The Hundred Group
of Finance Directors

Financial Reporting Committee

Hans Hoogervorst Esq
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

03 January 2012

Dear Hans

Exposure draft: IFRS 9, Chapter 6 - Hedge Accounting

We welcome the opportunity to comment on the Board's proposals for hedge accounting as part of the ongoing Financial Instruments project (IFRS 9) and are pleased to submit our views.

The Hundred Group is a non-political, not-for-profit organisation which represents the finance directors of the UK's largest companies, with membership drawn mainly, but not entirely, from the constituents of the UK FTSE100 Index. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the views of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual Members or their respective employers.

We recognise that the recent exposure draft to Chapter 6 of IFRS 9 is to be seen more as a 'fatal flaw' process, rather than the traditional exposure draft comments, and have limited our comments to those which we think fall under this category.

We have detailed comments on three key areas within the proposed hedge accounting rules, principally covering cash flow hedges and the impact of the proposals on currency basis, credit spreads and non-vanilla swaps. We believe that the guidance included in paragraph B6.5.5 creates conflict with paragraph B6.4.1 and that the principle in B6.4.1 that "hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item…" and "Hedge ineffectiveness is the extent to which the changes in the fair value or cash flows of the hedging instrument are greater or less than those on the hedged item" should override that of B6.5.5. We have included more detail on each of the three scenarios in the appendix.

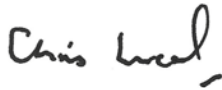
We welcome the decision to include a rebuttable presumption on inflation, however we believe that it shouldn't be limited to financial items. We have included a more detailed explanation of our view on this and the contractually-specified concept in the appendix.

We disagree with the requirements in 7.2.20 that any gain or loss on rebalancing from the change from IAS 39 to IFRS 9 should be recognised in profit or loss. As the impact of any imbalance may have built up over several years under IAS 39, we do not believe that it would be meaningful to include any rebalancing amount in profit or loss, and would suggest showing it as a movement to opening reserves on adoption.

We are concerned that, given the history of the financial instruments project, there is not enough certainty around when IFRS 9 will be finalised, and hence when it will be endorsed by the EU. Given the significant changes proposed in the (draft) standard, we do not believe that the current effective date of years commencing on or after 1 January 2015 gives prepares sufficient time to collate the information necessary for compliance with IFRS 9. We would greatly prefer that the standard has a longer transition period once it is fully finalised and would suggest delaying implementation to 2016 or 2017 so that prepares can take a controlled approach to adoption. We believe the current effective date could lead to prepares having to maintain two sets of accounting records – one in case EU endorsement does not happen in time and one in case it does. This is clearly not a cost effective approach.

We have included detailed comments on the proposals in the appendix. Please feel free to contact me if you wish to discuss them.

Yours sincerely



Chris Lucas
Chairman
Hundred Group – Financial Reporting Committee

Appendix

Detailed comments on the treatment of Cash Flow Hedges

There are three topics on Cash Flow Hedges (hereinafter CFH) that we would like to comment: currency basis, credit spreads and non-vanilla swaps.

1) Currency basis

Additional guidance about the use of the 'hypothetical derivative' has been included in paragraph B6.5.5. This paragraph states that:

"Consequently, a 'hypothetical derivative' cannot be used to include features in the value of the hedge item that only exist in the hedging instrument (but not in the hedge item). An example is debt denominated in a foreign currency (irrespective of whether it is fixed rate or variable rate debt). When using a hypothetical derivative to calculate the change in the value of such debt or the present value of the cumulative change in its cash flows, the hypothetical derivative cannot simply impute a charge of exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a charge (eg cross-currency interest rate swap)."

We believe that this additional guidance creates a conflict with the principle included in paragraph B6.4.1. This paragraph states that "Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item…" and "Hedge ineffectiveness is the extent to which the changes in the fair value or cash flows of the hedging instrument are greater or less than those on the hedged item."

Applying the additional guidance included in paragraph B6.5.5 would mean that in cash flow hedges of foreign currency where a cross-currency interest rate swap is used, some ineffectiveness would be recognised, as when measuring hedge ineffectiveness, a charge of exchanging different currencies will be considered when calculating the change in the value of the hedging instrument but would not be considering when calculating the change in the value of the hypothetical derivative/hedged item.

In our view, the principle included in paragraph in B6.4.1 is that to the extent that changes in the cash flows of the hedging instrument perfectly offset changes on the hedge item, no ineffectiveness should be recognised. We believe that the principle in paragraph B6.4.1 should be the overriding one, and that the guidance within B6.5.5 should be amended to reflect this.

2) Credit spreads

In our view the additional guidance included in B6.4.13 creates another conflict with the principle of B6.4.1 in the case of considering credit spreads on the hedging instrument and the hypothetical derivative/hedged item.

An interpretation of paragraph B6.4.13 could mean that when measuring the value in the hedging instrument, a credit spread has to be considered and the same credit spread shouldn't be considering when using the 'hypothetical derivative' as it could be interpreted as including features in the value of the hedged item that only exist in the hedging instrument.

We agree with the practical expedient included in the Exposure Draft 'Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities' published by the FASB on May 26, 2010. Paragraph 124 states that "When measuring the ineffectiveness to be recognised in net income by using a derivative that would mature on the date of the forecasted transaction and provide cash flows that

would exactly offset the hedged cash flows, an entity may use the same credit risk adjustment as that used in calculating the fair value of the actual hedging derivative instrument."

In our view the additional guidance included in B.6.4.13 should be eliminated as it creates a conflict with the more relevant principle that in the case of cash flow hedges no ineffectiveness should be registered if the changes in the cash flows of the hedging instrument perfectly offset the changes in the cash flows of the hedged item. Additionally, it would help the convergence with US GAAP.

3) Non-vanilla swaps

The additional guidance included in paragraph B6.5.5, in our view, creates an additional conflict with the principle of measuring effectiveness in CFH mentioned previously, in the case of using non-vanilla swaps in hedge relationships.

Paragraph B6.5.5 states that "…, an entity may use a derivative that would have terms that match the critical terms of the hedged item (this is commonly referred to as a 'hypothetical derivative'), and, for example for a hedge of a forecast transaction, would be at the money at the time of designation of the hedging relationship". A perfect match of the critical terms with a derivative at the money at inception can be achieved with a plain vanilla swap and also with a non-vanilla swap. However, the additional comment included in the paragraph "The hypothetical derivative replicates the hedge item…" could be interpreted as meaning that a non-vanilla swap cannot be considered as a hypothetical derivative. We do not agree with this interpretation.

In order to clarify that non-vanilla swaps could be used as 'hypothetical derivatives' and avoid the abuse of looking for an specific interest expense accounting, we would recommend that the final standard includes wording that is similar to that set out below:

"To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item (this is commonly referred to as a 'hypothetical derivative'), and, for example for a hedge of a forecast transaction, would be at market at the time of designation of the hedging relationship. The hypothetical derivative could replicate non-vanilla features of the hedging instrument, bearing in mind that the critical terms matches and it is at the money at the time of designation. However, the financial expense to be registered should not be influenced by any non-vanilla feature; instead the financial expense shall be recognised applying the effective interest method over the non-vanilla instrument in order to calculate the effective interest rate to be considered in the financial expense accounting."

Detailed comments on inflation

1) Rebuttable presumption

We welcome the decision of the Board to remove the prohibition to apply hedge accounting for inflation risks. That prohibition was a legacy item from IAS 39, which didn't permit application of the principle to some situations where there might be circumstances that could support identifying a risk component for inflation risk. However, in our view the principle should be applied for both financial items and non financial items.

In the basis of conclusions the Board explains why risk components (both contractually specified and those not contractually specified) should be eligible for designation as hedged items. That decision aligns the eligibility of risk components of non-financial items with that of financial items in IAS 39.
In our view, we believe that the rebuttable presumption for financial items should be extended to also include non-financial items as the accounting is currently inconsistent.

2) Contractually-specified

We believe that it would be helpful if the final standard includes a definition of the term contractually specified in the Appendix A.

In our view, this definition should be the same that the one included in the Exposure Draft of Revenue from contracts with customers. We believe that the contractual definition shouldn't be limited to a written contract. For example, there are industries where price regulation is applicable. In a legal context, regulation is an alternative to using contracts for creating legal consequences and both create enforceable rights and obligations under law. In those circumstances the effect of regulation can be economically equivalent to contractually agreed pricing formulas.

We would recommend the final standard would include the following definition of contractually specified in the Appendix A:

"Contractually specified: Explicitly mentioned in the contract between the parties of the arrangement. For the purposes of this standard, the definition of contract is as follows:

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. Additionally, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining when an agreement with a customer creates enforceable rights and obligations of the entity."