

9 March 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

AOSSG comments on IASB Exposure Draft ED/2010/13 *Hedge Accounting*

The Asian-Oceanian Standard Setters Group (AOSSG) is pleased to provide comments on Exposure Draft ED/2010/13 *Hedge Accounting*. In formulating its views, the AOSSG sought the views of constituents within each jurisdiction and various members participated in the IASB's outreach activities held during February 2011.

The AOSSG currently has 24 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macau, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi Arabia, Singapore, Sri Lanka, Thailand, and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Other views that are consistent or otherwise with the overall AOSSG comments are also provided within this submission. Individual member standard setters may also choose to make separate submissions that are consistent or otherwise with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard setters may hold.

This submission has been circulated to all AOSSG members for their comment after having been initially developed through the AOSSG's Financial Instruments Working Group. The AOSSG has not received any substantive contrary views from our constituents.

The AOSSG is supportive of the objective of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* in order to improve and simplify the accounting requirements for financial instruments. In particular, the AOSSG supports the IASB's decision to undertake a comprehensive review of the hedge accounting requirements to develop a principles-based approach that provides more meaningful information.

The AOSSG acknowledges that the global financial crisis highlighted that users of general purpose financial statements require better information to understand an entity's hedge accounting activities, how they reflect an entity's risk management activities and the extent to which those activities are successful in meeting an entity's risk management objective. The AOSSG notes that the proposals respond to concerns regarding the lack of transparency in the accounting for an entities hedge accounting activities. However, despite our overall support

for the proposals, a number of concerns have been raised by some AOSSG members with regard to the proposals as follows:

- (a) the link between the hedge accounting objective and an 'entity's risk management strategy' is quite broad and could lead to inconsistent use of hedge accounting (Question 1);
- (b) the objective of hedge accounting on 'exposures that impact profit or loss' is too narrowly focussed and this has impacted other proposals (for example, the proposal to prohibit instruments measured at fair value through other comprehensive income (OCI) from being designated as hedged items) without sufficient justification (Question 1);
- (c) instruments to which the fair value option has been applied should not be eligible as hedging instruments and this should be stated clearly in the requirements in order to prevent entities from 'managing' their accounting through loopholes in the requirements (Question 2);
- (d) a number of new terms have been introduced as part of the hedge effectiveness requirements which are not defined, and this is likely to result in diversity in practice. In addition, some members have raised concerns that the hedge effectiveness requirements could be onerous to apply in practice and believe that the IASB should reconsider these proposals (Question 6);
- (e) more guidance is required around the proposals for rebalancing given the significant degree of judgement required (Question 7);
- (f) the removal of the election to voluntarily discontinue hedge accounting is a concern of some members as it seems to be an unnecessary bright line rule. If the entity's risk management strategy is to enter and exit hedging relationships to mitigate risk exposures, then not allowing entities to voluntarily discontinue hedge accounting is inconsistent with the IASB's stated objective of hedge accounting (Question 8);
- (g) the proposed presentation of gains/losses for fair value hedges is not expected to provide decision useful information. Additionally, some members are of the view that the recognition of gains or losses on the hedged item in a separate line item is inconsistent with the definition of assets and liabilities in the *Framework* (Question 9);
- (h) a view has been expressed that the IASB should reconsider its decision on linked presentation (Question 9);
- (i) whilst many members believe there is merit in the treatment of the time value of options proposed by the IASB, some members are concerned that it is not sufficiently justified and is inconsistent with the treatment of acquisition costs in other IFRSs (Question 10);
- (j) a view has been expressed that the decision regarding the treatment of the time value associated with zero cost collars seems arbitrary and will likely give rise to structuring opportunities (Question 10);
- (k) the requirement for a net position to be designated as a hedged item only if the offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period seems unnecessarily restrictive, especially for entities that report on a quarterly or half-yearly basis. Some

members believe the requirement will conflict with an entity's risk management strategy and the IASB should justify its decision to depart from that principle (Question 11);

- (l) the disclosures should be reconsidered as some members are concerned that they could be unnecessarily burdensome on those entities applying hedge accounting. In addition, there may be repetition in the disclosure requirements for identifying an entity's risk exposures and the entity's risk management policies (Question 13);
- (m) the discussion around the hedging of credit risk is inconsistent with the IASB's previous decision to require the measurement and separate presentation of fair value changes due to changes in an entity's credit risk for financial liabilities designated at fair value through profit or loss in OCI – the IASB needs to justify its decision (Question 15);
- (n) it is not clear what the IASB's means by 'prospective' application in the proposals. In addition, there would be support for providing a once-off retrospective adjustment on transition to the new requirements, especially where an entity has long-dated existing hedging relationships and applying the requirements prospectively would require the entity to keep two sets of hedging books and report different results for the same type of hedging relationship (Question 16); and
- (o) there are still a number of hedge transactions that an entity may undertake for risk management purposes that will not achieve hedge accounting under the proposals. If these types of transactions will not achieve hedge accounting, then the IASB needs to explain why and clarify the meaning of the phrase 'manage its exposures' in the objective (Question 16).

The AOSSG is keen to play a key role in the development of a global set of high quality financial reporting standards and trusts that the IASB finds our comments helpful in progressing the replacement standard for IAS 39.

The AOSSG views, as summarised above, are incorporated in the direct responses to the questions in ED/2010/13 in Appendix A. Appendix B provides examples of different types of transactions that are undertaken for risk management purposes, but for which hedge accounting under the proposals will not be achieved. We also attach the comments from our Islamic Finance Working Group at the end of the letter.

If the proposals in ED/2010/13 were to proceed, we believe that consideration should be given to providing more guidance to assist preparers and auditors to implement the requirements given the level of sophistication, data availability and expertise in emerging markets such as those in many AOSSG jurisdictions. The AOSSG urges the IASB to consider those emerging markets in the process of adopting IFRSs.

If you have any queries regarding any matters in this submission, please contact us.

Yours sincerely



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IASB Exposure Draft ED/2010/13 *Hedge Accounting*

AOSSG specific comments

The AOSSG provides the following responses to the IASB's Exposure Draft ED/2010/13 *Hedge Accounting*.

Objective of hedge accounting (paragraphs 1 and BC11-BC16)

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

The AOSSG acknowledges the view that linking hedge accounting to an entity's risk management activities can provide greater transparency. More of the 'economic hedges' that previously did not qualify for hedge accounting will be disclosed in the financial statements in a way that is expected to better reflect the underlying substance of the transaction – in effect, better reflecting the reason for, and the way in which, the transaction was undertaken, to provide users with an improved understanding of the activities of the entity in the financial statements.

Some members also consider that 'looking through the eyes of management' is consistent with the approach taken in IFRS 8 *Segment Reporting* and IFRS 7 *Financial Instruments: Disclosures* which is a practical way of reflecting the business model of the entity in the financial statements.

However, a number of concerns with the proposed objective have been expressed.

(i) *Linking the objective to an entity's risk management strategy*

Some members of the AOSSG share the concerns of John T Smith (as expressed in the Alternative View) that linking hedge accounting to an entity's risk management strategy will result in hedge accounting being much more widely used, rather than an exception to 'normal' recognition and measurement requirements. The potential for an entity to override the fair value option (which is an irrevocable election at initial recognition) by electing to hedge account has already been identified in the Alternative View in ED/2010/13. Those members believe that the term 'risk management' should be defined such that entities cannot move freely in and out of hedge accounting to manage earnings.

In addition, they believe that there are inconsistencies within the ED which proposes that an entity's hedge accounting should reflect its risk management strategy, yet there are still a number of hedging transactions that take place in practice and pose real commercial risks to an entity, that cannot achieve hedge accounting – see (iii) below.

(ii) *Focussing on the impact to profit or loss*

The proposed objective is focussed on managing exposures that could affect profit or loss and it is clear that this decision has impacted other requirements proposed in the ED, such as:

- (1) the proposal to prohibit instruments measured at fair value through other comprehensive income (OCI) from being designated as hedged items. This appears consistent with the hedging objective of managing exposures that could affect profit or loss. However, there is nothing in IAS 39 that currently prevents entities from hedging investments in equity instruments that are not held for trading (previously classified as available-for-sale assets) whose movements in fair value are recognised in OCI, and there are entities that hedge those types of investments in accordance with their risk management strategy and would wish to use hedge accounting. This prohibition would prevent a relevant reflection of the entity's risk management activities;
- (2) the proposal to prohibit non-derivative financial instruments that are not measured at fair value through profit or loss from being designated as hedging instruments. The AOSSG does not believe the IASB has provided sufficient justification for excluding this type of instrument; and
- (3) the proposal that the accounting for fair value hedges would require gains or losses from the hedged item and hedging instrument to be recorded in OCI and any ineffectiveness to be transferred to profit or loss. In previous submissions, some members of the AOSSG raised the concern that recycling from OCI to profit or loss undermines the notion that items of revenue are 'income' and items of expense are 'expenses', regardless of where they are presented in the statement of comprehensive income. Therefore, those members believe that the IASB should clearly articulate and justify its focus on risks that affect profit or loss rather than comprehensive income, to ensure there is a conceptual basis for determining the types of assets that can be designated as hedged items. Other AOSSG members consider there should be more recycling, including in respect of instruments at FVTOCI (which they also consider should be able to be the subject of hedge accounting).

In addition, some members of the AOSSG believe that the hedging objective should consider the impact on the balance sheet, especially where an entity's risk management strategy may consider the presentation of risk exposures in the financial statements as a whole.

More generally there is a concern that the IASB is taking a view on the nature of items that are presented in profit and loss versus OCI in a number of projects without identifying an underlying principle, and the hedging proposals compound this concern - for example, the rationale for not allowing recycling is based upon the notion that there are no distinction between profit or loss and OCI. On the other hand, the proposed objective for hedge accounting is based upon the notion that there is distinction between profit or loss and OCI. Therefore, the AOSSG urges the IASB to finish its financial statement presentation project and identify the basis for presenting items in equity versus OCI versus profit or loss, so that it is understood, at a conceptual level, what it means to present items in the different areas of the financial statements.

(iii) *Defining what is meant by “...manage exposures arising from particular risks...”*

Some members of the AOSSG believe that the IASB should clarify what it means by ‘manage exposures’, because as discussed in (i) above, there are still a number of hedge transactions that take place but for which hedge accounting cannot be achieved. Therefore, the proposals for hedge accounting will not fully capture an entity’s risk management activities. Some examples are provided in Appendix B.

If the IASB intends that the examples provided should not be eligible for hedge accounting, then it should clarify the meaning of ‘manage exposures’. Those members consider that managing exposures should mean mitigating risk and does not include the conversion or swapping from one type of risk exposure to another.

(iv) *Hedge accounting as an option*

Some members of the AOSSG have expressed a preference for all financial instruments to be measured at fair value through profit or loss, and therefore retaining hedge accounting as an option. In addition, requiring mandatory application of hedge accounting could be too costly for some entities. However, those members note that linking the objective of hedge accounting with an entity’s risk management strategy could imply to users of financial statements that an entity that undertakes hedging transactions but chooses not to apply hedge accounting would not reflect its risk management strategy in its financial statements.

This would be unfortunate because risk management could also be reflected in disclosures and suggests that the IASB identify this in finalising its hedge accounting amendments.

Instruments that qualify for designation as hedging instruments (paragraphs 5-7 and BC28-BC47)

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?

The AOSSG agrees 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. However, as discussed in the response to Question 1 above, the AOSSG does not believe that there is sufficient justification for only allowing non-derivative financial instruments measured at fair value through profit or loss to be designated as eligible hedging instruments. If the entity’s risk management strategy is to use assets and liabilities measured at fair value through OCI to hedge a risk exposure, then disallowing it will result in inconsistency between the objective of hedge accounting and the entity’s risk management strategy.

Some members of the AOSSG propose that an instrument to which the fair value option has been applied should not be eligible as a hedging instrument. Whilst the fair value option cannot be revoked an entity could designate the instrument in a hedging relationship which will result in recognising gains and losses in OCI instead of profit or loss. Therefore, in order to prevent this loophole in the requirements, these members suggest that the requirements explicitly state that a financial instrument that has been designated at fair value through profit or loss on initial recognition cannot be designated as an eligible hedging instrument.

Some members are concerned with the IASB's decision to not address the disaggregation of non-derivative hedging instruments into risk components other than foreign currency risk (that is, the instrument is required to be designated in its entirety). Paragraph BC33 notes that doing so would be a significant expansion of the scope of the hedge accounting project and could significantly delay the project. Those members would prefer the IASB explore all possible ways to improve hedge accounting, rather than completing the Standard by a particular time.

Derivatives that qualify for designation as hedged items (paragraphs 15, B9 and BC48-BC51)

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?

Yes. The AOSSG supports the proposal to expand the exposures eligible for designation as a hedged item. Synthetic exposures are commonly created due to the way in which loans are originally hedged (as discussed in the example in paragraph BC50 of the Basis for Conclusions in ED/2010/13). Therefore, the AOSSG believes that any remaining variability in cash flows or fair value should be able to be accounted for consistent with an entity's risk management activities.

Some members have raised the need for further guidance in the form of numerical examples, to provide greater clarity on how the aggregated exposure should be accounted for (that is, the accounting mechanics) and to ease implementation issues and to ensure that the requirements are consistently applied.

There have also been concerns regarding the meaning of the terms 'exposure', 'risks' and 'risk components'. Some members believe that it would be helpful to explain these terms in the context of the ED/final standard.

Designation of risk components as hedged items (paragraphs 18, B13-B18 and BC52-BC60)

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?

The AOSSG agrees with the proposal to expand on the requirements in IAS 39 to allow an entity to designate changes in the cash flows or fair value of either a financial or non-financial item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable.

Some members believe that the wording in paragraph 18 should be expanded to include the guidance in paragraph B13 to more clearly articulate the principle that, if an entity cannot determine the impact of the risk component on the hedged item then it is not considered to be reliably measurable. Therefore, paragraph 18 could be amended to read as follows:

- (a) “only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided the risk component is separately identifiable and the changes in the cash flows or fair value of the item attributable to changes in that risk component are reliably measurable.”

Some members have identified the example within the discussion in paragraph B18 regarding the treatment of inflation as a risk component of a financial instrument as potentially being a rule that overrides the principle that a risk component must be separately identifiable and reliably measurable. If the guidance is a legacy paragraph from IAS 39 from a previous interpretation, and the IASB does not wish to re-address the issue, it should be more specific with the example. This would involve providing an explanation regarding the example, such as, the interest and inflation components are inextricably linked and cannot be separated, therefore resulting in the inflation component not being separately identifiable and reliably measurable.

Another concern raised by some members is the proposed guidance for whether a risk component is ‘separately identifiable’. Those members believe that it could be further developed. For example, paragraph B15 indicates that when designating risk components as hedged items, an entity should consider whether the risk components are explicit (i.e. contractually specified risk components) or implicit in the fair value or cash flows of an item (i.e. non-contractually specified risk components) to determine if they are separately identifiable. Those members believe that the latter is a rather generic criterion which could potentially result in the abuse of hedge accounting. Therefore, the IASB should provide more guidance on evaluating the ‘separately identifiable’ criterion for non-contractually specified risk components.

Designation of a layer component of the nominal amount (paragraphs 18, B19-B23 and BC65-BC69)

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?

Yes. The AOSSG agrees with the proposals outlined in questions 5(a) and 5(b) above in respect the designation of a layer component of the nominal amount for the reasons outlined in paragraphs BC65-BC69 of the Basis for Conclusions.

However, in respect of Question 5(a), some members of the AOSSG believe that it is necessary to clarify how to identify a layer component if the hedged item is sold. These members believe that in designating a layer component, it is necessary to predetermine the order in which components are deemed to be sold. This would ensure that there would be no abuse of designation of a layer component.

In addition, some members pointed out in relation to Question 5(b) that the IASB's forthcoming proposals regarding open portfolios may have an impact on the requirements for layers with a prepayment option. Therefore, these members urge the IASB to deal with these issues prior to finalising the hedging requirements.

Hedge effectiveness requirements to qualify for hedge accounting (paragraphs 19, B27-B39 and BC75-BC90)

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?

The AOSSG believes there should be hedge effectiveness requirements as part of the qualifying criteria for hedge accounting. Additionally, the AOSSG welcomes the removal of the 'bright-line' effectiveness testing rules under IAS 39. However, some members of the AOSSG are concerned that the requirements have been drafted in an overly complex manner and there would be confusion around the meaning of various terms being used (including 'unbiased' and 'accidental offset') and how the requirement for an entity to minimise expected hedge ineffectiveness will be applied in practice. Those members expect this to result in diversity in practice.

Additionally, some members of the AOSSG consider the explanation provided in IASB Agenda Paper 4 (hereinafter referred to as “the IASB AP”) for the IASB Board meeting held on 24 August in respect of determining the hedge ratio, to be easier to understand than the proposals in the ED. The IASB AP separates the process into two steps – the first step is to determine the designation ratio for the hedged item out of a population of the potential hedged item and the second step is to determine the hedge ratio, or the volume of hedging instrument, to be used to hedge the hedged item determined in the first step. Those members believe that incorporating this explanation in the proposals will assist users.

Some members are concerned that the expectation to achieve other than accidental offsetting by analysing the economic relationship between the hedged item and hedging instrument would be susceptible to diverse application. For example, paragraph B31 suggests that a statistical correlation between two variables that have no ‘substantive’ economic relationship would not support a valid expectation of other than accidental offsetting. However, the ED does not provide further guidance on what constitutes substantive.

In addition, some members of the AOSSG have raised concerns regarding the proposed effectiveness criteria requiring the hedge relationship to minimise expected hedge ineffectiveness. While the ED states that a hedging relationship to minimise does not have to be perfectly effective in order to qualify for hedge accounting, the ED is not clear whether the guidance proposes to reduce the current range of 80% - 125% or allows for more flexibility outside that range. The reference to minimise could be interpreted to be even more restrictive than the current threshold, particularly when the requirements for mandatory rebalancing are considered.

One member has suggested that the requirement to “produce an unbiased result and minimise expected hedge ineffectiveness” could be more simply described and suggests rewording along the following lines: “an entity is required on a reasonably estimable basis to determine a hedge ratio which is expected to make zero the average of the expected inefficient amount (i.e. the difference between the change in fair value of hedged item and the change in hedging instrument), while, of course, allowing the possibility of actual inefficient amount resulting in being other than zero.” That member believes that the revised expression is aligned more closely with an entity’s risk management activities and is a reasonable criterion for hedge effectiveness assessment.

In addition, the requirement to minimise hedge ineffectiveness could be inconsistent with an entity’s risk management strategy. In many cases, an entity may decide that a hedge that is substantially less than 100% effective may meet that entity’s particular risk tolerance, given the costs of hedging and other factors. It is unclear how a requirement to minimize is consistent with a principles based standard intended to align hedge accounting with risk management practices and those members are concerned that it may require an entity to search for the hedging instrument that most significantly reduces ineffectiveness regardless of whether it is economically advantageous or consistent with the entity’s risk management strategy and those hedging instruments that make operational sense for the entity to utilise.

Some members of the AOSSG consider that requiring hedging relationships to give unbiased results and minimise expected ineffectiveness may be an onerous and overly complicated task in practice, while providing limited benefit to users. Therefore, those members believe that a qualitative threshold such as “reasonably effective” should be adopted in connection with the broader proposed hedge accounting principles, as it would provide a necessary measurement basis against which to assess the competing objectives of minimising hedge effectiveness and achieving cost effectiveness. It would also allow for more qualitative hedge assessments, which would reduce the need for onerous quantitative effectiveness testing, which would be more aligned with the FASB’s proposal in its exposure draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* and result in a better matching of hedge accounting with an entity’s risk management objectives.

If the IASB intends to retain these requirements, some members of the AOSSG believe that the proposed wording could be simplified.

Paragraph 19(c) notes that, in order for a hedging relationship to qualify for hedge accounting, the hedging relationship must “...meet the hedge effectiveness requirements (see paragraphs B27-B39)...”. The hedge effectiveness requirements require the hedging relationship to:

- (i) meet the objective of the hedge effectiveness assessment; and
- (ii) achieve other than accidental offsetting.

Three new phrases are introduced in the above paragraph – (1) ‘hedge effectiveness requirements’, (2) ‘hedge effectiveness assessment’ and (3) ‘accidental offsetting’. In respect of (1), the hedge effectiveness requirements are clearly explained in sub-paragraphs 19(c)(i) and (ii).

However, phrases (2) and (3), are not discussed further in the proposed amendments to the body of IFRS 9. The only indication of where to find an explanation of what is meant by ‘hedge effectiveness assessment’ and ‘accidental offsetting’ is the reference to paragraphs B27-B39 in the Application Guidance (Appendix B).

The first mention of ‘hedge effectiveness assessment’ is not until paragraph B29, stating that its objective “...is to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. Therefore, a hedging relationship shall not reflect a deliberate mismatch between the weightings of the hedged item and the hedging instrument that would create ineffectiveness.”

The discussion on ‘accidental offsetting’ is located in paragraph B31, which notes that, when a relationship between the changes in the value of the hedged item and the hedging instrument breaks down (i.e. due to a deterioration in the credit standing of the issuer of the derivative), it would not be expected that the hedging relationship could achieve other than accidental offsetting – and as such, would fail to meet the hedge effectiveness requirements.

When considering the objective of the ‘hedge effectiveness assessment’, and the discussion on ‘accidental offsetting’, it seems that sub-paragraph (ii) repeats the intention of sub-paragraph (i) – if a hedging relationship is expected to ‘achieve other than accidental offsetting’ then one would expect that the hedging relationship is one which will produce an ‘unbiased result and minimise expected hedge effectiveness’.

Those members believe that the requirements could be made clearer if the objective of the hedge effectiveness assessment were included as part of the qualifying criteria in paragraph 19(c). The paragraph could be amended to simply say:

“A hedging relationship must produce an unbiased result and minimise expected hedge ineffectiveness.”

Although this would eliminate the 3 phrases which are undefined, they believes that the Application Guidance should articulate the intended meaning of ‘an unbiased result’ and as discussed above, expand on the discussion regarding how an entity minimises hedge ineffectiveness and obtains other than accidental offsetting.

Rebalancing of a hedging relationship (paragraphs 23, B46-B60 and BC106-BC111)

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?

Despite concerns that the requirement to continually rebalanced will be an overly onerous and complicated to implement, the AOSSG agrees with the proposal to require an entity to rebalance the hedging relationship if the hedging relationship fails to meet the objective of the hedge effectiveness assessment or if it is not expected to do so, because this means entities can continue hedge accounting and will not be forced to de-designate the hedge relationship where it still meets the entity’s risk management strategy.

It is our understanding that in both instances, rebalancing will take place after hedge effectiveness is assessed and hedge effectiveness for the following period would be based on the rebalanced hedge relationship. The AOSSG believes the IASB’s intention should be made clear.

Some members have expressed concern over the significant degree of judgement that would be required in applying the rebalancing requirements to assess whether changes in the extent of offset between the fair value of the hedging instrument and the hedged item would trigger rebalancing. It is recognised the judgement to delay rebalancing would result in more ineffectiveness being recorded in profit or loss. Therefore, in light of the significant judgement that could be involved in applying the rebalancing requirements, it is recommended that the IASB consider requiring disclosures of the circumstances that have triggered rebalancing (when required and when undertaken proactively), and the frequency, method and consequences of rebalancing.

In addition, some members have identified other issues that they believe require clarification:

- (a) *Replacement of old terminology* – it is not clear if the IASB is totally replacing its old terminology (de-designation and re-designation) with new terms (rebalancing, continuation and discontinuation), because there are a number of instances when the term de-designation is used in the Application Guidance. The IASB should ensure that the terms are used in a consistent manner so as to avoid confusion – for example what is the difference between ‘de-designation’ and ‘discontinuation’?;
- (b) *What constitutes a rebalancing event?* – whether a delay in the time of the hedged item would be a rebalancing event (for example, if the entity is hedging sales of its inventory for a particular date, but its manufacturing process breaks down, resulting in delays on production and ultimately delaying the sales date);
- (c) *Rebalancing vs overhaul event* – paragraph BC110 of the Basis for Conclusions introduces the term ‘overhaul’. This concept is not discussed elsewhere in the proposals and the AOSSG believes it is inappropriate to introduce a new notion in the Basis for Conclusions. In order to avoid interpretative issues, the AOSSG believes that this notion should be defined/articulated in the Application Guidance, along with detailed discussion of what would constitute an overhaul event versus a rebalancing event. Additionally, the IASB should clarify why the example of a severe deterioration in the credit risk of a hedging instrument is an overhaul and not a rebalancing event.

In addition, those members of the AOSSG that proposed that the explanation in IASB Agenda Paper 4 (IASB Board meeting held on 24 August) in respect of determining the hedge ratio be included in the proposals (see the response to Question 6), also consider that it would be helpful if an explanation was provided to clarify that rebalancing relates to the second step of determining the hedge ratio.

In finalising the requirements, the AOSSG strongly encourages the IASB to clarify the issues around the newly introduced idea of rebalancing and ensure that the terms are appropriately defined/explained in the final standard.

Discontinuing hedge accounting (paragraphs 24, B61-B66 and BC112-BC118)

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?

Whilst the AOSSG agrees that an entity should discontinue hedge accounting prospectively when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria, some members believe that the disclosure requirement in paragraph 44 should be enhanced to require an entity to disclose the reasons, if any, for an entity's change in risk management strategy. Those members believe that this will limit the potential for abuse of freely moving in and out of hedge accounting.

Some members of the AOSSG are concerned with the proposal in the ED that prevents an entity from voluntarily discontinuing hedge accounting. They consider the proposal to be an unnecessary 'bright-line' rule to mitigate the concerns raised in the Alternative View that linking hedge accounting to risk management activities would "...inappropriately expand the use of hedge accounting...", thereby making hedge accounting "...the norm and not the exception..." to recognition and measurement principles. If the concern of the IASB is to prevent entities from discontinuing hedge accounting for no reason, then this should be clarified and clearly expressed in the final standard.

Paragraph 91(c) of IAS 39 currently allows an entity to revoke its designation of the hedge accounting relationship and prospectively discontinue hedge accounting. Some members of the AOSSG consider that, whilst it is expected that the majority of circumstances when revocation may have been used will be replaced with rebalancing, revocation should remain available because entities often dismantle hedging positions for valid business reasons not associated with a change in risk management strategy.

If the entity's risk management strategy is to enter and exit hedging relationships to mitigate risk exposures, then not allowing entities to voluntarily discontinue hedge accounting is inconsistent with the IASB's stated objective of hedge accounting. Therefore, there should not be a difference in accounting if an entity terminates and pays out the hedging instrument or takes out a new instrument to offset the gains/losses on the designated hedging instrument – the accounting should reflect this regardless of whether the entity's overall risk management strategy remains unchanged.

Accounting for fair value hedges (paragraphs 26-28 and BC119-BC129)

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?

As discussed in the response to Question 1, the AOSSG has an overriding concern with the number of items being recognised in OCI prior to the completion of the IASB's presentation project. The AOSSG strongly encourages the IASB to finish its project on financial statement presentation to help ensure consistency in the items presented in OCI.

There are a number of concerns with the proposals.

Presentation of fair value adjustments

Some members do not consider that the presentation of fair value hedge adjustments in the balance sheet and statement of comprehensive income are appropriate. Those members believe that whilst the proposals to present hedged risks in a separate line item would avoid mixed measurement for the hedged item, it would have the following deficiencies:

- (a) hedge accounting is a mixed measurement accounting model. It is not appropriate to disallow the presentation of a mixed measurement, while allowing the accounting which would inevitably involve mixed measurement outcomes;
- (b) a separate line item should be derecognised together with its associated hedge item, when the hedge item is sold. It would be easier to trace this relationship when the hedge item is adjusted than when a separate line item is used;
- (c) some users have suggested that it would be easier to understand the relationship when the hedge item is adjusted rather than using a separate line item.

Use of OCI

The ED states that gains or losses arising from both a hedged item and a hedging instrument would be presented in OCI, to align fair value hedge accounting more closely with cash flow hedge accounting, making it possible for users of financial statements to see the movements in respect of all hedges in OCI.

Some members do not believe that making OCI a central place for recording gains or losses on hedged items and hedging instruments would of itself provide useful information. Instead,

those members believe that it would be more useful to disclose detailed information on the movements of OCI in the notes to the financial statements.

Both the proposed and existing requirements would produce the same outcome - that is, the effective portion of hedging relationship would not affect profit or loss, and only the ineffective portion affects profit or loss. Therefore, it is unclear why the proposals are that all the gains or losses be recognised first in OCI, and then the ineffective portion is reclassified to profit or loss. As discussed in the response to Question 1 and in the Other Comments section at the end of the submission, it is important that the IASB finalises its presentation project to identify what should be recognised in OCI.

Gain or loss on the hedged item

The presentation in the balance sheet is not appropriate as the adjustment for the fair value gain or loss on the hedged item would not be an element – that is, it would not meet the definition of an asset or a liability.

Linked presentation

Some members of the AOSSG commented that the purpose of hedge accounting is to present effects of hedge activities of the entity on financial statements and the purpose of financial statements is to provide useful information which is relevant and faithfully presents what it purports to represent.

An entity's risk management strategy might be to hedge a firm commitment with a view to creating stable net cash flows. Some AOSSG members consider that presenting the future realisable net cash flows on the statement of financial position would provide useful information to the users.

Those members believe that under the current hedging requirements and the proposals, the effect of hedge accounting is appropriately presented in the income statement, but not the statement of financial position. Moreover, when the exchange rate rapidly changes, the volatility in the statement of financial position may increase. As a result, in order to appropriately reflect an entity's risk management strategy and provide useful information to the users, there needs to be improvement in presenting the fair value hedge accounting of the firm commitment in the statement of financial position.

Those members acknowledge that linked presentation may not appropriately present the impacts of risks other than hedge risks and also may not enable a differentiation from offsetting. Improvements to the requirements may involve long-term research. However, the current IAS 39 and the ED also have weaknesses in that they do not appropriately present the hedge activities. Consequently, those members of the AOSSG would like to propose the following:

- (i) recognition of firm commitments that are hedged in the financial statements. Similarly, linked presentation should be allowed, but restricted to firm commitments relating to fair value hedges.
- (ii) the amount of hedged items, hedging instruments and hedge adjustments and net exposures per hedged risk should be disclosed irrespective of whether linked

presentation is allowed – refer to the disclosure requirement proposed in IASB's ED/2011/1 *Offsetting Financial Assets and Financial Liabilities*.

Accounting for the time value of options for cash flow and fair value hedges (paragraphs 33, B67-B69 and BC143-BC155)

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 (e.g. 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?

Treatment of the time value of options

Some members of the AOSSG support the proposals in respect of the treatment of the time value of options.

However, whilst the other members of the AOSSG acknowledge the pressure on the IASB to address the volatility recognised in profit or loss caused by the existing requirement in IAS 39 to treat the time value of options as held for trading, resulting in its measurement at fair value through profit or loss. Additionally, those members do not believe that accounting requirements should drive an entity's decision regarding its risk management strategy. However, they do not believe that the IASB has identified an appropriate solution.

Those members of the AOSSG believe that all hedging instruments can be viewed as providing ‘insurance’ to the entity. Therefore, they do not consider it appropriate to treat the time value of an option as a cost of hedging in isolation of other instruments because:

- (a) there are other types of instruments that have a time value component – for example, forward foreign exchange contracts. The recognition and measurement requirements for a time value component should be applied consistently across all types of instruments;
- (b) costs are associated with a number of off-market derivatives and there are implied costs in other instruments. Again, the associated ‘costs’ of hedging instruments should be treated in the same manner. In addition, those members of the AOSSG does not believe that the measurement of a derivative should exacerbate the accounting for transactions costs; and
- (c) IFRSs do not always capitalise costs associated with acquiring assets; for example:
 - (i) IFRS 3 *Business Combinations* – transaction costs incurred in a business combination are expensed in profit or loss at the date of acquisition; and
 - (ii) IAS 23 *Borrowing Costs* – borrowing costs are not capitalised to form part of the cost of an asset unless they are directly attributable to the acquisition, construction or production of a qualifying asset.

Zero cost collars

Some members of the AOSSG believe the current proposals in the ED are not appropriate and may encourage entities to undertake particular types of transactions – zero cost collars would be replaced by collars with a nominal cost so that the proposed accounting treatment for options can be applied (for example – \$10 collars would become a feature in the market).

Hedges of a group of items (paragraphs 34-39, B70-B82 and BC156-BC182)

Eligibility of a group of items as the hedged item (paragraphs 34, B70-B76, BC163, BC164 and BC168-BC173)

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?

Yes. The AOSSG supports the criteria for the eligibility of groups of items as a hedged item. The AOSSG believes that the criteria are clear and would result in accounting outcomes that reflect the entity’s risk management strategy.

However, some members have a concern regarding the requirement for a net position to be designated as a hedged item only if the offsetting cash flows in the group of hedged items exposed to the hedged risk affect profit or loss in their entirety in the same reporting period (including interim periods). Those members believe that this criterion could be a significant constraint in situations where risk management is based on the timing of cash flows rather than the timing of profit or loss impact.

The effect of this restriction is made even greater for entities that report on a quarterly or half-yearly basis. Those members are not convinced by the IASB’s rationale for the restriction as set out in paragraphs BC168 to BC173 of the Basis for Conclusion and urge the

IASB to reconsider the proposal in order to bridge the gap between hedge accounting and risk management in situations where the risk management objective and strategy is to hedge on a net basis but not all hedged items affect profit or loss in the same reporting period.

Presentation (paragraphs 37, 38, B79-B82 and BC174-BC177)

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Yes. The AOSSG supports the separate presentation of hedging instrument gains or losses from those line items affected by hedged items in profit or loss as this presentation avoids artificially grossing up gains or losses on the hedging instrument.

Disclosures (paragraphs 40-52 and BC183-BC208)

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?

The AOSSG supports the proposed disclosure requirements, especially in respect of an entity's risk management strategy. However, there are concerns that those entities choosing to apply hedge accounting would be required to comply with onerous disclosure requirements, while those entities that elect not to apply hedge accounting do not (as the requirements will only apply to entities that apply hedge accounting). Presumably the disclosures are intended to lead to clearer and more transparent reporting about an entity's risk management strategy and hedging activities, yet many entities would not be making those disclosures.

Some members of the AOSSG believe that paragraph 44 should be expanded to require disclosure of the reasons, if any, for a change to an entity's hedge strategy to prevent arbitrary hedges.

The IASB should consider how the existing disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* paragraph 33 (which consider the exposure to risks for which an entity does not apply hedge accounting) interact with the proposed disclosures of paragraphs 44 and 45 (which require disclosures about the entity's risk management strategy, the risks that an entity is exposed to, how an entity manages those risks, including whether an entity hedges risky items in their entirety or hedges a risk component, and the effect of the hedging strategy). In addition, some members have suggested that it would be useful for the IASB to provide further guidance/examples on the requirements of paragraphs 40, 43 and 44.

Accounting alternatives to hedge accounting (paragraphs BC208-BC246)

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative (Appendix C and paragraphs BC209-BC218)

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?

Yes. For the reasons outlined in paragraph BC209-BC218 of the Basis for Conclusions, the AOSSG agrees that an entity should be able to account for 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 at fair value if that is in accordance with the entity's risk management strategy.

Some members of the AOSSG have raised concerns about the meaning in paragraph BC214(b) of "if a commodity contract is in accordance with the entity's fair value-based risk management". Those members believe that this paragraph requires clarification to ensure that there is not unreasonable expansion of the use of fair value.

In addition, although types of expected risk management are described in paragraph BC213, meanings of both "management on a net position basis" and "net position to nil" need further clarification. Those members suggest that use of the examples in the IASB's Agenda Paper 18A (paragraphs 5-11) used for the IASB Board meeting held on 19th October will provide further clarification.

Accounting for credit risk using credit derivatives (paragraphs BC219-BC246)

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?

Some members of the AOSSG are concerned with the proposal in respect of credit risk and the justification that “...it is operationally difficult (if not impossible) to isolate and measure the credit risk of a financial item as a component that meets the eligibility criteria for hedged items...”.

Those members acknowledge that the spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements and that the methodology prescribed in IFRS 7 *Financial Instruments: Disclosures* may only deduce an approximate measure of the impact of credit risk. However, the IASB recently decided that the change in fair value due to own credit risk would be presented in OCI for financial liabilities designated at fair value through profit or loss and that the IFRS 7 methodology is a suitable proxy for determining the fair value change due to credit risk.

The IASB should be consistent in its decisions regarding credit risk – if it is satisfied that the fair value change of a financial liability that is due to a change in the entity’s credit risk can be measured sufficiently reliably to be presented in OCI, then it is not clear why financial institutions should not be able to achieve hedge accounting for credit risk.

The IASB has justified its decision by stating that hedging against credit risk is unlikely to meet hedging requirements because the value of the credit derivative cannot be expected to move in the same way as the value of receivables and it is not possible to measure the credit risk element of the receivable. However, financial institutions that have been consulted are of a different view. More generally, those members believe the IASB should specifically consider how to account for the impact of credit risk as it is becoming an increasingly significant issue in the application of IFRSs.

Some members believe that the IASB should consider accounting alternatives to hedge accounting the exposure to credit risk as the entity should be able to represent its hedging activities in its financial statements in accordance with its risk management strategy, even though this may introduce complexity into accounting for financial instruments.

Effective date and transition (paragraphs 53-55 and BC247-BC254)

Question 16

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

Some members of the AOSSG have raised a number of concerns with the proposed transition requirements and believe the IASB should reconsider the proposals.

- (a) *Meaning of prospective* – it is not clear whether the prospective transition requirements mean that hedges that are already in place can be dedesignated and redesignated in accordance with the proposed requirements, or whether the proposals would only apply to new hedging relationships entered into after transition to the new hedging requirements. Therefore, it would be appropriate to provide more guidance in this area.
- (b) *Once-off retrospective adjustments* – those AOSSG members believe that the requirements should accommodate retrospective application to legacy hedge relationships for those entities that wish to make adjustments. If a hedging relationship met the criteria in IAS 39 for hedge accounting at transition date, then that hedging relationship should be able to be accounted for in accordance with the new hedge accounting requirements. This would help ensure consistency in accounting of all hedging relationships within the entity and reduce the burden on preparers by avoiding the duplication of work and the requirement to keep two sets of hedging books – one for hedging relationships accounted for under the old requirements and one in accordance with the new requirements

In addition, allowing retrospective adjustments to hedging relationships that were designated under the existing IAS 39 requirements and that still qualify for hedge accounting under the proposals would be consistent with the transition requirements in respect of hedge accounting in IFRS 1 *First-time adoption of IFRSs*. It will also ensure consistency across entities for the following types of examples:

- (i) *Aggregated exposures* – there are different interpretations of the existing IAS 39 requirements in respect of synthetic debt with one interpretation resulting in ineffectiveness being recorded in profit or loss, while the other interpretation allows perfect hedge accounting. Therefore, those entities recording ineffectiveness under the existing requirements should be able to apply the proposed requirements and reverse ineffectiveness previously recognised in profit or loss and also avoid recording continuous ineffectiveness over the remaining life of the hedging instrument;
- (ii) *Options as hedging instruments* – those that have designated the intrinsic value of an option in a hedging relationship would have recorded the fair value changes of the time value of the option in profit or loss in accordance with existing IAS 39 requirements. It is likely that those entities would want to retrospectively apply the proposed requirements and restate the fair value changes of the time value of the option from profit or loss to OCI. If some transitional relief were provided, it would link the objective of hedge accounting with the entity's risk management

strategy in the comparative year as well as the current reporting period on transition;

- (iii) *Hedging of net positions* – those entities with a risk management strategy to hedge a net position of sales and purchases are incapable of achieving hedge accounting under existing IAS 39 requirements, and must therefore designate a portion of gross sales as the hedged item instead. Those entities should be able to align the accounting of these transactions with their risk management strategy.

In addition to the above concerns, some members of the AOSSG have expressed concern over a 2013 effective date. Those members would prefer to see the requirements being made effective from 2015 or 2016 because that would provide sufficient time entities to adjust accounting systems in preparation for applying the hedging requirements, thereby improving international comparability.

OTHER COMMENTS

Bifurcation of embedded derivatives in financial assets

In light of the Board's decision in phase 1 of IFRS 9 to prohibit the bifurcation of derivatives embedded in financial assets, the ED proposes not to allow such derivatives to be eligible for designation as hedging instruments. However, some members have identified from consultations with various stakeholders (particularly financial institutions), that derivatives embedded in financial assets are frequently used by entities to hedge their financial risk exposures. The prohibition on designation of such derivatives as hedging instruments would thus result in misalignment between financial reporting and risk management activities. Hence, we urge the Board to reconsider the proposal with respect to the prohibition and reiterate that alignment to the Board's decisions made in phase 1 of IFRS 9 should not take undue precedence over its decision making on the remaining phases of IFRS 9.

Those members would like to reiterate their view that the option to bifurcate embedded derivatives from financial assets should be included in IFRS 9 (retained from IAS 39) to better reflect the economic reality of hybrid financial instruments.

Basis adjustment

Some members disagree with the proposal in paragraph 29(d)(i) of the ED that the effect of a basis adjustment does not affect OCI. They propose that the effect of a basis adjustment should be recognised in OCI. Whilst those members acknowledge the arguments provided in paragraphs BC139 and BC140 they believe that, if a cumulative hedging gain or loss is removed from the cash flow hedge reserve and directly applied to the recognised non-financial item without going through OCI, it would be inconsistent with the definition of comprehensive income. This is because total comprehensive income would not be equal to the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. In addition, it would result in the sum of the total profit or loss and the total OCI across periods being unequal to the sum of the accumulated OCI and retained earnings.

Macro hedging

The ED on hedge accounting only addresses hedging activities for closed portfolios. However, the risk management strategy of financial institutions generally involves assessing risk exposure on a continuous and open portfolio basis (portfolio overlay where the assets can be added or removed from the portfolio). We understand that open portfolio/macro hedging will be the subject of an Exposure Draft to be released in Q2 2011. However, without the proposals on macro hedging, our assessment on hedge accounting could be limited or impaired, especially on proposals relating to groups of items. Given the importance of macro hedging, we urge the Board to expedite its development of a model for macro hedging and to finalise a standard on hedge accounting only when both general and macro hedging have been addressed.

Role of OCI

As highlighted throughout our submission, with the increasing use of OCI, evident from the requirements in Phase 1 of IFRS 9 (e.g. irrevocable election to present in OCI changes in the fair value of an equity investment that is not held for trading with no recycling allowed) and the proposals in this ED (e.g. gains or losses on hedging instrument and hedged item to be recognized in OCI), we are concerned with the following issues relating to OCI which the Board has yet to address and urge the IASB to expedite its efforts in addressing them:

- the characteristics of OCI items and the types of items that should be presented in OCI;
- the role of OCI in the context of measuring and reporting an entity's performance; and
- the notion of recycling and when OCI items can or cannot be recycled to profit or loss in subsequent periods.

Implementation guidance

We believe there are a number of proposals in the ED that require further clarification and guidance from the IASB. As a suggestion, the IASB may wish to consider retaining and reworking (where necessary) some of the implementation guidance (IG) in IAS 39 that could be useful in clarifying some of the requirements in the new standard. For example, the guidance in F.3.7 of the IG on evaluating whether a forecast hedged item meets the requirement to be highly probable should be retained as it is useful in providing clarity over this requirement. It is also not clear from the ED whether an 'all in one' hedge as described in F.2.5 of the IG would be permitted. In our view this is a valid hedging strategy and we recommend that it is made explicit that this type of hedge designation is permitted.

Global convergence

Whilst the FASB and IASB have reaffirmed their commitment to work towards a converged set of accounting standards by June 2011, we note that there are still differences in their respective proposals on hedge accounting. For example, there is a difference in:

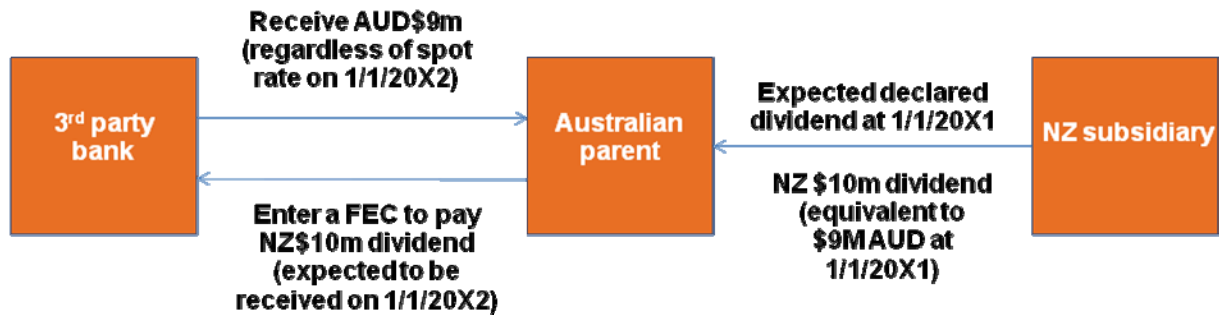
- (1) the approach to assessing hedge effectiveness (FASB – “reasonably effective” threshold; IASB – whether hedging relationship leads to “an unbiased result and minimises expected ineffectiveness” and is expected to achieve “other than accidental offsetting”);
- (2) the basis for discontinuation (FASB – rebalancing results in hedge discontinuation but not necessarily so if risk management objective changes; IASB – changes in risk management objectives results in hedge discontinuation but not if hedge relationship is rebalanced).

We urge the Board to continue to work closely with the FASB to align IFRS and US GAAP.

TRANSACTIONS THAT ARE UNDERTAKEN IN ACCORDANCE WITH THE ENTITY'S RISK MANAGEMENT STRATEGY, BUT THAT ARE NOT ELIGIBLE FOR HEDGE ACCOUNTING

(1)

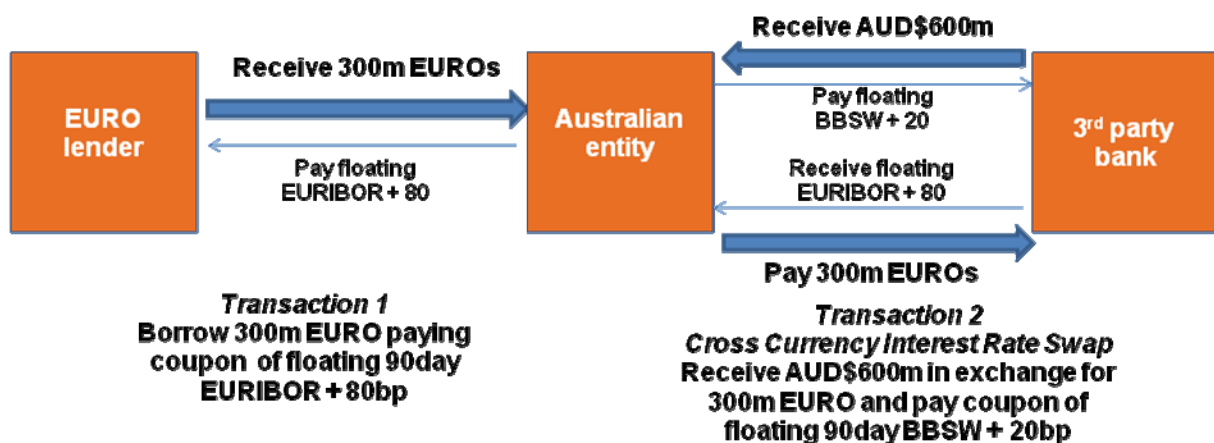
Forecast intra-group dividends



The above transaction is a common risk management strategy, especially in financial institutions, that for budgetary purposes, hedge the expected dividend from a foreign subsidiary. Under the current or proposed hedge accounting requirements, the consolidated entity cannot designate the expected declared dividend as a hedged item. We are aware that as a consequence of this, the entity will designate another 'item' in the balance sheet as the hedged item in the hedging relationship in order to achieve hedge accounting and to avoid the volatility of the forward exchange contract being recognised in profit or loss.

(2)

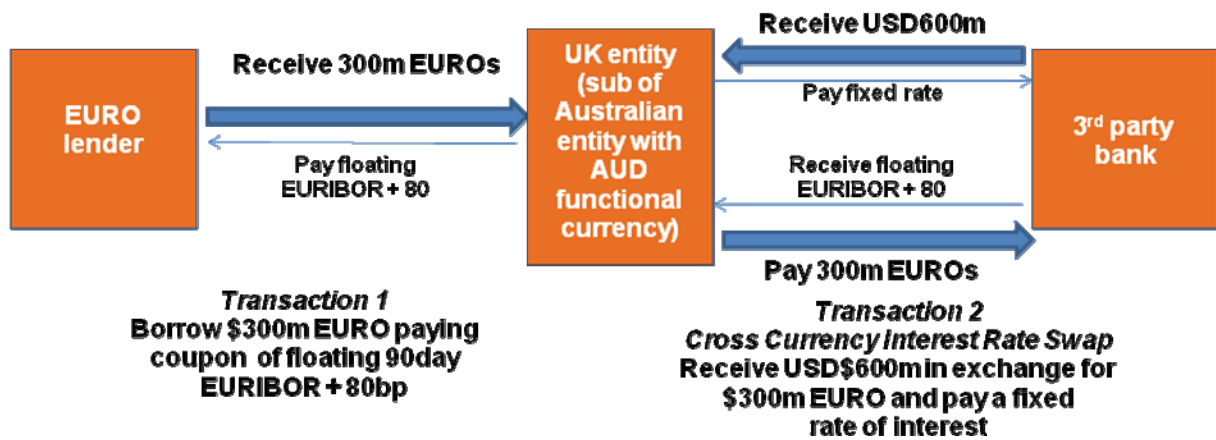
Basis Swap – interest rate



The above transaction is another example of a hedge transaction that does not achieve hedge accounting either under IAS 39 or the proposed requirements because the entity is still exposed to variability in cash flows due to the floating interest rate.

(3)

Basis Swap – FX



This is an example of a UK entity that has adopted its parent’s functional currency (AUD). The entity may convert its Euro borrowing to USD in accordance with its risk management strategy. However, the entity does not achieve hedge accounting because it is still exposed to foreign currency risk.

9 March 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

**AOSSG Islamic Finance Working Group comments on
IASB Exposure Draft ED/2010/13 *Hedge Accounting***

The Asian-Oceanian Standard-Setters Group (“AOSSG”) is pleased to provide comments from its Islamic Finance Working Group to IASB ED/2010/13 *Hedge Accounting*.

Introduction

- 1 The AOSSG’s Islamic Finance Working Group (“AOSSG IF WG”) was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events. The AOSSG IF WG comprises staff from the standard-setters of Australia, China, Dubai, Korea, Malaysia, Pakistan, and Saudi Arabia.
- 2 The working group had mainly discussed IASB ED/2010/13 in the context of Islamic hedging instruments. The comments are additional to the AOSSG Financial Instruments Working Group’s comments on IASB ED/2010/13 dated 9 March 2011, and focus only on issues that are specific to Islamic finance. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and none of those members have expressed significant disagreements.

Hedging & Islamic finance

- 3 With the prolific growth and increasing sophistication of the Islamic finance industry, there has been a corresponding demand for effective risk management and Shariah compliant means of hedging. Although ‘conventional’ entities may freely avail themselves of a host of instruments for hedging, there has been some apprehension about doing so within the Islamic finance industry.

- 4 Contemporary Shariah scholars recognise that there is a legitimate need to manage risk, but many are somewhat circumspect with regards to ‘exotic’ financial instruments and derivatives because their use could easily descend to speculative profit-seeking – a prohibited activity which entails *gharar* (excessive, unacceptable uncertainty), *maisir* (an element of gambling) and *riba* (illegitimate, usurious gain). Some Shariah scholars opine that the settling of net positions without delivery of, or payment for, an underlying asset could also be in contravention of Shariah law on trade. Thus, traditionally, Islamically-inclined entities had relied on strategies using economic or natural hedges.

Profit rate swaps

- 5 Nevertheless, developments in Islamic finance have seen the rise in some countries of the ‘profit rate swap’. Its use is very much similar to that of an interest rate swap; indeed some may say the difference is only in terminology. However, we would like to point out that its structuring is also different. A profit rate swap makes use of a two-leg ‘reciprocal *murabahah*¹’ of a reference commodity. For example, *A* has variable rate obligations, and fixed income. In the first leg, *A* would promise to sell a reference commodity to *B* at a notional principal, and *B* would promise to sell back the commodity to *A* at notional principal plus a fixed profit. In the second leg, *B* would promise to sell a reference commodity to *A* at notional principal, and *A* would promise to sell back the commodity at notional principal plus a floating rate return (i.e. separate individual contracts would subsequently be entered into, at differing prices). Hence, *A* hedges its floating rate obligations. The profit rate swap achieves very much the same objectives as an interest rate swap, in that the sales and repurchases of a reference commodity are meant to manage the cash flow risks related to *A*’s variable rate obligations; while its use of an underlying sale contract for a reference commodity is intended to keep it in line with Shariah principles.
- 6 The Working Group is not entirely clear on whether this type of transaction would be eligible for hedge accounting under the proposals because, as it is currently drafted, the hedged item is a ‘reference commodity item’ and it is not directly linked to the actual hedge transaction. However, perhaps such transactions should be eligible if they are intended to hedge risk consistent with the entity’s risk management strategies.

Future of Islamic derivatives

- 7 It should be highlighted that the profit rate swap is not universally accepted because some Shariah scholars, particularly in the Gulf jurisdictions, object to resale of the commodity to the party from whom it was originally bought. In jurisdictions where the profit rate swap is deemed acceptable, it has paved the way for exploration into other Islamic derivatives. For example, an Islamic cross-currency swap has been

¹ Murabahah (alternatively, ‘murabaha’, ‘morabaha’) is simply a sale at a mark-up. However, in Islamic finance it is often used in conjunction with other contracts and arrangements to achieve financing.

developed, also based on *murabahah*. There is also discussion on developing structures based on other trade contracts. In March 2010, the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) introduced a standardised master agreement for privately negotiated arrangements. With the forecasted proliferation of Islamic derivatives in future, regulators and Shariah scholars are drafting guidelines to ensure that these products are used exclusively for hedging.

Comments on IASB Exposure Draft ED/2010/13 Hedge Accounting

- 8 The proposals in this ED could potentially be significant to Islamic finance given the inroads made with regards to derivatives and hedging in the industry. However, as derivatives and hedging are relatively new areas in Islamic finance, the issues we have identified are limited and may not be exhaustive. The AOSSG IF WG hopes to conduct further study on the matter, and will inform the IASB of any new findings. The remainder of this letter comprise our responses to questions that are relevant to Islamic finance in ED/2010/13's invitation to comment.

Objective of hedge accounting

- 9 We agree with the proposed objective of hedge accounting. The objective of the ED to represent the effect of an entity's risk management activities in the financial statements would provide useful information that may not otherwise have been made available to users. Additionally, reflecting the effects of hedging primarily through the statement of comprehensive income assists in clarifying that these transactions are not meant to be income-generating activities of the entity, which is congruent with Shariah views on not using financial instruments and derivatives for speculative trading purposes.

Eligibility of a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss for designation as a hedging instrument

- 10 We 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. Indeed, we would like the IASB to consider allowing other assets and liabilities as hedging instruments as well, given that they may be involved in an entity's risk management strategy. Some Shariah-compliant hedging strategies may make use of non-derivative financial instruments, especially since many common derivative instruments are not allowed under Shariah principles. Thus, allowing non-derivative instruments could potentially open up hedge accounting to Islamic financial institutions. Therefore, it is appropriate that such items may be recognised as hedging instruments.

Designation as a hedged item an aggregated exposure that is a combination of another exposure and a derivative

- 11 We understand that under the proposal, an entity is permitted - but not required - to designate as a hedged item an aggregated exposure that is a combination of another

exposure and a derivative. Nevertheless, we are not clear at this point whether Shariah scholars would allow designating as a hedged item an aggregated exposure where one of its components is a derivative; the derivative may need to be considered separately. Thus, an entity under the auspices of a Shariah board may need to seek its advice before electing to use such a designation, despite being allowed to do so under the proposal.

Hedge effectiveness requirements to qualify for hedge accounting

- 12 We agree with the hedged effectiveness requirements proposed by the exposure draft. The Shariah board of an Islamic financial institution would often require evidence that a hedging transaction is what it purports to be before allowing it to take place. Thus, we expect that the criterion for hedge effectiveness to qualify for hedge accounting would not be in conflict with criteria placed by an Islamic financial institution's Shariah board. Additionally, we welcome the elimination of the '80-125%' effectiveness requirement. As mentioned, there are not many hedging tools available to Islamic entities, and an entity may well have to utilise instruments that, though intended for hedging, may fall short of the previous effectiveness requirement.

Discontinuing hedge accounting for a hedging relationship that still meets the risk management objective and strategy

- 13 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 on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria. As mentioned in earlier paragraphs, contemporary Islamic scholars only allow the use of certain derivative items for hedging purposes. Discontinuing hedge accounting for a hedging relationship that fails the hedge effectiveness assessment, but which is still intended by management to be hedging in nature, may erroneously signal to users that the entity is now engaged in a prohibited transaction.

Accounting for value hedges

- 14 We agree that for a fair value hedge, the gain or loss on the hedging instrument and hedged item should be recognised in other comprehensive income. However, transferring the ineffective portion to profit and loss may confuse users as profit and loss is associated with items which are income in nature. It may create the impression that the entity has used a derivative for speculative trading, which is prohibited by Shariah scholars. To prevent any perception issues, the ineffective portions of the hedging instrument and hedged item would need to be segregated from other profit and loss items for users to more clearly understand the economic effects of the hedging relationships, without overstepping the Shariah guidelines. Some working group members are of the opinion that this could satisfactorily be dealt with by applying paragraph 85 of IAS 1, which is believed to be broad enough to address the classification of ineffective hedges.

Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

- 15 This provision could potentially be useful for Islamic hedging arrangements as we expect most would be based on some form of trade contract, whereby the Islamic financial institution contractually takes delivery of the goods with one contract, and then offsets its exposure with a parallel contract. The contracts could be settled net in cash, using the principle of *muqasah*². In these cases, the trade-based contracts may fall under the normal use scope exception. Allowing entities to elect derivative accounting in normal use circumstances could open up hedge accounting to more Shariah-compliant arrangements.

Conclusion

The use of exotic financial instruments and derivatives in Islamic finance for hedging is in its infancy, and the AOSSG Islamic Finance Working Group will closely monitor its development. We plan to convey to the IASB any findings we may make, and would be honoured to assist the IASB in considering the related accounting issues.

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,



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Leader of the AOSSG Islamic Finance Working Group

² Muqasah means settling through a contra transaction, or off-setting.