Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

via email: standard@aasb.gov.au

16 March 2011

Dear Kevin

Re: ED 208 *Hedge Accounting* and Tier 2 Supplement to ED 208

I am enclosing a copy of the PwC response to the International Accounting Standards Board's Exposure Draft ED/2010/13 *Hedge Accounting* [AASB ED 208]. The letter reflects the views of the PwC network of firms and as such includes our own comments on the matters raised in the exposure draft.

I am also responding to your request for comment on the tier 2 Supplement to ED 208.

We appreciate the Board's aim to issue complete Australian standards which address the tier 2 requirements as soon as the equivalent international standards are approved. We also understand that to be able to do so, it is necessary to consult with stakeholders as early as possible. However, we question whether this is necessarily the best use of resources for standards such as the one on hedge accounting, where it is likely that the final standards will differ from their exposure draft versions. In particular, we are concerned that a second round of consultation may be necessary if the disclosures in the final standards differ significantly from those proposed in the exposure drafts.

In our view, a short delay of three to six months between the issue of a new standard and the finalisation of the reduced disclosures applicable under this new standard would still be acceptable. In our experience, entities reporting under tier 2 of the reduced disclosure regime are less likely to adopt a new standard early and it should therefore be unlikely to be major issue for those companies should there be a short delay.

Leaving these concerns aside, we have provided specific comments on the supplement in Appendix A to this letter.

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I would welcome the opportunity to discuss our firm's views at your convenience. Please contact me on (02) 8266 8350 if you would like to discuss our comments further.

Yours sincerely,

Regina Fikkers
Partner, PricewaterhouseCoopers

Appendix A – Specific matters for comment

1. Do you agree with the AASB disclosure proposals regarding paragraphs 40-52 of ED 208 in relation to Tier 2 entities as set out in the Analysis of Proposed Disclosures section?

Presentation of items

We note that the supplement only considers those paragraphs from the ED that are covered under the heading of "Disclosure" (ie paragraphs 40 to 52) and does not discuss any presentation issues such as paragraphs 37 to 39 and paragraph 26(b) which require separate presentation of hedging gains and losses both in the income statement and the statement of financial position.

Paragraph 9 of the AASB's *Tier 2 Disclosure Principles* acknowledges that sometimes judgement is required as to whether a particular requirement relates to presentation or disclosure. It goes on to say that "Presentation requirements are limited to requirements that specify the broad structure of financial statements including the basis of classification of items. Specifications relation to sub-classifications or line items to be shown on the face of financial statements or in the notes, are treated as matters of disclosure".

For this reason, paragraphs 37 and 38 should also be considered in the context of tier 2 disclosures. In any case, as explained in our submission to the IASB on ED/2010/13, we do not believe either of these two disclosures should be required (see enclosure, answers to questions 9 and 12). There is already sufficient guidance in AASB 101 *Presentation of Financial Statements* as to what should be disclosed on the face of the primary statements based upon materiality and what should be included in the notes. Should the two paragraphs remain in the final standard, they should be excluded from the tier 2 disclosures on that basis.

Other disclosures that should be excluded

Paragraph 40 sets out the general disclosure principles for hedge accounting. While there are arguments either way to include or exclude this paragraph in the tier 2 requirements, we do note that similar paragraphs have been excluded from the tier 2 requirements of other standards (eg AASB 3 and AASB 119). On that basis, paragraph 40 should also be excluded. The same applies to paragraph 43 which provides guidance on the application of paragraph 40.

Should the Board disagree and decide to retain paragraphs 40 and 43, it should at least exclude paragraph 40(b) from the tier 2 disclosures. This would be consistent with the fact that none of the information in paragraphs 45 to 48 is required for tier 2 entities. If tier 2 entities had to comply with paragraph 40(b) this would raise the question of how this requirement could be satisfied without applying any of the supporting paragraphs. In our view, none of this information is essential for tier 2 entities under the Boards' *Tier 2 Disclosure Principles*.

We further question whether the information required by paragraph 52 is necessary for tier 2 companies on cost-benefit grounds. AASB 101 paragraph 106 already requires a great deal of detailed information for the reconciliation of accumulated other comprehensive income and this, together with the disclosure requirements of paragraph 51 of the ED should be sufficient.

2. Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of these proposals, particularly any issues relating to (a) not-for-profit entities, and (b) public sector entities?

We do not believe that there are any regulatory or other issues that would affect implementation of the proposals in Australia.

3. Overall, would the proposals result in financial statements that would be useful to users?

Subject to our specific comments above, we believe that the proposals would result in financial statements that are useful to users.

4. Are the proposals in the best interests of the Australian economy?

The introduction of the reduced disclosure regime has significantly reduced the regulatory burden for those entities that are eligible to report under tier 2 of the new regime. It is therefore in the best interests of the Australian economy if new standards provide consistent disclosure relief for tier 2 entities on a timely basis. However, as explained on page 1 of this submission, we do question whether tier 2 requirements have to be finalised at the same time as a new standard is issued.

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

9 March 2011

Dear Sirs

Exposure Draft: Hedge Accounting

We are responding to the invitation of the IASB ('the Board') to comment on the exposure draft *Hedge Accounting* (the 'exposure draft' or 'proposed standard'). Following consultation with members of the PwC network of firms, this response summarises the views of those member firms who commented on the exposure draft. 'PwC' refers to the network of firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the effort of the IASB to comprehensively review the hedge accounting requirements in IAS 39 and believe the proposed changes will be positively received. We agree the current guidance is overly complex and often yields results that do not appropriately reflect the entity's risk management strategy. We believe that overall the proposals in the exposure draft make significant progress towards aligning the accounting more closely with risk management, establishing a more principles-based approach and addressing many of the inconsistencies and weaknesses in IAS 39. We are particularly supportive of eliminating the current bright line for effectiveness testing, allowing effectiveness to be assessed on a qualitative basis, expanding the ability to hedge component risks to non-financial items, and allowing hedge accounting to be applied to groups of items that include offsetting positions.

However, there are some areas where changes to the proposed standard should be considered to better address the project's objective. Those areas include the limitation of hedge accounting to exposures affecting profit or loss, the new hedge effectiveness assessment criteria to qualify for hedge accounting, the clarity of the new component risk hedging guidance, certain of the changes related to hedging groups of items, and some of the presentation and disclosure requirements.

We are also concerned with the timeline for finalising the hedge accounting project. The Board has decided not to address open portfolios and macro hedging as part of the exposure draft, and will instead address any changes in a second exposure draft to be issued later this year. The ability to hedge open portfolios and to hedge on a macro basis is very important to many entities and a critical component of their risk management strategies. The decisions made in finalising the macro hedging phase may have implications for the proposals in this exposure draft. We believe that the complete set of amendments to the hedge accounting standard when finalised, need to be consistent and operational as a package. Accordingly, the Board should consider not finalising the guidance in the exposure draft until there is greater clarity as to the conclusions that are expected to be reached on the ability to apply hedge accounting for risk management strategies involving open portfolios and macro hedging. However, if this would result in a significant delay, we recommend that the Board finalise the guidance in this exposure draft as planned and commit to make any necessary amendments upon

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completion of the macro hedging phase. We believe that: (1) developing a complete and integrated hedge accounting model, and (2) enabling entities to avail themselves of the significant enhancements proposed in the exposure draft as soon as possible, are both important goals.

Objective of hedge accounting

We agree that the objective of hedge accounting should be to allow the financial statements to more appropriately reflect the effects of an entity's risk management activities when financial instruments are used to manage exposures arising from particular risks. We believe a closer alignment of hedge accounting to an entity's risk management activities should make financial statements more reflective of the economics of these activities and therefore more understandable for users.

However, we disagree that hedge accounting should be limited to only the exposures that could affect profit or loss. There are legitimate risk management strategies that an entity may undertake with respect to exposures that may only affect items recognised in other comprehensive income (for examples see Question 1 in the appendix). In the absence of the ability to apply hedge accounting, the entity's financial statements will not appropriately reflect the effect of those risk management strategies. Given the objective of this project is to enable the application of hedge accounting to better reflect an entity's risk management activities, we believe that the Board should consider adapting the hedge accounting model to accommodate exposures that could affect total comprehensive income.

Qualifying criteria for hedge accounting

We believe that removing the 80-125 % effectiveness threshold to qualify for hedge accounting and allowing an entity, where appropriate, to qualitatively evaluate hedge effectiveness are significant improvements. We believe that removing this bright line threshold will eliminate a major stumbling block to qualifying for and applying hedge accounting and ease the administrative burden on preparers. It also enhances the information given to users, as it provides a better link to the entity's risk management strategy.

However, we are concerned with the impact of the new "objective of hedge effectiveness assessment" and the restriction on de-designations of hedging relationships. Requiring hedging relationships to produce unbiased results, minimise expected ineffectiveness and to be continually rebalanced is overly complex and adds an "accounting only" exercise that may lead to a different designation of the hedging relationship than is done for risk management purposes.

Furthermore, it is not uncommon for entities to enter into or continue with hedging relationships that are somewhat "biased" because they are a practical means to cost-effectively hedge an exposure. An entity may accept some additional ineffectiveness in a hedging relationship, because a less than perfect hedge ratio may be operationally simpler to monitor and explain (e.g., a 1-to-1 ratio), or the reduction in reported ineffectiveness may not justify the cost of rebalancing the hedge. If a hedge is not economically rebalanced as part of a risk management strategy, the requirement to rebalance for accounting purposes does not change the economic ineffectiveness, but changes how it is reported in the financial statements by reclassifying a portion as trading. We do not believe relabeling "ineffectiveness" as "trading" within the income statement will improve a user's understanding of the effectiveness of the risk management strategy applied.

These new requirements surrounding "unbiased" hedge relationships appear to be principally anti-abuse provisions, and we believe the desired effect can be achieved without forcing the complexities of the "unbiased" hedge requirement on the preparers. We believe requiring that (1) there is an appropriate economic relationship between the hedging instrument and the hedged item that meets the risk management objective, (2) hedge ineffectiveness be reliably measurable and recognised in profit or loss, and (3) all designations and de-designations be made prospectively, are sufficient safeguards.

Hedging component risks

We support the extension of the ability to hedge component risks in transactions involving non-financial items beyond the current ability to hedge foreign currency risk. Allowing risk components to be identified as the hedged item better reflects common risk management strategies which are often to hedge only one or more components rather than the entire item. This also provides more useful information to users on the degree of effectiveness of hedges, as the change in fair value or cash flows of components that were not part of the risk management strategy are not reported as ineffectiveness. Furthermore, this will remove an arbitrary distinction between financial and non-financial items that has not helped users understand risk management activities.

We agree with the Board's proposal that entities should be able to apply hedge accounting to risk components provided that the component is separately identifiable and reliably measurable. We also agree that the evaluation of whether a risk component is eligible for hedge accounting should take into consideration both the market structure of the hedged item and the market for the hedging activity. Therefore, the risk components eligible for hedge accounting should not be limited to only those that are contractually specified.

However, we are concerned that the proposed guidance is not sufficiently clear to ensure consistent application in practice. Specifically, we are concerned about situations where the risk components are "implicit" in the total fair value or cash flows of the hedged item. For example, where there is a known cost component for a product, is the mere physical presence of that component and the logical belief that it would in some way influence the pricing of a product be sufficient to support eligibility for hedge accounting?

We believe that it may be helpful to further clarify the guidance for non-contractually specified risk components. One way would be to state that a known cost component of an item can be eligible for designation as a risk component, if knowledgeable and willing buyers and sellers would be expected to explicitly consider it in determining the fair value or transaction price of the total product. This will typically be the case, for example, when prices are determined using a building block approach.

Hedging groups of items

We support the application of hedge accounting to groups of items that include offsetting positions (net hedging). We also believe that when hedging a net position the overall group of items that make up the net position should be identified as the hedged item. However, we disagree with the proposed requirements that the cash flows of the offsetting hedged items designated as a group in a cash flow hedge must affect profit or loss in the same interim period. The hedging gain or loss is determined when the hedged transaction occurs, not when it is reported in profit or loss. The proposed cut-off point will create arbitrary outcomes that will reduce the comparability between entities and over time.

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We believe there should be no requirement that offsetting cash flows or transactions occur or affect profit or loss in the same reporting period, as this will not align the hedge accounting with the risk management practices and thus undermines the purpose of allowing hedges of net positions.

We also disagree with the proposal requiring hedges of net positions to be presented differently than hedges of gross positions, as it is inconsistent with an objective to align hedge accounting with the risk management activities undertaken. The objective from a risk management perspective may be to hedge the risk on all of the items in the group, and therefore, they should all be accounted for at the hedged rate in profit or loss.

Presentation of hedge accounting

Presentation changes to fair value hedge accounting

We agree that it is useful to provide users with information about the original accounting basis for the hedged item separately from the fair value adjustment, because it retains the information content of the (amortised) cost measurement and provides a clear understanding of the effect of fair value hedge accounting. However, we believe that disclosing the hedge accounting adjustment and the (amortised) cost in the notes to the financial statements is sufficient to provide users with the relevant information they desire without burdening the statement of financial position with excessive detail.

We believe that retaining the IAS 39 presentation, (i.e., reporting all effects in profit or loss) is preferable to the proposal in the exposure draft to present the changes in the fair value of the hedged item and hedging instrument separately in other comprehensive income. In addition, we believe a requirement to place all hedging disclosures in one note on a disaggregated basis provides users with more information, makes it easier for users to locate and assess the impact of the entity's fair value hedges and does not clutter the face of the financial statements.

Basis adjustment for the effects of cash flow hedges

We disagree with the proposal to reclassify the deferred hedging gains or losses directly from equity, instead of recycling them through other comprehensive income, as it introduces a new class of transactions in the statement of equity that is not a transaction with the owners. We believe that it is unnecessary to change the recycling out of other comprehensive income when applying basis adjustment until the purpose of other comprehensive income is determined.

Disclosures

We believe disclosure requirements are an essential part of enhancing the usefulness of the financial statements when applying hedge accounting and many of the proposed disclosures are appropriate. However, we are concerned that certain of the disclosures appear excessive, and that the exposure draft does not strike the right balance between the needs of users and the burden of providing the information.

We are particularly concerned with the requirements related to the total forecast exposures, as many preparers may find this information to be commercially sensitive. We believe that disclosure of information regarding the notional amount and key terms of derivative positions by risk category and hedge type should be sufficient to give users adequate information as to the nature and extent of an entity's risk management activities.

Our answers to the specific questions in the exposure draft are attached in the appendix to this letter.

In addition, there are a number of matters that are not addressed in the questions to the exposure draft, but which we believe should be addressed or further clarified in the final standard. These issues are described in greater detail after our response to question 16 in the appendix to this letter.

If you have any questions in relation to the letter please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 20 7804 2497), or John Althoff (+44 20 7213 1175).

Yours faithfully

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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Appendix

Responses to detailed 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?

We agree that the objective of hedge accounting should be to allow the financial statements to more appropriately reflect the effects of an entity's risk management activities when financial instruments are used to manage exposures arising from particular risks. We believe a closer alignment of hedge accounting to an entity's risk management activities should make financial statements more reflective of the economics of these activities and therefore more understandable for users.

However, we disagree that hedge accounting should be limited to only those exposures that could affect profit or loss. There are legitimate risk management strategies that an entity may undertake with respect to exposures that may only affect items recognised in other comprehensive income. For example:

- an entity may wish to hedge its exposure to changes in the foreign currency risks or the changes in the fair value of its strategic investments to protect its regulatory capital from adverse market movements,
- an entity may later decide to exit a strategic relationship and wishes to hedge its exposure to the changes in the expected proceeds on the sale of the related investment, or
- an entity may wish to hedge its exposure to actuarial gains and losses in post employment benefit plans, which under the proposals in IAS 19 exposure draft would be recognised directly in other comprehensive income and not in profit or loss.

In the absence of the ability to apply hedge accounting, the entity's financial statements will not appropriately reflect the effect of the risk management strategy. Given the objective of this project is to enable the application of hedge accounting to better reflect an entity's risk management activities, we fail to see why hedge accounting should be limited to only those items that could affect the profit or loss section of total comprehensive income.

We believe that the Board should consider adapting the hedge accounting model to accommodate exposures that could affect total comprehensive income. One approach would be to recognise the effective portion of the changes in fair value of the hedging instrument in other comprehensive income and not recycle through profit or loss if this is consistent with the accounting for the hedged item.

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?

We agree that non-derivative financial instruments measured at fair value through profit or loss should be eligible as hedging instruments if they are a part of the entity's risk management strategy.

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We believe that the eligibility of these financial instruments as hedging instruments would better align with the classification model of IFRS 9 and therefore make the hedge accounting model better able to address hedging strategies that could evolve in the future.

Question 3

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

We agree that an aggregated position that is a combination of another exposure and a derivative should be eligible for hedge accounting. For example, it is not uncommon for an entity to manage the foreign exchange risk and interest rate risk associated with a foreign currency denominated financial instrument separately and to establish those hedging relationships at different points in time. Allowing aggregated positions that include a derivative as part of the hedged item better aligns hedge accounting with the entity's risk management activities.

We believe however, that it may be necessary to further clarify the application of hedge accounting to an aggregated exposure that includes a derivative instrument to ensure consistency in practice. Allowing a derivative to be designated as a hedged item may need to be limited to only those situations where the derivative is presently designated in a hedging relationship. Absent such a limitation, it will likely be challenging to determine the amounts to be recycled from other comprehensive income. In addition, we believe that when hedging an aggregated position, the derivative must be included in its entirety. It may not be appropriate to designate only selected cash flows of a derivative as the hedged item.

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 (i.e., 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?

We support the extension of the ability to hedge component risks in transactions involving non-financial items beyond the current ability to hedge foreign currency risk. We believe that allowing risk components of non-financial items to be identified as the hedged item better reflects common risk management strategies which are often to hedge only one or more components rather than the entire item. Allowing the designation of a risk component for hedge accounting purposes also provides more useful information to users on the degree of effectiveness of hedges, as the effect of components that were not part of the risk management strategy will not be reported as ineffectiveness. Furthermore, extending risk components to non-financial hedged items removes an arbitrary distinction between financial and non-financial items that has not helped users understand risk management activities.

We agree with the Board's proposal that entities should be able to apply hedge accounting to risk components provided that the component is separately identifiable and reliably measurable. We also agree that the evaluation of whether a risk component is eligible for hedge accounting should take into consideration both the market structure of the hedged item and the market for the hedging activity. Therefore, the risk components eligible for hedge accounting should not be limited to only those that are contractually specified.

However, we are concerned that the proposed guidance, as drafted, is not sufficiently clear to ensure consistent application in practice. Specifically, we are concerned about situations where the risk components are "implicit" in the total fair value or cash flows of the hedged item. For example, where there is a known cost component for a product, is the mere physical presence of that component and the logical belief that it would in some way influence the pricing of a product be sufficient to support eligibility for hedge accounting?

We believe that it may be helpful to further clarify the guidance for non-contractually specified risk components. One way would be to state that a known cost component of an item can be eligible for designation as a risk component, if knowledgeable and willing buyers and sellers would be expected to explicitly consider it in determining the fair value or transaction price of the total product. This will typically be the case, for example, when prices are determined using a building block approach.

Cash flows of hedged component must be less than cash flows of the entire item

We understand the Board's concern regarding hedging relationships where the cash flows associated with the hedged component could theoretically exceed those of the total cash flows for the financial asset or financial liability. However, we do not agree with the proposed prohibition on the application of hedge accounting on a component risk basis in all such circumstances.

This issue is not limited to situations involving financial instruments, but also potentially exists with respect to hedges of non-financial items. For example, it is not uncommon for the pricing of a non-financial item to be based on a standard benchmark quality or location for the item (the base component price), plus or minus an amount (the basis difference) due to the actual quality or location of the item. In these circumstances, as well as those involving financial instruments, hedging the base component price for the item with a forward contract based on the standard benchmark rate or quality/location would be a reasonable risk management strategy regardless of whether the basis difference for the item is positive or negative. Furthermore, the chances of having a price movement in the benchmark rate or similar component so as to result in an overall negative rate or price would likely be rare.

We therefore believe this restriction is unnecessary and potentially undermines many risk management strategies. Nevertheless, in view of the Board's concerns, we recommend that the Board consider precluding such hedging relationships only when the likelihood of a negative rate or price is more than remote.

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?

We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item since identifying a layer of the nominal amount for either a single item or a group is a common risk management strategy. Designating a percentage component of a nominal amount can give rise to a different accounting outcome compared with designating a layer component of a nominal amount. Therefore, if hedge accounting is not aligned with the risk management strategy, the result in profit or loss may be misleading or provide less useful information to users.

We also believe the possibility of prepayments or uncertainties such as breaches (or cancellations) of contracts can be better modelled when considering a layer of the nominal amount of an item or a group of items. However, we believe that the "sufficiently specific" test should be retained (i.e., when a transaction occurs, it should be clear whether or not it is part of the hedged layer). For example, a layer should not be defined as the last 100 CU to be sold or purchased in a period.

(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?

We agree that for certain types of instruments it may be difficult to separate the effects of changes in the fair value of a prepayment option that is affected by the changes in the hedged risk. This is however a fundamental question to be resolved by the macro hedging phase of the hedging project. The solution that is appropriate for macro hedging may also be appropriate when hedging a single transaction. If considered in isolation, we agree that when a prepayment option gives the holder the right to prepay at par or at a pre-determined amount it would not be appropriate to use a layer to isolate the effects of the prepayment option.

We note however that there are situations, especially in the case of mortgages, where there may exist compensation mechanisms (e.g., a make whole provision) that substantially mitigate, but do not fully eliminate the effect of the hedged risk. In these situations, we believe it may still be appropriate to designate a layer even though there may still be some relatively small impact on the prepayment option attributable to the hedged risk (i.e., interest rate risk). However, we do not support a general prohibition of applying a layer approach to contracts that include a prepayment option, merely because the option may create uncertainty related to the effectiveness of the hedging relationship.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

We believe that removing the 80-125 % effectiveness threshold to qualify for hedge accounting and allowing an entity, where appropriate, to qualitatively evaluate hedge effectiveness are significant improvements. We believe that removing this bright line threshold will eliminate a major stumbling block to qualifying for and applying hedge accounting and ease the administrative burden on preparers. It also enhances the information given to users, as it provides a better link to the entity's risk management strategy.

However, we are concerned with the impact of the new "objective of hedge effectiveness assessment" and the restriction on de-designations of hedging relationships. Requiring hedging relationships to produce unbiased results, minimise expected ineffectiveness and to be continually rebalanced is overly complex and adds an "accounting only" exercise that may lead to a different designation of the hedge relationship than is done for risk management purposes. This will in particular be the case for example, in commodity-based hedging strategies, where the changes in the value of the hedging instrument could "systematically either exceed or be less than the changes in the value of the hedged item" due to the presence of an unhedged basis risk. Such situations might be considered to produce a biased result if effectiveness is evaluated on the total price (i.e., inclusive of the unhedged basis risk).

Furthermore, it is not uncommon for entities to enter into or continue with hedging relationships that are somewhat "biased" because they are a practical means to cost-effectively hedge an exposure. An entity may accept some additional ineffectiveness in a hedging relationship, because a less than perfect hedge ratio may be operationally simpler to monitor and explain (e.g., a 1 to 1 ratio), or the reduction in reported ineffectiveness may not justify the cost of rebalancing the hedge. If a hedge is not economically rebalanced as part of a risk management strategy, the requirement to rebalance for accounting purposes does not change the economic ineffectiveness, but it changes how it is classified and reported in the financial statements. We do not believe relabeling "ineffectiveness" as "trading" by reclassifying a portion as trading within the income statement will improve a user's understanding of the effectiveness of the risk management strategy. In contrast, if as part of its design the risk management strategy contemplates dynamic rebalancing, we believe that rebalancing the hedging relationship without requiring de-designation and re-designation would be an improvement to current accounting.

These new requirements surrounding "unbiased" hedge relationships appear to be principally anti-abuse provisions, and we believe the desired effect can be achieved without forcing the complexities of the "unbiased hedge" requirement on preparers. If the Board's rationale for this new requirement is to prevent the deliberate designation of mismatches to achieve an accounting effect (e.g., in a cash-flow hedge, deliberately designating a larger volume of the hedged item than needed to ensure that over-hedging never occurs), it should state that an accounting motivated designation of a biased hedging relationship is not a valid risk management strategy. The Board might consider retaining the requirements of IAS 39 AG.107A to mitigate concerns regarding potential abuse.

We therefore propose that the objective for hedge effectiveness assessment is removed from the qualification criteria. The qualification criteria would thus include three parts: (1) the hedge can only include eligible hedged items and eligible hedging instruments, (2) documentation is prepared at inception that links the hedging relationship to the entity's documented risk management strategy (that, if material, is disclosed in the financial statements), and (3) the hedge achieves other than accidental offset. Further safeguards are provided by the proposed requirements that: (1) there is an appropriate economic relationship between the hedging instrument and the hedged item that meets the risk management objective, (2) hedge ineffectiveness be reliably measureable and recognised in profit or loss, and (3) all designations and de-designations be made prospectively.

There is some lack of clarity over what the Board means by a "risk management objective and strategy" in the exposure draft. We believe the risk management objective and strategy should be specified in sufficient detail that it is possible to determine whether or not a particular transaction meets them. This issue also has implications for the discontinuation of hedge accounting (see question 8(b)).

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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?

As described under question 6, we believe that "the objective of the effectiveness assessment" should be removed from the qualification criteria. Requiring entities to continuously monitor the optimal hedging ratio when rebalancing is not an inherent component of the risk management strategy introduces significant complexities and burdens on preparers. Furthermore, the benefits to users are limited, because any additional ineffectiveness that results from a non-optimal hedge ratio will be reported in profit or loss. The requirement to rebalance a hedging relationship will require entities to determine a different hedging ratio for accounting purposes than they are using for risk management purposes.

We agree that if the hedging strategy includes determining the optimal hedging ratio then rebalancing would be undertaken whether or not the accounting standard requires it. Permitting entities to rebalance thus enables entities to reflect the effect of the risk management activity in the financial statements. We believe that the ability (as opposed to a requirement) to rebalance would be an improvement to current guidance that must be applied in dynamic hedging strategies (for example, delta hedging) whereby hedges must be de-designated and re-designated. For dynamic hedging strategies that explicitly consider rebalancing, rebalancing hedging ratios without having to re-designate hedging relationships would reduce complexity and be more aligned with risk management strategies.

If an entity decides that the change in the optimal hedging ratio does not require it to change the actual hedging strategy, the effect of requiring a rebalancing for accounting purposes may in many situations only have the effect of relabeling the ineffectiveness within the financial statements (i.e., as trading). We do not believe relabeling "ineffectiveness" as "trading" by reclassifying a portion as trading will improve users' understanding of the effectiveness of the risk management strategy.

(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?

We support providing entities with the ability to rebalance a hedging relationship if that is in accordance with the risk management strategy for the hedge relationship (see comments under 7(a)).

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?

We agree that entities should be required to discontinue hedge accounting if the hedged item or hedging instrument is derecognised, the risk management strategy changes, or the hedging relationship ceases to meet the other than accidental offset criterion. The latter could occur in situations where the counterparty to the hedging instrument is experiencing financial distress.

However, we do not agree that these are the only cases that an entity should be permitted to discontinue prospectively hedge accounting (see part (b)).

(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?

We disagree with the proposal to prohibit an entity from discontinuing hedge accounting for a hedging relationship that still meets the risk management strategy and that continues to meet all other qualifying criteria. De-designating hedge accounting is an important tool in any dynamic hedging strategy. This is allowed under IAS 39 today, and we are not aware of problems that have arisen in practice. It is a voluntary choice to apply hedge accounting, and therefore, we believe stopping hedge accounting on a prospective basis should also be discretionary. We further note that the proposed prohibition can be circumvented by terminating the derivative and replacing it with another derivative substantially identical to the original one, albeit by incurring additional transaction costs.

Although we disagree conceptually with prohibiting the discontinuance of hedge accounting, it is not clear whether this is a significant issue. Under the proposed guidance, a hedging relationship can be discontinued if the "risk management objective" for a hedging relationship has changed. If the risk management objective is considered broadly across multiple hedging relationships, then this is potentially a significant issue. However, if the risk management objective is viewed narrowly, say at the individual hedge transaction level, then de-designation can be achieved by simply changing the risk management objective for the hedging relationship in question. This is likely to be much less of an issue, as the conditions giving rise to an entity wanting to de-designate a hedging relationship would generally result from a change in the risk management strategy for the individual hedged transaction. Regardless of what the Board decides to do on the issue of de-designations, we believe the granularity of the "risk management objective" should be clarified.

The prohibition on de-designation also has implications for some commonly used strategies which will become more complicated. For example, when hedging the cash flows from forecast sales in a foreign currency with a derivative that matches the payment date, it is common practice to discontinue hedge accounting at the point in time when the sales have occurred. After the sales have been recognised in profit or loss resulting in a balance sheet receivable being established, a natural offset is achieved and no hedge accounting is needed. De-designation may be in line with the entity's risk management policy as some entities manage the risk of receivables and payables separately from forecast transactions. We believe this practice should not be prohibited.

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We do not believe that generally there is an abuse driving de-designation. The frequency of de-designating and re-designating hedge relationship that can be observed today has been to some extent due to the disconnect between the requirements to achieve hedge accounting and the risk management strategies applied. In order to achieve hedge accounting reflecting the risk management activities, a different hedged item may be identified for accounting purposes (proxy designation).

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?

We agree with the decision not to apply cash flow hedging mechanics to fair value hedges, but believe that retaining the IAS 39 presentation, (i.e., reporting all effects in profit or loss) is preferable to the proposal in the exposure draft (i.e., present the changes in fair value of the hedged item and derivative separately in other comprehensive income).

We understand that users want to have greater insight into the fair value changes of the hedging instrument and the hedged item, as well as the amount of ineffectiveness that is reported. However, we believe that this type of information is better communicated in the notes to the financial statements. Presenting the effective and ineffective portions of the hedging relationship gross in other comprehensive income and then transferring the ineffectiveness to profit or loss would add three compulsory line items to the statement of comprehensive income that simply net to zero. Given this information will most likely be presented on an aggregate basis for all of the entity's fair value hedges, it will provide only marginal information to users. A requirement to place all hedging disclosures in one note on a disaggregated basis provides users with more information, makes it easier for users to locate and assess the impact of the entity's fair value hedges and does not clutter the face of the financial statements.

(b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?

We agree that it is useful to provide users with information about the original accounting basis for the hedged item separately from the fair value adjustment, because it retains the information content of the (amortised) cost measurement and gives a clear understanding of the effect of fair value hedge accounting. The unit of account, however, should be maintained on the face of the statement of financial position. We believe splitting the hedged asset or liability into two line items is inconsistent with the unit of account. It may also significantly increase the number of lines in the financial statement of certain entities, such as financial institutions, that likely have fair value hedges affecting multiple balance sheet line items.

We believe that disclosing the hedge accounting adjustment and the amortised cost in the notes to the financial statements provides users with relevant information they desire without burdening the statement of financial position with excessive detail.

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(c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

We believe the question of whether or not a linked presentation should be part of IFRS financial statements is not only limited to fair value hedge accounting. It could for example also be applicable for derecognition issues, pension accounting, subleasing, etc. and should be considered in a broader context. We therefore suggest that the issue of linked presentation be considered either within the financial statement presentation project or the conceptual framework project.

Question 10

(a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?

We agree that when options are used for hedging, the initial time value of the option is a cost associated with the hedging relationship and should be part of hedge accounting. We also agree with the proposal to defer changes in the time value of options in other comprehensive income. Recognising changes in the time value in other comprehensive income makes sense, as this is where other effects of hedging are recognised.

However, to reduce complexity, we suggest replacing the two different recognition methods described (i.e., transaction related and time period related) with a broader principle. For example, the cost should affect profit or loss in a manner consistent with how the hedged item affects profit or loss. Such a principle is well understood in practice and would eliminate the need to provide rules distinguishing "transaction related" and "time period related" strategies.

When using the method described in the ED as "transaction related" (or the principle that we recommend above), we agree that the amount accumulated in other comprehensive income should be reclassified in accordance with the general requirements. However, please note that we disagree in general with the proposed accounting for basis adjustments that requires reclassifying directly from equity instead of recycling through other comprehensive income (see cover letter and the "other issues" section of the appendix).

(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?

When using the method described in the exposure draft as time period related (or the principle described in our response to 10 (a)), we agree that the transfer from other comprehensive income to profit or loss should be on a rational basis to reflect the risk management strategy undertaken.

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(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?

We agree that the measurement of the hedged item should be based on an option that has critical terms that perfectly match the hedged item. This is the normal procedure for using a hypothetical derivative to measure the hedged item for the hedged risk.

However, we do not believe that the new term "aligned time value" implies anything different from a "the time value of a hypothetical option" and would suggest that the "hypothetical derivative" terminology that is already accepted in practise be used.

Question 11

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

We agree that all items in a group should individually be eligible hedged items and be managed on a group basis to be eligible as a group of items for hedge accounting. We also agree with allowing designation of a group of items to include a net position. However, clarification may be needed that eligible hedged items may include eligible aggregated positions (i.e., derivatives can be included the group).

One commonly used risk management strategy is to aggregate exposures of a group including offsetting items, as this reduces the number of external derivative transactions entered into and thus mitigates the cost of hedging. The proposed changes should improve the possibility of aligning accounting with the risk management activities undertaken. We believe being able to represent the hedging of groups that includes offsetting positions (net hedging) is important and should be addressed. We also believe that when hedging a net position, the overall group of items that make up the net position should be identified as the hedged item.

We disagree with the proposed requirements that the cash flows of the offsetting hedged items in a cash flow hedge must affect profit or loss in the same interim period. The hedging gain or loss is determined when the hedged transaction occurs, not when it is reported in profit or loss. The cut-off points will create arbitrary outcomes that will reduce the comparability between entities and over time. For example, if hedging the purchase of inventory, the treatment depends on whether or not the inventory is subsequently sold in that particular reporting period. There might therefore be differences among entities depending on their inventory turnover. There will also be significant differences in eligible strategies between jurisdictions where quarterly versus half-yearly financial statements are required.

This restriction also adds unnecessary complexity, as similar strategies may be eligible or not depending only on timing of the transactions. For example, two transactions with offsetting risks occurring 1 January and 30 June would be treated differently from two similar transactions occurring 30 June and 1 July for an entity that has a reporting date of 30 June and 6 months interim periods. Additional operational complexities arise when one item in a designated net group is delayed, as it will

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be necessary to exclude other transactions from the hedged group that are not delayed. In the case of a purchase of inventory, the same issue arises for hedged purchases that occurred in the expected period, but where the subsequent sale of the hedged inventory was delayed. The delay does not economically mean that no offset was achieved for the hedged period, but will be treated as such for accounting purposes. We therefore believe that there should be no requirement that offsetting cash flows or transactions occur or affect profit or loss in the same reporting period, as this will not align the accounting with the risk management practices and thus undermines the purpose of allowing hedges of net positions.

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?

We disagree with the presentation requirements, as they will introduce more complexity and may not truly capture the risk management activities undertaken. The proposal to present hedges of net positions differently than hedges of gross positions is inconsistent with an objective to align hedge accounting with the risk management activities undertaken. From a risk management perspective, it does not matter whether the offset is achieved through the fair value changes of a hedging instrument or another hedged item.

The objective from a risk management perspective may be to hedge the risk on all of the items in the group. However, as the fair value/cash flow changes on some items offset those on others, it may often be more cost effective to enter into a derivative or other hedging instrument only for the net position, rather than for each of the gross positions. This implies that all items in the designated group have been hedged and should therefore be accounted for at the hedged rate in profit or loss.

The exposure draft's proposal is inconsistent and gives different accounting in profit or loss for different types of hedges (individual versus group designations). Single transactions that are hedged and groups without offsetting positions will be reported at the hedged rate. For groups with offsetting positions, there will be three ways of accounting for the same economic relationships. A hedge of offsetting positions (for example a foreign currency hedge of sales and a lesser amount of purchases) can be accounted for as follows:

1) Hedge with two derivatives on a gross basis. Sales and cost of sales reported at hedged rate (current IAS 39).

2) Hedge with one derivative designating a portion of sales. Sales partly reported at hedged rate, cost of sales at transaction rate (current IAS 39).

3) Hedge with one derivative designating the net position of the group of offsetting items. Sales and cost of sales reported at transaction rate, separate line item for derivative (new presentation proposed in the exposure draft).

If the entity also has hedges of single transactions or groups of items without net positions, the presentation in the profit or loss will be a mix of some hedged transactions being reported at the hedged rate, some hedged transactions being reported at the transaction rate with the effects of hedge accounting being reported on a separate line item, and some transactions being reported at an unhedged rate.

We do not believe that such alternative accounting presentations would help users understand the impact of hedge accounting, and it is not consistent with the risk management strategy. Many entities regard all items in the group as being hedged, and therefore, we believe that in such circumstances all items in the hedged group should be reflected at the hedged rate, as that best reflects the risk management strategy. This will give a consistent accounting whether or not a hedged item is part of a micro-, gross group- or net group hedge. It will also faithfully portray what the entity considers to be the full impact of its hedging strategy, and therefore, be consistent with the focus on risk management strategies in the exposure draft.

Question 13

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

We believe disclosure requirements are an essential part of enhancing the usefulness of the financial statements when applying hedge accounting and many of the proposed disclosures are appropriate. However, we are concerned that certain of the disclosures appear excessive and that the exposure draft does not strike the right balance between the needs of users and the burden of providing the information.

We are particularly concerned with the requirements in paragraph 46 of the exposure draft. We understand that information about total forecast exposures may be useful for some users, but many preparers may find this information to be commercially sensitive. If these exposures are not hedged, it is unclear why disclosure of unhedged risk should be required as part of a hedge accounting standard. We also note that requiring forecast information in financial statements may be prohibited in some jurisdictions or may result in increased audit costs given its nature and subjectivity.

Furthermore, it is unclear why an entity that partially hedges a risk is required to provide disclosures related to its unhedged exposures when an entity that does not hedge at all, or does not apply hedge accounting, has no such disclosure obligations. As a result, such disclosure requirements could serve as a disincentive for preparers to elect to apply hedge accounting to their risk management activities, which is contrary to the objectives of this project. We believe that disclosure of information regarding the notional amount and key terms of derivative positions by risk category and hedge type should be sufficient to give users adequate information as to the nature and extent of an entity's risk management activities.

Should the Board proceed with requiring these disclosures, we recommend that some of the terminology be clarified. We believe the threshold for disclosing the monetary amount to which the entity is exposed is unclear. For example, should it be based on "reasonably expected" or "highly probable" or "firmly committed" forecast transactions? We also believe it is unclear whether "each subsequent period" is related to every interim reporting period, each annual period or aggregated

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annual periods (e.g., 5 year periods for hedges of long term debt). Although we disagree with the disclosure of exposures in paragraph 46, if they are required, we believe aggregation would reduce the burden to preparers and still give useful information for users.

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

We believe that some of the information that the exposure draft would require to be presented on the face of the statement of financial position or other comprehensive income should be disclosed in the notes. (See question 9)

We do not believe that there are any other additional disclosures that should be mandatory.

Question 14

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

We agree with the proposed change, as it will enable some entities to better reflect the risk management activities undertaken. We note however, that this will benefit a limited number of entities where no or minor transformation is undertaken to the purchased commodity, and where 1) little or no inventory is held, and 2) purchase and sales contracts have a net settlement clause or the inventory is readily convertible to cash. There are a number of entities who manage commodity risk on a fair value basis where the commodity is transformed and the purchase and sales contracts generally do not have a net settlement clause or where there is an inventory of the goods in question that will not benefit from the proposed change. We also believe the requirement to manage the entire business is unclear. We note that an entity may have different portfolios or businesses and should thus be allowed to apply the proposed solution for a part of its business even though other businesses may be managed differently.

We also believe that the paragraphs in IAS 39 related to the own-use exception are problematic, not only in the context of entities who want to apply financial instrument accounting for a commodity contract, but also for entities whose valid business transactions are forced into IAS 39 when fair value does not most appropriately reflect the business model. For example, if an entity has settled similar contracts net in the past, there is currently no clear mechanism for the own-use exception to be applied in subsequent periods again.

These questions are not primarily hedging issues, but they do not fall into any of the other IFRS 9 phases. We therefore propose that the Board address these issues as an additional project once hedging and impairment have been finalised.

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Question 15

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

We are pleased that the IASB has responded to constituents who find the current difficulty of achieving hedge accounting for credit risk problematic by assessing alternative methods to achieve a reasonable accounting. We do not, however, find any of the proposed alternatives to be viable.

Nevertheless, we believe it is important to find a method for hedging credit risk and therefore, recommend that the Board further consider approaches to reasonably measure the credit risk in financial assets for purposes of applying hedge accounting. We agree that currently there are challenges in measuring "pure" credit risk. However, we believe that it should be possible to develop a reasonable measurement approach for hedge accounting purposes, and therefore do not agree with the statement made in the exposure draft that it is "impossible" to do so.

The exposure draft notes a number of structural differences between a credit default swap and a debt instrument which indicate that the use of a credit default swap to hedge credit risk might be conceptually flawed. Whilst we acknowledge that there are differences, we do not believe that they are sufficient to preclude any type of hedge accounting, especially when one considers the current approach for hedging the risk free rate in a debt instrument. For example, the issues of funding and counterparty credit risk exist for interest rate swaps hedging benchmark interest rates, as well as credit default swaps hedging credit risk. Both the interest rate swap and credit default swap are synthetic instruments that do not need to be funded and are subject to counterparty credit risk. There are also differences in liquidity between the derivatives markets versus the debt markets, although the magnitude of the difference in liquidity may be different for the credit default market compared to the interest rate swap market.

Other structural differences may exist today, but there is nothing to suggest that markets may not evolve so that these differences may be addressed over time, or more sophisticated models of adjusting for them may be developed. The market has changed since the financial crisis. For example, we understand that the "cheapest to deliver option" term is no longer used frequently in the current market place for credit default swaps, and many derivative contracts now require collateral to be posted, which lessens the effect of counterparty credit risk.

At a minimum, we believe the Board should consider the guidance in IFRS 7 and IFRS 9, which require the credit risk component of own debt to be identified and accounted for separately or separately disclosed for reporting purposes in certain circumstances. Whilst the Board acknowledged the difficulties in measuring the credit risk component, it also provided a "default" method and acknowledged there may be other methods. It is illogical to provide for separation of credit risk under these standards, but preclude its use for hedge accounting purposes. We would therefore allow the use of the default method, or any refinement of that method that an entity believes more faithfully represents the measurement of the credit risk in a financial instrument, because it better isolates the credit risk component.

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(b) If not, which of the three alternatives considered by the Board in paragraphs BC226–BC246 should the Board develop further and what changes to that alternative would you recommend and why?

Please see our answer to question 15 (a).

Question 16 – Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We agree, in principle, with the transition requirements, but believe entities should be able to elect to apply IFRS 9 hedge accounting retrospectively to allow consistent accounting on adoption of the other phases of IFRS 9.

For example, an entity may have hedged (and applied hedge accounting under IAS 39) to a financial asset measured at amortised cost with a separated embedded derivative. Under IFRS 9 this instrument may be measured at fair value through profit or loss. It will be inconsistent to require retrospective application of measurement of the financial asset, but propose that hedge accounting should be maintained in the comparatives. Conversely, an entity may have economically hedged an item that was measured at fair value through profit or loss under IAS 39 but will be measured at amortised cost under IFRS 9. The entity would not have obtained hedge accounting under IAS 39 but might do so under IFRS 9. It therefore seems inconsistent to restate comparative amounts for the change in measurement, but not allow the retrospective application of hedge accounting if the appropriate documentation is in place at the beginning of the comparative accounting period.

We also believe *allowing* IFRS 9 hedge accounting from the beginning of the transition period will enable hedge accounting for hedging strategies permitted under IFRS 9 but not under current IAS 39 to be applied in the comparative period. If entities would apply IFRS 9 hedge accounting from the beginning of the transition period, they will need to prepare hedge documentation by the beginning of the hedging period and keep two sets of hedging accounting entries. As the transition period is expected to be fairly long, it may still be workable to have the necessary hedge documentation in place at the start of the comparative period. Furthermore, the Board should give specific consideration to how pre-existing hedges should be accounted for at transition so as to enable entities to take advantage of the new hedging requirements.

We agree that early application should be permitted. We believe that the effective date needs to be considered in the context of other related projects. For many entities outside the financial sector there is probably little or no linkage between the hedging phase and the previous phases of IFRS 9 that will change the accounting for the items being hedged. We therefore believe that allowing the hedge accounting phase to be early adopted without adopting the other phases may be appropriate.

Other issues

Deletion of the IGs

The IASB issued implementation guidance to IAS 39 in the form of IGs to further explain some of the requirements of the standard. We understand that some paragraphs of IAS 39 will be retained in IFRS 9, but the IGs attached to these paragraphs will be deleted. This raises the question whether or not the guidance in the IGs is still applicable or not. Some of the guidance in the IGs is helpful, for example, IG. F.2.5 on cash flow hedges "all in one" hedge, and IG.F.2.17, on partial term hedging. There is no equivalent guidance in IFRS 9. Additionally, IG.F.6.2 and IG.F.6.3 have also been very helpful guidance for certain financial institutions in applying hedge accounting. Until new macro hedge accounting guidance is issued, these IGs should be carried forward too. We recommend the Board comprehensively review the IGs and carry forward those that continue to provide relevant guidance.

Measuring the hedged item for ineffectiveness

In paragraph B43, the Board states that when measuring the hedged item for ineffectiveness, it must be measured using a present value basis. We agree that in many hedging relationships the time value of money should be included in the measurement of ineffectiveness. However, we disagree with requiring the hedged item to be measured on a present value basis if the interest component is excluded from the hedging instrument. This is inconsistent with both the designation of the hedge and how the hedged risk is considered in the risk management strategy.

It is common practice to use the "undiscounted spot" method when hedging foreign currency risk by separating the interest element from the foreign currency derivative. Changing current practice would make it necessary to change treasury systems and develop reporting structures to monitor changes of timing of the cash flows. We believe in most situations the resulting ineffectiveness reported will be insignificant.

Hypothetical derivatives

We agree that the hypothetical derivatives method is useful for measuring the change in the hedged risk in a cash flow hedge. However, the Board may want to consider providing some additional, principle-based guidance on how to apply a hypothetical derivatives method to ensure consistency in practice. The principle should state that the terms of the hypothetical derivative should be defined in a manner that matches the key characteristics of the hedged item such that there should be no expectation of ineffectiveness.

Under IAS 39, the hypothetical derivatives method has been applied only to cash flow hedges. Paragraphs B43-B45 in the exposure draft could be interpreted as stating it is acceptable to use hypothetical derivatives also for fair value hedges. We disagree with this change, as it would make it possible to impute cash flows that are not present in the hedged item. For example, a reset of a floating leg equal to that of the actual swap used will need to be imputed.

Basis adjustment

We do not believe that the choice between basis adjustment and leaving the amount in other comprehensive income, is a major source of complexity for the users. However, if only one of the alternatives is retained we agree that basis adjustment is the preferable alternative.

We disagree with the proposal to reclassify the deferred hedging gains or losses directly from equity instead of recycling them through other comprehensive income as that introduces a new class of transactions in the statement of equity that is not a transaction with the owners. Furthermore, the effect will be that the result of the hedge will be accounted for twice in total comprehensive income over time. In our view, this is less useful than portraying the recycling as a performance event. We believe that it is unnecessary to change the recycling out of other comprehensive income when applying basis adjustment until the purpose of other comprehensive income is determined.

Collars

Certain rules relating to the use of options as hedging instruments have been retained from IAS 39, for example, a written option may be used to hedge a purchased option. However, designating as a hedging instrument a combination of a purchased option and a written option is prohibited even if it results in a net purchased option. It is not clear why combining two options that result in a zero cost collar or a net purchased option should be prohibited from being used as a hedging instrument. Furthermore, it is unclear why a combination of two options resulting in a net written option cannot be used to hedge an embedded purchased option or a combination of embedded options constituting a net purchased option, when a single written option is eligible to hedge a single embedded purchased option.