

Feedback on ED Hedge Accounting

10 March 2011

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

Dear Sirs:

Exposure Draft Financial Instruments – Hedge Accounting

I am pleased to provide, in my personal capacity, comments on the above exposure draft.

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?

The proposed objective is to “represent in the financial statements the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss”.

The focus on “profit or loss” narrows the impact of the ED on hedge accounting in general and restricts its scope. The ED should aim to be a comprehensive standard which incorporates multi-faceted hedging activities of reporting entities. The prohibition of hedge accounting for investments in equity instruments at fair value through other comprehensive income results in a possible disconnect between the representation of risk management activities in the financial statements and the actual risk management activities undertaken by an entity.

Further, in aiming to be a comprehensive standard, the ED should incorporate hedge accounting requirements on open portfolios. Until the Board has completed its deliberations on hedge accounting for open portfolios, the present proposals would not be able to fully achieve the stated objective of hedge accounting. As an authoritative point of reference on hedge accounting, the ED should also aim to be the one standard that determines hedge accounting requirements. Presently, IAS 39 still determines the requirements for portfolio hedge of interest rate risk. Preparers would have to consult two standards to achieve the goals of hedge accounting. The ED should be the one standard that determines the overarching principle that aligns hedge accounting with risk management activities.

The long-term objective should be for the hedge accounting standard to be all-inclusive and to provide principles that enables an entity to account for its risk management activities in all manner and form. The restrictive focus on “financial instruments” as eligible hedging instruments should be removed eventually (also refer to response in Question 14). Over the long run, the ED and the consequent standard should have the capacity to grow and change with subsequent developments to incorporate non-financial instruments in its scope.

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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?

Non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments if they are used to hedge risks in accordance with an entity's risk management activities. The guiding principle is that an entity's risk management activities determine what should or should not be included as eligible hedging instruments.

To be a truly principles-based standard, the ED should avoid defining the assets or liabilities that may or may not be included as hedging instruments in a prescriptive manner. It should provide a clear principle of what may or may not be included and allow the risk management activities of the entity to determine the appropriate hedging instruments.

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, except for some written options...."

The ED emphasizes basis of measurement as a critical requirement for eligible hedging instruments. The Board should consider if this emphasis is in line with corporate hedging strategies. An entity normally would not consider the basis of measurement in determining eligible hedging instruments in its risk management activities. Typically, it would consider the economic attributes of the hedging instrument and the ability of the instrument to mitigate the risk arising from a particular exposure. The emphasis on "fair value through profit or loss" as a pre-requisite condition excludes other potential hedging instruments that are not measured on this basis.

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?

The aggregated exposure may be designated as a hedged item if it is clearly identified as such in an entity's risk management activities. It is not uncommon for an entity to hedge new risks arising from a combination of hedged items and hedging instruments. The proposal to include the aggregated exposure as a hedged item aligns hedge accounting requirements with the economic processes of identifying hedged items.

However, there must be greater clarity in what may be included in the "exposure" and what may be included in the "aggregation". It is clear that an exposure may arise from an anticipated, committed or existing transaction. However, the likelihood of the exposure crystallizing into actual risks for the entity may vary depending on the source of the

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exposure. For example, if the exposure arises from only an anticipated transaction, the outcome may not be as probable as one that arises from an existing transaction.

For example in B9 (a), an exposure arises from expected coffee purchases in two years. Does it matter if the coffee purchases were only “expected” and not “highly probable”? If the coffee purchase is not probable, it appears to be incongruent with the requirement in paragraph 14 that a forecast transaction must be “highly probable”. Further, as the terms “exposure” and “risks” or “risk components” are interpreted differently by constituents, it will also be helpful to have a glossary to explain what these terms mean in the context of the ED.

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?

I agree that an entity should be allowed to designate a risk component as a hedged item, regardless of whether it relates to a financial or non-financial item. This would ensure that there is no artificial dichotomy in hedged risks for financial and non-financial items. In this regard, the proposal in the ED is an improvement over the existing practice in IAS 39 that limits the eligibility of risk components for designation as hedged items on the basis of whether the risk component is part of a financial or a non-financial item. There is no conceptual merit in applying different eligibility criteria for financial and non-financial items.

However, the requirement that the risk components be “separately identifiable” and “reliably measurable” is onerous, given the nature of risks that co-exist and the difficulty of disentangling the “separately identifiable” components. The separately identifiable criterion poses a great challenge to many entities who hedge composite risks such as credit risks (refer Question 15). While these risks are specific, they do not meet the criterion for separate identification. To allow hedge accounting to be aligned with an entity’s risk management activities, the Board should reconsider the criterion that risks be “separately identifiable”. To align hedge accounting with entity risk management activities, the identification of hedged risks should be consistent with the activities. An externally-imposed criterion of separate identification excludes commonly hedged risks such as credit risks and inflation risks. The exclusion of credit risks on account of this criterion is a cause of concern as credit risks are significant risks to many entities, in particular, financial institutions. The incumbent standard IAS 39 permits credit risks to be designated as a hedged risk. Given its focus on the risk management activities, the ED should not be more restrictive than IAS 39 in this respect.

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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?

I agree. The designation of a layer of the nominal amount as the hedged item is a possible hedging strategy in an entity's risk management activities.

(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?

I do not agree. Being a principles-based standard, exceptions and limitations should be minimized in the ED. If the "separately identifiable" criterion is removed (see Question 4), this exception can be eliminated.

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?

Yes, I agree that professional judgement should be permitted to determine hedge effectiveness. However, the 80-125% qualifying criterion is useful to serve as an example to guide professional judgement without replacing it.

The current proposals appear to err on the side of leniency with its emphasis on minimizing "expected hedge ineffectiveness" and the goal to achieve "other than accidental offsetting". These criteria appear to be lowering the bar a little too low. While the Board may be concerned that "hedge effectiveness" is a difficult goal to measure, the proposed requirements pushes the threshold to a level that is considerably lower than the existing threshold of 80-125%. Hedge accounting would extend to the grey areas (neither effective nor ineffective) under the proposed principle. The lower bar raises the issue of whether the objectives of hedge accounting will be achieved in financial reporting. The IASB may wish to consider presenting the objectives in a positive manner than in the proposed negative mode.

While a principles-based approach in the ED should be lauded, safeguards should be built in to ensure that hedge accounting does not degenerate into opportunistic reporting. Hence, besides tightening the criteria to determine hedge effectiveness, the ED should require entities to demonstrate accountability by disclosing the quantitative criteria (or suitable

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ranges) that are applied to determining hedge effectiveness, the basis for determining the criteria and subsequent changes to the criteria.

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?

I agree with the guiding principle that if hedge effectiveness is met through rebalancing, the rebalanced hedge relationship should be deemed as a continuation of the original arrangement. However, the concept and process of rebalancing is complex and is appropriate only if it is aligned with an entity's dynamic hedging strategies.

There are a few concerns that I have with the proposed requirements:

- In the re-balancing process, entities have to determine if the hedge ratio (a) remains valid or (b) no longer appropriately reflects the relationship between the hedging instrument and the hedged item (paragraph B50). To minimize the risk that entities change the hedge ratio freely to simplify the rebalancing process, the ED should provide guidance for a proper due process and require appropriate disclosures to ensure that judgement is applied fairly and in a transparent way.
- On re-balancing, the hedge ineffectiveness of the hedging relationship is determined and recognized in profit or loss immediately (paragraph B47). Further guidance is required on how the hedge ineffectiveness can be practically determined to arrive at a reliable measure of profit or loss.

(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?

Voluntary rebalancing should be permitted if it is in line with an entity's risk management strategies to pro-actively rebalance the hedging relationship if there is expectation of failure to meet the hedge effectiveness assessment. However, the ED should provide more guidance to ensure that the voluntary rebalancing is appropriate and that judgement is fairly applied in assessing expected hedge ineffectiveness.

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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?

I agree that an entity should discontinue hedge accounting prospectively in response to changes in circumstances that cause the hedging relationship (or part of a hedging relationship) to cease to meet the qualifying criteria (in spite of any rebalancing). However, if there is clear evidence that the qualifying criteria or hedging relationship was incorrectly determined in a previous period, the change should be accounted for retrospectively.

(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?

I agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the qualifying criteria. An entity that elects to apply hedge accounting should do so for as long as the hedging relationship meets the qualifying criteria. To permit a discretionary change midway would give rise to earnings management tendencies. However, a limitation of this requirement is that an entity may be compelled to continue with the application of hedge accounting even if its circumstances and hedging strategies have changed. A mitigating factor is that an entity can avoid being hemmed in by its initial decision through terminating the hedging instrument and replacing it with another instrument that is not part of the entity's documented hedging strategy (paragraph 24). Hence, there is sufficient flexibility in the ED to allow an entity to discontinue hedge accounting if there is a change in strategy and the ED is not unduly onerous in this respect.

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?

I do not agree that the gain or loss on the hedging instrument and hedged item for a fair value hedge should be recognized in other comprehensive income. The difference between a fair value hedge and a cash flow hedge is muted if the changes in fair value of hedging instruments and hedged items in both categories are taken to other comprehensive income. The two categories are clearly different with respect to the

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characteristics of hedged items. Hedged items in a fair value hedge are more likely to be recognized and are more certain in their realization than hedged items in a cash flow hedge. As hedged items for a fair value hedge are assets and liabilities that are recognized or committed (as compared to forecast transactions or variable interest rate payments or receipts in a cash flow hedge), the change in their fair value should be taken to the income statement where the gains or losses on recognized financial instruments (other than investments in equity instruments at fair value through other comprehensive income) are presented. Investors will have a better view of the financial effects of recognized financial instruments if the changes are reflected in one statement. Further, the concept of other comprehensive income remains an elusive one in the absence of a clear definition of this income item.

By reflecting gain or loss arising from a fair value hedge in the income statement, there is also no need for an entity to separate gains or losses in a hedging instrument in which only a percentage of its nominal amount is designated for hedge accounting. The change in fair value of the hedging instrument can be fully reflected in the income statement, without being “dismembered” into portions that flow into other comprehensive income and the income statement.

(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?

I agree. The separation of the gain or loss from the carrying amount of the hedged item provides more information to investors on the components of the hedged item. Separation also preserves the measurement basis of the hedged item and corrects the anomalous position when a hedged cost item is measured on a “cost plus” basis which is neither historical cost nor fair value. The proposal is an improvement over IAS 39 where a reporting entity has to adjust the historical cost of a hedged item by including changes in fair value of the hedged asset arising during the period of the hedge.

(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?

I agree with the Board’s decision that linked presentation in the statement of financial position is not necessary. Showing the links between related assets and liabilities is presently not done for other assets and liabilities and it would not be meaningful to show a partial representation of links in a subset of assets and liabilities. Disclosures on hedging would provide more critical information than the linked presentation. However, linked presentation or clear identification in the income statement or statement of comprehensive income of gains and losses on hedging instruments and hedged items should be shown to show the effectiveness of the hedging strategies.

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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?*
- (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?*

I disagree with the proposed treatment because the time value of an option is a cost of hedging that has no future benefit other than to facilitate the hedging relationship. Analogous to the time value of the option is an insurance premium that an insured party purchases to obtain protection from the losses arising from a specified event. The premium is amortized over the life of the policy and has no value at the end of the insured period. The premium is not capitalized into the cost of an asset because it does not enhance the future benefits arising from the asset. The premium is a necessary cost to ensure that the future benefits of the asset are maintained in its present state but it does not increase those benefits.

Applying this principle, the distinction between a "transaction related hedged item" or a "time period related hedged item" as proposed by the ED would not be relevant.

For example, if a foreign currency option is purchased to hedge the foreign currency payable of a forecast fixed asset purchase, should the time value be adjusted to the carrying amount of the asset when the asset is recognized?

Paragraph 16 of IAS 16 *Property, Plant and Equipment* states that the cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

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- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

The intrinsic value of the option provides the direct hedging effects by locking in the effective exchange rate applicable to the purchase. However, the time value is a cost of the hedging transaction and is not an integral part of the purchase transaction. In my view, the time value is a transaction cost that is consequence and not a cause of the purchase transaction. Hedging is a discretionary activity with respect to the purchase of an asset and it provides an entity with certainty with regards to the price or exchange rate. However, hedging is not a necessary activity to bring an asset to its present condition and location. I therefore question the conceptual justification for capitalizing the cost of the hedge into the cost of the non-financial asset.

The proposed three-prong treatment in paragraph 33 (b) is complex and difficult to apply and is unlikely to be cost beneficial. However, more importantly are the issues relating to the expense and capitalization principles as discussed above.

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?

I agree with the criteria for the eligibility of groups of items as a hedged item. "Natural hedging" is a commonly practised risk management strategy of many entities as it is a cost beneficial strategy for hedging. It is also an effective form of hedging for companies who are able to mitigate their risks through managing the timing, amount and nature of the cash inflows and outflows. However, the Board's deliberations on "macro hedging" and "open portfolios" are on-going and the outcome of the deliberations will be crucial to determining the Board's stand on hedging groups of items at the highest level.

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 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.

I agree with the presentation. The separate presentation should also apply to the hedge of single items (albeit in aggregate level).

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Question 13

- (a) *Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?*
- (b) *What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?*

I agree (refer responses to Question 9 and Question 12 as well).

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?

I agree. However, I do not agree with the manner by which changes are made to the definition of a financial instrument to achieve the desired application. A contract that is held for the primary purpose of a physical delivery does not qualify as a financial instrument as defined by IAS 32. The ED proposes to change paragraph 8 of IAS 32 by including contracts for physical delivery as financial instruments. The definition of financial instruments should not be changed to extend the application of derivative accounting. To include such contracts in the ambit of the ED, amendments should be made within the context of the ED to apply derivative accounting to such contracts that may fall in an entity's fair value-based risk management strategy without amending IAS 32.

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?*

I agree that the three alternative accounting treatments are onerous and depart from the intention of the standard to move away from a prescriptive approach. As explained in my response to Question 4, the Board may wish to consider removing the criterion that the risks should be "separately identifiable" as this is not necessarily a feature in an entity's risk management activities. Suffice that the risks are "identifiable". However, risks (as with credit risks) may co-exist with other risks or exist as a composite of different risks and the separation of risks may be impracticable. To omit credit risks as a possible hedged risk on

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the basis that it is not possible to further identify the specific risks would weaken the impact of the proposed standard as credit risks is a major risk in financial institutions.

Question 16

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

Yes, I agree. The requirements are reasonable and permit entities sufficient time to adopt the requirements without the burden of retrospective application.

Yours sincerely



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