



Accounting Standards Board

Aldwych House, 71-91 Aldwych, London WC2B 4HN

Telephone: 020 7492 2300 Fax: 020 7492 2399

www.frc.org.uk/asb



Françoise Flores
European Financial Reporting Advisory Group
35 Square de Meeûs
B-1000 Brussels
Belgium

E-mail: Commentletter@efrag.org

1 March 2011

Dear Françoise

EFRAG Draft Comment Letter on the IASB Exposure Draft 'Hedge Accounting'

Thank you for providing the UK Accounting Standards Board (ASB) with the opportunity to comment on your draft comment letter (DCL) to the International Accounting Standards Board's (IASB's) Exposure Draft (ED) 'Hedge Accounting'.

The ASB broadly agrees with the EFRAG DCL in that the IASB's proposals align hedge accounting with an entity's risk management strategy. We also agree that the proposals could go a step further in certain areas but do not share all of EFRAG's concerns, as noted in the covering letter to the DCL, on some of the detailed aspects of the IASB's proposal. In particular, we do not believe that embedded derivatives should be eligible as hedging instruments. In common with EFRAG, we also have a general concern over the number of disclosures the IASB is adding across each of the phases of its financial instruments project as this increases clutter in the financial statements.

Our response to the IASB on this ED is attached for your information. The main area where our views differ to EFRAG is that the IASB should retain the option for voluntary discontinuation of hedge accounting where this is in line with an entity's risk management strategy.

Our responses to the questions in the DCL are included in the Appendix to this letter.

We also note that EFRAG issued a supplement to the DCL on the sub-LIBOR issue on 23 February. Given your deadline for comments of 2 March, we have not responded to the specific questions in that supplementary document but, in line with our response to the IASB, we believe that the IASB should reconsider the sub-LIBOR issue.

Should you have any queries regarding this response please contact Deepa Raval, Project Director, on +44 207 492 2424 or by email d.raval@frc-asb.org.uk.

Yours sincerely



Roger Marshall

Chairman

DDI: 020 7492 2434

Email: r.marshall@frc-asb.org.uk



Appendix: responses to questions set out in the DCL

Paragraph 17

Do you believe there is in effect an inconsistency between (i) the irrevocable designation of a financial instrument as at fair value through profit or loss and (ii) hedge accounting that may be discontinued if that is in line with an entity's risk management strategy?

No. We do not believe that there is an inconsistency in this area. An entity can choose not to apply the fair value option on transition to IFRS 9 if an entity wishes to designate a non-derivative financial instrument as a hedging instrument.

We view the choice for discontinuation of hedge accounting as a separate issue from irrevocable nature of the fair value option although we acknowledge that in practice entities may prefer to use the fair value option as an alternative to hedge accounting. We firmly believe that the use of the fair value option is a broader issue and should be irrevocable to prevent entities switching fair value accounting on and off. Discontinuing hedge accounting should only be permitted where this is in line with an entity's hedge accounting strategy and an entity should be required to disclose this to avoid abuse.

Paragraph 33

Do you have any concerns regarding inflation as a non-contractually specified risk component of financial instruments? If so, please provide examples.

Yes. Please see our response to question 4 of the IASB ED.

Paragraph 34

Do you have concerns with the issue of sub-LIBOR within the context of the general hedging model, i.e. hedges of individual items or closed groups of items excluding macro hedging? If so, please provide examples to substantiate your concerns?

Yes. We believe that not being able to achieve hedge accounting for sub-LIBOR components is an issue for banks and not in line with their risk management strategy. We consider that this is an area which the IASB need to explore further. See our response to question 4 of the IASB ED.

Paragraph 42

EFRAG understands from its initial consultation activities that, while the proposals are considered appropriate for single items, it may not be the case for prepayment options in the context of portfolios. We understand that, at a portfolio level, it may be possible to separately identify the risk component and facilitate the measurement of hedge effectiveness. Do constituents agree with this assessment? If so, please provide examples of the instances where an alternative treatment is appropriate.

Yes. See our response to question 5(b) of the IASB ED.

Paragraph 132

Do constituents believe that the proposed disclosures meet the objective of providing transparency into an entity's hedging activities?

No. The proposed disclosures are one of our main areas of concern. We believe that there is a gap in the disclosures where an entity uses financial instruments for hedging purposes but chooses not to apply hedge accounting. See our response to question 13 of the IASB ED.

Paragraphs 141 and 142

Do you believe the proposals will be useful in addressing problems in practice?

From its initial consultation activities, EFRAG has understood that this issue may be broader than what the IASB considered in finalising the proposals in the ED. Are there any other issue with the 'own use' exception that you are aware of? If so, what solution do you believe would be appropriate to resolve the issue(s).

See our response to question 14 of the IASB ED. At this stage, we are not aware of any other issues relating to the 'own use' scope exception.

Paragraph 161

When economic hedges of credit risk do not qualify for hedge accounting for the sole reason that the credit risk component cannot be reliably measured, the IASB has considered, but rejected, accommodating hedge accounting using an alternative method. Which of the three proposed alternative methods considered by the IASB do you believe would be appropriate and why?

See our response to question 15 of the IASB ED.



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Martin Friedhoff
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

1 March 2011

Dear Martin

IASB ED *Hedge Accounting*

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the IASB Exposure Draft (ED) *Hedge Accounting*.

The ASB supports the general direction of the hedge accounting model in so far as it aims to better align hedge accounting with the risk management activities of an entity.

Our main area of concern is that the ED proposes too many restrictions on the application of hedge accounting to bring the proposals closer to an entity's risk management strategy in practice. We believe that the IASB should focus on a principles based standard for hedge accounting rather than including detailed rules. We note that in some areas the proposals are more flexible than IAS 39 but we believe that there is scope to go further.

Our detailed responses to the questions in the ED are included in the Appendix to this letter. Our main concerns which relate to the practical aspects of the proposals are summarised below:

- a) *Objective* – We do not believe the objective as set out in the ED represents the purpose of hedge accounting. We believe that hedge accounting is not about risk management per se; it is a financial reporting method that is designed to enable entities to report the effects of their hedging strategy in their financial statements more clearly than would otherwise be the case.
- b) *Rebalancing* – We agree with the concept of rebalancing in so far as it avoids discontinuance of hedge accounting when the risk management activities change but the objective of hedge accounting remains the same. That said, the requirements for rebalancing in the ED are not well understood and should be explained more clearly. We would recommend field testing this area.
- c) *Discontinuation* – We believe that voluntary discontinuation should be permitted when this is in line with an entity's hedge accounting strategy. This would enable the effects of an entity's hedging strategy to be reflected in the financial statements (see our response to question 8 for an example). To prevent abuse, clear disclosure of an entity's hedge accounting strategy should be required.

- d) *Credit risk* – We support the principle that risk components should be eligible as hedged items. Using credit derivatives to manage credit risk is a common risk management strategy for financial institutions. We do not believe that there should be an explicit prohibition on hedge accounting for credit risk. If an entity is able to demonstrate that a hedge is effective then hedge accounting should be permitted regardless of the type of hedge.
- e) *Disclosures* – Overall, we are concerned that the IASB is adding additional layers of disclosure in its proposals on hedge accounting, impairment and offsetting. This increases the disclosure burden for preparers and increases clutter in financial statements without necessarily improving the usefulness of information to users. We therefore recommend that, before IFRS 9 is finalised, the IASB should review the disclosures across each project phase as well as the existing disclosures in IFRS 7 and eliminate those disclosures which do not provide useful information.

Turning to the proposed hedge accounting disclosures, there is a need for the disclosures to be more holistic. The disclosures focus only on those hedges where hedge accounting is applied. There is no disclosure of exposures which are hedged but no hedge accounting is applied or unhedged exposures. We are also concerned that the disclosure requirements are too detailed. This could result in entities having to disclose information that is commercially sensitive.

- f) Finally, the IASB should not finalise the general hedge accounting model until the issues relating to portfolio hedge accounting have been resolved. Portfolio hedge accounting is a fundamental aspect of the project and is a key issue for banks. There are areas, such as groups, where decisions on the general hedge accounting model are likely to have an impact on the portfolio hedge accounting model and vice versa. We encourage the IASB to address the portfolio hedge accounting expeditiously as this is likely to have an impact on EU endorsement of IFRS 9.

If you would like to discuss these comments, please contact Deepa Raval on 020 7492 2424.

Yours sincerely



Roger Marshall

Chairman

DDI: 020 7492 2434

Email: r.marshall@frc-asb.org.uk

Appendix: responses to questions set out in the ED

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

No. We do not believe the objective as set out in the ED represents the purpose of hedge accounting. We believe that hedge accounting is not about risk management per se; it is a financial reporting method that is designed to enable entities to report the effects of their hedging strategy in their financial statements more clearly than would otherwise be the case.

Hedge accounting is an exception to the normal recognition and measurement principles that is necessary to facilitate better communication between an entity and the users of its financial reports with regards to its risk management activities. As such, it should only be used when the application of the normal recognition and measurement principles would potentially confuse users. So, for example, hedge accounting may be an appropriate mechanism to demonstrate the offset between an exposure on an unrecognised amount and a hedging instrument.

If the normal recognition and measurement principles result in information that provides a clear explanation of the entity's risk management activities then hedge accounting is unnecessary. Thus, when a hedged item is recognised hedge accounting may no longer be necessary to demonstrate the offset.

It follows from this analysis that there may be circumstances when hedge accounting ceases to be necessary although the hedging relationship (and risk management strategy) remains in place.

We also note that, the objective of hedge accounting in paragraph 1 of the ED restricts the use of hedge accounting to those risk exposures that affect profit or loss. Although only a small subset of financial instruments (investments in equity instruments) may be designated at fair value through other comprehensive income (OCI), in our view, investments in equity instruments at fair value through OCI should be eligible for hedge accounting if this is in line with an entity's risk management strategy. We believe that any ineffectiveness on these instruments should be recognised in the profit and loss account. That said, there is a need for a principle for the presentation of items in OCI and we would suggest that the IASB proposes adding this topic to its active agenda after June 2011.

Finally, due to the complexities associated with hedge accounting we agree that hedge accounting should not be mandatory.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

Yes. If a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss is used for hedging purposes, it seems reasonable that it is an eligible hedging instrument.

Internal derivatives

We agree that internal derivatives should not be eligible as hedging instruments. We note that a central treasury function typically uses internal derivatives to pool exposures of a group which may be a net position. We believe that hedge accounting should be permitted in the consolidated financial statements when there is a net external exposure and the central treasury function hedges that exposure with an external derivative. As the IASB's proposals allow a net position to be a hedged item, hedge accounting in these circumstances should be possible. We believe that there is a need for more clarity in the ED in this area.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

Yes. Economically, entities may hedge different risks contained in an aggregated exposure that is a combination of another exposure and a derivative differently. This approach, which enables an aggregated exposure and a derivative to be designated as a hedged item, is more closely aligned with an entity's risk management strategy.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (i.e. a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

Yes. We agree that risk components should be eligible hedged items if the risk component is separately identifiable as, this reflects how risks are hedged in practice.

We also welcome the relaxation of the IAS 39 requirements relating to designation of risk components in non-financial items. In particular, this will enable corporate entities to achieve hedge accounting where, for example, a risk component of a commodity contract is hedged.

Inflation

We support the more principles based approach to determining the risk components based on an evaluation of the facts and circumstances. That said, we do not agree with the bright line that inflation cannot be designated as a risk component of a financial instrument unless it is contractually specified. Whilst it may be difficult to separately identify and reliably measure inflation as a risk component, an entity should be left to determine whether they can do this rather than including a separate rule in the standard. Furthermore, no such restriction exists for non-financial items which results in an inconsistency with the treatment for financial items.

Sub-LIBOR

Both IAS 39 and the ED restrict hedge accounting for interest-rate risk exposures at sub-LIBOR. This is an issue for banks as hedging the sub-LIBOR component of an interest bearing financial asset or financial liability is a risk management strategy applied by banks in practice. Therefore, we would recommend that the IASB explore the sub-LIBOR issue further.

Question 5

- (a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk? Why or why not? If not, what changes do you recommend and why?

- (a) Yes. A layer approach works well under conditions of uncertainty. Being able to designate a layer of the nominal amount will be useful for hedge accounting for open portfolios.
- (b) No. We do not believe that there should be a restriction on a layer component containing a prepayment option on the basis that the risk component cannot be separately identified. At a portfolio level, it may be possible for certain entities to separately identify and reliably measure the risk component. The determination of whether this is possible should be left to the entity rather than prescribed in the ED.

Question 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

Yes. We support the removal of the arbitrary 80-125% test that exists in IAS 39 and the move towards an objective-based approach to effectiveness testing. We also support the elimination of retrospective effectiveness testing. We consider that the

removal of these bright lines in the qualifying criteria will make hedge accounting available to a wider range of entities.

Paragraph 19(c) and paragraphs B27-B39 require that the hedging relationship meets the hedge effectiveness requirements. A clearer explanation of the objective of hedge effectiveness assessment in paragraph 19(c)(i) would be helpful in the main body of the standard. More clarity is also required around the terms 'unbiased' result and 'expected to achieve other than accidental offsetting'.

Question 7

- (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge relationship? Why or why not? If not, what changes do you recommend and why?

- (a) No. Although we support the concept of rebalancing as it does not result in discontinuation of hedging relationship if circumstances change, the proposals should be explained more clearly.

We believe that it is the IASB's intention that rebalancing should reflect the economics of a dynamic hedging strategy. Our understanding is that rebalancing requires a company to assess changes in the hedge ratio and adjust the hedged item or hedging instrument as appropriate. This would avoid discontinuation and restart of hedge accounting if economic circumstances change. However, rebalancing is not expressed in this way in the ED which makes it difficult to understand.

We are also concerned about the practical aspects of the rebalancing requirements. There are no triggers for rebalancing in the ED. A requirement for rebalancing daily would be impracticable.

Rebalancing is a new concept and is one of the areas in the ED which is least well understood in terms of application. Therefore, we would recommend that the IASB field tests this area to make the proposals more operational.

- (b) Yes. We agree that voluntary proactive rebalancing should be permitted as this will enable hedge accounting to follow an entity's risk management where it anticipates a change in the effectiveness of a hedge.

Question 8

- (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not? If not, what changes do you recommend and why?

(a)&(b)No. We believe that voluntary discontinuation should be permitted when this is in line with an entity's hedge accounting strategy. This would enable the effects of an entity's hedging strategy to be reflected in the financial statements.

For example, an entity may apply hedge accounting when an entity hedges future sales proceeds but stop hedge accounting at the point when the receivable is recognised on the balance sheet. The IASB's proposals for discontinuation would result in an inconsistency with an entity's dynamic hedging strategy, where hedge accounting is discontinued as and when appropriate; and with the IASB's objective for hedge accounting.

To prevent abuse, clear disclosure of an entity's hedge accounting strategy should be required.

Question 9

- (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?
- (c) Do you agree that linked presentation should not be allowed for fair value hedges? Why or why not? If you disagree, when do you think linked presentation should be allowed and how should it be presented?

(a) No. We do not support the two-step approach for recognition of gains and losses in OCI and then a transfer of any ineffectiveness to the profit or loss account. We would prefer a one-step approach where any ineffectiveness is

recognised immediately in profit or loss. The two-step approach would result in additional line items on the face of the primary financial statement but is unlikely to add value to users. It would also be helpful for the IASB to establish a principle for determining which items are presented on the face of the primary financial statements and which items should be presented in the notes.

- (b)&(c)No. We agree that the hedged item should not be adjusted for the fair value gains and losses on the hedged items. The adjustment that exists in IAS 39 today results in the hedged item being neither at amortised cost nor fair value which is not desirable.

We believe that linked presentation is a more appropriate presentation method for fair value hedges as it better reflects the economic substance of the transactions. Where fair value hedge accounting is applied to a firm commitment, the change in fair value of the firm commitment is recognised on the balance sheet. In our view, showing this as a separate balance sheet line item does not provide meaningful information. Linking the change in the fair value of the derivative to the change in the fair value of the firm commitment enables a user to assess the impact of derivatives an entity uses for hedging purposes against the risk it is hedging.

Linked presentation is a concept that has existed in UK GAAP for some time, in FRS 5 *Substance of transactions*. For hedge accounting purposes, application of a similar concept reflects the 'real' exposure to the hedged risk whilst still showing the gross amounts of the face of the balance sheet.

Question 10

- (a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. like a basis adjustment if capitalised into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?
- (b) Do you agree that for period related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis? Why or why not? If not, what changes do you recommend and why?
- (c) Do you agree that the accounting for the time value of options should only apply to the extent that the time value relates to the hedged item (i.e. the 'aligned time value' determined using the valuation of an option that would have critical terms that perfectly match the hedged item)? Why or why not? If not, what changes do you recommend and why?

No. We agree that the choice in IAS 39 relating to accounting for time value of options should be eliminated. By only designating the intrinsic value of the option as a hedging instrument the proposals address a practical issue relating to ineffectiveness created by the time value component.

The proposals require an entity to distinguishing between transaction and period related hedged items and account for them differently. We believe that this additional complexity is undesirable. A single method for transferring amounts relating to the time value component accumulated in OCI would reduce some of the complexity in this area. In our view, the time value of the option is a cost of obtaining protection. Therefore, we would suggest that the time value of the option accumulated in OCI is amortised to the profit and loss account on a systematic basis (such as over the life of the hedging instrument).

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

Yes. We broadly agree with the IASB's proposals for the eligibility of groups of items as hedged items. We believe that the proposed model for groups of items is more flexible than IAS 39 and should facilitate the development of a model for portfolio hedge accounting.

We welcome the change to permit hedge accounting for net positions as it better reflects an entity's risk management.

Any decisions on groups of items will have an impact on the hedge accounting model for open portfolios, therefore it is difficult to comment and conclude on this without seeing proposals in that area. We would recommend that the IASB completes its discussions on portfolio hedge accounting as soon as possible.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (e.g. in a net position hedge), any hedging instrument gains or losses recognised in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

Yes. For a group of items with offsetting risk positions that affect different line items in the income statement an arbitrary allocation of gains and losses on the hedging instrument to the income statement line affected by the hedged items would not be desirable.

We do not agree with the balance sheet presentation of net positions in a fair value hedge. The ED requires "the gain or loss to be presented on a gross basis next to

each line item that includes the related asset or liability". This is likely to result in the number of line items on the balance sheet increasing. We would recommend that, in these circumstances, the fair value changes should be aggregated into a single line item.

Question 13

- (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
- (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

- (a) No. We agree with the principles based approach to disclosures. We support the disclosures which, as set out in paragraph 40 of the ED, provide information about an entity's risk management strategy, its hedging activities and the effect of hedge accounting on the financial statements. However, we believe the level of granularity required by paragraphs 44-52 of the ED is inappropriate.

We have concerns over the commercial sensitivity of the disclosures proposed in the ED. This arises from the amount of the quantitative information required for each type of risk and category of hedge. The requirement to disclose of volumes of commodities, for example, is a problematic area.

In summary, the number of disclosure requirements appear to be excessive. We also have a general concern that the IASB is adding additional layers of disclosure in its proposals on hedge accounting, impairment and offsetting. This increases the disclosure burden for preparers and increases clutter in financial statements. We therefore recommend that, before IFRS 9 is finalised, the IASB should review the disclosures across each project phase as well as the existing disclosures in IFRS 7 and eliminate those disclosures which do not provide useful information.

- (b) The disclosures focus on hedges where hedge accounting is applied. We acknowledge that the scope of this ED is hedge accounting but there is a need for improved disclosures where derivatives are used for hedging but hedge accounting is not applied. This is important information for users and in our view, this is not adequately covered by the disclosure requirements in IFRS 7. We also believe that there should be a link between the financial risks identified in IFRS 7 and whether these risks are hedged or unhedged.

Question 14

Do you agree that if it is in accordance with the entity's fair value-based risk management strategy derivative accounting would apply to contracts that can be settled net in cash that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements? Why or why not? If not, what changes do you recommend and why?

Yes. We agree that commodity contracts should be accounted for as derivatives if this is in line with the entity's fair value-based risk management strategy. We believe that this resolves a practical issue where an accounting mismatch is created such as where a commodity contract outside the scope of IAS 39 is hedged with a derivative.

Question 15

- (a) Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?
- (b) If not, which of the three alternatives considered by the Board in paragraphs BC226-BC246 should the Board develop further and what changes to that alternative would you recommend and why?

(a)&(b)No. We support the principle that risk components should be eligible as hedged items. Using credit derivatives to manage credit risk is a common risk management strategy for financial institutions. We do not believe that there should be an explicit prohibition on hedge accounting for credit risk. If an entity is able to demonstrate that a hedge is effective then hedge accounting should be permitted regardless of the type of hedge.

We acknowledge that it may be difficult to find an effective hedge for credit risk but this should be left to the entity should determine rather than prescribed in the Standard. We also note that there is also always the possibility of a new instrument developed in the future which provides an effective hedge for credit risk.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

Yes. We support prospective application as it is more practical. However, we would urge the IASB to review transition requirements across different phases of the IAS 39 replacement project as there are inconsistencies between the transition requirements in different phases which may impair comparability.

We agree with the effective date and early application requirements.