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European Financial Reporting Advisory Group ■

EFRAG's preliminary position on the IASB  
Exposure Draft *Hedging Accounting*

Draft comment letter 18 January 2011

# EFRAG's overall assessment



	EFRAG preliminary position
<i>EFRAG agrees with</i>	<ul style="list-style-type: none"><li>• 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.</li><li>• The proposals remove a number of important restrictions to hedge accounting that exist in IAS 39.</li><li>• 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.</li></ul>

## EFRAG's overall assessment (continued)



	EFRAG preliminary position
<i>EFRAG has a number of concerns</i>	<ul style="list-style-type: none"><li>• The revision of IAS 39 into a number of phases that are interdependent. We believe that the IASB will need to consider the entire package of proposals as a whole before finalising the resulting standards.</li><li>• We believe that a certain restrictions regarding eligible hedging instruments and eligible risk components as hedged items should be further considered.</li><li>• The proposals rely heavily on judgement and on the link to risk management. We believe that the IASB should conduct field-testing and outreach activities to ensure that proposals are operational.</li><li>• We believe the proposed general model for hedge accounting is a reasonable approach to hedging individual items. However, 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.</li></ul>

# Objective of hedge accounting (Question 1)



	EFRAG preliminary position
<i>Proposed objective of hedge accounting</i>	<p>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.</p> <p>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.</p>

# Eligibility of non-derivative financial instruments (Question 2)



	EFRAG preliminary position
<i>Non-derivative instruments at fair value through profit or loss</i>	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, because it enables an entity to align its hedge accounting closer to its risk management objectives.
<i>Non-derivative instruments not at fair value through profit or loss</i>	However, EFRAG believes that non-derivative instruments other than those at fair value through profit or loss should be eligible as hedging instruments. We believe 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.
<b>Question to constituents</b>	EFRAG is interested in obtaining views from constituents on a possible 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.

## Derivatives as hedged items (Question 3)



	EFRAG preliminary position
<i>Derivatives as hedged items</i>	EFRAG agrees that a synthetic exposure may be designated as a hedged item. EFRAG believes this proposal will eliminate a significant unnecessary restriction of IAS 39 that should contribute to aligning hedge accounting with actual risk management practices.

## Risk components (Question 4)

	EFRAG preliminary position
<i>Risk components eligible hedged items</i>	EFRAG welcomes the proposal to allow the designation of a risk component as a hedged item if it is separately identifiable and measurable.
<i>Non-contractual inflation components</i>	We question why non-contractually specified inflation cannot be designated as a component and urge the IASB to reconsider this issue. 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. We note that to qualify as hedged item an item must be separately identifiable and reliably measurable.
<i>Sub-LIBOR components</i>	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. We may supplement our preliminary views in the coming weeks.
<b>Questions to constituents</b>	<p>EFRAG is interested in obtaining views from constituents on the designation of non-contractual inflation component as hedged items.</p> <p>Do constituents have any concerns regarding the proposals on hedging sub-LIBOR components?</p>

## Layers as hedged items (Question 5)

	EFRAG preliminary position
<i>Layer components as hedged items</i>	EFRAG agrees that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item, as this will allow entities to align their financial reporting closer to their risk management strategies.
<b>Question to constituents</b>	<p>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.</p> <p>However, we understand that, at a portfolio level, it may be possible to separately identify the risk component and facilitate the measurement of hedge effectiveness. EFRAG is interested in obtaining examples of the instances where an alternative treatment is appropriate.</p>



## Hedge effectiveness (Question 6)

	EFRAG preliminary position
<i>Removal of 80 to 125 per cent bright line</i>	EFRAG welcomes the removal of the 80 to 125 per cent bright line for assessing and measuring hedge effectiveness. It will simplify the implementation of hedge accounting.
<i>Hedge effectiveness testing</i>	EFRAG supports the elimination of the retrospective effectiveness test and welcomes the assessment of hedge effectiveness based on the entity's internal risk management strategy.
<i>Ineffectiveness</i>	<p>We are concerned about potential inconsistencies that the proposed method of assessing effectiveness and measuring ineffectiveness may create between risk management and accounting.</p> <p>For example, during the life of the hedge the fair value changes on the hedged item and those of the hedging instrument might not correlate perfectly, due to different degrees of volatility in the markets where the hedged item and the hedged instrument are traded. This will create ineffectiveness under the proposals, 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.</p>

## Rebalancing (Question 7)

	EFRAG preliminary position
<i>Notion of rebalancing</i>	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.
<i>Improvement</i>	We see the 'rebalancing' feature as an improvement since it will avoid frequent discontinuation and restarting of hedge relationships in those cases where the risk management remains unchanged.
<i>Field-testing</i>	<p>The notion of rebalancing is not yet well understood. We believe that the notion could be articulated in a way that conveys the concept more clearly.</p> <p>The proposals rely heavily on judgement and the link to risk management. We believe that the IASB should conduct field-testing and to ensure that proposals can be operationalised.</p>

## Discontinuation (Question 8)

	EFRAG preliminary position
<i>Discontinuation criteria</i>	<p>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.</p> <p>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.</p>
<i>Concern about specific risk management practices</i>	<p>However, we are concerned that the prohibition of voluntary discontinuation of hedging relationships may cause problems for entities that adopt an internal risk management strategy that relies on the use of internal derivative contracts. It is important that the IASB clarify this in finalising the proposals.</p>

## Accounting for fair value hedges (Question 9)

	EFRAG preliminary position
<i>Two-step approach</i>	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 this would provide to users of financial statements.
<i>Fair value adjustment of hedged item</i>	<p>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.</p> <p>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.</p>
<i>EFRAG proposes alternative</i>	Instead we suggest to aggregate all fair value hedge adjustments into a single net amount to be reported on the assets or liabilities side of the statement of financial position, depending on its balance. Disaggregation should be provided in the notes to the financial statements.

## Time value of options (Question 10)

	EFRAG preliminary position
<i>Ineffectiveness</i>	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.
<i>Reclassification from other comprehensive income to profit or loss</i>	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.

## Groups as hedged items (Question 11)

	EFRAG preliminary position
<i>Macro hedging</i>	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.
<i>Underlying principle</i>	<p>We observe that some restrictions will be maintained in the general hedging model for closed groups of hedged items and the rationale for these restrictions is not always clear.</p> <p>We believe that further outreach and field-testing should be undertaken to avoid replacing one set of complex, rules-based, requirements with another.</p>

## Presentation of hedged groups (Question 12)

	EFRAG preliminary position
<i>Hedge of net position of offsetting items</i>	EFRAG agrees with the proposals regarding the presentation in profit or loss of the effects of hedge accounting for groups of items.
<i>Fair value hedges of groups of items</i>	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.

## Disclosures (Question 13)

	EFRAG preliminary position
<i>Understand risk management strategy and hedging activities</i>	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.
<i>Prescriptive nature of the disclosures and interaction with IFRS 7</i>	We are concerned about the prescriptive nature of the disclosure requirements and the interaction with the disclosure requirements of IFRS 7.



## “Own use” exception (Question 14)

	EFRAG preliminary position
<i>Derivative accounting</i>	EFRAG supports the proposal that derivative accounting would apply to contracts that would otherwise meet the ‘own-use’ scope exception if that is in accordance with an entity’s risk management strategy.
<i>Flow of goods on a fair value basis</i>	<p>We note that these proposals do not address the concerns of entities that manage the price risk on their entire flow of goods on a fair value basis. Even under these proposals, many of these entities 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.</p> <p>We believe that the IASB should take a more holistic approach to the underlying concerns and address these as part of a separate project.</p>
<b>Question to constituents</b>	EFRAG is interested in obtaining practical examples of instances that illustrate the current accounting problems and shows whether the issue is broader than what the IASB had considered in finalising the proposals in the ED.

## Credit derivatives and hedging (Question 15)

	EFRAG preliminary position
<i>Eligible hedged items</i>	<p>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.</p> <p>We acknowledge that hedge accounting of credit risk may be difficult to achieve in practice, in some circumstances, albeit not systematically.</p> <p>EFRAG supports the IASB in its efforts to investigate further the development of the proposed accounting alternatives.</p>
<i>Question to constituents</i>	EFRAG is interested in obtaining constituent's views on the three proposed alternative methods considered by the IASB.

## Transition (Question 16)



	EFRAG preliminary position
<i>Effective date</i>	EFRAG supports the effective date of 1 January 2015 for all phases of IFRS 9 and other major projects currently under consideration by the IASB.
<i>Transitional provisions</i>	EFRAG supports prospective application of the proposals.