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EFRAG

European Financial Reporting Advisory Group

Comments should be submitted by 2 March 2011 to Commentletters@efrag.org

[XX March 2011]
International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

Dear Sir / Madam

Re: Exposure Draft Hedge Accounting

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft on *Hedge Accounting* ('the ED') that the IASB issued on 9 December 2010. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission, on endorsement of the definitive IFRS in the European Union and European Economic Area.

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

Economic hedging and risk management activities are not straightforward. Reporting for these activities therefore has an inherent level of complexity too. In EFRAG's view, the proposals have introduced new complexities, particular in the rebalancing of hedge relationships and the treatment of time value of options. However, we believe that the benefits of these approaches outweigh the cost and complexity.

The proposals remove a number of the restrictions to hedge accounting in IAS 39 *Financial Instruments: Recognition and Measurement.* In EFRAG's view, there are important improvements relating to assessing hedge effectiveness, the possibility to designate derivatives, risk components and net positions as hedged items, and the possibility to apply hedge accounting to components of non-financial items. These proposals make the hedge accounting model significantly more flexible, and will help to increase the appropriate use of hedge accounting.

EFRAG believes that disclosures play a fundamental role in complementing financial information derived from the principles-based proposals in the ED. The proposals require application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the overall risk management strategies. We believe that the proposed disclosure objectives are appropriate, but have certain concerns about the detailed requirements.

Having expressed these views, EFRAG has a numbers of concerns, the most significant of these are:

(a) The IASB has split the revision of IAS 39 into a number of phases. However, considerable interdependencies exist among the phases of this project (particularly the amortised cost and impairment phase and macro hedging) and other projects that the IASB is concurrently working on (e.g. insurance and financial statement presentation). Therefore, we believe that the IASB will need to consider the entire package of proposals before finalising the resulting standards. We anticipate the following area for further development:

  (i) the eligibility of embedded derivatives as hedging instruments,

  (ii) the inconsistency between the irrevocable nature of a fair value option and the optional nature of hedge accounting; and

  (iii) the eligibility of equity instruments measured at fair value through other comprehensive income as hedged items.

(b) We believe that a number of issues require further consideration. These include the eligibility of:

  (i) instruments at amortised cost as hedging instruments;

  (ii) non-contractually specified inflation risk as hedged item;

  (iii) credit risk as a risk component;

  (iv) other risks not affecting profit or loss; and

  (v) a benchmark component in hedging a debt instrument with a negative indexation to the benchmark (the sub-LIBOR issue).

  In our view, these issues could create inconsistencies with risk management practices.

(c) The proposals rely heavily on judgement and the link to risk management. To ensure that this link is truly achieved, we believe that the IASB should conduct field-testing and outreach activities to ensure that proposals can be operationalised.

(d) While we believe the proposed general model for hedge accounting is a reasonable approach to hedging individual items, we are not able to comment more fully on the proposals relating to groups of items until we gain a better understanding of the Board's direction in respect of macro hedging. Given the importance of macro hedging, we believe that the IASB should not finalise a standard on the general hedge accounting model, before developing a model for macro hedging.

If you wish to discuss our comments further, please do not hesitate to contact Katrien Schotte, Chiara Del Prete or me.

Yours sincerely,

Françoise Flores
EFRAG, Chairman

Appendix – Response to questions in the 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?

Notes for EFRAG's constituents

1 The IAS 39 hedge accounting model has been criticised for not always reflecting the economic consequences of hedging activities and often producing arbitrary outcomes. Preparers criticised these requirements for being driven by an 'accounting-centric' approach, for reflecting only a part of the overall hedging activities of the entity in the reporting, and sometimes even for leading entities to adjust their economic hedges in order to qualify for hedge accounting. Users criticised the same requirements for providing only for a partial view of an entity's risk management activities.

2 There is no stated objective for hedge accounting in IAS 39. The hedge accounting requirements in IAS 39 are designed either:

(a) to eliminate or reduce measurement mismatches caused by measuring hedging instruments and hedged items in a different way (fair value hedge accounting); or

(b) to affect the timing or recognition, in profit or loss, of gains and losses on hedging instruments (cash flow hedge accounting).

3 The ED explicitly introduces an objective for hedge accounting 'to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. This approach aims to convey the context of hedging instruments in order to allow insight into their purpose and effect'. Under the proposed hedge accounting model, hedge accounting will continue to be optional, because an economic hedge will be required to meet the qualification criteria.

EFRAG's response

EFRAG agrees with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of an entity's risk management activities.

We do not believe that hedge accounting should be restricted to risks that affect profit or loss only. We therefore urge the IASB to reconsider carefully why it is necessary to prohibit hedge accounting for items that affect other comprehensive income or equity as well.

4 EFRAG agrees with the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of the entity's risk management activities. EFRAG believes that this objective helps to provide the basis for an approach to hedge accounting that allows a more transparent and consistent representation, in the primary financial statements and in the disclosures, of the extent and impact of the hedging activities on the economic performance of the entity.

5 We agree with the proposed approach in the ED that hedge accounting should not be mandatory for all risk management activities of an entity and be based on voluntary designation of hedge relationships. We believe that, it would not be meaningful nor feasible to make hedge accounting mandatory because:

(a) An entity's risk management approach includes a large variety of strategies and actions, many of which are operational in nature and do not involve the use of financial instruments (e.g. insurance of risks, supply management and general terms of business);

(b) It is impossible to translate into accounting mechanics (i.e. either fair value hedge accounting or cash flow hedge accounting) the full range of risk management strategies that exist in practice;

(c) Requiring an entity to identify all its risk management activities and to document at inception which of those qualify for hedge accounting would be challenging from an operational point of view; and

(d) Many activities undertaken in the context of risk management would never meet the proposed hedge accounting requirements although they mitigate risk.

6 The application of hedge accounting is an exception to the general recognition and measurement requirements. Therefore, it is necessary to have a disciplined designation process to avoid that it becomes unrestricted accounting choice. EFRAG believes that for an entity to apply hedge accounting it is necessary to have internal controls that enables it to explain how a designated hedge fits into it risk management strategy.

7 While we agree with the broad outline of the proposed objective, we do not believe that hedge accounting should be restricted to risks that affect profit or loss. We understand that the IASB decided not to permit hedge accounting of risks that affect other comprehensive income because it could result in reclassification of gains or losses out of other comprehensive income to profit or loss. In our view, it is possible to engage in meaningful management of the risks that are reflected in other comprehensive income or equity. The following are examples of items that could be hedged in accordance with an entity's risk management; investments in equity instruments at fair value through other comprehensive income, pension obligations under defined benefit schemes, revaluation of emission rights under IAS 38 and foreign currency tax payments related to equity transactions. In particular, it is common to hedge equity investments measured at fair value through other comprehensive income. The gains or losses on the hedging instrument would be reflected in profit and loss, while the equity investments would be reflected in other comprehensive income. In our view, this does not accurately portray the effects of an entity's risk management activities. We believe the IASB should carefully reconsider why it is necessary to prohibit hedge accounting for such items.

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?

Notes for EFRAG's constituents

8 Under IAS 39, non-derivative financial instruments are only eligible as hedging instruments in hedges of foreign currency risks.

9 The ED proposes to extend the eligibility of non-derivative financial instruments as hedging instruments to non-derivative financial instruments measured at fair value through profit or loss, if they are designated in their entirety.

10 Non-derivative financial instruments are required to be designated in their entirety because the IASB decided not to allow the disaggregation of a non-derivative financial *instrument into risk components other than foreign exchange risk for the following reasons:*

(a) the foreign currency risk component is already available for incorporation in the hedge accounting requirements as it is determined in accordance with the foreign currency translation requirements in IAS 21 The Effects of Changes in Foreign Exchange Rates; and

(b) the disaggregation into other risk components would have involved the need to develop guidance on how to determine those risk components. This would have involved an expansion of the scope of the project beyond financial instruments. This was viewed as not desirable because:

(i) the outcome would be highly uncertain;

(ii) it could have involved the need to review other standards as well; and

(iii) it might have lead to significant delay of the hedge accounting project.

11 Therefore, the effect of not allowing bifurcation of derivatives embedded in non-derivative financial assets – which can be designated as hedging instruments – is partially offset by the Board's decision to permit non-derivative financial assets at fair value through profit or loss to be designated as hedging instruments.

12 The option to extend the eligibility to non-derivative financial instruments other than those at fair value through profit or loss was rejected because it was viewed as inconsistent with the earlier decision not to permit hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income, and it was considered to lead to operational problems.

EFRAG's response

EFRAG agrees that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible as hedging instruments. Furthermore, we also believe that non-derivative instruments other than those at fair value through profit or loss should be eligible as hedging instruments.

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

14 Considering the objective of hedge accounting, EFRAG thinks that the nature of the hedging instrument should be much less important than the achievement of the risk management objective. Therefore, EFRAG believes there is no conceptual basis for excluding as eligible hedging instruments any non-derivative financial instruments that are not at fair value through profit or loss. The IASB understands that the practice of using non-derivative instruments that are not at fair value through profit or loss as hedging instrument may be limited. However, this should not be a reason for excluding these instruments in the absence of a strong conceptual argument.

15 We believe that the IASB should fully explore all avenues for improving hedge accounting. In particular, we believe that the Board should consider the possibility to further extend the range of eligible hedging instruments (e.g. equity investments designated as at fair value through other comprehensive income, financial instruments at amortised cost, disaggregation of non-derivative hedging instruments into components other than foreign currency risk).

16 There appears to be a conceptual inconsistency between the objective of hedge accounting and the decision to extend the range of eligible hedging instruments to

include non-derivative financial instruments measured at fair value through profit and loss. In particular, a financial instrument should be designated as at fair value through profit or loss at initial recognition and such designation is irrevocable. Where such instruments would be designated as at fair value through profit or loss to serve as a hedging instrument in accordance with an entity's risk management strategy, it would not be possible to revoke that election subsequently if that were to be in line with a change in that entity's risk management strategy.

Question to constituents

17 Do you believe there is in effect an inconsistency between (i) the irrevocable designation of a financial instrument as at fair value through profit or loss and (ii) hedge accounting that may be discontinued if that is in accordance with an entity's risk management strategy?

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?

Notes for EFRAG's constituents

18 The ED proposes to permit hedges of synthetic exposures (i.e. a combination of a non-derivative instrument and a derivative). Such a combination may be managed as a single exposure for a particular risk (or risks), in which case the entity may designate the synthetic exposure as the hedged item.

19 The proposal intends to eliminate an inconsistency in IAS 39 that does not allow a derivative to be designated as hedged item. These derivative instruments were considered to be held for trading and were required to be measured at fair value through profit or loss. Therefore, hedge accounting was considered unnecessary as the gains and losses on the hedged item would already be recognised in profit or loss. However, for derivatives that are hedging instruments themselves this rationale did not apply as their gains and losses were not recognised in profit or loss.

20 The proposal aims to enable entities to reflect their risk management strategy, whereby they manage different risk components of their economic transactions independently by applying different risk management strategies and different degrees of coverage for each risk component (e.g. a company may hedge the oil price and currency risks in crude oil purchases separately).

EFRAG's response

EFRAG agrees that a synthetic exposure may be designated as a hedged item.

21 Entities may hedge risk exposures independently using different risk management strategies and different degrees of coverage for each type of risk. A hedged item may therefore consist of a combination of a derivative and a non-derivative instrument. EFRAG agrees with the decision to permit the designation of such a synthetic exposure as a hedged item.

22 We believe this change from IAS 39 will eliminate a significant unnecessary restriction, and should facilitate hedge accounting for entities that enter into transactions that give

rise to a combination of different risks. We support this approach as it allows hedge accounting to be more closely aligned with actual risk management practices.

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?

Notes for EFRAG's constituents

23 Under IAS 39, risk management practices and hedge accounting are misaligned. IAS 39 uses an entire item as its default 'unit of account', and then defines which risk components of that entire item can be subject to hedge accounting. However, for risk management purposes entities generally use the individual risks as the reference unit rather than the financial reporting 'unit of account'.

24 Under IAS 39, a non-financial item can only be designated as a hedged item for foreign currency risk or for all risks in their entirety because it was believed that designation of risks other than foreign currency risk would conflict with the principles of identification of the hedged item and effectiveness testing.

25 Where risk components are contractually specified there usually is no issue with identifying and measuring the changes in the cash flows or fair value associated with the risk component. For non-financial items risk components are often not contractually specified as they are not an explicit part of the fair value or cash flow. Nevertheless, the Board believes that these risk components are often identifiable and measurable with sufficient reliability. Assessment of which risk components qualify for hedge accounting should depend on the relevant facts and circumstances of the particular market. This decision aligns the eligibility of risk components of non-financial items with the eligibility of risk components of financial items in IAS 39.

26 IAS 39 allows an entity to designate a portion of the cash flows of a financial instrument as a hedged item, provided that the portion is less than the total cash flows of the instrument. For example, an entity holds an investment in an interest-bearing financial instrument and decides to hedge the interest rate risk. The entity could designate the LIBOR component of the interest rate as the hedged item provided that the cash flows that relate to the LIBOR component are less than the total interest cash flows of the investment.

(a) If the interest rate of the financial instrument is benchmarked to LIBOR by adding a zero or positive spread, then the effective interest rate will be above LIBOR (i.e. the cash flows that relate to the LIBOR component will be less than the total interest cash flows of the instrument) and the LIBOR component will be eligible as hedged item.

(b) If the interest rate of the financial instrument is benchmarked to LIBOR by adding a negative spread, the effective interest rate of the instrument will be below LIBOR (i.e. the cash flows that relate to the LIBOR component will be more than the total interest cash flows of the instrument). In this case the LIBOR component cannot be designated as hedged item.

27 The ED retains this restriction. In paragraph 24, it defines a component as 'a hedged item that is something less than the entire item'. If a component of the cash flows of a *financial instrument is designated as the hedged item, that component must be less than or equal to the total cash flows of the financial asset or financial liability.*

28 *The rationale for maintaining the restriction of IAS 39 was based on examples that demonstrated that the risk management strategy to offset changes regarding the LIBOR component of an interest rate risk would only be achieved if LIBOR does not fall below the absolute value of the negative spread. Where LIBOR does fall below the absolute value of the negative spread, the hedge would cause the interest rate on the financial instrument to become negative leading to counterintuitive results (e.g. a lender should pay interest on the loan he has granted, or a funding cost would change in the opposite direction of the market rates).*

29 *However, IAS 39 nor the ED prevent an entity from designating all of the cash flows of the entire financial instrument as the hedged item and hedge them for one particular risk only (e.g. only for changes that are attributable to changes in LIBOR). Considering the proposed requirements on the assessment of hedge effectiveness, an entity should then choose a hedge ratio that minimises the expected ineffectiveness of the hedge and produces an unbiased result.*

EFRAG's response

EFRAG welcomes the proposal to allow the designation of a risk component as a hedged item if it is separately identifiable and measurable.

We question why non-contractually specified inflation cannot be designated as a component and urge the IASB to reconsider this issue.

30 EFRAG welcomes the decision to permit the designation of cash flows or fair values of an item attributable to a specific risk or risks as hedged items irrespective of the nature of the item being hedged. We believe that this will eliminate a significant issue for those companies that manage individual risk components separately and enables closer alignment of risks management practices to the accounting treatment.

31 Paragraph B18 of the ED asserts that 'inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified.' We appreciate the difficulties that exist in identifying and measuring reliably non-contractual inflation components, and are aware of past IASB and IFRIC discussions on the topic. However, it is not clear to us why inflation components are unique to such an extent that the IASB should add a rule to a principles-based standard to prohibit specifically their designation as a hedged risk component (a similar remark is made in Question 15 regarding the eligibility of credit risk components as hedged items). In addition, it is not clear to us why paragraph B18 of the ED only applies to financial instruments, but not to non-financial instruments. We believe that the IASB should develop a stronger conceptual basis for deciding which non-contractual inflation components may be designated as hedged items.

32 EFRAG will continue its analysis of the implication of the proposals regarding sub-LIBOR components. As part of this assessment we will liaise with the IASB and engage with constituents who have identified concerns in this regard. Therefore, we do not express a view at this time.

Questions to constituents

33 Do you have any concerns regarding inflation as a non-contractually specified risk component of financial instruments? If so, please provide examples.

34 Do you have concerns with the issue of sub-LIBOR within the context of the general hedging model, i.e. hedges of individual items or closed groups of items (excluding macro hedging? If so, please provide examples to substantiate you concerns.

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?

(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?

Notes for EFRAG's constituents

35 When anticipated or forecast transactions are designated as hedged items, IAS 39 requires an entity to identify and document these transactions with sufficient detail so that those transactions can be identified unambiguously when they occur. Drawing from this requirement it is possible to designate, under IAS 39, a forecasted transaction as a layer component of a nominal amount. For example, the first 100 tonnes of coffee purchases for the month can be designated as a component for hedge accounting purposes.

36 This way of designating a layer component in a hedge relationship provides for more robust hedge designation, because it allows for flexible yet specific identification of transactions in the face of uncertainty surrounding the timing or the amount of the hedged item. In the above example, if an entity had designated the total volume of expected coffee purchases for the month as the hedged item, any deviation from the expectation would have resulted in hedge ineffectiveness.

37 Designating a percentage component of a nominal amount as the hedged item (e.g. 40% of the contractual cash flows) was already permitted under IAS 39 for both forecast and existing transactions.

38 The IASB now proposes to permit designation of a layer component of a nominal amount as a hedged item (e.g. the first CU 50 of the contractual cash flows) for existing transactions. For example, an entity may want to hedge the interest rate exposure on fixed rate debt it may prepay early. It may designate in accordance with its risk management policy a top layer portion of a fixed rate bond (e.g. the top CU 50 out of a CU 200 fixed rate bond).

39 As the accounting outcome depends on whether an entity designates a percentage or layer component, an entity needs to designate the component for accounting purposes consistently with its risk management objective.

40 A layer component of a contract that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. If allowed, this would result in designation of a risk component that is not separately identifiable. If the fixed rate bonds in the above example included a prepayment option at fair value, this would mean that the option's fair value would not change when the hedged interest rate changed.

EFRAG's response

EFRAG agrees that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item.

41 EFRAG welcomes the decision to permit the designation of a layer component as hedged item. We believe that this will eliminate issues for those companies that manage layer components in their risk management strategies.

Question to constituents

42 EFRAG understands from its initial consultation activities that, while the proposals are considered appropriate for single items, it may not be the case for prepayment options in the context of portfolios. We understand that, at a portfolio level, it may be possible to separately identify the risk component and facilitate the measurement of hedge effectiveness. Do constituents agree this assessment? If so, please provide examples of the instances where an alternative treatment is appropriate.

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?

Notes for EFRAG's constituents

43 Under IAS 39, a hedging transaction qualifies for hedge accounting when it is expected to be highly effective, both prospectively and retrospectively, in achieving the offset of changes in fair value or cash flows attributable to the hedged risk. IAS 39 considers a hedge to be highly effective when the extent of offsetting is within the range of 80 to 125 per cent.

44 A major concern with IAS 39 is the requirement to discontinue hedge accounting if, over a period of time, the hedge effectiveness drops below the 80 per cent floor.

45 The IASB decided to eliminate the 80 to 125 per cent test and to replace it with an objectives-based assessment that enhances the link between hedge accounting and an entity's risk management. The objective of assessing the effectiveness of a hedging relationship is that the entity should designate a hedging relationship that leads to an unbiased result and minimises expected ineffectiveness.

(a) The hedge ratio represents the relative volumes of hedged item and hedging instrument involved in the hedge relationship, to achieve the optimal hedging relationship.

(b) An unbiased result means that there is no expectation that for the designated hedge ratio, the changes in the value of the hedging instrument will <u>systematically</u> <u>either</u> exceed <u>or</u> be less than the change in value of the hedged item.

46 The requirement to minimise expected hedge ineffectiveness does not involve a requirement to achieve 100 per cent effectiveness, nor does it mean that the entity should choose the most effective hedging instrument.

(a) The entity should rely on its risk management to determine the hedging instrument. An entity's risk management approach may not require the use of the most effective instrument, but may instead use an alternative instrument (e.g one that is traded in a more liquid market or that is less expensive).

(b) *Given the choice made under (a) above, the entity should determine the optimal hedge ratio in order to minimise expected hedge ineffectiveness. . The designation of the hedge ratio should therefore consider the basis risk which arises from a difference in terms between the hedged item and the hedging instrument (e.g. differences in price, indices or rate), quality, timing and/or location).*

47 *In addition to the requirement that the hedging relationship should produce an unbiased result and minimise expected ineffectiveness, an entity should also:*

(a) *demonstrate that the expected offsetting is other than 'accidental' (i.e. not solely based on a statistical relationship but involving an economic relationship);*

(b) *choose the type of assessment (quantitative or qualitative) depending on the relevant characteristics of the hedging relationship and the potential sources of ineffectiveness, and change the method whenever unidentified sources of ineffectiveness occur or when the hedging relationship is rebalanced; and*

(c) *reassess the hedge ratio on an ongoing basis at the beginning of each reporting period or when significant changes in the underlying assumptions occur (the assessment is forward looking).*

48 *An entity should assess at inception, and on an ongoing basis, if it expects the hedging relationship to meet the effectiveness requirements. The assessment considers expectations about hedge ineffectiveness and offsetting. Therefore it should only be forward looking (i.e. it is not required to perform a retrospective test). It should be performed, at a minimum, at the beginning of each reporting period or upon a significant change in the circumstances underlying the effectiveness assessment, whichever comes first.*

49 *The proposals do not specify which method an entity should use for the effectiveness assessment. When the terms of the hedged item and the hedging relationship are closely aligned, a qualitative assessment method may be appropriate. When these terms are less closely aligned, a quantitative assessment would be more suitable. Since quantitative assessment tests offer a wide range of tools and techniques, the entity should consider the complexity of the hedge, and the availability of data, as well as the level of uncertainty of offset in the hedging relationship.*

50 *Under these proposals, the sole purpose of measuring hedge effectiveness will be the recognition of all hedge ineffectiveness in profit or loss. The Board proposes that hedge ineffectiveness should be measured by comparing the changes in their value (i.e. on a 'dollar offset' basis). The measurement should be based on the actual performance of the hedging instrument and the hedged item and should consider the time value of money (i.e. the difference in timing of cash flows) and the effects of credit risk.*

EFRAG's response

EFRAG welcomes the removal of the 80 to 125 per cent bright line test for assessing and measuring hedge effectiveness and the introduction of an objectives-based assessment.

We are concerned that the proposed guidance may create inconsistencies between risk management and accounting as explained in paragraph 54 below.

51 EFRAG welcomes the removal of the 80 to 125 per cent bright line test for assessing and measuring hedge effectiveness. It is a significant step towards introducing flexibility and abolishing unnecessarily restrictive requirements that currently discourage entities from applying hedge accounting. The elimination of this requirement would simplify

implementation of hedge accounting and align it closer to an entity's risk management strategy.

52 We agree also with the elimination of retrospective hedge effective testing; this should facilitate the application of hedge accounting, as it prevents de-designation in situations in which minor changes in price cause a hedge to be retrospectively ineffective.

53 In line with the purpose of defining designation criteria that are closely aligned to an entity's internal risk management strategy, we agree with the proposed method to assess effectiveness based on an entity's internal risk management strategy.

54 However, we are concerned about potential inconsistencies that the proposed guidance on the method of assessing effectiveness and measuring ineffectiveness may create between:

(a) the notion of (in)effectiveness for the purpose of assessing/designating a hedge relationship (e.g. for internal risk management purposes the hedge is considered 100% effective); and

(b) the (in)effectiveness that is required to be reported in profit or loss under the proposals (i.e. which requires an entity to take account of the time value of money and the effect of credit risk). For example, the hedged item and the hedging instrument may be traded on different markets with different degrees of liquidity. Therefore, during the life of the hedge, the fair value changes on the hedged item and those of the hedging instrument do not correlate perfectly. For hedge accounting purposes, the proposal is that this difference should be accounted for as ineffectiveness even though risk management considers the hedge to be effective, as upon settlement the hedging instrument still perfectly offsets the cash flow on the hedged item.

We believe that the lack of a component approach for the hedging instrument contributes to the divergent view on hedge effectiveness. Therefore, EFRAG believes this requirement may cause a disconnect between the risk management view of hedge effectiveness and the accounting view. We believe that this introduces unnecessary complexity in hedge accounting and represents a departure from the objective to reflect an entity's internal risk management in its financial statements.

Question 7

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

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

Notes for EFRAG's constituents

<u>IAS 39 did not distinguish accounting consequences of mandatory and voluntary interruption</u>

55 Mandatory discontinuation of hedge accounting is required under IAS 39 when the criteria for hedge accounting are no longer met. This applies to instances where the hedge fails the effectiveness test. Voluntary de-designation is also allowed under IAS 39 (i.e. an entity can voluntarily revoke the hedge designation, even if the criteria for *hedge accounting are still met), but the accounting consequences of a voluntary de-designation and of those of mandatory discontinuation are the same.*

56 *Under IAS 39, any adjustment to the existing and documented hedging relationship that was not envisaged in the hedge documentation results in prospective discontinuation of hedge accounting. This approach has been criticised for being rigid and for not reflecting the flexibility of an entity's risk management activities. In particular, we understand that entities that apply the requirements in IAS 39 voluntary de-designate or interrupt certain hedge relationships when:*

(a) they expect that the hedging relationship will fail the effectiveness test in the future and they want to prevent the resulting mandatory discontinuation of the hedge accounting; or

(b) from an economic perspective they adjust a hedging relationship, in order to reflect changes in the underlying variables affecting the hedging relationship.

57 *After the voluntary de-designation under IAS 39, an entity can re-designate a new hedge relationship, according to the revised terms of the economic hedge. However, the entity cannot avoid the accounting consequences of the discontinuation, such as the hedge ineffectiveness that results from the fact that upon re-designation the hedging derivative may have a value other than zero.*

<u>The ED introduces the possibility to adjust a continuing hedge relationship ('rebalancing')</u>

58 *The ED introduces the concept of 'rebalancing' a continuing hedge accounting relationship. This provides a more flexible accounting approach that ensures that a hedge relationship is not discontinued when an entity adjusts its risk management activities from an economic perspective. Rebalancing is the process of adjusting hedge relationships that are continuing from a risk management perspective, as opposed to 'discontinuation' or mandatory interruption of such hedging relationships.*

59 *The ED clarifies that an entity cannot voluntarily interrupt a hedging relationship, if the criteria for hedge accounting continue to be met. In particular, in order to decide whether to rebalance or discontinue a hedging relationship, the entity needs to consider:*

(a) whether the hedging relationship no longer meets the objective of the hedge effectiveness assessment; and

(b) the continuity of the risk management objective for that designated hedging relationship.

An entity shall rebalance the hedging relationship if it no longer meets the objective of the hedge effectiveness assessment (or is expected to cease meeting that objective), but the risk management objective for that designated hedging relationship remains the same.

60 *When a hedging relationship continues to meet the objective of the hedge effectiveness assessment, but the risk management objective for the hedging relationship has changed, hedge accounting shall be discontinued. In this case, the entity might designate a new hedging relationship that involves the hedging instrument or hedged item of the previous hedging relationship.*

<u>The role of the hedging ratio in the 'rebalancing'</u>

61 *The hedge ratio (i.e. weightings of the hedging instrument and the hedged item as identified at initial designation) is a key element in hedging relationships. Under the proposals, rebalancing involves adjusting the hedge ratio to reflect changes in the*

relationship between the hedging instrument and the hedged item, arising from their underlying or risk variables. An entity can rebalance and continue hedge accounting to the extent that the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio. Otherwise, hedge accounting needs to be discontinued.

62 *On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised in profit or loss immediately before adjusting the hedging relationship.*

63 *Rebalancing is a judgemental process. Provided that the risk management objective of a hedging relationship is unchanged, the entity will be asked to ascertain to what extent the current ineffectiveness can be considered to be:*

- *(a) a fluctuation around a continuing trend in the economic relationships that link the hedged item and the hedging instrument (i.e. rebalancing is not needed); or*
- *(b) leading to a new trend in this economic relationship (i.e. a new hedge ratio is required to appropriately reflect the sources of ineffectiveness that the entity currently expects).*

In both cases, the entity is required to recognise the hedge ineffectiveness.

<u>Practical ways of 'rebalancing' a hedge accounting relationship</u>

64 *The ED mentions that the hedge ratio can be adjusted in different ways. The entity may increase of decrease the volume of the hedged item or the volume of the hedging instrument in the hedge relationship.*

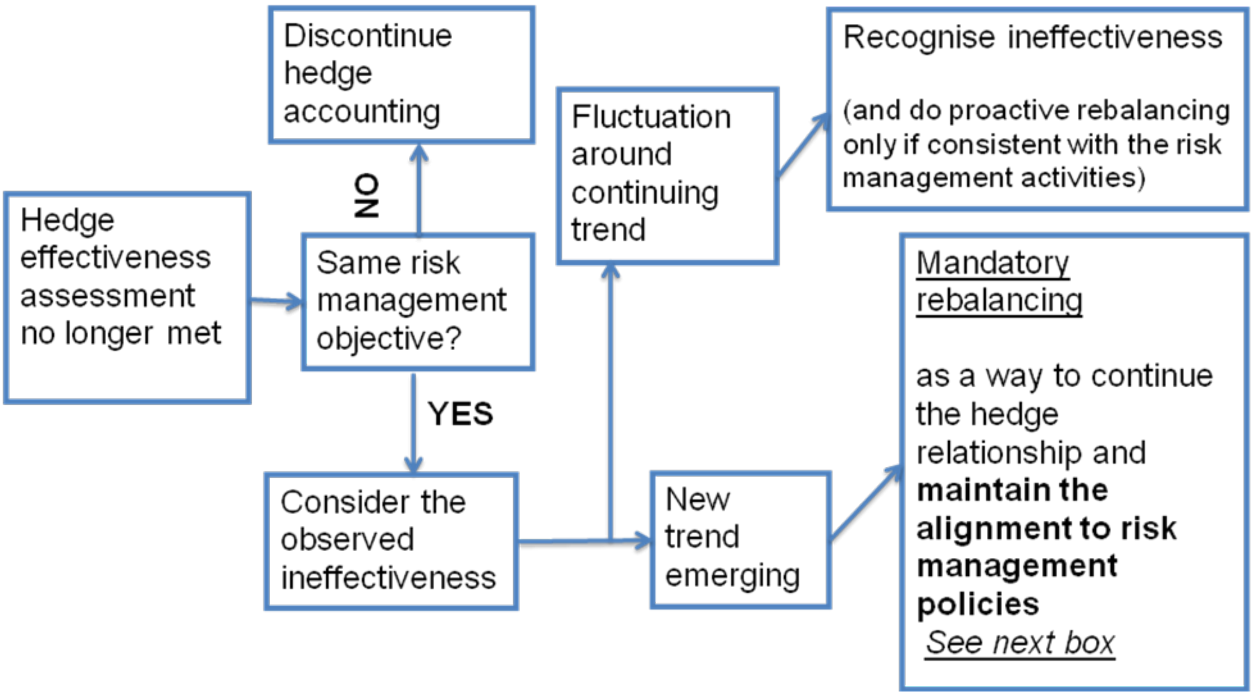
65 *As a result of this process:*

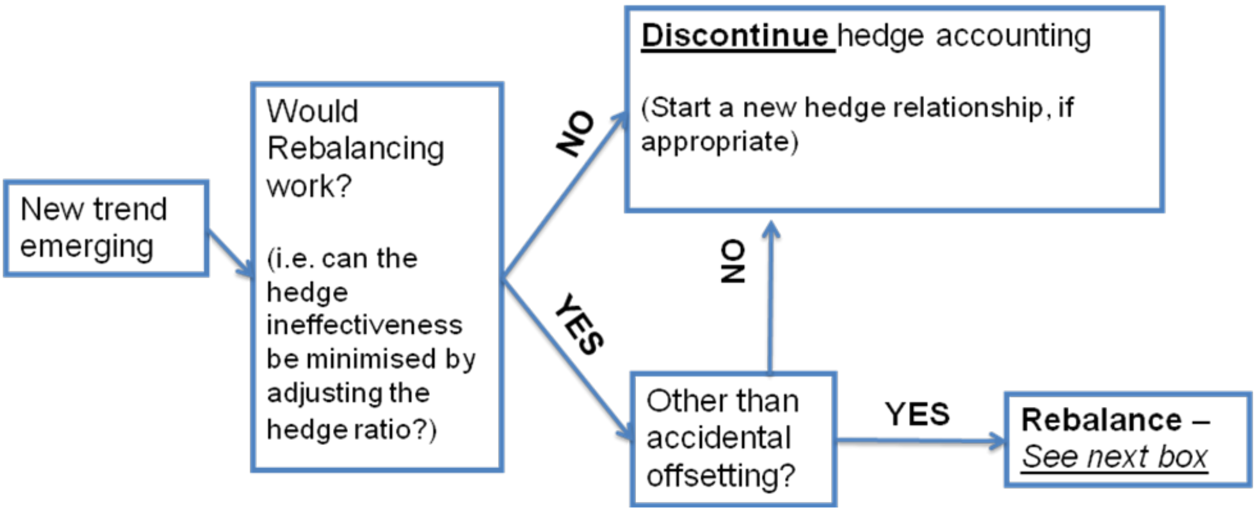
- *(a) It can happen that only a part of the hedging instrument remains designated in the hedge relationship, while the remainder of the derivative is accounted for at fair value through profit or loss. Alternatively, the entity might unwind (i.e. terminate with the counterparty) the corresponding volume of the hedging derivative;*
- *(b) If additional volume of hedged item is designated as part of the hedging relationship upon rebalancing, the changes in the value of the hedged item also include the change in the value of the additional volume of the hedged item starting from the date of rebalancing. Similarly, if additional volumes of the hedging instrument are designated as part of the hedge relationship upon rebalancing, the changes in the value of the hedging instrument also include the change in the value of the additional volume of the hedging instrument from the date of rebalancing;*
- *(c) Sometimes, in order to increase the volume of the hedging instrument, the entity might use hedging instruments that have different critical terms than the existing hedging instrument, because they were entered into at different points in time (including the possibility of designating derivatives into hedging relationships after their initial recognition);*
- *(d) If the entity reduces the volume of the hedged item that is part of the hedge relationship, it should consider that the reduced part the hedge relationship has been discontinued and should apply the requirements for discontinuation;*
- *(e) The entity might roll-over or replace the hedging instrument, without discontinuing the hedge relationship, provided that this is part of the risk management strategy; and*

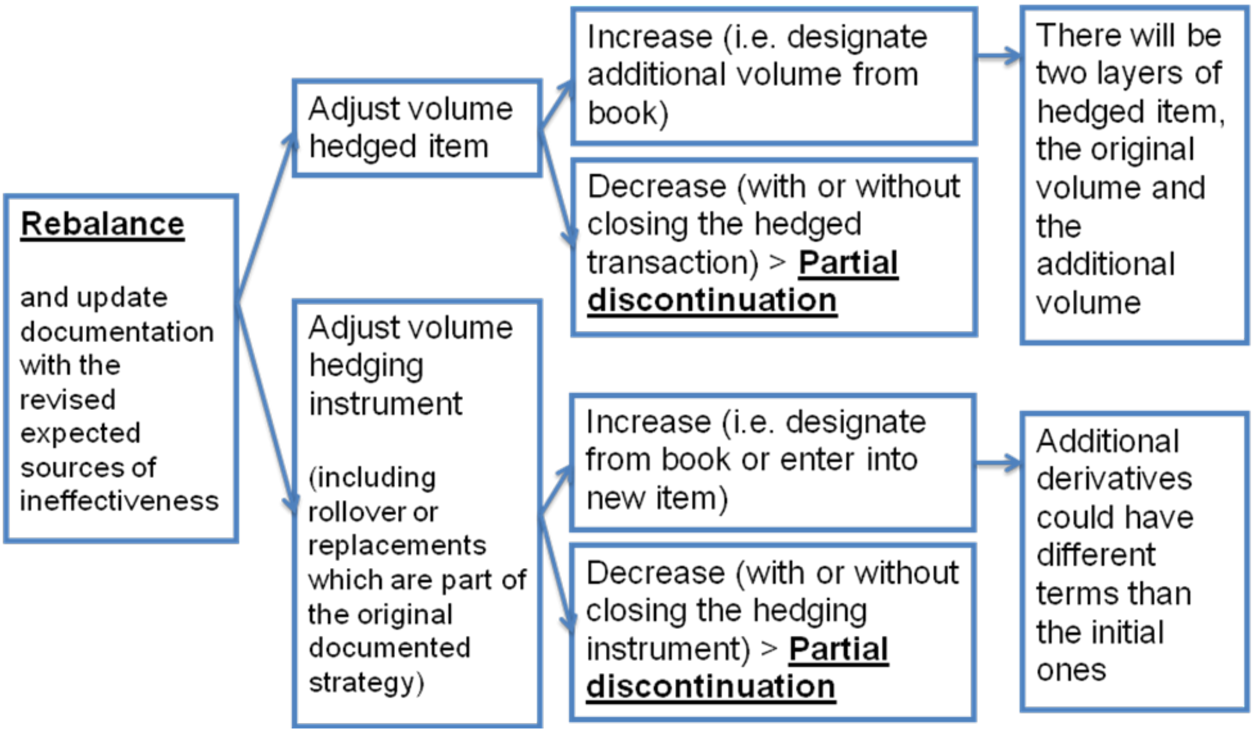
(f) *The documentation of the hedging relationship shall be updated to reflect the changes in the hedge relationship, hedge ratio and updated expected sources of ineffectiveness.*

Decision tree for rebalancing and illustrative example

66 *The following diagram illustrates the steps in the decision process for rebalancing a hedge relationship.*







67 *The following example illustrates the decision process for rebalancing.*

(a) *Entity A (EUR functional currency) is a manufacturing entity that buys materials in Brazilian Real. As part of its risk management, entity A would like to hedge the foreign exchange risk of a highly probable forecast purchase of 10.000.000 BRL worth of materials in 12 months' time.*

(b) *Since there is no cost efficient foreign exchange market for the EUR/BRL, entity A uses the highly liquid and cost efficient EUR/USD market to hedge its exposures. From a risk management perspective, Entity A considers that a EUR/USD forward contract will be an appropriate hedge due to the high levels of correlation between the EUR/USD and the EUR/BRL (i.e. the USD serves as a proxy for the BRL).*

(c) *The hedge ratio that will achieve the best offsetting and minimise ineffectiveness is set to be 70:100 (i.e. weightings of the hedged item and hedging instrument are respectively 70 and 100).*

(d) *The entity observes a change in the previously observed trend between the two exchange rates (i.e. EUR/USD and EUR/BRL). From a risk management perspective, assuming that the risk management objective is unchanged, the entity would assess the nature of this change.*

(e) *If the change is considered to be a fluctuation around a continuing trend (since It represents an isolated event) and the entity confirms the initial expectations of the extent of offsetting between hedging instrument and hedged item, the entity does not rebalance the hedge relationship, but only recognises the hedge ineffectiveness.*

(f) *If the change is considered to be evidence of a new trend in the relationship between the hedged item and the hedging instrument from a risk management perspective, the entity shall rebalance the hedge relationship, in order to continue the hedge relationship.*

EFRAG's response

EFRAG agrees with the notion of 'rebalancing' hedging relationships, because this enables an entity to reflect in hedge accounting the changes in hedge ratio that it makes for risk management purposes.

The notion of rebalancing is not yet well understood and we therefore suggest that the IASB undertake the necessary field-testing to ensure that the proposals can be operationalised.

68 EFRAG agrees with the notion of 'rebalancing' hedge relationships, because this enables an entity to reflect changes that occur in a hedging relationship from a risk management perspective. Risk management is a dynamic activity and, in order to report the effects and the extent of the risk management activities, a flexible approach is required that allows for adjusting a continuing hedging relationship. In this way, accounting would reflect the developments of the risk management activities.

69 The introduction of the rebalancing notion is an improvement as it avoids frequent discontinuation and restarting of hedge relationships when the risk management objective remains the same. In addition, the proposals have the potential to simplify the accounting and reduce the ineffectiveness arising from the use of derivatives with a value other than zero in a restarted hedge relationship.

70 However, we believe that the rebalancing and discontinuation model as proposed requires a significant degree of judgement. In particular:

(a) Economic strategies are adjusted daily; it is not always straightforward to identify when the risk management objective has changed from hedging to trading.

(b) Understanding whether a new trend is emerging, or whether there are fluctuations around a long-term trend, requires judgement. This is particularly difficult when the time horizon under consideration is well into the future.

71 We acknowledge that this judgement is a necessary consequence of a more principles-based approach. Nevertheless, we consider that:

(a) the concept of rebalancing could be articulated in a way that conveys the concept more clearly; and

(b) given the degree of judgement required in applying the guidance on rebalancing of hedge relationships, the IASB should consider whether users require additional disclosures to understand the circumstances leading to the rebalancing and the frequency, method and consequences of the rebalancing.

72 We believe that the proposals on rebalancing might have the potential to add new complexity to hedge accounting to the extent that an entity might need to perform and document assessments that are not currently part of their risk monitoring procedures. For these reasons, we believe that the rebalancing proposals should be subject to appropriate field-testing before finalisation.

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?

(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?

Notes for EFRAG's constituents

73 The ED does not allow for prospective de-designation of hedge relationships when the qualifying criteria are still met (after taking into account the effects of rebalancing) and the entity still pursues the same risk management objective.

74 When a hedging relationship was discontinued under IAS 39 because of a decrease in the hedged quantities of forecast transactions, this resulted in discontinuation of hedge accounting of the entire hedging relationship. The ED introduces the possibility, by way of rebalancing, to discontinue partially a hedged relationship, while continuing the hedge accounting for the remainder of the relationship.

75 The ED states that an entity can designate a new hedging relationship that involves the hedging instrument or hedged item for which hedge accounting was (in part or in its entirety) discontinued. This does not constitute a continuation of a hedging relationship but a restart.

EFRAG's response

EFRAG agrees 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.

EFRAG agrees that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy, and that continues to meet the qualifying criteria.

76 EFRAG agrees 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. Consequently, we 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, and that continues to meet the qualifying criteria.

77 EFRAG agrees with the introduction of rebalancing and partial discontinuation. We believe that rebalancing would help to achieve more flexible accounting requirements and would help to reflect better the developments of the entity's risk management activities in the financial statements. We understand, in particular, that the proposals permit avoiding discontinuation of hedge accounting when the entity intends to continue to use the same hedging instrument for managing the same underlying risk. However, in that case an entity needs to change the weightings of hedged item and hedging instrument to reflect the unexpected changes in the economic hedging relationship.

78 In the response to Question 7 above, we have raised a number of concerns regarding the complexity, operationality, administrative burden and need for field-testing of the rebalancing/discontinuation proposals. In addition, we are concerned that the proposals may not be flexible enough to allow for the discontinuation in instances where external derivative instruments – acquired in accordance with a risk management strategy based on matching internal derivatives – continue to be held while the relationship between the hedged item and the internal hedging instrument ceases to exist. We believe that it is not clear whether this would constitute a change in risk management objective and therefore lead to discontinuation of the hedging relationship. It is important that the IASB clarify this in finalising the proposals.

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?

(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?

(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?

Notes for EFRAG's constituents

79 Analysts have raised various concerns about the presentation of hedge accounting under IAS 39.

(a) Some analysts have difficulties in understanding the distinction between fair value hedges and cash flow hedges as this is an accounting concept.

(b) Analysts are also concerned about the fact that the impact of hedge accounting is scattered throughout the financial statements, which makes it difficult to assess how effective management is in hedging risks.

(c) Under IAS 39, the carrying amount of the hedged item is adjusted through profit or loss for the fair value gain or loss on the hedged item attributable to the hedged risk. This results in a mixed measurement for the hedged item that is neither amortised cost nor fair value, something that analysts find difficult to understand.

80 The first proposal of the IASB was to replace the fair value hedge accounting mechanics by the cash flow hedge accounting mechanics.

(a) The hedged item would not be remeasured.

(b) The gain or loss from remeasuring the hedging instrument would be recognised in other comprehensive income (to the extent that it is effective).

81 The main reasons for considering this approach were:

(a) reducing complexity by requiring a single method for hedge accounting;

(b) increasing the usefulness of information for users by presenting the effects of hedge accounting in one place on the face of the statement of financial position (i.e. in other comprehensive income); and

(c) eliminating the mixed measurement of hedged items.

82 This proposal was abandoned because the tentative approach would:

(a) introduce artificial volatility in profit or loss as it would not reflect the underlying economics (i.e. where an entity has hedged an existing item, the gain or loss on the hedged item is different from the anticipated gain or loss on the forecast transaction that does not yet exist);

(b) make movements in other comprehensive income more difficult to understand;

(c) not facilitate understanding the type of risk management strategy that is applied (e.g. fair value versus cash flow hedge, hedge of existing versus non-existing or forecast items); and

(d) potentially result in a negative equity which for financial institutions could have serious consequences in terms of prudential and solvency requirements.

83 The IASB proposes to change the fair value hedge accounting mechanics as follows in order to address the above mentioned issues.

(a) The gain or loss from remeasuring the hedged item and the hedging instrument will be recognised in other comprehensive income.

(b) The ineffective portion of the gain or loss (i.e. any difference between the fair value of the hedged item and the hedging instrument), shall be transferred from other comprehensive income to profit or loss.

(c) The gain or loss on the hedged item shall not adjust its carrying amount, but instead be presented on a separate line item in the statement of financial position adjacent to the line item that includes the hedged asset or liability. The separate line item shall be reported within assets for those reporting periods when the hedged item is an asset and within liabilities for those reporting periods when the hedged item is a liability. Where assets and liabilities are hedged as group in a fair value hedge, the gain or loss shall be presented on a gross basis adjacent to each line item that includes the related asset or liability.

84 The IASB also considered whether it should require linked presentation for fair value hedges. The issue is inherently linked to the limitation of the statement of financial position in capturing only recognised assets and liabilities.

85 A specific group of preparers were concerned with the fact that they have a large of amount of firm commitments denominated in foreign currency. Their risk management practice is to enter into forward contracts to hedge that foreign exchange risk exposure. They argued that the real exposure to foreign currency risk would be reflected by the net amount representing the difference between the hedged item (the firm commitment) and the hedging instrument (the forward contract). These preparers argued that because the fair value of the firm commitment and the hedging derivative are reported gross, their statement of financial position looks more risky when hedging instead of showing a reduced foreign currency risk exposure.

86 Linked presentation for fair value hedges would result in the gross assets and gross liabilities that are related through a fair value hedge being presented together on the same side of the statement of financial position.

87 Linked presentation differs from offsetting as:

(a) it would report the gross amounts of the assets and liabilities that are linked (offsetting would present a net amount); and

(b) it provides information about the relationship between specific assets and liabilities whereas offsetting reflects that the asset and liability are in fact a single asset or liability (because the entity has the right to offset the amounts and intends to do so).

88 The IASB decided not to allow linked presentation for the following reasons:

(a) The hedging activity only considers a particular risk. For the purpose of a financial ratio analysis it would be inappropriate to ignore the gross leverage position as the risks that have been left unhedged would not be considered (e.g. credit risk).

(b) There may be a range of different types of relationships between assets and liabilities, which would make it very difficult to establish a clear principle to determine when linked presentation would be required.

(c) Disclosures would be a better tool to provide users with information on the different types of assets and liabilities, any relationship between them and the impact of such relation on the leverage.

EFRAG's response

EFRAG acknowledges that the proposed presentation of fair value hedges would show the effect of hedging transactions in a single place of the financial statements. However, we fail to see what additional information that this would provide to users of financial statements.

EFRAG does not support linked presentation where gross assets and gross liabilities that are related by way of a fair value hedge are presented together on the same side of the statement of financial position.

89 EFRAG believes the IASB was right in abandoning its original proposal to replace the fair value hedge accounting mechanics with the cash flow hedge mechanics for the same reasons as those stated in paragraph BC120 of the ED.

90 EFRAG believes that the introduction of the two-step approach would not have additional information value:

(a) We believe there is no principle for supporting the first step (i.e. posting the gains or losses on the hedged item and the hedging instrument in other comprehensive income.

(b) The second step would immediately transfer any ineffectiveness from other comprehensive income to profit or loss thus ultimately reporting all ineffectiveness in profit or loss. This is not a change from IAS 39, which already require ineffectiveness to be reported in profit or loss.

EFRAG agrees that the transfer via other comprehensive income would show all information on hedge (in)effectiveness in a single place on the face of the financial statements. However, we believe this additional step would only create operational complexity for preparers without adding value to the information for the users. The three proposed line items in other comprehensive income (change in fair value of the hedged item, change in fair value of the hedging instrument and ineffectiveness transferred to profit or loss) would reflect an aggregation of different types of hedging strategies and hedging transactions that would inevitably have different degrees of effectiveness. We believe those net amounts are at a level of aggregation that prevents users from assessing the effectiveness of an entity's risk management strategy. Furthermore, we do not believe the face of the primary financial statements is the best place to explain complex hedging strategies involving a large number of underlying items.

91 EFRAG agrees with the proposal not to adjust the hedged item for the gain or loss associated with the risk being hedged. We believe this change to the fair value hedge accounting mechanics would avoid using a measurement attribute that is neither amortised cost nor fair value (i.e. an amortised cost adjusted with a fair value adjustment for the risk that is being hedged). The proposed change will lead to a more transparent presentation of the hedged item on the face of the statement of financial position that is easier to understand for users of the financial statements.

92 We acknowledge that the presentation of that valuation adjustment as a separate line item in the statement of financial position, adjacent to the line item that includes the hedged asset or liability, would increase the information provided on the face of the statement of financial position. However, the clarity and usefulness of this information would decrease the more hedge accounting an entity uses. We consider that when an entity applies hedge accounting to a wide range of different assets and liabilities, the new presentation requirements may substantially increase the number of line items presented on the face of the statement of financial position. In addition, the effect of presenting the hedging gain or loss on a separate line item adjacent to the hedged statement of financial position item will to a certain extent be negated by the effect of aggregating individual hedges, even when those hedges are straightforward. Finally, where an entity is hedging a net position of assets and liabilities the split presentation of the adjustment on both sides of the statement of financial position will be rather artificial and will not be representative of the risk management approach to hedging. Users will not be able to distinguish between hedging gains and losses resulting from single hedges and hedges of closed groups of assets and liabilities unless these would be shown in further line items, which could further increase the number of line items on the statement of financial position.

93 Therefore, we would suggest to aggregate all fair value hedge adjustments of the hedged items into a single net amount that would be reported on the face of the statement of financial position (on the asset side in case of a debit balance and on the liabilities side in case of a credit balance). The net amount should be disaggregated in the disclosures at a level that would allow users to identify the hedged items and the associated gains or losses related to those items.

94 EFRAG agrees that linked presentation is not an appropriate tool to report on the link that the entity's risk management strategy establishes through hedge accounting between different assets and liabilities. We believe that the risk management strategy of an entity should be explained in the notes to the financial statements. Showing linkage on the face of the statement of financial position would create confusion and impair comparability between entities. Considering the risk management practices in some industries, to manage risks on a portfolio basis using dynamic hedging strategies, EFRAG thinks it would be difficult to achieve linked presentation in practice without affecting the comparability of financial information for the entity across different reporting periods.

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?

Notes for EFRAG's constituents

95 In IAS 39, a hedging instrument normally needs to be designated in its entirety. There are two exceptions to this general requirement in respect of options and forward contracts designated as hedging instruments. For these instruments, an entity can elect to designate the entire derivative as a hedging instrument, or only the component whose fair value changes is expected to react to changes in the hedged risks and offset the changes in fair value of the hedged item. If the entity elects to designate only that component of the derivative (i.e. the intrinsic value of an option and the change in the spot element of a forward contract) then the residual component (i.e. the time value of the option and the interest element of the forward contract, respectively) would be measured at fair value through profit or loss.

96 By designating only the intrinsic value of an option, or the interest element of a forward contract, an entity can avoid hedge ineffectiveness, because only these elements vary in response to the underlying risk being hedged.

97 It should be noted that the time value component of an option will decline as the exercise date approaches and will be nil at exercise date, unlike other sources of ineffectiveness (e.g. basis risk).

98 From its outreach activities the IASB has learned that the entities try to avoid this undesired accounting consequence by changing the risk management practice towards the use of non-option derivatives such as forward contracts or swaps, often adopting sub-optimal and less cost efficient strategies.

99 The Board decided to retain the exception that exists in IAS 39, and to introduce specific requirements to address the issue of potential ineffectiveness in relation to time value of an option. The proposals in the ED require:

(a) the same accounting treatment in the case of cash flow hedges and fair value hedges;

(b) treating the time value of an option as an additional cost of the hedging strategy akin to an insurance premium paid for hedging the underlying risk; and

(c) the introduction of a separate component of equity (accumulated other comprehensive income) in which to recognise the cumulative fair value attributable to the time value of the option.

100 The accumulated other comprehensive income is reclassified to profit or loss according to the underlying nature of the transaction.

(a) For 'transaction-related' hedged items (e.g. a forecasted transaction) it should be reclassified similarly to the requirements for cash flow hedges;

(b) For 'time period-related' hedged items (e.g. inventory), it should be allocated over the relevant period on a rational basis.

101 The Board also considered that such an approach would achieve consistency with other standards, like IAS 2 or IAS 16.

102 The approach requires that an entity distinguish between the time value component of the hedging instrument (actual time value) and that of a hypothetical hedging instrument having critical terms that perfectly match those of the hedged item (aligned time value). Under the proposals, the amount that is recognised in accumulated other comprehensive income would have to be determined by reference to the lower of the cumulative fair value change of the actual time value and the aligned time value.

EFRAG's response

EFRAG welcomes the proposals, which address the issue of ineffectiveness due to the time value component in options and provide a solution to an important practical issue.

The Board should consider a single approach for the reclassification from other comprehensive income to profit or loss of the time value component accumulated in other comprehensive income. EFRAG believes that an allocation over the relevant period on a rational basis would be the most appropriate method.

103 We welcome these proposals, which address the issue of ineffectiveness due to the time value component in options and provide a solution to an important practical issue.

104 We acknowledge that these proposals have the potential to introduce additional complexity. Nevertheless, we consider that the proposals achieve a reasonable trade off between the added complexity and the benefits of solving this issue, from a practical perspective.

105 In order to limit the complexity, we believe that the Board should select a single approach for the reclassification from other comprehensive income to profit or loss of the time value component accumulated in other comprehensive income. EFRAG believes that an allocation over the relevant period on a rational basis would be the most appropriate method.

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?

Notes for EFRAG's constituents

<u>Closed portfolios</u>

106 The ED includes the requirements for hedging individual items and groups of items that are part of a closed portfolio. In November 2010, the IASB started discussions about the requirements on a hedge accounting model for open or dynamic portfolios ('macro-hedge').

Hedging a group of items should be consistent with risk management strategy

107 *Under the proposals, a group of items can qualify as a hedged item if this is consistent with the risk management strategy of an entity. Appendix B to the ED clarifies that this is not a matter of assertion or mere documentation, but a matter of fact and part of an established risk management strategy normally approved by key management personnel.*

Eligibility criteria for a group of items (including a group that constitute a net position)

108 *The ED proposes that a group of items would be eligible as hedged item, only if:*

(a) the individual items (or components of items) in the group are individually eligible; and

(b) the group is managed on a group basis for risk management purposes.

The IASB believes that an individual hedge approach and a group hedge approach are similar in concept.

109 *For cash flow hedging there is an additional condition to the those mentioned above; any offsetting cash flows in the group of hedged items exposed to the hedged risk, should affect profit or loss in the same reporting period and in that period alone.*

110 *Appendix B of the ED clarifies that when an entity intends to designate as a hedged item a group that constitutes a net position, the entity shall designate the gross positions that together give rise to the net position and cannot designate an abstract net position. For example, the entity can designate the gross amount of purchases and gross amount of sales in foreign currency which will be settled in the same timing and whose resulting net position is the hedged exposure to currency risk.*

Eligibility criteria for percentage component and layer component of a group

111 *A percentage component of an eligible item or of a group of eligible items can be designated as a hedged item, if this is consistent with the risk management objective.*

112 *The ED permits designation as hedged items of layer components in groups of items*

113 *The following conditions apply for the eligibility as hedged item of a layer of a group of hedged items:*

(a) the layer is separately identifiable and reliably measurable;

(b) the risk management objective is to hedge the layer component;

(c) the items in the overall group are exposed to the same risk and measurement of the layer is not dependent on which items form part of the layer;

(d) for hedges of existing items the entity can identify and track the overall group of items from which the layer has been identified; and

(e) the fair value of any prepayment options in relation to items in the group are not affected by the hedged risk.

114 *Appendix B of the ED clarifies that a hedging relationship can include a layer component of a group of assets and layer component of a group of liabilities.*

A group of items that has nil net position as hedged item without instrument

115 *The IASB has proposed that a group of items that constitutes a nil net risk position would be eligible as a hedged item. In this case, the resulting hedging relationship*

would not include a hedging instrument, but only hedged items that offset each other. The following conditions should be met:

(a) the hedge is part of a rolling net risk hedge strategy that uses net positions that change in size over time;

(b) over the life of the rolling net risk hedge strategy, eligible hedging instruments will be used when the position is not nil;

(c) hedge accounting is normally used when the net position is not nil, using eligible instruments; and

(d) not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes compared to applying hedge accounting to the offsetting risk position.

EFRAG's response

EFRAG will not be able to comment on these proposals in full until we gain a better understanding of the Board's direction in respect of macro hedging.

It is not immediately evident from the ED, what the underlying principle is for the treatment of groups of items. We believe that further outreach and field-testing should be undertaken to avoid replacing one set of complex, rules-based, requirements with another.

116 We understand that these proposals represent an intermediate step towards the development of an accounting model for hedges of open portfolios (i.e. macro hedges). However, until we gain a better understanding of the Board's direction in respect of macro hedging, we will not be able to comment on these proposals in full.

117 We observe that some restrictions will be maintained in the general hedging model for closed groups of hedged items and the rationale for these restrictions it is not always clear.

(a) We note that all individual items in a group need to meet the eligibility criteria in order to be collectively designated as hedged items. For a group that represents a net position, the corresponding gross amounts need to be identified as well. We have concerns about the possible internal inconsistencies in this approach as it tries to give prominence to the risk management approach but continues to pursue an accounting approach based on individual items.

(b) The Board concluded that permitting designation of cash flows that occur in different periods would be inconsistent with the general hedge accounting requirements ; therefore, cash flow hedge accounting of net positions is only permitted if the corresponding cash flows offset in the same reporting period. We believe that this issue has not been explored sufficiently, and the reasoning behind this decision requires a better explanation.

118 We understand that in its deliberations the Board considered a series of practical examples from a number of industries. However, it is not always immediately evident what the principle underlying the resulting changes in the hedge accounting model is. We believe that further outreach and field-testing should be undertaken. Otherwise, the Board risks replacing one set of complex, rules-based, requirements with another.

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?

Notes for EFRAG's constituents

Presentation of cash flow hedge accounting when hedged risks affect different lines

119 Appendix B of the ED includes specific requirements for presenting gains and losses from hedged items when they are reclassified from other comprehensive income to profit or loss in a cash flow hedge accounting:

(a) if the group of items does not have an offsetting position (e.g. different expenses denominated in the same foreign currency) and is recognised in different lines of the profit or loss, the gains or losses reclassified from other comprehensive income to profit or loss will be apportioned to the different line items; and

(b) if the group of items does have an offsetting position (e.g. group of sales and expenses denominated in the same foreign currency), the gains or losses reclassified from other comprehensive income to profit or loss will be presented in a separate line item.

Linked presentation of gains and losses in a group of items designated in a fair value hedge

120 For groups of assets and liabilities that are hedged using a fair value hedge, the gains or losses should be recognised in the statement of financial position and presented on a gross basis adjacent to the assets or liabilities themselves.

Separate presentation of net interest accrued from a net position under a FV hedge

121 When an entity applies a fair value hedge to a net position comprising a fixed rate asset and a fixed rate liability, it shall present on a net basis the accrual of net interest from the hedging relationship in a separate line in profit or loss.

EFRAG's response

EFRAG agrees with the proposals regarding the presentation in profit or loss of the effects of hedge accounting for groups of items.

EFRAG disagrees with the way gains or losses from fair value hedges of net positions are proposed to be presented. Rather than requiring presentation on a gross and disaggregated basis in the statement of financial position, we would recommend that all fair value changes be aggregated into a single item in the statement of financial position and to provide details in the notes.

122 We agree with the proposals regarding the presentation in profit or loss of the effects of hedge accounting for group of items. In particular, we agree with the proposal to present on a net basis in a separate line item in profit or loss, the gains or losses from the hedging instrument, when it is designated in a hedging relationship of a net position of offsetting items that affect different lines of that statement. This would avoid artificial grossing up of gains or losses.

123 However, we are concerned about the proposals in the ED in relation to the presentation in the statement of financial position of the effects of fair value hedge

accounting for group of items. In particular, when an entity designates as a hedged item a group of items (including a net position) in a fair value hedge, the cumulative change in fair value of the hedged risk from each of the items is required to be presented on a gross basis adjacent to the related assets and liabilities in a separate line item. We believe that this would result in artificial grossing up of assets and liabilities.

124 Finally, as explained above in our response to Question 9, we recommend that all fair value changes be aggregated into a single line item in the statement of financial position and to provide details in the notes. We consider that where an entity is hedging a net position, the split presentation of the adjustment of the assets and liabilities would be rather artificial and not represent the risk management approach to hedging.

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?

Notes for EFRAG's constituents

125 The ED proposes disclosure requirements that provide information about:

(a) an entity's risk management strategy and how it is applied to manage risk;

(b) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(c) the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

126 Furthermore, in the reconciliation of accumulated other comprehensive income, an entity should provide sufficient detail to allow users to understand the effects of hedge accounting on the statement of comprehensive income. In addition, an entity should distinguish amounts recognised regarding the time value of options between transaction related hedged items and time period related hedged items in the reconciliation of accumulated other comprehensive income.

127 The required disclosures should be presented in a single note or separate section in the financial statements. However, an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference.

EFRAG's response

EFRAG supports the categories of disclosures proposed in the ED. We believe that disclosures play a fundamental role in providing users with an understanding of an entity's risk management strategy and hedging activities.

We are concerned about the prescriptive nature of the disclosure requirements and the interaction with the disclosure requirements of IFRS 7.

128 EFRAG believes that disclosures play a fundamental role in complementing financial information derived from the principles-based proposals in the ED. The proposals

require application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the overall risk management strategies. Disclosures should also allow users to understand results of both the hedged and un-hedged positions where an entity could have applied hedge accounting but elected not to do so.

129 We believe that the proposed disclosure objectives aim to achieve this. EFRAG supports the categories of disclosures proposed in the ED. We agree that these categories provide an insight into an entity's hedging activities and the effect of those activities on the performance of the entity.

130 Having said that, we are concerned about the prescriptive nature of the wording and in particular the use of words such as 'shall' as opposed to 'may or may not' in paragraph 44 and others. In our view, this may result in a checklist approach and entities providing boilerplate disclosures rather than meeting the disclosure objectives in the most information-rich way. Furthermore, we find it difficult to understand how the proposals would interact with the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*. We urge the IASB to consider these issues in finalising disclosures that would meet the objectives set out in the ED.

131 In addition, we would urge the IASB to review carefully the existing disclosure requirements regarding financial instruments to ensure that there is an appropriate cost-benefit trade-off. In this context, we note that, where possible, the IASB should consider disclosures already required by prudential regulators.

Question to constituents

132 Do constituents believe that the proposed disclosures meet the objective of providing transparency into an entity's hedging 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?

Notes for EFRAG's constituents

133 Contracts accounted for in accordance with IAS 39 include those contracts to buy or sell non-financial items that can be settled net in cash, as if the contracts were financial instruments. Many commodity contracts meet criteria for net settlement in cash because in many instances commodities are readily convertible to cash.

134 *When such contracts are accounted for as a derivative, they are measured at fair value with changes in the fair value recognised in profit or loss. If an entity enters into a derivative to hedge the changes in the fair value of these commodity contracts, derivatives will also be measured at fair value with changes in fair value recognised in profit or loss. Hedge accounting is therefore less important in these instances.*

135 *However, such contracts are excluded from the scope of IAS 39 if they 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. This is commonly referred to as the 'own use' scope exception of IAS 39.

136 *In these situations, contracts are accounted for as normal sales or purchase contracts. Consequently, if an entity enters into a derivative contract to hedge changes in the fair value or cash flow exposures arising from such contracts, it creates an accounting mismatch because the change in the fair value of the derivative is recognised in profit or loss, while the change in the fair value of the commodity supply contract is not recognised.*

137 *To eliminate the accounting mismatch, an entity could apply hedge accounting. It could designate the commodity supply contracts (which meet the definition of a firm commitment) as hedged items in a fair value hedge relationship. Consequently, the commodity supply contracts would be measured at fair value and the changes would offset the changes in fair value of the derivative instruments. However, hedge accounting in these circumstances is administratively burdensome and often produces a less meaningful result than fair value accounting. Furthermore, entities enter into large volumes of commodity contracts, and within the large volume of contracts some positions may offset each other. An entity would therefore typically hedge on a net basis. Moreover, in many business models, this net position also includes physical long positions such as commodity inventory. The net position is typically monitored, managed and adjusted daily. As a result of the frequent movement of the net position and therefore the frequent adjustment of the net position to nil or close to nil, an entity would have to adjust the fair value hedge relationship frequently if the entity were to apply hedge accounting.*

138 *The Board noted that in such situations hedge accounting is not an efficient solution because entities manage a net position of derivatives, executory contracts and physical long positions in a dynamic way. Hence, the Board proposes that derivative accounting would apply to contracts, that would otherwise meet the 'own use' scope exception, if that is in accordance with the entity's fair value-based risk management strategy. The Board believes that this approach would faithfully represent the financial position and performance of entities that manage their entire business on a fair value basis, provide more useful information to users of financial statements, and be less onerous for entities than applying hedge accounting.*

EFRAG's response

EFRAG agrees that the proposals are a step in the right direction, but urge the IASB to investigate this issue further in finalising the proposals.

139 EFRAG supports the proposals in the ED regarding the 'own use' scope exception subject to disclosures that would clarify the accounting treatment applied by an entity. We believe that the proposals will solve a practical issue for those IFRS appliers that adopt a risk management strategy that is based on fair value. Furthermore, we find that the proposals will result in useful information by allowing entities to better reflect their activities. In our view, this will better serve users of financial statements.

140 However, we note that these proposals do not address all concerns of our constituents. In particular, entities that process or refine commodities often manage the price risk on their entire flow of goods on a fair value basis (e.g. oil refineries that manage their purchase and sale contracts as well as their physical inventory at fair value). However, even under these proposals they will not be able to apply fair value accounting to their physical inventory, as they are neither producers of commodities nor broker-dealers as required by IAS 2. Rather than addressing these concerns on a standard-by-standard

basis, we believe that they IASB should take a more holistic approach to the underlying concerns and address these as part of a separate project.

Question to constituents

141 Do you believe the proposals will be useful in addressing problems in practice ? If not please explain.

142 From its initial consultation activities, EFRAG has understood that this issue may be broader than what the IASB had considered in finalising the proposals in the ED. Are there any other issues with the 'own use' exception that you are aware of? If so, what solution you believe would be appropriate to resolve the issue(s)

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?

Notes for EFRAG's constituents

143 Many financial institutions use credit derivatives to manage the credit risk resulting from their lending activities. Portfolio managers typically manage the credit risk depending on the circumstances and only for a portion of the loans and/or loan commitments. This flexible approach allows them to consider, for example, the expected pattern of drawdown and/or repayments and changes in credit quality.

144 In practice credit risk managers use Credit Default Swaps (CDSs) to manage the exposure to credit risk. The credit risk managers transfer the credit risk to a third party by paying a periodic premium to the third party in return for a set payment if a credit event[1], such as bankruptcy, occurs. The CDS acts economically as an insurance policy as it will compensate the buyer for a credit loss.

145 Under the current requirements in IFRS it may be difficult to achieve hedge accounting for CDSs that are used to hedge credit risk. Credit risk can only be designated as a hedged item if it is possible to isolate and reliably measure the credit risk component. As the spread between the risk free interest rate and the market interest rate incorporates credit risk, but is also affected by other types of risk, such as liquidity risk, the IASB argues it is difficult to isolate and measure the changes in fair value that are attributable only to the change in credit risk.

146 An entity could choose to use the Fair Value Option (FVO) as an alternative to hedge accounting.

(a) However, because of the restrictions linked with this option, this alternative does not fit within credit risk management practices. For example, the FVO requires an entity to designate the entire financial instrument as at fair value through profit or loss and it also is an irrevocable designation only available at initial recognition. As such the FVO is incompatible with the flexible and active credit risk

[1] A credit event triggers a settlement payment by the protection seller to the protection buyer. Credit events in a standardised CDS will include bankruptcy, obligation default, failure to pay, repudiation/moratorium, obligation acceleration and restructuring.

management as adopted by most entities (e.g. an entity may hedge less than 100% of the instrument or may start hedging credit risk after initial recognition of the instrument when economic circumstances deteriorate).

(b) Moreover, the FVO is only available to instruments that are within the scope of IAS 39, which is not the case for most loan commitments (they are usually within the scope of IAS 37). Therefore, few entities elect to use the FVO as an alternative to hedge accounting for credit risk.

147 Financial institutions that use credit default swaps to hedge the credit risk of their loan portfolios would recognise any changes in the fair value of those swaps in profit or loss. However, if those entities cannot achieve hedge accounting nor elect the FVO, their loan portfolios would be measured at amortised cost (and loan commitments that meet the scope exception of IAS 39 would not be recognised). The result is an accounting mismatch that creates volatility in profit or loss and which is not representative of the substance of the credit risk management strategy of those entities.

148 The IASB did not want to amend the hedging model or to extend its scope in order to resolve this tension between credit risk management practices and the hedge accounting requirements as that might affect other industries or other hedging transactions. Instead, the IASB considered three alternative approaches to accommodate accounting for economic hedges of credit risk that do not qualify for hedge accounting for the sole reason that the credit risk component cannot be measured.

*(a) **alternative 1:** subject to qualification criteria, permit:*

(i) electing fair value through profit or loss (FVTPL) only at initial recognition;

(ii) designation of a component of nominal amounts; and

(iii) discontinuation.

*(b) **alternative 2:** subject to qualification criteria, permit:*

(i) electing FVTPL at initial recognition or subsequently (if subsequently, the difference between carrying amount and fair value is recognised immediately in profit or loss)

(ii) designation of a component of nominal amounts; and

(iii) discontinuation.

*(c) **alternative 3:** subject to qualification criteria, permit:*

(i) electing FVTPL at initial recognition or subsequently (if subsequently, the difference between carrying amount and fair value is amortised or deferred);

(ii) designation of a component of nominal amounts; and

(iii) discontinuation.

149 These alternatives could be applied provided the economic relationship between the financial instrument and the credit derivative is based on the same credit risk (i.e. matching the name (of the loan or loan commitment and the reference entity of the credit derivative) and the seniority (of the financial instrument and the instruments that can be delivered in accordance with the credit derivative).

150 The alternative methods would be discontinued if the accounting mismatch no longer exists because the derivative expires, is sold, terminated or settled, or the credit exposure of the financial instrument is no longer managed on a fair value basis using credit derivatives. Considering the rationale of for electing fair value through profit or *loss (i.e. resolving the accounting mismatch), the IASB considered it would be logical to make discontinuation mandatory if the discontinuation criteria are met.*

151 *Alternative 1 would only be available at initial recognition which may not fit the needs of the risk management if credit protection is acquired for an exposure after its initial recognition. On the other hand, the requirement to apply this method at initial recognition of the exposure is an advantage as there will be no difference between the carrying amount of the exposure at the date of election and its fair value. Therefore, alternative 1 is less complex than the other two alternatives.*

152 *Alternative 2 may be elected after initial recognition of the exposure to credit risk, meaning that election would also be available for exposures for which fair value through profit or loss was elected (and discontinued) previously. As such, it would allow an entity to reflect the active and flexible risk management practice appropriately in the accounts and significantly reduce the accounting mismatch between credit risk exposures and the credit derivatives. This method is more complex than alternative 1 because of the 'measurement change adjustment' (MCA), which is the difference between the carrying amount and the fair value of the exposure at election of FVTPL. Alternative 2 requires recognition of the MCA in profit or loss at the date of election (this also applies when the financial instrument is elected again after a previous discontinuation). At the date of discontinuation the fair value will be the deemed cost (as in alternative 1). Alternative 2 will operationally be less complex than alternative 3.*

153 *Alternative 3 provides the same eligibility and discontinuation criteria as alternative 2 but proposes that the MCA should be amortised for loans and deferred for loan commitments that are in the scope of IAS 37. More specifically, alternative 3 proposes to treat the MCA as follows:*

- *(a) for loans that are within the scope of IFRS 9:*
  - *(i) amortisation of the MCA over the life of the loan;*
  - *(ii) when the MCA plus the FV is greater than the carrying amount if the loan had been continued to be measured at amortised cost, the amount above amortised cost should be recognised as an impairment;*
  - *(iii) the deemed cost of the financial instrument at discontinuation of FVTPL should be its FV plus any unamortised MCA amount.*
- *(b) for loan commitments within the scope of IAS 37, the MCA is deferred until the earlier of:*
  - *(i) the discontinuation of fair value through profit or loss accounting; and*
  - *(ii) recognition of a provision in accordance with IAS 37.*

154 *An advantage of alternative 3 over alternative 2 is that it will not deter the election of the FVTPL in scenarios where after initial recognition the fair value of the credit exposure has already declined. However, alternative 3 is the most complex approach of the three alternatives. Furthermore, it would give rise to issues on the presentation of:*

- *(a) the MCA as:*
  - *(i) an integral part of the carrying amount of the exposure (leading to a mixed measurement amount that is neither fair value nor amortised cost); or*
  - *(ii) a separate line item next to the line that includes the credit exposure (which may possibly be confused with the hedging adjustment); or*
  - *(iii) an item in other comprehensive income.*

(b) the periodic charge for amortisation of the MCA as

(i) interest revenue (conflicting with the requirements on interest revenue recognition as the relating exposure would not be measured at amortised cost); or

(ii) other gains or losses.

155 The IASB considered that transparency on the MCA could be provided through disclosures that reconcile the changes in the MCA during the reporting period.

156 *The Board tentatively decided not to support any of these alternatives.*

EFRAG's response

EFRAG believes that, where the hedged item is credit risk, there is not any inherent obstacle to achieving hedge accounting per se and hedge accounting should be permitted provided that the hedging relationship meets the general requirements for qualification and is consistent with the risk management activities.

We acknowledge this may be difficult to achieve in practice. Therefore, we support the IASB in its efforts to investigate further the development of the proposed accounting alternatives.

157 EFRAG believes that, considering the objective of the hedge accounting (i.e. to represent the effect of an entity's risk management activities), the requirements should provide entities with the tools to capture their risk management practices in the financial statements. However, we understand that under these proposals it would be difficult for credit derivatives to qualify as hedging instruments.

158 The IASB argues that the spread between the risk-free and market interest rate incorporates components other than credit risk (i.e. liquidity, funding and any other unidentified risk component). In the IASB's view, this makes it operationally difficult (if not impossible) to isolate and measure the change in fair value attributable to the credit risk and therefore to meet the criteria for designation.

159 Financial institutions normally measure at fair value through profit or loss those credit derivatives for which it is difficult to achieve hedge accounting, due to the ineffectiveness arising from the different terms between the hedging instrument and the hedged item (e.g. when the derivatives only provides protection for changes in credit rating of the entity and not on default events specific to the hedged debt instrument). However, where the hedging derivative provides protection specifically from default events of the hedged debt instrument, it is in theory possible to achieve hedge accounting under existing IAS 39 and under the proposals in the ED.

160 As EFRAG has stated in its response to Question 4, we believe the IASB should develop a principles-based standard without adding rules to outlaw specific components. Therefore, EFRAG believes that, where the hedged item is credit risk, there is not any inherent obstacle to achieving hedge accounting per-se and hedge accounting should be permitted provided that the hedging relationship meets the general requirements for qualification and is consistent with the risk management activities. We acknowledge this may be difficult to achieve in practice. Hence, where entities fail to meet the qualifying criteria for hedge accounting, they should have access to an alternative for hedge accounting. We support the IASB in its efforts to investigate further the development of the proposed accounting alternatives.

Question to constituents

161 When economic hedges of credit risk do not qualify for hedge accounting for the sole reason that the credit risk component cannot be reliably measured, the IASB has considered, but rejected, accommodating hedge accounting using an alternative method. Which of the three proposed alternative methods considered by the IASB do you believe would be appropriate and why?

Question 16

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

Notes for EFRAG's constituents

162 Consistent with the earlier phases of IFRS 9, the IASB proposes 1 January 2013 as the effective date. The proposals allow for early application only if all earlier phases of IFRS 9 are also adopted. The ED acknowledges that the IASB is consulting on the effective dates of various standards and notes that feedback on that consultation will be considered in finalising these proposals.

163 While the other phases of IFRS 9 generally require retrospective application, this ED proposes prospective application on the presumption that a hedging relationship can only be designated prospectively.

EFRAG's response

EFRAG supports an effective date of 1 January 2015 for all phases of IFRS 9 and the other major projects currently under the consideration of the IASB.

EFRAG supports prospective application of the proposals.

164 EFRAG supported the proposals regarding effective dates and transition in earlier phases of the consultation on the replacement of IAS 39, with the exception of the proposals relating to the fair value option for financial liabilities. In that instance, EFRAG supported the amendment of IAS 39 because the proposals represented a solution to an existing problem that could easily be implemented as a short-term improvement.

165 However, in its draft comment letter on the IASB's Request for Views on *Effective Dates and Transition Methods*, EFRAG suggested that the standards resulting from the projects on Revenue from Contracts with Customers, Leases, Insurance Contracts, Financial Instruments (IFRS 9) and Fair Value Measurement should have a single effective date of 1 January 2015 at the earliest.

166 Providing different effective dates and early adoption requirements for first-time adopters might be considered for purely pragmatic reasons (i.e. first-time adopters would not have to adopt standards that are about to be abolished). However, this should not result in a mandatory acceleration of effective dates for existing IFRS reporters.

167 EFRAG generally supports retrospective application, as retrospective application facilitates comparability between periods. However, in this case EFRAG agrees with the IASB that prospective application is appropriate because:

(a) it would be very difficult to apply the provisions retrospectively without the application of hindsight; and

(b) entities would in many instances find it difficult to provide the necessary documentation to support the hedging relationships (e.g. they would be required to compile and assess historic market data to determine effectiveness).

168 EFRAG agrees that the alternative approach that grandfathers the accounting under IAS 39 is inappropriate. We also agree that no changes to IFRS 1 are necessary.