's business model for holding that instrument changes from one of holding the instrument to one where it will be sold. We believe that such a treatment would better reflect the entity's risk management activities within their financial statements (assuming that the hedging relationship complies in all other respects with the ED). We do not agree that permitting such hedge accounting would result in the development of another framework that would add significant complexity (BC26 of the ED). If the Board were to permit FVTOCI instruments to be accounted for in a fair value hedge relationship; we suggest that both changes in the fair value of the hedged item and hedging instrument (designated in terms of paragraph 8-11 of the ED) be recognised in OCI consistent with the treatment of fair value hedges described in paragraph 26 of the ED. We believe that any hedge ineffectiveness as a result of over-performance of the hedging instrument, measured in absolute terms relative to the hedged item, should be recognised in profit or loss. We believe that this principal will ensure consistency with IFRS 9's measurement and recognition requirements for equity instruments that are designated to be measured at fair value through OCI.

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We have illustrated our suggestion through the following scenarios:

Scenario	Change in hedged item	Change in hedging instrument	Ineffectiveness recognised in profit or loss
1	+100	-110	10
2	-90	+110	20
3	-90	+85	NIL

If the Board determines that it is appropriate that the hedged risk must satisfy the “could affect profit or loss” test, we request that additional guidance be provided on how this criterion should be applied. While in most transactions it is clear that the hedge risk will affect profit or loss through the impact of depreciation or the sale of the item in the ordinary course of business (e.g. inventory), this may not always be the case. We have provided two examples where we believe the application of the “could affect profit or loss” test may not be apparent, could lead to application difficulties and diversity in practice:

- An entity may hedge the foreign exchange risk inherent in a forecast acquisition of an equity instrument. At the time of designation of the hedging relationship, the entity cannot state explicitly whether the hedged risk (changes in foreign exchange rates) will affect profit or loss, because the entity has yet to determine whether it intends to classify the instrument at Fair Value through Profit or Loss (FVTPL) or FVTOCI; and
- Some of our respondents noted that an entity may hedge the foreign exchange risk inherent in the planned acquisition of an associate or the forecast capitalisation of a subsidiary and at the time of acquisition the transaction does not affect profit or loss, but could do so if the investment were one day to be disposed of. Those respondents questioned whether the test “could affect profit or loss” has any time lines associated with it or whether it should be interpreted as being open ended.

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 non-derivative financial assets and financial liabilities that are measured at fair value through profit or loss should be permitted to be eligible hedging instruments. We note that permitting financial assets that are measured at fair value through profit or loss will allow embedded derivative features that would otherwise have been bifurcated in terms of IAS 39, to be designated as a hedging instrument, together with the related host contract, as a hedging instrument in terms of IFRS 9. Whilst we believe that this is an appropriate allowance given that such features cannot be separated from financial assets in terms of IFRS 9, we believe that such designation will result in unavoidable hedge ineffectiveness, could result in a hedge relationship that does not reflect the economic rationale and the risk management of the entity and may cause the hedging relationship to produce results which are not “unbiased”. Accordingly, we recommend that the Board consider developing requirements that, whilst noting that the financial asset must be measured at fair value through profit or loss, permit an embedded derivative feature to be designated in the hedging relationship with changes in fair value from the remainder of the host contract (also measured at fair value) being excluded from the hedge relationship and

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hence reducing possible hedge ineffectiveness and disqualification of otherwise economic hedging relationships from being accounted for in terms of the ED.

We further do not believe that the ED or Basis for Conclusions (BC) clearly explains the Board's rationale for disallowing non-derivative financial assets and non-derivative financial liabilities, other than those measured at fair value through profit or loss, from being eligible hedging instruments. We do not fully understand what the potential *operational problems* that would arise by relaxing this restriction (from a reading of the BCs of the ED) and hence question whether the Board has fully considered whether the benefits achieved through permitting hedge accounting using such instruments would exceed the costs associated with the operational problems as noted by the Board. Although we cannot identify instances in practice where such types of instruments would be used in economic hedges and where an entity would seek to apply hedge accounting, we are concerned that this restriction could unintentionally result in economic hedges not being permitted to be reflected within the financial statements in accordance with management's risk management activities (and hence not in accordance with the ED's stated objective for hedge accounting).

Designation of hedging instruments

While this question requests our views on the qualification of non-derivative financial assets and liabilities that are measured at fair value through profit or loss as hedging instruments; the ED includes guidance and BCs on the designation of hedging instruments. Because no other specific question addresses this issue, we have provided the following comments on the designation of hedging instruments:

- 1) We would like to recommend the following minor editorial change to paragraph 6 of the ED: *'For a hedge of foreign currency risk, a **non-derivative** financial asset or financial liability may be designated as a hedging instrument'*.
- 2) Paragraph 8(b) of the ED allows as an exception that an entity may separate *'... the interest element and the spot price of a forward contract and designating as the hedging instrument only the change in the spot element of a forward contract and not the interest element.'* The term "interest element" can be viewed as prohibiting the non spot component of forward contracts with a non-financial underlying (such as commodities and, in some instances, equity instruments) from being designated for the risks relating to changes in spot rate, since the differential between the forward price and the spot price includes elements other than 'interest'. For example, insurance, storage, dividends and other non-interest costs. We recommend that the Board reconsider the use of the term "interest element" such that the spot element of such forward contracts may be permitted to be designated as the hedging instrument and to simplify the manner in which hedge accounting may be achieved for such hedge relationships.
- 3) The ED prohibits an entity from using two or more instruments (a synthetic position) where one of them is a written option or a net written option. It appears that the restrictions around written options and net written options contained within IAS 39 have merely been carried forward by the Board to this ED, without sufficient guidance provided why. In its re-deliberations, the Board believes the restriction remains appropriate when the combination of instruments in the hedge instrument is not a net

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written option. We recommend that the Board re-consider the qualification of written options into hedging relationships.

To illustrate, where the existing rules within IAS 39 (and as carried forward into the ED) do not achieve the ED's objective for hedge accounting: An entity may hedge a forecasted foreign denominated cash flow exposure with a forward exchange contract and this qualifies as an eligible hedge. Another entity that has the identical underlying risk exposure, but elects to hedge the risk by simultaneously entering into a call option and a written put option (which together represent a synthetic forward) does not achieve hedge accounting since one of the instruments (whether the options are with the same or different counterparties) is a written option, that entity cannot achieve hedge accounting. We recommend that the Board permit hedge accounting in such instances, especially since it was noted by some of our respondents that in certain markets, hedging of certain exposures may only be achieved by means of options that together equate to forward contracts.

- 4) We note in BC46-47 that the foreign currency difference arising from an intragroup monetary item that affects consolidated profit or loss is allowed to be designated as a hedged item, but not as a hedging instrument. The Board notes that permitting such an intragroup monetary item to be designated as a hedging instrument would require a review of the requirements of IAS 21 – *The Effects of Changes in Foreign Exchange Rates* (IAS 21) and that such a review is not currently planned. Some of our respondents noted that this restriction resulted in the economic rationale for such hedges not appropriately being reflected from an accounting perspective. Further, those respondents noted that this restriction, particularly in a group scenario, affected the manner in which currency related hedges were transacted so as to achieve a particular accounting outcome. We recommend that the Board reconsider its decision since we believe that not permitting qualification as a hedging instrument, in such an instance, is contrary to the objective stated in paragraph 1 of the ED. Further, without a planned project to consider this issue, it appears unusual that the Board would not consider hedge accounting proposals in this instance since there are clearly offsetting profits or losses that are readily identifiable and measurable in terms of IAS 21.
- 5) Paragraph 24 states that *replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy*. We note that this requirement has remained unchanged from IAS 39. No guidance exists as to the application of this requirement and accordingly we recommend that the Board consider including further guidance and/or examples to illustrate how a rollover or replacement strategy would be implemented in terms of the proposals. Especially how a rollover or replacement impacts the hypothetical derivative assessment, i.e. should the hypothetical derivative mirror the impact of the rolling, remain unchanged, or be based on an at-market derivative on designation date based on the rolled/replaced hedging instrument.

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Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree that an aggregated exposure that includes a derivative should be allowed to be designated as a hedged item, because it reflects the practical methods used by entities to manage particular risk exposures.

Our constituents did however raise concerns as to how the entity would operationally account for the hedge in the situation where the aggregated exposure is designated as a hedged item. More specifically, it was questioned whether the accounting treatment for the hedge as referred to in B9 of the ED is either:

- a) synthetic hedge accounting of the combination of the two instruments as a variable rate domestic currency instrument; or
- b) the derivative, that is measured at fair value, together with the hedged item that is adjusted for the hedged risk (akin to fair value hedge accounting) is then designated as the hedged item in terms of a cash flow hedging relationship.

The treatment should be carefully considered in light of the fact that hedge accounting of the underlying combination of instruments could cease in the future (due to the criteria in B46). Therefore if (a) is followed, then the swap that was designated as part of the aggregated exposure would presumably be required to be re-measured to fair value and hence result in volatility in reported profit or loss at the time at which the hedge ceases to qualify in terms of the ED. Further, we recommend that the Board provide examples to demonstrate the accounting treatment of this scenario.

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 (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?

Our comments below address the following separately:

- Identification of risk components and the concept of separately identifiable and reliably measurable; and
- Application of the separately identifiable and reliably measurable requirement to other exceptions, as noted in the ED.

Identification of risk components and the concept of separately identifiable and reliably measurable

We agree with the principle contained in paragraph 18 that an entity may designate a specific risk or risk component, provided that the risk component is separately identifiable and reliably measurable.

The ED provides limited guidance on how an entity identifies whether a risk component is separately identifiable and reliably measurable. We note that the Board has provided

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guidance on the issue through the examples included in paragraph B15 and has also indicated in B14 that ‘*an entity assesses such risk components in the context of the particular market structure to which the risks relate and in which the hedging activity takes place*’. A number of our constituents expressed difficulty in interpreting how to practically apply the guidance, especially that of B14. More specifically, whilst it is relatively simple to apply this principle to contracts where a link to a specific variable is contractually specified, it is less clear for those contracts that include risk variables that are not contractually specified. One view expressed was that a non-contractually specified risk component is separately identifiable and reliably measurable using a ‘building block’ approach, only where the ‘building blocks’ are accepted and known by market participants in determining the price of that item. Alternatively, it is questioned whether the application of B14 merely requires that there is a demonstrable relationship between the pricing of the hedging instrument and that of the hedged item (as implied by B15(b)).

We recommend that the guidance be expanded to provide the underlying principles and indicators that an entity should assess in determining whether a risk component is separately identifiable and reliably measurable

Application of the separately identifiable and reliably measurable requirement to other exceptions, as noted in the ED

We do not agree with the Board’s inclusion of the following prohibition within the ED’s application guidance “*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*” [ED paragraph B18].

Our view is that the aforementioned rule is contrary to a principle-based standard and would not be required if the ED provided robust guidance on how an entity should assess whether a risk component is separately identifiable and reliably measurable. Further, we question how this exclusion is consistent with the example specified in B15(b). In that example it is concluded that the risk component can be hedged, despite it not being specified contractually, since there was a relationship between the risks and the risks inherent in the hedging instrument. We question why such a principle cannot be applied to contracts for inflation risk despite not being specified contractually.

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?*

Yes, we agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item where such designation is aligned with the entity’s risk management strategy.

(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?*

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We agree with the Board that a layer component that includes a prepayment option is not eligible as a hedged item in a fair value hedge if the prepayment option's fair value is affected by the hedged risk.

We wish to raise the following comments on the drafting of the guidance contained within B19 to B23:

- the terms '*layer*' and '*component*' should be more clearly defined and included in Appendix A as defined terms;
- the guidance should clarify that a percentage component of a hedged item is exposed to the relevant percentage of all of the risks associated with that hedged item;
- the guidance on prepayment options should be clarified. The Board should consider including portions of BC63 to BC69 within the body of the standard;
- it should be clarified whether the guidance applies equally to the writer and holder of the prepayment option; and
- an example of a layer, where the fair value of the prepayment option is not impacted by the hedged risk (e.g. where prepayment is contractually limited to 40% of the amount advanced) and an example illustrating where the fair value of the prepayment option is impacted by the hedged risk, should be included within the final standard's application guidance.

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 that the hedge effectiveness requirements should form part of the qualifying criterion for hedge accounting. However, we do not agree with how the word '*minimise*' has been used in the hedge effectiveness requirements.

Whilst we agree that when the entity initially calibrates or subsequently rebalances its hedge ratio, the hedge ratio selected should seek to minimise expected hedge ineffectiveness; the use of the word '*minimise*' in other contexts can create confusion. An entity's risk management objective may be to reduce a particular risk exposure to an acceptable level as opposed to minimising the risk exposure. As a consequence, the entity selects the most cost-effective hedging instrument to reduce the exposure to an acceptable level, although it could be argued that it has not minimised the hedged risk through its choice of hedging instrument. Further, the word '*minimise*' may be implied as requiring ineffectiveness to be reduced to the least possible amount or degree. Some respondents were concerned that this could imply a greater threshold than 80-125% and that the entity will be required to ensure that the selected hedging instrument would almost eliminate hedge ineffectiveness.

We recommend that the Board considers alternative wording such as '*managed*', '*reduced*', or '*limited in accordance with the entity's risk management strategy*'.

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*

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

Yes, we agree that an entity should be required to rebalance its hedge relationship where the objective of the hedge effectiveness assessment is no longer met and provided that the risk management objective for the hedging relationship remains the same.

However, we wish to raise a practical concern with the requirement to rebalance the hedge relationship. For example, an entity importing coffee beans from Brazil hedges the price risk with an exchange traded forward contract, e.g. Chicago Board of Trade (CBOT). Due to grade and location differentials it determines that it requires 1.1 of notional exposure on CBOT for every 1 of underlying exposure.

At the end of year 1, due to changes in the market, the entity rebalances the hedge ratio from 1.1 to 1.05, with the excess derivative measured at fair value through profit or loss. At the end of year 2, due to the subsequent market changes, the entity rebalances the hedge ratio from 1.05 to 1.08. The entity uses the hypothetical derivative method to measure hedge ineffectiveness. Our view is that the requirements in paragraph B55 require the hypothetical derivative to be constructed as a blend of: 1.05 based on a hypothetical derivative that was at the money on the date of designation, plus 0.03 of hypothetical derivative that was at the money on the date of rebalancing. In contrast an entity which only rebalanced the hedge ratio at the end of year 2 would use a hypothetical derivative that was at the money only on the date of designation. The above example only includes two instances of rebalancing. However, where an entity performs multiple rebalancing of a hedge relationship, the construction of the hypothetical derivative would become complex and an operational challenge. We recommend that the Board provides further guidance on the construction of the hypothetical derivative where rebalancing occurs.

(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?

Yes, we agree that an entity should proactively seek to rebalance the hedge relationship if it might fail the objective of hedge effectiveness in the future and provided that the risk management objective for the hedging relationship remains the same.

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?

Yes, subject to our response to part (b) below, we agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship ceases to meet the qualifying criteria.

We do wish to note that we believe that a change in an entity's future risk management objective and strategy should not affect the current hedging relationship, i.e. if an entity is

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currently hedging a position and changes its risk management objective and strategy for all future positions, then that existing hedge relationship should not be affected by the change in risk management strategy.

- (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?*

Whilst we do not disagree with the principle that an entity should not be permitted to voluntarily de-designate a hedge while the hedging relationship still exists, we believe that the requirement will create unnecessary operational challenges.

One such operational challenge was noted where entities hedge foreign exchange risk on inventory purchases/sales, for example, in terms of their risk management strategy from the order date until the expected payment date. However, once the underlying goods have been received/delivered those entities often cease hedge accounting (through voluntary de-designation in terms of IAS 39), because the fair value movements on the hedging instrument and the re-measurement of the hedged item (receivable or payable) to closing spot rate (as required by IAS 21), are both recognised in profit or loss. Therefore, the application of hedge accounting becomes an unnecessary burden for the entity from the date the receivable or payable is recognised within the financial statements. We recommend that the Board allow voluntary de-designation of a hedge relationship where not applying hedge accounting would achieve a substantially similar result to that where hedge accounting was applied and such risk offset is in terms of the entity's risk management objective and strategy.

We also note that many entities that wish to cancel a hedging instrument do not terminate, sell, exercise, or otherwise cause the instrument to expire, because of the costs associated with early termination of these contracts. Rather, those entities remove the exposure to the hedging instrument by entering into an equal, but opposite instrument. We believe this has the same effect as the entity terminating, selling, exercising, cancelling, or causing the instrument to expire, because in substance the hedging instrument ceases to be used to hedge the designated risk in terms of the entity's risk management policies as the risk mitigation provided by the hedging instrument, in conjunction with the offsetting instrument, no longer exists. We recommend that the Board consider providing further guidance on the term '*expire*' in paragraph 24 of the ED and extends the term to include the offsetting hedging instruments described above.

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?*

Whilst we agree with the Board's proposals to retain fair value hedge accounting, we do not agree with the proposed recognition of gains and losses on the hedging instrument and hedged item within OCI with the ineffective portion being transferred to profit or loss.

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We believe that the above approach will result in a net zero impact on OCI and effectively constitutes a two step approach to fair value hedge accounting, first a transfer to OCI followed by a transfer to profit or loss. We view the proposed approach as adding to the complexity of understanding the components making up OCI. We believe further that continued use of OCI should be limited until such time as the Board has completed its deliberations on what the components of OCI represents. Finally, we believe that the Board's proposals are similar to the initial proposals for IFRS 9 regarding the recognition of changes in fair value of financial liabilities due to changes in own credit risk to OCI by means of a two step approach. Our disagreement with the Board's proposals for this ED is therefore consistent with the disagreement that we noted in the ED that dealt with the proposed changes to financial liabilities in IFRS 9.

In addition, in the current drafting of the proposals it is not clear whether paragraph 26(a) and (b) are required to be provided on the face of the statement of comprehensive income or within the notes to the financial statements. We do not support separate presentation on the face of the statement of comprehensive income and believe that disclosure in the notes is appropriate and sufficient.

We also recommend that guidance be provided for the following (for fair value, cash flow and net investment hedges):

- Where the effective component of the fair value gains or loss on a hedging instrument should be recognised, i.e. in the same line item as the hedged item or elsewhere;
- Where the ineffective component of hedges should be recognised within the statement of comprehensive income; and
- Where changes in fair value of economic hedges (not designated) should be recognised in the statement of comprehensive income.

Those constituents that expressed concerns about the voluntary designation of hedge accounting on a transaction-by-transaction (refer to our General Comments above) suggested that the Board consider requiring all hedging instruments in designated hedges to be initially recognised in profit or loss with a separate adjustment of the appropriate amount out of profit or loss into OCI. These constituents believe that such disclosure would allow for better comparisons across entities which apply hedge accounting and those which do not apply hedge accounting.

(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 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 and not be presented as part of the hedged item. We recommend that the Board clarify whether this disclosure is intended to be provided on the face of the statement of financial position or within the notes to the financial statements. We would not support separate disclosure of the gain or loss on the hedged item attributable to the hedged risk on the face of the statement of financial position and believe that disclosure in the notes is appropriate and sufficient.

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- (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 should not be allowed. Linked presentation would allow the offsetting of separate financial positions contrary to the current and proposed guidance for offsetting financial assets and liabilities. We concur with the Board's decision that disclosures about hedging would provide a better alternative to providing information about the relationship between hedged items and hedging instruments.

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 (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?*

We agree with the proposals to treat the option's time value accumulated in OCI as a 'basis adjustment' in line with the general requirements for non-financial items. This treatment avoids the need for additional rules that add to complexity. However, we note that the proposed 'basis adjustment' in paragraph 29 (d)(i) states *that such an adjustment is not a reclassification adjustment (see IAS 1 Presentation of Financial Statements) and hence it does not affect other comprehensive income.* Our reading of the aforementioned paragraph is that it will create an additional type of movement within the statement of changes in equity other than total comprehensive income, transactions with owners, and transfers between equity reserves. We suggest the Board retains the basis adjustment as currently drafted in IAS 39 where a basis adjustment is recognised via OCI.

Some of our respondents noted that the "interest element" of a forward exchange contract can be viewed as being similar to the time value of an option. Therefore, they wish the Board to consider whether similar accounting requirements as allowed for options could be applied to the "interest element" of a forward exchange contracts when excluded from the hedge relationship.

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

We agree with the proposal that the time value element of period related hedged items should be transferred from OCI on a rational basis. Further we agree with the Board's proposals to not prescribe what an appropriate rational basis for releasing the time value element should be. This is because the rational basis selected will depend on the individual entity's view of what is appropriate and rational in terms of its risk management objective and strategy.

- (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*

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perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

Yes, we 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. Since this represents a cost of hedging, the amount that is deferred into OCI and accounted for in terms of the ED should only relate to the hedged risk or cost that specifically relates to the hedged risk. Any additional cost should be recognised directly in profit or loss.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree with the criteria for the eligibility of groups of items as hedged items, as it is a considerable improvement from IAS 39's cash flow hedge accounting requirements for groups of items where each of the individual items are required to share the risk exposure that was being hedged and the changes in fair value attributable to the hedged risk. Previously each individual item in the group was required to be approximately proportional to the overall change in fair value attributable to the hedged risk for the group of items. Further, the approach suggested by the Board better reflects the manner in which entities manage their risk exposures.

Concerns were however raised on the requirement that '*... any offsetting cash flows in the group of hedged items, exposed to the hedged risk, affect profit or loss in the same and only in that reporting period*' [ED paragraph 34(c)]. We note the Board's concerns around the deferral of gains and losses on net cash flow positions where the cash flows occur in different periods [BC169 – 173], but believe that the restriction placed on hedges of net positions does not completely deal with the issues raised. On initial designation the offsetting cash flows may be expected to occur within the same period, but due to a change in expected delivery/supply dates part of the forecast cash flows is now expected to occur in a subsequent accounting period. The entity would be required to cease hedge accounting from the date of the change in forecasted cash flows, because the hedged item will no longer be eligible in terms of paragraph 34(c). However, any cumulative differences deferred in the cash flow hedging reserve would still need to be reclassified to profit or loss as the underlying transactions impact profit or loss, resulting in the same operational issues as discussed in BC169 – 173.

We note that the eligibility requirement for a group of items as a hedged item requires that, for a cash flow hedge only, the offsetting cash flows in the group of hedged items that are exposed to the hedged risk affect profit or loss in the same and only in that reporting period. Such a requirement does not extend to fair value hedges. We do not believe that the ED has provided sufficient clarification why an exception has been made for fair value hedges, e.g. where an entity hedges a net position of firm commitments in a fair value hedge where the underlying items affect profit or loss in different reporting periods. We recommend that the Board clarifies this in the final standard. We believe that symmetrical requirements for cash flow and fair value hedge accounting are appropriate, because a hedge of foreign currency risk of a firm commitment may be accounted for as a fair value hedge or a cash flow hedge.

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 with the proposal that a hedge of a group of items that affect different line items in the income statement should be presented in a separate line from those affected by the hedged items.

However, it is unclear whether the separate line item is required to be presented on the face of the income statement or whether the proposals require disclosure of the separate line item within the notes to the financial statements. Our preference is for the disclosure to be included within the notes to the financial statements.

Question 13

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

We agree with the general disclosure requirements that allow an entity to disclose how its management views risks and risk management and in a manner that is appropriate for the entity. We do however have the following observations and recommendations:

- There is confusion in the disclosures as to whether certain disclosures were required for where an entity economically hedges and applies hedge accounting and other disclosures which appear to only be required for where the entity economically hedges, but does not necessarily hedge account. To illustrate, paragraph 44, refers to an entity's risk management strategy '*... for each category of risk exposure that it decides to hedge and for which hedge accounting is applied*', which implies both economic hedging and hedge accounting. In contrast, paragraph 45, refers to the disclosures on the amount, timing and uncertainty of cash flows based on '*... the extent to which each type of risk exposure is hedged and the effect of the hedging strategy on each type of risk exposure*', which implies economic hedging only. We are not sure whether there is an editorial oversight and, if not what was implied by the Board. We therefore recommend that the Board clarify whether all such disclosures are required only where hedge accounting is applied. If not, then such disclosures should be clearly split between disclosures that are required for general risk management activities regardless of whether the entity applies hedge accounting and disclosures specific to risk management activities which have been hedge accounted. We do however believe that in a statement covering hedge accounting that such disclosures should only be required where hedge accounting has been applied.
- Paragraph 44(b) requires disclosure of how an entity manages each risk, which shall include whether an entity hedges an item in its entirety for all risks or hedges a risk component, whilst paragraph 44(c) requires disclosure of the extent of risk exposures that the entity manages. Further to our comment above, we question whether paragraph 44(b) is requiring disclosures where such risks have been hedged and whether paragraph 44(c) requires disclosure of the extent of risk exposures that

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are economically managed by an entity (but not hedge accounted). If this is not the case, then paragraphs 44(a) and (b) appear to require disclosures relating to similar items and it is questionable whether this is duplication.

- We note in the disclosure paragraphs that an entity is required to present in a tabular format, the notional amounts or other quantities of related hedging instruments. Whilst for most instruments this is a fairly straight forward exercise, it is less clear on derivatives such as cross currency swaps and forward exchange derivatives where, for example, leg (1) of the swap is denominated in the entity's functional currency and leg (2) is denominated in a foreign currency. In that regard, would the notional be disclosed as leg 1 or leg 2 and, if leg 2, would it presumably be translated into the entity's functional currency at the reporting date? We recommend that the Board provide additional guidance on how notional amounts should be determined, through examples of derivatives such as cross currency swaps, forward exchange contracts, and interest rate swaps such as roller-coaster swaps. We recommend that disclosure be provided of the receive leg of a derivative since for some entities, e.g. regulated financial institutions, that disclosure would be consistent with other regulatory requirements. Further, we recommend that the notional amount be translated into the entities functional/ reporting currency at the balance sheet and be based on the notional amount that will be used to determine the next amount of cash that will either be received or paid in terms of the derivative contract.
- In comparing paragraph 51's disclosure requirements with that of Illustrative Example (IE3), requirements a(ii) and c(iii) appear to be missing from paragraph 51. We recommend that the Board consider including those items in paragraph 51.

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

We do not have any additional disclosure suggestions and prefer the Board's focus on risk exposures, allowing entities to appropriately tailor the disclosure to how they view risk management activities.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

We agree with the principle proposed that entities managing own use contracts on a fair value basis should be provided with a mechanism to reflect this risk management strategy within their financial statements without having to revert to hedge accounting. However, we are unable to fully commit on the proposal because, in our view, the proposed amendment in Appendix C is not yet fully developed and drafted. Our reading of the proposal in Appendix C is that the proposals shall be mandatory for entities that manage their 'own use' contracts on a fair value-based risk management strategy. We are concerned that such a proposal is contrary to the view that hedge accounting shall be applied on a voluntary basis.

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As a consequence of our comments above and the general concerns of our constituents regarding the scope of IAS 32 – *Financial Instruments: Presentation* (IAS 32) and IAS 39, we recommend that the Board consider undertaking a more comprehensive review of IAS 32 and IAS 39’s scope paragraphs in the area of ‘own use contracts’. We have noted the following specific concerns that we have with the current scope of IAS 32 and IAS 39:

- The IFRS Interpretations Committee (IFRS IC) considered in March 2010 an issue on unit of account for contracts with volume flexibility. The IFRS IC’s rejection wording created an expectation that the Board would address the issues arising from contracts with volume flexibility as part of the process to replace IAS 39;
- The operational challenges for entities that may previously have net settled a portion of their ‘own use’ contracts and the prohibition in IAS 39 for these entities reverting back to ‘own use’ accounting once they intend to gross settle these contracts, i.e. gross settled contracts remain measured at fair value through profit or loss;
- Contracts which fail the “own use” exemption and are required to be treated as derivatives, could be viewed as net written options where the entity receives cash upfront (premium for writing an option in terms of IAS 39 IG F.1.3(b)) and the commodity is readily convertible into cash, i.e. the contract allows for net settlement [IAS 39 paragraph 6]. However, the contracts are always physically settled and never settled net in cash;
- The fair value risk management strategy adopted by the entity may continue to exist once the entity has recognised the underlying commodity in its statement of financial position. While many entities that manage their commodities on a fair value basis will meet the ‘broker-trader’ exemption in IAS 2 - *Inventories* to fair value inventory, the exemption is not always met in instances where the entity transforms the product (for example, the commodity is crushed to produce seed oil and other by-products); and
- Whether the amendment implies that all such contracts will be required to be measured at fair value in accordance with a single business model or whether an entity may have different business models which allow some contracts to continue to be measured at cost and others on a fair value basis.

Question 15

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

We agree that an alternative accounting model should not be developed specifically for accounting for hedges of credit risk. The general hedge accounting model and specifically the guidance of risk components should be developed so as to be sufficiently robust as to provide entities with the appropriate guidance on when a risk component, including credit risk, is separately identifiable and reliably measurable.

The three proposals developed to address the accounting for credit risk hedging would introduce unnecessary complexity, which is contrary to the Board’s proposed objective of simplifying accounting for financial instruments. The proposals in BC226 would require the Board to develop additional rules and disclosures primarily due to the ability to elect to measure and discontinue measuring instruments at fair value through profit or loss subsequent to initial recognition of the financial instrument.

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(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 do not support the Board developing these models further as we believe the general hedge accounting model should provide sufficient guidance on risk components, which would include credit risk.

In addition to the above, we believe for a non-contractually specified risk component to be separately identifiable and reliably measurable, the risk component should not be defined as a residual component (unless that residual is a specific identifiable risk component). In this case we note, for example, that identifying the credit risk as a specifically identifiable risk may be complicated by the fact that the spread above an interest rate in a contractual interest rate may include other components, such as liquidity spreads. We recommend that instead of the Board specifying that credit risk may not be hedged, that the standard rather indicate that credit risk may be hedged provided that it is separately identifiable, reliably measurable and that residuals may not be designated as the hedged risk (unless the residual is a specifically identifiable risk variable). Achieving hedge accounting in such instances may be challenging, yet we believe that allowing hedge accounting in such instances rather than not allowing hedge accounting on the basis of the challenges is more appropriate and aligned to a principal based set of standards.

Question 16

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

We agree with the proposed transition requirements that hedge accounting should be applied prospectively and not retrospectively. Allowing entities to designate hedges retrospectively is open to abuse because designation might be driven by the impact on the financial statements.

However, there may be instances where an entity had hedged a particular risk that may have been prohibited from being able to be accounted for in terms of IAS 39's hedge accounting requirements. For example a portion of a non-financial item or an aggregated exposure containing a derivative that would under the proposals in the ED qualify as a hedged item. We recommend that the transition requirements allow hedge accounting (in terms of the ED's proposals) to be used only from the date that the designation and documentation of a hedge relationship is completed similar to the requirements of IFRS 1 – *First-time Adoption of International Financial Reporting Standards* [IFRS 1 paragraphs B4-B6]. We accept that it would not be appropriate for the date of designation to be earlier than the date these proposals are issued as an IFRS, but should be allowed to be earlier than the start of the entity's reporting period in which it first applies the amended IFRS. We recommend that such hedges be permitted to be hedge accounted in this manner to enhance comparability between reported periods and reduce the potential impact of any hedge ineffectiveness that is created by designating the hedge relationship other than on inception (due to the requirement to use an on-market hypothetical derivative).

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OTHER COMMENTS

Consequential amendments

We note the consequential amendments included in Appendix C are not fully developed. We are uncertain whether the Implementation Guidance for hedge accounting as contained within IAS 39 will be retained, subject to amendments for the changes proposed by the ED. We believe the illustrative examples are useful and should, where applicable, be retained.

Specifically we believe the following guidance should be retained for the reasons articulated below:

IG	Title	Rationale
F1.2	Hedging with a non-derivative financial asset or liability	This example explains how the foreign currency component of a sales commitment can be a hedging instrument if the foreign currency component is separated as an embedded derivative under IAS 39.AG33(d). Under IFRS 9, the separation of embedded derivatives from non-financial host a contract (the sales commitment) remains. Therefore, the guidance provided by this example remains appropriate and relevant.
F1.3	Hedge accounting: use of written options in combined hedging instruments	We recommend that this guidance be retained since it clarifies what a net written option is. Without this guidance it would be unclear as to what the standard envisages by reference to a 'net written option' [ED paragraph 11].
F1.12 F1.13 F2.18	Hedges off more than one type of risk Hedging instrument: dual currency forward contract Hedging instrument: cross currency interest rate swap	The exposure draft is unclear as to whether a single hedging instrument may be split and be accounted for in two separate hedging relationships. The International Financial Reporting Interpretations Committee (IFRIC) issued a rejection notice in July 2007 regarding the hedging of multiple risks with a single derivative financial instrument. The IFRIC noted that IAS 39's implementation guidance (F1.12, 1.13 and 2.18) did result in an entity being required to impute a notional leg into a derivative such that the derivative would be split into multiple components in order to assess hedge effectiveness. The IFRIC noted further that the splitting of the derivative into multiple risks should not result in any new cash flows and any new risks which were not evident in the contractual terms of the derivative. We believe that the splitting of a derivative should continue to be permitted and, in many respects, would be consistent with the risk management objective and strategy of the entity. Accordingly, we recommend that the guidance included within F1.12, F1.13, and F2.18 be retained.

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IG	Title	Rationale
F2.8	Hedge accounting: risk of a transaction not occurring	The example explains the distinction between a general business risk and a risk associated with recognised asset or liability, firm commitments, and highly probable forecast transactions. The ED introduces the concept of a general business risk in paragraph B7, but does not expand on why hedge accounting may not be applied to a general business risk. Accordingly, we believe that such guidance be retained.
F1.13 F2.17	Hedging instrument: dual currency forward contract Partial term hedging	F2.17 indicates that an entity is permitted to partial term fair value hedge account a risk exposure. We believe that this guidance should be retained since the exposure draft is not clear on whether or not partial term hedge accounting is permitted or not. We understand that many entities either elect to partial term hedge risk exposures (from a risk management perspective) or are forced into partial term hedging their risk exposures since the tenor of the hedging instrument available in the market may not be equivalent to the tenor of the hedged item (e.g. 3 year commodity derivatives may only be available where as the risk exposures extend beyond 3 years). We further recommend that the exposure draft clarify whether, and if so in what instances, partial term cash flow hedge accounting is permitted. We note that there has been considerable debate regarding this item with divergent guidance and application being noted. An example is a 3 month foreign currency derivative that hedges a 12 month cash flow. We note that some guidance suggests that partial term cash flow hedge accounting is permitted in some instances but not in others, whilst some guidance suggests that it is permitted in all instances but that the timing of the cash flows needs to be taken into account in determining the effectiveness of the hedging relationship, while yet further guidance suggests that the discounting effect of the cash flows can be excluded where on the spot element is hedged. We recommend that partial term cash flow hedge accounting, in terms of an entity's risk management strategy, be permitted. F1.13 provides some guidance in terms of permitting partial term cash flow hedge accounting for a financial instrument and hence we recommend that the guidance be retained (in addition to the reasons noted above).
F3.7	Hedge accounting: forecast transaction	Many users of IAS 39 have routinely used F3.7 as a basis to determine whether a hedged transaction is sufficiently probable to permit cash flow hedge accounting. Accordingly, we recommend that this guidance be retained.

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Effective date

In line with our comments on the Board's *Request for Views on Effective Dates and Transition Methods* we request the Board to reconsider the effective date of the hedge accounting phase of IFRS 9 (and IFRS 9 more generally), to be a date not earlier than annual reporting periods beginning on or after 1 January 2014. While hedge accounting remains voluntary under the proposals, we expect entities which currently apply hedge accounting under IAS 39 to have to make significant system changes in order to continue applying hedge accounting under the proposals.

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