THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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Our ref: ICAEW Rep 03/08

Mr Stig Enevoldsen
Chairman
EFRAG
Avenue des Arts 13-14
1210 Brussels
Belgium

By email: commentletter@efrag.org

Dear Stig

PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – HEDGE ACCOUNTING

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on EFRAG's draft comments on the IASB exposure draft *Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - Hedge Accounting*, published by EFRAG in November 2007.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

We support much of the draft EFRAG letter. However,

- We do not agree with EFRAG that the proposed guidance in AG99E is appropriate. We are aware that there are significantly differing views on the issue amongst the major accounting firms and companies that use hedging strategies that utilise options, and do not believe that this matter has been the subject of sufficient debate by the IASB Board. As explained in our submission at Appendix 2, we recommend that this paragraph is removed from the current proposals;

- Our preference is that the IASB should develop a principles-based approach to the concerns addressed in the exposure draft. Robust principles will provide the flexibility to cope with changing strategies and products developed in the markets. By contrast, lists of rules can be exploited by artificial structures, will rapidly become outdated and so require constant revision, and are likely to have unintended consequences. We do believe that EFRAG's proposal that the amendment of paragraph 80 be recast as application guidance provides a satisfactory solution to these concerns;

- We suggest that concerns regarding the hedging of non-financial instruments should be should be emphasised more strongly in EFRAG's covering letter. In our view, the hedging of portions of financial and non-financial items should both be subject to the same principle and treated in a similar way. Different treatments can lead to anomalous results that are counter-intuitive and difficult to explain to users and preparers.

I attach as Appendix 1 our responses to the specific questions raised by EFRAG, and as Appendix 2 our submission to the IASB on the proposals.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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APPENDIX 1
RESPONSE TO EFRAG QUESTIONS

Do you support retrospective application of the amendments proposed in the exposure draft despite of the consequences as described above? Or (b) Do you believe that prospective application would be more appropriate in so far that entities would be able to keep their designations until the effective date of these amendments, but would have to redesignate all previously designated hedge relationship in accordance with the new requirements going forward from the effective date of the amendments? If you do believe this is more appropriate, please explain your reasoning.

We support propspective application, as explained in our submission to the IASB.

Do you agree with EFRAG that the proposed guidance in AG99E is appropriate? If not, do you believe that hedge accounting provisions in IAS 39 should make it possible to designate option contracts in their entirety and designate time value of a hypothetical written option as part of the hedged item. Thus, when measuring hedge effectiveness and determining to which extent the hedge is effective, time value of a hypothetical written option would be included in estimation of changes in present value of cash flows of the hedged item attributable to the hedged one-sided risk? If so, how would you justify appropriateness of this method under IAS 39?

We do not agree that the proposed guidance in AG99E is appropriate, as explained above and in our submission to the IASB.

APPENDIX 2

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 05/08

PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT EXPOSURES QUALIFYING FOR HEDGE ACCOUNTING

Memorandum of comment submitted in January 2008 by The Institute of Chartered Accountants in England and Wales in response to the IASB exposure draft 'Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement Exposures Qualifying For Hedge Accounting', published in September 2007

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the International Accounting Standards Board (IASB) Exposure Draft of 'Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* Exposures Qualifying For Hedge Accounting', published in September 2007.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures that these skills are constantly developed, recognised and valued.

MAJOR POINTS

Overall response

4. We agree that many questions about when an entity may designate an exposure to a financial instrument as a hedged item have arisen in practice, and we are pleased that the Board's motivation was to limit this exposure draft to providing clarification of the existing "rules" pending the results of the longer-term project on accounting for financial instruments. We would prefer that the Board develop a principles-based approach rather than further rules. This said, it may be that with some improvements to the proposed clarifications, the Board's objective could be achieved, but very careful analysis will be required to avoid unintentional consequences, some of which we have identified in the body of this response. On the other hand, the proposals regarding hedging with options will have significant effects on some practices and hedging strategies that are commonly used under the present version of IAS 39. We consider that such an important issue on which there are divergent views should be dealt with more directly rather than slipped into the standard as an obscure piece of application guidance. Furthermore, we have highlighted certain anomalies between hedging of financial and non-financial items that we consider should be resolved in the near future, if not now.

Principles vs. rules

5. In the circumstances, we are disappointed that the Board abandoned its attempt to develop appropriate principles. Robust principles will provide the flexibility to cope with changing strategies and products developed in the markets. By contrast, lists of rules can be exploited by artificial structures, will rapidly become outdated and so require constant revision, and are likely to have unintended consequences. In our view, the principle in paragraph 81 of IAS 39 (i.e., that the risk should be identifiable, separable and measurable) is generally sufficient when combined with professional judgement to determine which risks qualify for hedge accounting. It should therefore be possible to deal with hedging of portions of financial instruments on the same basis. Where a portion of the cash flows (or fair value) of a hedged item is a separately identifiable and reliably measurable component of the total cash flows (or fair value) of the hedged item, then it should qualify for hedge accounting. If the Board considers that further elaboration of the basic principle is necessary, it should be able to do so without resorting to rules.

6. Further elaboration might clarify the distinction between hedging 'risks' and hedging 'portions' of a hedged item. While interrelated, risks and portions are not the same things. Consequently, the basic principle could be expanded to make clear that while a portion eligible for hedging must be a contractually specified component of a cash flow or fair value, an eligible risk for hedging must have a predictable and reliably measurable effect on the cash flows or fair value of the designated hedged item.

The rules-based approach

7. As indicated above, our preference is that the Board should develop a principles-based approach. However, if it is determined to apply a rules-based solution, we have identified a number of places where further clarification is required to make the proposals in the exposure draft operative. We also consider that there is a need to address non-financial items, if not now then in the near future, as set out in paragraphs 17 to 19 below. Set out immediately below are the areas that have given us some difficulty.

8. The distinction drawn between risks and cash flows for the purposes of paragraphs 80Y and 80Z is questionable. It is not clear why certain items are on one list and not the other. For example, paragraph 80Y(e) is included as a risk, but deals with cash flows. We suggest that a more useful distinction would be that between cash flow hedges and fair value hedges.

9. However, there are confusions in the exposure draft between cash flow hedging and fair value hedging. For example, paragraphs 80Z(e) and 80Z(f) refer to cash flow portions of a financial instrument in circumstances that point to a fair value hedge of interest rate risk.

10. We have the following comments on the detail of the lists in paragraphs 80Y and 80Z.

    (a) The list of hedgeable risks is not fully inclusive of those set out in IFRS 7. We would expect that all risks consistent with those defined in IFRS 7 would be eligible for hedge accounting including 'other price risk'.

Such a risk may include equity risk or commodity risk, which are separable and measurable risks. In many cases, financial instruments whose cash flows are linked to equity or commodity prices will have embedded derivatives that are not closely related and thus not eligible for designation in a hedge relationship. However, the list should not automatically preclude their eligibility in appropriate circumstances. If the Board has particular reasons why equity, commodity or other price risk are not eligible, the Basis for Conclusions should provide an explanation.

(b) Paragraphs 80Y(a) and (b) repeat the definitions of the risks from IFRS 7 but paragraphs 80Y(c) and (d) provide no definition, even though credit risk is defined in IFRS 7. To be consistent these risks should be defined, although in the case of 'prepayment risk' this will require a new definition. Furthermore, other terms and expressions should be defined to avoid questions arising over their interpretation, such as, "market interest rates" (paragraph 80Y(a)). Is this the same as "quoted fixed or variable inter-bank rate" (paragraph 80Z(f)) and a "risk free rate" (paragraph 80Y(e))?

(c) Paragraph 80Y(e) provides the proposition that for a risk to be eligible for designation as a hedged risk it has to be associated with a contractually specified cash flow, which itself must be independent of any remaining cash flows in the instrument. We agree that this proposition supports the rational for inflation not being a separable, independent component in a fixed rate instrument. However, if this to be a general proposition, it brings into question other risks that are apparently eligible for hedge accounting, such as credit risk. Is credit risk associated with a contractually specified cash flow that is independent of other cash flows in a debt instrument? As suggested in paragraph 6 above, distinguishing between portions and risks and applying appropriate principles should achieve a greater clarity.

(d) We are unsure whether a portion of risks within a proportion can be hedged. For example, hedging fair value exposure to US prime rate on 70% of the par amount of a US dollar denominated bond. This might be what is intended by the last sentence of paragraph AG99BB but clarification would be useful.

Hypothetical derivatives (paragraph AG99E)

11. The proposal in paragraph AG99E is particularly controversial as there are differing views held in the market on hedging strategies that use options. It is disappointing that the issue has been included in the exposure draft almost as if by stealth. We consider that it would be better if the revised standard deals with hedging with options more directly. While the issues involved had some exposure through the IFRIC, we are not aware of any significant debate by the Board before this paragraph was belatedly slipped into the exposure draft. There are many facets to the debate on hedging with options and the use of hypothetical derivatives for assessing the effectiveness of option based hedging strategies. These should be considered carefully before concluding,

as it seems paragraph AG99E does, that it is something that should be prohibited. Paragraph BC14 does not demonstrate that the Board reassessed the tentative conclusion reached by the IFRIC as it does not provide a detailed explanation of the Board's rationale that has led to the proposed prohibition of the hypothetical derivative method for option based hedging strategies. As the Board has agreed recently at its October 2007 meeting to take on to its agenda a new project on hypothetical derivatives, this would appear to be an ideal opportunity for the issues arising from option hedging strategies that underlie AG99E to be thoroughly examined and that this paragraph is removed from the current proposals.

12. To illustrate the need for a full debate, consider the example of hedging a risk that a foreign exchange rate will exceed a specified rate. There are two strongly held views about how this risk may be hedged using options. One view is that this one-sided risk can be modelled using an option pricing model to capture the volatility of exchange rates. It in effect implies a hypothetical option. The appropriate hedging instrument would be a purchased foreign exchange option. Ineffectiveness arises to the extent that 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. Proponents of this view consider that this hypothetical derivative approach does not imply that time value is an imputed cash flow (as time value is not a cash flow); it is merely a method for modelling the changes in expected cash flows that constitute the hedged risk and compares it to the actual derivative.

13. Proponents of the alternative view hold that the strategy described above does imply that the changes in time value are treated as cash flows but as changes in time value cannot be a cash flow their imputation as such invalidates their treatment as hedgeable risks. Consequently, inclusion of time value in the hedge relationship should create ineffectiveness. Put simply, this is because time value is the likelihood of something happening, and is only evident in the hedging instrument not the hedged item.

14. Paragraph AG99E takes this alternate view and would mean that the time value of a purchased option used as the hedging instrument would give rise to ineffectiveness (assuming that it would be possible to prove that there is valid hedging relationship to start with). Questionably, this seems to imply a contradiction of paragraph 74 of IAS 39, which specifically allows for both the intrinsic and time value of an option contract to qualify for hedge accounting, and method B in IG.F.5.5 of the Implementation Guidance to IAS 39 that explicitly permits the use of a hypothetical derivative method of assessing hedge effectiveness.

15. Paragraph BC13 does not explain why, when starting from similar positions under IAS 39 and FAS 133, the IASB should create a difference with the guidance under US GAAP (Statement 133 Implementation Issue No. G20 'Cash Flow Hedges: Assessing and measuring the Effectiveness of a purchased Option Used in a Cash Flow Hedge'). The Board should provide details of its rationale for creating the proposed difference in this case.

16. Should the Board decide to retain paragraph AG99E, we do not believe the paragraph achieves the Board's objective. This is, principally, because the example given is a fair value hedge of a financial item; the hypothetical derivative method is used in testing the effectiveness of cash flow hedges. Moreover, paragraph BC5 implies that paragraph AG99E is intended to apply only to financial hedges, although, in practice, the issue is more common in hedges of non-financial items (such as the use of options to hedge the foreign currency risk of forecast foreign currency sales).

Non-financial items

17. Despite the statement in BC5 that the exposure draft does not deal with hedges of non-financial items, as drafted paragraph 80Z could be read as restricting some hedging strategies for non-financial items that are allowed under the current version of the standard. For example, as the exposure draft considers portions to include both percentages (paragraph 80Z(b)) and one-sided risks (paragraph 80Z(c)), the implication is that hedges of percentages and one sided risks of non-financial items will not qualify for hedge accounting. However, as currently permitted, hedging percentages of forecast cash flows, or hedging one-sided risks on forecast sales or purchases are common strategies. We assume the Board did not intend to narrow the application of hedge accounting for non-financial items in this way. Perhaps paragraph 80Z can be clarified or these particular hedging strategies should be confirmed as acceptable and dealt with separately outside of paragraph 80Z.

18. While the Board has indicated that at this stage it does not intend to go further than the existing standard on the issue of hedging of non-financial items, it is a matter that does warrant further consideration in the near future, if not now. In our view, the hedging of portions of financial and non-financial items should both be subject to the same principle and treated in a similar way. Different treatments can lead to anomalous results that are counter-intuitive and difficult to explain to users and preparers. In the 10 years or more period since views were formed on the questionable reliability of portions of non-financial items, commodity markets have become sophisticated and liquid, and analytics more advanced. Consequently, the old perception must be challenged; portions of non-financial items can be measured reliably. This would mean that a portion that is separately identifiable and reliably measurable would meet the criteria we suggest in paragraph 6 above, regardless of whether it is a portion of a financial or non-financial item.

19. To illustrate the arbitrariness of not permitting the hedging of portions of non-financial items, particularly in the context of commodities and leasing, consider the following situations:

    (a) A contract to buy rolled aluminium where the price to be paid is set as the market price of the refined aluminium ingots (a traded commodity) plus the actual costs of rolling plus a margin. The traded market price of the refined aluminium ingots is a contractually specified subset of the total cash flows to be paid. However, this portion is not allowed to be designated in a hedge relationship despite it being no different in concept to the inflation portion of an inflation linked bond that paragraph 80Y(e) would explicitly permit to be hedged.

(b) A lease whose payments are linked to LIBOR. 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 (paragraph AG9 of IAS 32 – operating leases are regarded as non-financial). On the other hand, if the lease is classified as a finance lease, the interest rate portion can be hedged.

SPECIFIC QUESTIONS

Question 1 – Specifying the qualifying risks

The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y.

Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks? If not, why? Are there any other risks that should be included in the list and why?

20. As set out in paragraphs 5 and 6 above, we consider that a principles-based approach would be preferable. As referred to in paragraph 8 above, we believe that the exposure draft is confused in its distinction between risks and cash flows. However should the Board choose to continue with this approach, a more appropriate distinction would be between fair value and cash flow hedges. As set out in paragraph 10, we have a number of comments on the lists in paragraphs 80Y and 80Z.

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

The proposed amendments specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item.

Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why?

Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item? If so, which situations and why?

21. As set out in paragraphs 5 and 6 above, we prefer a principles-based approach and thus are not attracted by listing the portions of the cash flows of a financial instrument as a hedged item. Reference should also be made to paragraphs 17 to 19 above regarding non-financial items.

Question 3 – Effect of the proposed amendments on existing practice

The aim of the proposed amendments is to clarify the Board's original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in practice from arising.

Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

22. As described in paragraph 17 above, we consider that the exposure draft could restrict the current application of hedge accounting to non-financial hedging relationships. In addition, in paragraphs 11 to 16 above we discuss the implications of paragraph AG99E on certain common hedging strategies involving options. We also consider that the wording of AG99E might call into question the ability to partial term hedge (which is clearly allowed by IG.F.2.17 in the Implementation Guidance to IAS 39).

Question 4 – Transition

The proposed changes would be required to be applied retrospectively. Is the requirement to apply the proposed changes retrospectively appropriate? If not, what do you propose and why?

23. We do not agree that the proposed changes should be applied retrospectively. Redesignation of hedging relationships should be required only from the time that the revised hedge accounting is applied, so that hedge accounting would only be disallowed prospectively for hedges that no longer qualify when the amendments to the standard are implemented. If the difference between the current and the comparative year is material, disclosure should be made in compliance with IFRS 7. As there has been wide-spread divergence in respect of hedging with options, we submit that it would be very hard on entities whose hedging strategy would now be barred by paragraph AG99E to have to restate prior years merely for employing a hedging strategy that seemingly qualified for hedge accounting under a previous version of the standard.

DETAILED POINTS

24. We note that the proposed amendments to paragraph AG99C are inessential cross references. As paragraph AG99C is part of the European carve-out, we suggest that it might be preferable and less confusing to leave this paragraph unamended.

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