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March 15, 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David,

Re: Comments on IASB's Exposure Draft on Hedge Accounting

The International Auditing and Assurance Standards Board (IAASB) is pleased to provide comments on the IASB's Exposure Draft (ED) on *Hedge Accounting*.

In formulating the comment letter, we have established a working group to monitor the development of the IASB project on Fair Value and Financial Instruments. The focus of the Working Group is to identify significant aspects of IASB proposals which could pose difficulty in an auditing context and, therefore, where the IAASB members' expertise can add value to the IASB's deliberations – for example, aspects of proposals where preparers' compliance may not be able to be achieved on the basis of objective evidence or where the basis for their judgments may be difficult to substantiate.

Through our discussion, we have identified several proposed requirements that may be problematic from a verifiability/auditability perspective. The attached Appendix includes, comments on what, in the Working Group's view, are likely to be the most substantive issues from an auditing perspective resulting from changes in the proposed standards from current practice. Where possible, the Working Group has offered suggestions for the IASB's consideration as to how language in the standard could be amended to address the issues noted.

The IAASB looks forward to continuing to work with the IASB as early as possible in its standard-setting processes. I hope you find the comments in the Appendix valuable and encourage you to engage us in further dialogue if necessary as you finalize these proposed standards.

Yours sincerely,

Prof. Arnold Schilder
Chairman, IAASB

Appendix

IASB EXPOSURE DRAFT—

HEDGE ACCOUNTING

Comments of the IAASB Working Group

QUESTION 1 – Objective of Hedge Accounting

OVERALL COMMENTS

Issue Description

The ED proposes that an entity may choose to apply hedge accounting when certain conditions are met. Paragraph 1 of the ED states that "the objective of the application of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss."

Given the significant effect that application of hedge accounting has on financial statements, the Working Group believes it important to clearly indicate: (i) when the application of hedge accounting is appropriate, and that (ii) when hedge accounting is applied, it is clear what support (or basis) an entity is required to have to be able to demonstrate that all conditions for application have been met. Such considerations are especially important when setting out the requirements around hedge effectiveness. Comments below identify certain areas where, in the Working Group's view, either the conditions, or the expectations of entities to support their application of hedge accounting, were not sufficiently clear.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends the IASB take into account the abovementioned matters in finalizing the standard.

APPLICATION OF HEDGING ACCOUNTING

Issue Description

Paragraph 1 of the ED proposes the abovementioned objective. While the Working Group does not have particular comments on the proposed wording, we are not sure how an objective is meant to be applied in the context of an International Financial Reporting Standard (IFRS).

Under International Standards on Auditing (ISAs), the objective of an ISA is considered to be of paramount importance. Although the requirements in an ISA are intended to be sufficient to meet the objective of the ISA, the auditor is expected to perform additional procedures if necessary to achieve the objective. Further, if an objective in a relevant standard cannot be achieved, the auditor is required to evaluate whether this prevents the auditor from achieving the overall objectives of the auditor, and whether the auditor needs to modify the auditor's opinion or withdraw from the engagement.

The Invitation to Comment explains that the Board thought an objective would be helpful in setting the scene for hedge accounting and to lay the foundation for a more principles-based approach. Thus, the authority of the objective in the proposed IFRS appears to be simply to provide context for the requirements rather than setting an obligation for performance. If the objective were to be viewed, for example, in the same way as an ISA objective, it would in fact or perception be providing a strong indication that for financial statements to be fairly presented, hedge accounting would need to be followed whenever hedging is undertaken. On the other hand, we interpret the proposed standard as being permissive – allowing the use of hedge accounting as long as certain conditions exist.

There could be confusion unless the purpose and authority of the objective is quite clear, particularly as the explanation in the Invitation to Comment would not be part of the final standard.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends the IASB to consider clarifying the intended authority of the objective as necessary, and how it affects the application of proposed standard.

QUESTION 4 – Designation of Risk Components as Hedged Items

HEDGING RISK COMPONENT OF NON-FINANCIAL ITEM

Issue Description

Paragraph 18 of the ED would allow the use of risk components as hedged items, provided that the risk component is separately identifiable and reliably measureable. Paragraph B13 permits a separately identifiable component of the non-financial item to be a hedged item. In addition, paragraph B15 states that, when designating risk components as hedged items, an entity considers whether they are explicitly stated in a contract or whether they are implicit in the fair value or cash flow of an item of which they are part.

We understand that there are instances where risk components of non-financial items are separately identifiable and reliably measurable even when it is not specified in a contract (paragraph B15 (b) provides a good example). As another example, the price of coffee is often determined on a building-block basis, where the prices of various types and grades of coffee are calculated by adding to the price of standard-grade coffee, with additional factors taken into account.

However, the Working Group wonders whether it is sufficiently clear when a risk component can be identified and, if not, whether the proposals could be interpreted more broadly than intended. We understand that a risk component of a financial item is often traded and therefore separately identifiable and reliably measurable, but question how easy it will be to identify separable components for non-financial items unless it is specified in a contract. Further guidance would be useful regarding what an entity would need to do to be able to demonstrate that the criteria of separately identifiable and reliably measurable are met.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that the IASB articulate in the standard when a risk component of a non-financial item is considered to be separately identifiable and reliably measureable, and what is necessary to be able to demonstrate that. It would also be useful if the standard could provide additional examples illustrating when it is practicable to do so (such as identifying the risk components of coffee pricing), and other examples of where the criteria of “separately identifiable or reliably measurable” have not been met.

QUESTION 6 – Hedge Effectiveness Requirements to Qualify for Hedge Accounting

APPROPRIATENESS OF CRITERIA

Issue Description

Paragraph 19 of the ED proposes that a hedging relationship qualifies for hedge accounting only if clauses (a) through (c) in the paragraph are met. The criterion in paragraph (c) is that the hedging relationship meets the hedge effectiveness requirements (see paragraphs B27–B39). A hedging relationship meets the hedge effectiveness requirements if it (i) meets the objective of the hedge effectiveness assessment (i.e., to ensure that the hedging relationship will produce an *unbiased* result and *minimise* expected hedge ineffectiveness per paragraph B29) and (ii) is expected to achieve other than accidental offsetting.

The Working Group questions whether the standard is sufficiently clear regarding the meanings of *unbiased* and *minimise* noted above. The Working Group understands hedging transactions modify the risk profile but cannot obviate the risk entirely and whether the result is biased or not is different from how risk is regarded. In addition, though paragraph B29 states that "this does not mean that a hedging relationship has to be expected to be perfectly effective," the Working Group is not clear what level of relationship or effort is expected.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that the IASB consider providing further guidance in paragraph 19 and/or paragraphs B29–31 regarding how an entity can demonstrate that a hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness.

QUESTION 7 – Rebalancing of a Hedging Relationship

AMBIGUITY AROUND REBALANCING

Issue Description

Paragraph 23 of the ED proposes that "if a hedging relationship ceases to meet the objective of the hedge effectiveness assessment but the risk management objective for that designated hedging relationship remains the same, an entity shall rebalance the hedging relationship so that it meets the qualifying criteria again."

The Working Group believes that a significant degree of judgment 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 (that is, when rebalancing is necessary). We therefore wonder if rebalancing is well-understood and whether it will be consistently applied in practice.

In addition, the Working Group questions whether rebalancing is possible when it is not stated in the risk management strategy. If it is not stated, auditors would not be able to verify that it is consistent with the entity's risk management strategy.

Further, the Working Group feels that paragraph 23, as well as the words "Mandatory rebalancing of the hedging relationship" in the flowchart of paragraph B46, can be read as requiring an entity to undertake transactions that would result in rebalancing. We presume that is not the intent of the IASB.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends the IASB consider changing the wording of paragraphs 23 and B46 to convey the intended message more clearly.

QUESTION 13 – Disclosures

INFORMATION INCORPORATED BY CROSS-REFERENCE

Issue Description

Paragraph 41 of the ED proposes that an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated *by cross-reference* from the financial statements to some other statements (e.g., management commentary or risk report).

The Working Group acknowledges that existing paragraphs in the IFRSs refer to this type of disclosure (for example, paragraph B6 of IFRS 9[1]). However, in our view, it is important in allowing cross-referencing that the IFRSs require that any cross-referenced information (i) be clearly identified and presented in the cross-referenced document as being part of the financial statements and (ii) have all of the characteristics of information suitable for inclusion in financial statements. The proposed standard focuses on the cross-referencing necessary in the financial statements, but not the implications for the presentation of the information presented elsewhere.

Finally, we would like to draw your attention that the IAASB published the Discussion Paper, *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications,* in January 2011, which identifies cross-referencing to other information as one of the areas that may necessitate consideration from an auditing perspective.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that the IASB clarify in this standard, and in other circumstances if it continues to permit entities to include required disclosures outside of the financial statements, the expectations regarding the presentation of that information so that users are able to differentiate information that is considered an integral part of the financial statements (and, therefore, subject to audit).

RISK MANAGEMENT STRATEGY

Issue Description

Paragraph 44 of the ED states that "an entity shall explain its risk management strategy for each category of risk exposure...This explanation should enable users of financial statements to evaluate (for example) (a) how each risk arises etc ..."

The Working Group understands entities need to exercise significant judgment in developing appropriate disclosure of risk exposures. However, in our view, paragraph 44 would be clearer if the words "for example" were replaced by "at a minimum." In our view, this more definitive approach is warranted in this paragraph to provide financial statement preparers and auditors a clear benchmark regarding what types of matters, at a minimum, should be covered by disclosures, while still leaving room for significant judgment in how this might best be done in an entity's particular circumstances.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that paragraph 44 be modified for reasons noted above.

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[1] IFRS 9, *Financial Instruments*

HEDGING RELATIONSHIP

Issue Description

Paragraph 46 of the ED proposes that the financial statements disclose, for each subsequent period, how the hedging relationship is expected to affect profit or loss including how hedging changes the exposure.

The Working Group is of the view that this will, in effect, require disclosure of the entity's total forecast exposures whether or not hedge accounting is applied. A forecast exposure is subjective and difficult to verify. Furthermore, this information is likely not needed to obtain an understanding of the nature of an entity's hedging strategy.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends the IASB reconsider whether paragraph 46 is appropriate.

QUESTION 15 – Accounting Alternatives to Hedge Accounting – Accounting for Credit Risk using Credit Derivatives

CREDIT DERIVATIVES

Issue Description

As stated in paragraph BC220, the ED does not permit credit derivatives as hedging instruments when applying hedge accounting, since 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 (including reliability in measurement) for hedged items.

We appreciate that paragraphs 13 and 18 (a) of the ED stress the importance of the concept of "reliability" in assessing whether a particular item is permitted to be a hedged item. Though we acknowledge that some sophisticated financial institutions use credit derivatives to manage their credit risk exposures arising from their lending activities, we are not convinced that an entity can isolate and measure the credit risk component of a financial item consistently in a global context.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends the IASB continue to place importance on the concept of "reliability" in deciding whether credit derivatives ought to be one of hedging instruments.