

Peter Godsall  
Accounting Standards Board  
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London  
WC2B 4HN

16 January 2008

Dear Mr Godsall,

**ASB Exposure Draft - Exposures Qualifying for Hedge Accounting**

We are responding to the invitation to comment on the proposed Amendment to FRS 26 (IAS 39), 'Financial Instruments: Recognition and Measurement' – Exposures Qualifying for Hedge Accounting. We are pleased to enclose as appendix A our firm's global response to the IASB in respect of the equivalent exposure draft issued by the IASB.

In this letter, we focus specifically on the two additional questions raised in the invitation to comment to the ASB's proposed amendment to FRS 26.

***ASB Q1: Are you aware of any issues that would affect those UK entities that will be required to implement the proposals outlined in this exposure draft?***

In our attached response to the IASB, we have identified that the proposed paragraphs 80Y and 80Z may result in the disqualification for hedge accounting of some hedges of non-financial items that are currently commonly applied in practice. Although paragraph BC5 notes that the exposure draft does not deal with hedges of non-financial items, the lists of portions proposed in the exposure draft will reduce the ability to apply hedge accounting to such hedges. See under 'Portions of non-financial items'. This is an example of unintended consequences that are likely to emerge from the IASB's rules-based approach.

Furthermore, as set out under 'Paragraph AG99E', we have explained why the proposed paragraph will prohibit certain hedging strategies using options that companies are currently using under the existing standard. We do not agree with this prohibition for the reasons given in our response to the IASB.

Finally, as noted under 'Hedging Portions', the rules based approach proposed in the exposure draft would not permit hedge accounting for new products and hedging strategies that are likely to develop in the future as markets and risk management tools evolve. Some of these strategies might qualify for hedge accounting under the present standard or if an alternative principles-based approach were adopted.

***ASB Q2: Do you agree that the benefits of the proposals in the exposure draft would outweigh any additional costs involved? If not, why not?***

We do not agree that the benefits of the proposals will outweigh any additional costs. In the absence of an underlying principle, application difficulties leading to requests for interpretations, inconsistencies with other parts of the standard and unintended consequences are inevitable. In addition, those companies with current hedging strategies for hedging non-financial items and



hedging with options that obtain hedge accounting under the existing standard will be forced to find alternative hedging strategies in order to continue to use hedge accounting, which will involve further expense in developing those strategies.

For the reasons set out in our response to the IASB, in our view a principles-based approach, rather than the provision of detailed lists and rules, would better accomplish the Board's goals. Furthermore, we believe the distinction between financial and non-financial items is arbitrary and in some case gives rise to anomalous results that are hard to explain to users and preparers. We would ask the ASB to encourage the IASB to address these issues.

Should you have any questions concerning this letter, please contact Sandra Thompson (0207 212 5697).

Yours sincerely

PricewaterhouseCoopers LLP

**Appendix A – Response to IASB Exposure Draft - Exposures Qualifying for Hedge Accounting**

Rachel Knubley  
International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH

7 January 2008

Dear Ms Knubley

**IASB Exposure Draft - Exposures Qualifying for Hedge Accounting**

We are responding to your invitation to comment on the above exposure draft, published in September 2007, on behalf of PricewaterhouseCoopers. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on the draft interpretation. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

**Hedging Portions**

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We support the IASB's project to clarify which exposures qualify for hedge accounting as this is in area in which questions have arisen in practice. Furthermore, we support the Board's objective of clarifying its original intentions rather than significantly changing practice.

However, we do not support the approach taken in the exposure draft of providing a detailed, finite list of the exposures that can qualify for hedge accounting. In our view a principles-based approach, rather than the provision of detailed lists and rules, would better accomplish the Board's goals. This is because:

- A principles-based approach is conceptually preferable given that IFRS is a principles-based set of Standards;
- Providing principles is more consistent with the Board's stated long-term objective of simplifying hedge accounting;
- A principles-based approach is more durable. It can be applied as market participants develop new products and new hedging strategies without the need for additional guidance; and
- Principles avoid the arbitrary distinctions and structuring opportunities which are inherent in any set of rules.

We are aware that, in developing the exposure draft, the Board considered whether to pursue a principles-based approach, and concluded that a rules-based approach would be the best way to achieve its short-term objective pending a more fundamental revision of IAS 39. However, in our view, the issue of what may qualify as a hedged exposure is so fundamental to the use of hedge

accounting, and has such far-reaching practical implications, that a rules-based approach is unlikely to be effective. Given the constant evolution of financial risk management techniques, we believe that any finite list of qualifying risks will rapidly become outdated as markets and risk management tools evolve. Additionally, in the absence of an underlying principle, application difficulties leading to requests for interpretations, inconsistencies with other parts of the standard and unintended consequences are inevitable.

The comments that follow expand on how a principles-based approach could be developed. However, we recognise that the Board may choose to continue with the approach in the exposure draft. Accordingly, in the appendix to this letter we set out our comments on the detailed lists of exposures proposed in the exposure draft.

### ***A suggested principle***

The key issue in developing a principles-based approach is to identify what the principle(s) should be. The exposure draft and IAS 39 both refer to hedging 'risks' and hedging 'portions' of a hedged item, without a clear distinction being made between these two interconnected notions. In our view, an important element of developing a principle is to clarify this distinction, and then to define principles for each.

#### *Distinguishing portions from risk*

In practice entities often hedge the change in 'X' attributable to 'Y' (e.g. the change in some of the cash flows of a hedged item attributable to movements in a specified interest rate). In this context, 'X' is the portion and 'Y' is the risk being hedged.

#### *Principles underlying portions*

- A portion of the cash flows of a hedged item is a separately identifiable subset of the total cash flows of the hedged item
- A portion of the fair value of a hedged item is a separately identifiable component of the fair value of the hedged item that market participants would typically consider in determining the fair value of the instrument.

#### *Principles underlying risks*

- A risk eligible for hedge accounting must have a predictable and reliably measurable effect on the cash flows or fair value of the designated hedged item.

We recognise that a key concern for the Board is the ability to assess hedge effectiveness reliably. Where the principles proposed above are met, we believe that effectiveness will be reliably measurable.

We suggest that the application of the above principles be explained by giving examples of portions and risks that are – and are not - eligible for hedge accounting. These examples could cover issues that have arisen in practice. As such, examples of portions and risks that qualify for hedge accounting might include:

- (a) The portion represented by a contractually specified sub-set of the total cash flows of an item, such as the inflation portion of an inflation-linked bond included as an example in paragraph 80Y(e) of the exposure draft. In this context, the risk being hedged would be the change in these cash flows attributable to changes in the underlying inflation rate.
- (b) The portion represented by any embedded derivative within a hedged item that is not separated because it is closely related to the host contract. The risk being hedged would be the change in the cash flows or fair value of the embedded derivative attributable to a specified risk (such as changes in interest rates).
- (c) In the context of portions of fair value, any of the inputs to valuation techniques mentioned in IAS 39.AG82.
- (d) A "proportion" of a portion, that is a percentage of an eligible portion.

Conversely, examples of portions that do not qualify for hedge accounting might include:

- (a) An inflation component of a fixed rate bond, since expectations of inflation are not typically considered by market participants in determining the fair value of a fixed rate instrument.
- (b) A US prime rate portion of a sterling floating rate bond whose interest payments are defined as LIBOR plus a spread, since US prime rates are neither a separately identifiable subset of the total cash flows of such a bond, nor are they typically used by market participants in determining the fair value of such a sterling floating rate bond.

In implementing this principle, consequential amendments may be required to certain paragraphs of the standard and implementation guidance. However, we do not believe the standard will need to be significantly modified.

### ***Portions of non-financial items***

One major unintended consequence of the current exposure draft relates to non-financial hedging relationships. Although paragraph BC5 notes that the exposure draft does not deal with hedges of non-financial items, the lists of portions proposed in the exposure draft will reduce the ability to apply hedge accounting to such hedges. For example, the exposure draft considers portions to include both percentages (80Z(b)) and one-sided risks (80Z(c)). Accordingly, one might infer that hedges of percentages or one-sided risks of non-financial items would not qualify for hedge accounting, even though hedge accounting is commonly applied to such hedges in practice. We do not support further narrowing the application of hedge accounting to non-financial hedging relationships and we do not believe that this was the Board's intent. Accordingly we believe that the Board should explicitly clarify that these hedging strategies can continue.

Furthermore, we believe financial reporting would be improved if the right to hedge portions was extended to non-financial hedged items. The distinction between financial and non-financial items is arbitrary and in some case gives rise to anomalous results that are hard to explain to users and preparers. We recognise that when IAS 39 was initially drafted and improved the Board was concerned about permitting portions of non-financial items to be hedged because such portions were not considered to be reliably measurable. However, given today's sophisticated (and in many cases highly liquid) commodity markets and the increasingly advanced analysis tools now in daily use, this argument no longer holds true. In fact, identifying and measuring portions of non-financial items is in many cases easier than identifying and measuring portions of financial items. We believe that if hedge accounting was allowed for hedges of portions of non-financial items, it would most commonly be applied to commodity and operating lease contracts. We illustrate the arbitrariness of not permitting portions to be hedged in these cases in the two examples below:

The first example is a lease whose payments vary directly with a quoted market interest rate (eg LIBOR). Currently, if the lease is classified as an operating lease, the interest rate portion cannot be hedged, as such payments (although contractually specified) are a portion of a non-financial item<sup>1</sup>. However, if the lease is classified as a finance lease, the interest rate portion can be hedged. The second example is a contract to buy a non-financial item in which the price to be paid is determined by a formula that includes a quoted market variable. For instance, in a contract for the purchase of rolled metals, the price to be paid may be set as the market price of the refined metal ingots (a traded commodity) plus the actual rolling costs plus a margin. In this example, the traded market price of the refined metal ingots cannot be designated as a hedged portion despite the fact that it is contractually specified subset of the total cash flows that directly affects the cash price to

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<sup>1</sup> IAS 32.AG 9 clarifies that under IAS 17, an operating lease is regarded as not being a financial instrument, whereas a finance lease is a financial instrument.

be paid. This portion is conceptually identical to the inflation portion of an inflation linked bond that paragraph 80Y(e) would explicitly permit to be hedged.

### Paragraph AG99E

In our view, the issues addressed in AG99E do not relate to identifying the portions and exposures that may be hedged. Rather, they relate to how effectiveness should be measured for hedges of one sided risks. More specifically, they relate to how a one-sided risk should be modelled when using a hypothetical derivatives method to test effectiveness. We note that the Board, in its October meeting, agreed to develop guidance on what is meant by a hypothetical derivative for testing effectiveness. We believe that this issue would be most appropriately addressed as part of that work rather than in the present exposure draft.

That being said, we continue to believe that using hypothetical derivatives for assessing effectiveness of option based hedging strategies should be permitted. In our response to the IFRIC's rejection on the matter we noted:

- IAS 39 does not specify a single method for assessing hedge effectiveness. Rather the method an entity adopts for assessing hedge effectiveness depends on its risk management strategy (IAS 39.AG 101). IG F.5.5 (method B) explicitly permits the use of a hypothetical derivative method of assessing hedge effectiveness.
- IAS 39 paragraph 86(b) defines a cash flow hedge as a hedge of the exposure to variability in cash flows attributable to a particular risk, while IAS 39 paragraph 96(a) requires that the cumulative change in fair value of the expected future cash flows are considered. In this case, the hedged risk is a one-sided risk: that is the risk that the exchange rate will exceed a specified rate. The change in fair value of the hedged one-sided cash flows should include the possibility that, even if the exchange rate is below the specified level today, this may not continue to be the case. This element is captured by using a probability weighted approach reflecting the volatility of exchange rates, which is equivalent to an option pricing model. Consequently, the perfect hypothetical derivative to hedge such a risk would be a purchased option. Ineffectiveness would arise to the extent there are differences between the actual derivative used and the hypothetical derivative that best models the change in fair value of the forecast cash flows for the hedged one-sided risk.
- The hypothetical derivative approach does not imply that the hedged item is a written option. Nor does it imply that time value is an imputed cash flow - time value is not a cash flow. Rather the hypothetical derivative approach simply models the changes in expected cash flows that constitute the hedged risk and compares it to the changes in the actual derivative.

Some have argued that in option strategies the premium paid on the option should be expensed over the term that the option is outstanding rather than deferred in equity until the hedged transaction occurs. Those supporting this view see an option as analogous to buying insurance against a one-sided risk and believe that such insurance premiums should be expensed over the period for which the entity has protected itself from the risk.

In our view, this argument overlooks the fact that under IFRS, insurance accounting is fundamentally different from hedge accounting. Under insurance accounting, the premium paid by a policyholder is amortised over the period of the insurance. Under cash flow hedge accounting, the hedging instrument is measured at fair value with gains and losses on the hedge, to the extent it is effective, being deferred in equity until the hedged item affects profit or loss. Accordingly, the premium paid for the option (being the time value of the hedging instrument) is appropriately accounted for as part of the measurement of hedge effectiveness rather than by amortisation over the life of the option.

Finally, we do not believe that, as currently drafted, AG99E has the effect that the Board intended. AG99E gives the example of a fair value hedge of a financial item. However, generally the hypothetical derivatives method for testing effectiveness is used in cash flow hedges of non-financial items, for example when options are used to hedge the foreign currency risk of forecast foreign currency sales, and this was the context of the IFRIC's debates. Furthermore, it is unclear whether AG99E is intended to apply to non-financial hedging relationships given that paragraph BC 5 of the exposure draft states that the proposed amendments apply only to hedges of financial items.

### Transition

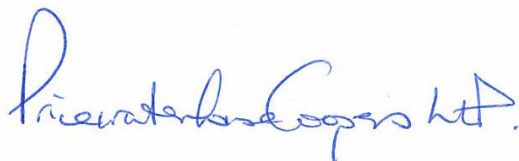
The exposure draft's transitional provisions propose retrospective application. We note that this differs from the transition requirements granted to previous changes to hedging requirements, where redesignation of hedging relationships is required from the time that the revised hedge accounting is applied and retrospective designation is not permitted.

Consistent with these earlier transition requirements we believe that amounts deferred in equity for existing cash flow hedges should remain in equity and be transferred to profit or loss when the hedged transaction affects profit or loss, but hedge accounting should be disallowed prospectively for hedges that no longer qualify when the modifications to the standard are adopted.

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If you have any questions in relation to this letter please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7802 4555), or Pauline Wallace (+44 20 7804 1293).

Yours sincerely,



PricewaterhouseCoopers

## Appendix – Detailed Comments On the Proposals in the Exposure Draft

### Question 1 – Specifying the qualifying risks

As discussed in the main body of this letter, we would prefer a principles-based approach to determining what portions qualify for hedge accounting. However, we recognise that the Board may choose to continue with the approach in the exposure draft. Accordingly, we set out below our comments on the detailed lists of exposures set out in the exposure draft.

In our view, these comments and issues arise from adopting a rules-based approach. In the absence of an underlying principle, application difficulties, inconsistencies with other parts of the standard and unintended consequences are inevitable. Set out below are the main issues we have identified to date. However, we expect that additional issues will arise if the proposals in the exposure draft are finalised and applied in practice.

#### *Distinction between risks and cash flows*

We question the need for the distinction between the list of risks in paragraph 80Y and cash flows in paragraph 80Z. For example, paragraph 80Y(e) seems to be an example of a cash flow, but is included in the list of risks. We believe a clearer and more helpful distinction would be between portions eligible in cash flow hedging relationships and those portions eligible in fair value hedging relationships.

#### *Other comments*

Our other main comments on the detailed proposals in 80Y and 80Z are as follows:

- 80Z(e) and (f) appear to be proportions of a financial instrument and hence covered in 80Z(b). Accordingly, we are unclear why they need to be separately identified.
- IFRS 7 defines several financial risks. We believe the risks eligible for hedge accounting should be consistent with the risks defined in IFRS 7. In particular, we are unclear why other price risk specific to the hedged item such as equity price risk, has not been included as a risk eligible for hedge accounting.
- It is unclear whether a portion of risks within a proportion can be hedged. (e.g. hedging fair value exposure to LIBOR on 80% of the face amount of a bond)
- Few definitions are provided for the terms in 80Y and 80Z. For example, “market interest rates” in paragraph 80Y(a) are not defined. It is unclear if this is the same as a “quoted fixed or variable inter-bank rate” in 80Z(f) or a “risk free rate” in 80Y(e). We expect that, without further clarification, this will lead to a number of questions arising in practice over the interpretation of these terms with the effect that the Board’s stated objectives (in BC13) of clearly defining eligible portions and thus of simplifying the application of IAS 39 may not be achieved.

### Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item

Please see our comments in the main body of the letter under the heading “Portions of Non-Financial Items”.

### Question 3 – Effect of the proposed amendments on existing practice

Please see our comments in the main body of the letter concerning the effect of the proposals on existing hedges of non-financial items under the heading “Portions of non-financial items” as well as our discussion under the heading “Paragraph AG 99E”.

### Question 4 – Transition

Please see our comments in the main body of the letter under the heading “Transition”.