EUROPEAN ASSOCIATION
OF CORPORATE TREASURERS

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The European Association of Corporate Treasurers

Comment letter in response to IASB ED/2010/13: Hedge Accounting

European Association of Corporate Treasurers (EACT)

The EACT is a grouping of 20 national associations representing treasury and finance professionals in 19 European countries. We bring together in excess of 8,500 members representing approximately 5,000 companies located in Europe. We comment to the European authorities, national governments, regulators and standard-setters on issues faced by treasury and finance professionals across Europe. We seek to encourage the profession of treasury, corporate finance and risk management, promoting the value of treasury skills through best practice and education.

Our contact details are provided on the final page of this document.

EACT response

1. General comment

We welcome the IASB's project to improve and simplify IAS 39 and undertake a fundamental review of the standard. IAS 39 has widely been regarded as unduly complex and often leading to unrepresentative accounting outcomes. We believe that hedging is an economic activity and that hedge accounting should be designed to reflect the economic reality of risk management. IAS 39 hedging is rules based whereas IFRS is, in general, principles based.

Many of the rules related to hedge accounting were drafted to prevent abuse. We believe that these strict anti-abuse provisions encourage constituents to structure transactions to avoid running afoul of these rules. As a result, the treasury community has experienced a worrying trend in recent years, of risk management activities often being structured sub-optimally to fit within the strict guidelines of IAS 39. In addition, compliance requires significant time and effort that is disproportionate to the benefit obtained. Although we recognize that there have to be controls over the application of hedge accounting, we believe that this control would best be accomplished through use of professional judgment rather than rules based standards.

Notwithstanding the comments above EACT agrees with the objectives of the Board. It is felt by our members that IASB had taken the right approach in not starting 'with a blank page' but focusing on patching up the current framework. In general the changes proposed by the Board are welcomed, as they bring accounting closer to the risk management strategy of non-financial companies and simplify hedge accounting rules.

EACT hopes that the IASB will consider that the concerns expressed in this comment letter are essential, to allow the hedge accounting part of the new IFRS 9 standard to be better tailored to meet the requirements of practical financial risk management approaches and strategies of non-financial companies.

We discuss below particular areas where EACT wants to make comment and which should be changed in the interest of reducing complexity.

2. Qualifying for hedge accounting

a. Voluntary de-designation prohibited

EACT does not agree with the proposed prohibition on de-designation, for the following reasons:

- This is not in line with current risk management market practice, for example when a company enters into a cash flow hedge for forecasted sales in foreign currency. As the aim of risk management strategy is to protect its cash flows, the hedging horizon would be until settlement of the invoice. However, hedge accounting would only be applied up to the moment the sales invoice becomes an on-balance sheet item, after which the company obtains a natural offset in the income statement through the revaluation of both hedged item and hedging instrument. Please refer to Appendix 1 where an example is illustrated.

- EACT feels that this rule could be circumvented by applying the strategy of taking an opposite derivative position, and applying hedge accounting on the whole structure. Hence we do not see the benefit of this prohibition.

- EACT members have difficulty in applying this concept to situations of net investment hedges. Voluntary de-designation should be permissible for net investment hedges if a partial/total reduction of hedge occurs. If a corporate has an investment in a company and, for whatever reason, the amount of the investment is partially or totally reduced, then the hedge should be de-designated and unwound in order to avoid profit and loss effects. Furthermore, if the risk management objectives change and the company decides to reduce the amount of net investment hedges in place, these hedges should be de-designated and then unwound.

- There is a general consensus among our members that de-designation flexibility is needed and required to more closely align hedge accounting to the risk management strategy. It is also important to state that de-designation is allowed when changes in the risk management policies take place, therefore reinforcing the idea that voluntary de-designation is closely tied to risk management, which is dynamic and therefore should be permitted.

b. Mandatory rebalancing

EACT is pleased that the arbitrary 80-125% rule is to be removed; however it is felt that it is unnecessary to introduce mandatory rebalancing, for the following reasons:

- This represents a lack of confidence in risk management, whereas the risk management strategy and results need to be disclosed in the financial statements and defended towards auditors and investors

- Rebalancing is the core responsibility of risk management, which is a serious profession with appropriate standards and controls in place

- This will not be equal for every company, as each has to deal with different circumstances

- If a company were to rebalance, this would mean in practice a need to recognize ineffectiveness into profit and loss, which would yield the same result

- If a company were to set the optimal ratio incorrectly, the resulting ineffectiveness would in any event need to be recorded in the income statement

EACT believes that rather than reduce complexity this would in fact increase it. For example, how to define the optimal ratio? Different risk managers will reach different conclusions, as this is not a matter of fact but rather based on interpretation and differing models or views of the market. Another example would be how to deal with a gradual change in hedging ratio. Such changes in the hedging ratio can imply de-designation when the hedge has to be adjusted to a lower ratio, whereas when the hedge has to be increased this can be done entering into a new hedge.

c. Calculation of ineffectiveness using discounted spot

In general EACT agrees with the need to include time value in the ineffectiveness calculations; however this should not be made mandatory. We consider that this would give rise to unnecessary ineffectiveness in some circumstances e.g. when using short term rolling forward contracts, whereby the intent is to hedge the undiscounted spot component but not the interest component. In currencies with very high interest rates (for example emerging markets currencies), the ineffectiveness amount tends to be larger. An example in Appendix 2 illustrates this point. Therefore, we would propose to allow the use of undiscounted spot in some circumstances.

3. Hedge items – components of non-financial items

a. Separately identifiable and reliably measurable

EACT supports the proposed changes, but at the same time believes that the Board should elaborate further the concept of separately identifiable and reliably measurable, setting a range of examples in order to avoid arbitrariness. In terms of the eligibility of the implicit risk, it is proposed that each company should be able to decide whether an implicit risk is an eligible hedge item, based on the link/correlation and overall risk management strategy; however it should also be required to provide sufficient disclosures on this in the notes to the financial statements, and therefore enable users to understand the nature of the strategy.

Hence in cases where it is difficult to measure the implicit component, we would make the assumption that the hedge relationship would be 100% effective, and that to be consistent with the risk management strategy, the hedging result should be taken when the hedged item affects the income statement. This simple and pragmatic approach is proposed because it is difficult to imagine a way to determine any ineffectiveness on the hedged implicit risk.

b. Designation of a layer component of the nominal amount

We support the IABS's proposed changes.

c. Designated component must be less than or equal to the total cash flows

EACT disagrees with this restriction. We believe that if the components are present, they should be entitled to the same hedging possibilities. In instances where a commodity is quoted or priced at a discount to the futures price, the exchange-traded amount should still qualify as a component that can be hedged.

4. Hedge items – groups and net positions

a. Income statement presentation

EACT does not agree with the proposed changes, as it believes this leads to misleading/meaningless numbers in the income statement as it represents only part of the profit and loss impact of those items being hedge accounted. We would propose to gross up the net resultant profit and loss impact in a manner similar to creating synthetic derivatives. This would be the only way to truly reflect the risk management rationale behind hedging sales and purchases on a net basis.

This approach furthermore ensures conceptual alignment with the hedging of a gross group of dissimilar items (which also includes opposite movements), where here it would be acceptable to gross up the result. For example, if we use a FTSE100 index option to hedge a portfolio of FTSE100 shares, which perfectly replicate the index, the portfolio shares will offset the option perfectly, although the individual shares in this portfolio might move in different directions. What should be recycled when one of the shares is sold? In our opinion, if you do not gross up the net result on the index option (i.e. allocation of hedging gains and losses to individual share according to how much they moved by) then you do not know how much to release when a single share is sold.

IASB has not addressed the mechanics of how this would work for groups of dissimilar items. However IASB is proposing rules to constrain this (same period and non-grossing up of gains and losses) in relation to pure net exposures. We do not see why net positions would be treated more restrictively than portfolios of dissimilar items, which include some element of offsetting.

b. Same period

We disagree with the proposed changes, as from a risk management perspective treasurers generally hedge the cash flow in a defined period and not the profit and loss. Given the overall objective to align hedge accounting with the risk management strategy the ability to net hedge account even where items impact the profit and loss in different reporting periods should not be prohibited. Any restriction in periods would create a restriction on hedge accounting that in no way reflects the risk management strategy. Please see Appendix 3 for a worked example of designating net positions in a hedging relationship where items impact the profit and loss account in different reporting periods.

To conclude, EACT welcomes the proposed changes, however it believes they do not go far enough as most cases of net position hedging are related to the hedging of sales and purchases in foreign currency, which typically does not occur in the same month.

5. Hedging with options

It is agreed that these are positive changes, as they bring IFRS closer to US GAAP. EACT agrees with the fact that the premium has to be reflected in the underlying whether it is sales, purchases or interest. For period-related hedges, it was felt that the correct period for amortization should be the entire life of the underlying taking into account amortizing schedules. In terms of transition period, EACT would encourage more clarity (e.g. to amortize the OCI over the lifespan of the underlying).

6. Presentation and disclosures

a. Fair value hedge model

We do not see the benefits of grossing up OCI, for the following reasons:

- In spite of helpfulness of more comprehensive disclosures, it is not useful for investors to have this information on the face of the balance sheet
- This approach adds unnecessary complexity

b. Cash flow hedge model – mandatory basis adjustment

EACT does not agree that this should be made mandatory. Mainly for operational reasons it would be preferable to allow the current flexibility of choosing whether to make the basis adjustment or not (e.g. inventory systems are not designed to deal with this adjustment).

c. Cash flow hedge model – recycling out of equity

This is not considered a useful change, as it adds unnecessary complexity. Also, cash flow results should be considered as a higher or lower cost of the hedged item. According to our members, the perception is that equity is meant for transactions with owners and should hence not be mixed.

d. Disclosures

There is a general concern regarding the disclosure of commercially sensitive information. This issue is particularly prevalent in corporations reporting under IFRS and where key competitors are private companies and hence not required to provide detailed numerical of hedges in place impacting future periods and average hedged rates. Disclosing quantitative hedged amounts and rates is an area of commercial sensibility. We do not think such disclosures are compatible with the fiduciary duty of Directors to protect shareholder's interests. Many EACT members believe such disclosures, including those on risk exposures, whether hedged or not, should be part of a broader project on risk management in more general terms, rather than financial risks only. EACT representatives would like to offer to work together with investors and the IASB to come to a suitable solution to help disclose the appropriate level of detail on the risks, risk exposures and risk management.

Appendices:

Appendix 1

Cash Flow Hedge Example to illustrate the need for voluntary de-designation

- Each Business Line sets up a purchase budget with a predetermined FX rate dictated by Risk Management. This implies an assumed risk between today (T0) and the different Accounting Record dates (T2) that impacts the CAPEX figure. The Financial Department assumes the risk from the moment the purchase is accounted for. Between T2 and T3, Foreign Exchange changes are financial income/expense. (See Figure 1)

- **Financial Instruments and Accounting Consideration**
    - **Forward**
        - Using forwards implies locking a fixed foreign exchange rate.
    - **Accounting Issues**
        - Forward: no restriction to obtain hedge accounting under IFRS. Although under current proposal voluntary de-designation could cause problems.

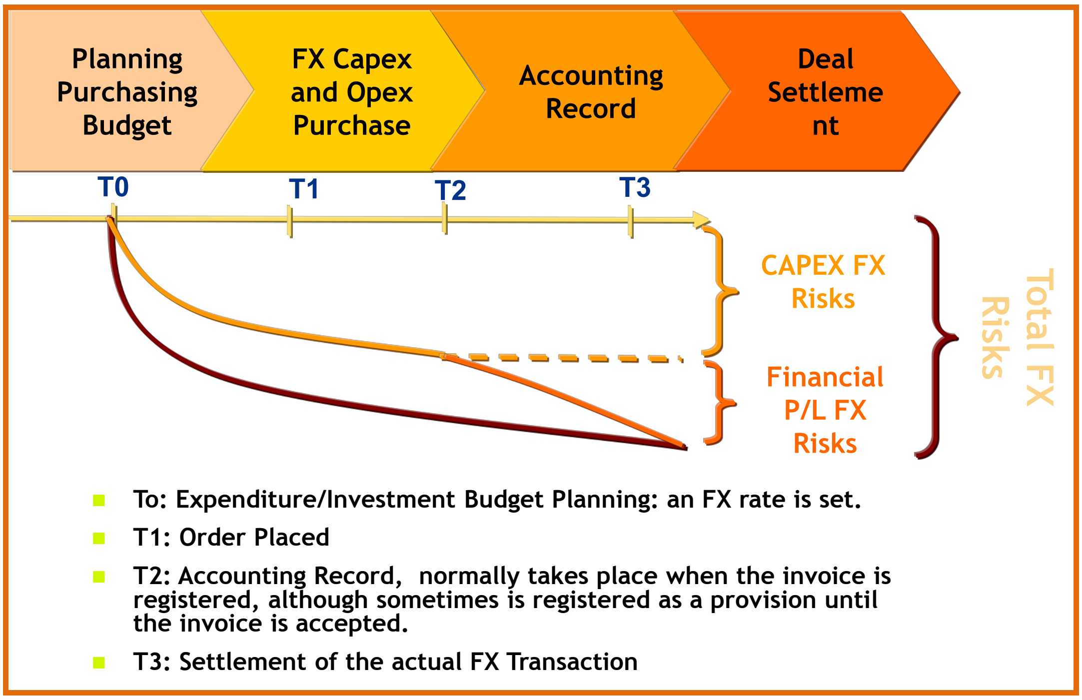

Figure 1.

- **How is De-Designation Applied**

- Suppose that in T1 a pre-hedge of an invoice was done. For the accounting record, we will designate it like a cash flow hedge of a "highly probable cash flow" using the Forward Method. Between T1 and T2 the FWD Market Value change is registered in Reserves. The invoice is not registered yet so no effect at all.

- In T2 (Accounting Record of Invoice), the up to date value registered in Reserves goes CAPEX Spending (AR/AP) and from that date on the forward is de-designated from CFH to MTM creating foreign exchange differences. The invoice also starts creating foreign exchange differences. Between T2 and T3, we have an account payable/receivable in the opposite sense that compensates the FX changes due to the Forward.

Appendix 2

Hedging foreign currencies with high interest rates:

BRAZIL			
Actual Scenario			
3m Roll			
Amount MM BRL	100	100	AMOUNT OF HEDGE
Roll 1			
Amount MM BRL	100	100	AMOUNT OF HEDGE
Inneficieny Amount	0		
Hedge Rebalancing		0	
Hedged Item	100	100	AMOUNT OF HEDGE
Spot to Spot hedged Forwrd Points to MTM			
BRAZIL			
Discounted Spot			
3m Roll			
Amount MM BRL	100	100	AMOUNT OF HEDGE
Roll 1			
Amount MM BRL	98	100	AMOUNT OF HEDGE
Inneficieny Amount	2		
Hedge Rebalancing		-2	
Hedged Item	98	98	AMOUNT OF HEDGE
Spot to Spot Unhedged Hedge Rebalancing needed Forwrd Points to MTM			
USD			
Discounted Spot			
3m Roll			
Amount MM BRL	100	100	AMOUNT OF HEDGE
Roll 1			
Amount MM BRL	100	100	AMOUNT OF HEDGE
Inneficieny Amount	0		
Hedge Rebalancing		0	
Hedged Item	99,94	99,94	AMOUNT OF HEDGE
Spot to Spot Unhedged Hedge Rebalancing needed Forwrd Points to MTM			

Appendix 3

A worked example of designating net positions in a hedging relationship where items impact the profit and loss account in different reporting periods

NET HEDGING DESIGNATION EXAMPLE

From an economic perspective the Treasurer is hedging net USD cash inflows of 50 for the month of March (stated in GBP equivalent for simplicity)

For hedge accounting purposes he/she has designated the net 50 inflow as the hedged item i.e. Hedging the net of sales cash inflows and purchase outflows for the month of March

Hence hedge accounting is aligned to the risk management policy

The example below shows that even though the net items impact the profit and loss account in different periods, it is possible to hedge account for these items by grossing up the movements through OCI for the individual components i.e. Sales and purchases.

Assumptions:

1	60 day credit terms on sales
2	30 day credit terms on purchases
3	stock turnover = 0mths i.e. Stock is sold in the month of purchase
4	100% effective hedge i.e. Cash flows occur when forecast to
5	FX policy is to hedge 100% forecast cash flow on a 3 month rolling basis
6	hedge = Fwd FX contract (sell USD, buy GBP) bought in Dec, maturing in Mar

Forecast cash flows:	(all in GBP equivalent)				
	Dec	**Jan**	**Feb**	**Mar**	**Apr**
USD sales		100	90	85	100
USD purchases		40	40	35	30
Net forecast cash flow		60	50	50	70
Hedges in place as at December		60	50	50	0

For March forecast cash flows				
Sales impact profit and loss account in January (60 days credit terms)				
			DR	**CR**
31-Jan	DR	Accounts Receivable	85	
	CR	Sales		85
Purchases impact profit and loss account in February (30 days credit terms)				
			DR	**CR**
28-Feb	DR	Purchases	35	
	CR	Accounts Payable		35

Accounting for derivative fair value of derivative is:	**Change in FV of derivative**	**Grossed up for Sales**	**Grossed up for Purchases**
31-Jan	2	3.4	-1.4
28-Feb	1	1.7	-0.7
31-Mar	2	3.4	-1.4
Accumulated fair value	5		

			DR	**CR**
31-Jan	DR	Derivative (balance sheet)	2	
	CR	OCI		2
	Recording change in FV of derivative in Jan			

			DR	**CR**
31-Jan	DR	OCI	3.4	
	CR	Sales - FX gain		3.4
	De-designation of cash flow hedge for sales component as sales have occurred			
	NB. Purchases have not yet impacted P&L in Jan so no de-designation entry			

			DR	**CR**
28-Feb	DR	Derivative (balance sheet)	1	
	DR	OCI	0.7	
	CR	FX gain (P&L)		1.7
	Recording change in FV of derivative in Feb. FX gain on sales component directly to P&L as hedge de-designated in Jan			

			DR	**CR**
28-Feb	DR	Purchases - FX loss	2.1	
	CR	OCI		2.1
	De-designation of cash flow hedge for purchases component as purchases have occurred This removes the entire OCI balance relating to purchases i.e. 1.4 in Jan and 0.7 in Feb			

			DR	CR
31-Mar	DR	Derivative (balance sheet)	2	
	CR	FX gain (P&L)		2
	Recording change in FV of derivative in Mar			
	No longer hedge accounting for sales and purchases so all goes to P&L			
			DR	**CR**
31-Mar	DR	Cash - GBP	55	
	CR	Cash - USD		50
	CR	Derivative (balance sheet)		5
	Maturity of derivative			

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Registered Office:	20 rue d' ATHENES 75442 PARIS Cedex 09
EACT Chairman: EACT board member – accounting standards:	Richard Raeburn richard.j.raeburn@gmail.com +44 7802 966 665 Francois Masquelier francois.masquelier@rtlgroup.com + 35 2 42 142 2121
Website:	www.eact.eu