

17 January 2013

International Accounting Standards Board  
Attn. Hans Hoogervorst  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir,

**Re: Review Draft IFRS 9 General hedge accounting**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to inform you about the findings from the field-test conducted on the Review Draft (RD) IFRS 9 *General hedge accounting*, issued by the IASB on 7 September 2012.

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

In September 2012, EFRAG initiated a field-test together with the ANC, ASCG, FRC and OIC. In total 44 companies provided responses in the field-test, covering all major sector groups within the Euro Stoxx index. A list of the names of the respondents to the field-test is included in Appendix 1, together with a breakdown by sector and by country. During the field-test we have been in contact with IASB staff and provided them with the detailed findings and supporting materials collected as part of the exercise.

The respondents in the field-test confirmed that the Review Draft introduces important improvements in the hedge accounting requirements such as: (a) improvements in the hedge effectiveness testing requirements; (b) the treatment of the time value of options and the treatment of forward points; (c) the possibility to designate aggregated exposures as eligible hedged item; (d) the ability to designate risk components as eligible hedged item; and (e) the ability to rebalance hedge relationships.

*Complexity in the model*

Although the general hedge accounting model is more flexible than IAS 39, there are still a number of complexities associated with the model because of the number of exceptions, restrictions and options. Examples include the restrictions on eligible hedged items in the general model such as sub-LIBOR risk and credit risk; and different ways for accounting for the time value of options depending on whether the hedged items are transaction related or period related. These complexities may deter preparers from applying hedge accounting.

*Drafting and balance between standard and application guidance*

There are areas of the standard where the drafting could be made clearer, for example, the requirements relating to re-balancing using the hedge ratio. As currently drafted, the Review Draft requires even financial instruments specialists considerable time to understand which indicates that there is certainly scope to improve the drafting. As shown in Appendix 2, a large number of respondents have requested additional guidance and examples to be added to the standard which can be seen as an indicator that the drafting of the standard could be further improved.

The final standard needs to be drafted such that it is capable of being read and understood by accountants that may not be financial instruments specialists. Both IAS 39 and IFRS 9 are standards that apply to both financial and non-financial institutions. There may be some preparers in non-financial institutions that may only refer to accounting standards when preparing their year-end financial statements. The requirements in the standard also need to be capable of being understood by this group.

In addition, the balance between the information contained in the core standard and in the application guidance warrant review. It is difficult to read the standard without continually cross referring to the application guidance.

*Readability of hedge accounting standard as a standalone document*

The IASB has been issuing parts of the IFRS 9 standard in phases. The hedge accounting document contains cross references to parts of IFRS 9 that have already been issued as well as the macro hedge accounting requirements in IAS 39. Consequently, the hedge accounting standard is difficult to read as a standalone document. This raises the question of whether the IASB need to issue a review draft of the whole package so that there is an opportunity to consider whether there are any fatal flaws relating to the interaction between the different parts of the model.

Respondents outside the financial sector noted that the standard is mainly focused on typical risks and products of the financial sector and not on the industrial sector. Additional examples clarifying the standard for non-financial companies would therefore be welcomed by some respondents, for example rebalancing of commodity risk exposures.

*Implications of the Review Draft for current macro hedging practices*

Many participants in our field test of the Review Draft reported that it was unclear to them whether the requirements in the Review Draft would change the way they deal with macro hedge relationships. For example, the Review Draft deletes a part of the Implementation Guidance of IAS 39 (section F), which is the basis for a number of macro cash flow hedge relationships currently used by respondents. Also, questions arose as to which macro hedge relationships were covered by the Review Draft and which macro hedge relationships would be covered by the project on macro hedging. Overall, respondents were concerned about unexpected changes for macro hedge relationships under the Review Draft as well as the lack of guidance to assist in the changes mainly for macro cash flow hedges.

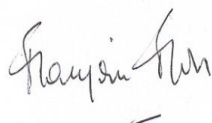
EFRAG is currently undertaking a detailed analysis of the impact of the consequential amendments proposed by the Review Draft, which will be subject to full due process with our constituents. Given the importance of this topic for European companies, EFRAG will address this topic in more detail in a separate letter, which we expect to send at the end of February 2013.

Appendix 2 includes an overview of the implementation difficulties, including fatal flaws and requests for additional guidance identified by the respondents. More specifically, the appendix addresses issues in relation to the use of net positions, the tensions between economic hedges and hedge accounting, the treatment of basis risk in cross currency interest rate swaps, the own use exception and the treatment of time value and forward points.

Appendix 3 describes a number of issues that have been fully considered as part of the IASB’s due process on the general hedge accounting model, but which have important consequences for the respondents to the field-test. These points relate to the application of hedge accounting to a net position with foreign currency risk, the treatment of credit risk, the sub-LIBOR issue, and the disclosures required. EFRAG believes that given the widespread comments and concerns raised by respondents, the IASB should explain clearly in the effect analysis accompanying the standard how it considered these concerns.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Marc Labat or me.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Françoise Flores', with a short horizontal line underneath.

Françoise Flores  
**EFRAG Chairman**

Appendices

## Appendix 1 – Respondents by sector and country

### Names of participating companies

EFRAG would like to thank the following companies for participating in the field-test:

Alcatel-Lucent, Allianz, Areva, AXA, Banesto, Barclays, BPCE, Commerzbank, Crédit Agricole, Daimler, Danfoss, Deutsche Bank, DZ Bank, EADS, EDF, EnBW, Enel, ENI, Erste Group, France-Telecom, GDF Suez, Handelsbanken, Helaba, Intesa San Paolo, KfW, L’Oréal, Mediobanca, Merck, RTL, RWE, Safran, Sanofi, Siemens, Telefonica, ThyssenKrupp, Unicredit Group, Vinci, Volkswagen, Wüstenrot, Yara, and four undisclosed companies.

### Respondents by sector

<i>Sector</i>	<i>Participants</i>
Oil and gas	1
Basic materials	1
Industrials	8
Consumer goods	4
Healthcare	2
Consumer services	1
Utilities	6
Banks	16
Insurance companies	2
Technology	3
Total	<u>44</u>

### Respondents by country

<i>Country</i>	<i>Participants</i>
Austria	1
Denmark	1
France	13
Germany	15
Italy	5
Luxembourg	1
Norway	1
Spain	2
Sweden	1
United Kingdom	4
Total	<u>44</u>

## Appendix 2 – Fatal flaws, implementation difficulties and requests for additional guidance

*The appendix contains three sections that deal with fatal flaws, implementation difficulties and requests for additional guidance, respectively. EFRAG believes that the IASB should amend the wording of the Review Draft to take these into account.*

### Fatal flaws

#### *Hedged items: aggregated exposures and net positions*

- 1 According to paragraph 6.6.6 of the Review Draft an entity is permitted to designate a hedge that consists of a group of items with a nil net risk position even if the group does not include a hedging instrument. Respondents (mostly banks) noted that paragraph 6.6.6 of the Review Draft relating to net position used ‘risk’ in the singular when the hedged item was a group that was a nil net position, (i.e. if the hedged items among themselves fully offset the ‘risk’ that was managed on a group basis, an entity was permitted to designate it in a hedging relationship that did not include a hedging instrument). In contrast, paragraph B6.3.3 of the Review Draft, which refers to aggregated exposures that are a combination of an exposure and a derivative, used ‘risks’ in plural. Respondents believed that the IASB should clarify in the standard, that the net position could consist of several risks that on a net basis adds up to a nil position.

#### *Hedge ratio and effectiveness*

- 2 The hedge ratio definition (paragraph 6.4.1(c)(iii) of the Review Draft) assumes that there is always a clearly identified direct relationship between hedged items and hedging instruments. However, for banks and energy companies that manage high volumes of financial transactions believe this is very difficult to achieve. Consequently, banks and energy companies that responded proposed a rewording of the hedge ratio or required additional guidance to take into account the tensions existing between economic hedges and hedge accounting.
- 3 EFRAG notes here that some of the practices used in high volume hedge accounting are close to macro hedge accounting. Therefore, we believe that the IASB should also consider some of the feedback received on this Review Draft in the work it is conducting on the Macro Hedging project and be mindful of any potential inconsistencies (cross cutting issues) between the two projects.
- 4 Finally, respondents believed that it was not clear how the hedge ratio and its potential rebalancing (paragraphs 6.4.1(c)(iii) and 6.5.5 of the Review Draft) interacted with each other. For example, it was not clear to a respondent from the energy sector whether effectiveness of foreign currency risk management should be tested on the change in value of the net position or on the change in value of the gross positions. The latter would require tracking of the gross positions over their lifespan.

### Implementation difficulties

#### *Treatment of basis risk in cross currency interest rate swaps*

- 5 Respondents commenting on this point came from the banking sector and industrial sector.
- 6 Paragraph B6.5.5 of the Review Draft states that ‘a hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a

change’. Respondents understand this as meaning that it is not possible to use synthetic cross currency swaps for measuring hedge effectiveness.

- 7 Banks as well as corporates argued that the basis risk element could be included in the pricing of debt instruments when an investor looks at the pricing in other markets and swaps those back into its functional currency. Banks expected to develop an accounting treatment based on fair value measurement for derivatives under IFRS 13. This treatment would include basis risk charges. They also believed that basis spreads should be treated in the same way as the time value of options or forward points, because there would be no actual risk of volatility in cash flows.
- 8 Respondents noted that the proposed accounting treatment of basis risk would be inconsistent with the Board’s objective of aligning hedge accounting with risk management strategies and change the current practice applied today.
- 9 Banks discounted the hypothetical derivative using an overnight indexed swap curve, which assumed that the hedging instruments are collateralised (i.e. are not exposed to credit risk). The discount curve used for collateralised derivatives was not assumed to be a term of the hedged item but merely aligned the discounting methodology of the swap and the hypothetical derivative. In addition, the underlying cash flow exposures were also hedged on a post impairment basis so the little credit risk that remains was deemed to exist in the hedged item.
- 10 Respondents overall believed that further clarification should be provided in the Review Draft to avoid diversity in practice. Furthermore, they believed the IASB should clarify that the overnight indexed swap discount curve could be used for discounting the hedged item.

*Time value and forward points*

- 11 Respondents commenting on this point came from the banking sector and industrial sector.
- 12 The accounting treatment for time value of options and forward elements for forward contracts was assessed as operationally complex, in particular by respondents in the industrial sector because:
  - (a) the difference in treatment between transaction related hedged items and time period related hedged items was seen as too complex. Respondents preferred one accounting treatment, based on straight-line amortisation.
  - (b) it would be necessary to determine the ‘aligned time value’ (or the ‘aligned forward element’), thus entities would have to price ‘hypothetical operations’ at each reporting date in addition to the existing derivatives. Respondents were concerned that this requirement would double the number of valuations needed.
  - (c) the accounting treatment of the time value would depend on whether actual time value (or actual forward element) was higher or lower than the aligned time value (or aligned forward element). Only the lower of both could be recognised in OCI. The requirement therefore increased complexity.
  - (d) credit margins and trading margins on derivatives should be treated like the cost of insurance. It was seen as inconsistent to limit the amortisation of these costs only for the time value of options and the forward element of forwards contracts. Costs of insurance existed for all derivatives and the accounting

treatment should be the same for all: these costs should be recognised in OCI and amortised through profit or loss.

- (e) when an entity uses these instruments to hedge foreign currency risk, respondents did not understand why a basis swap could not be treated in the same way as the forward element for forward contracts. This would imply separating the spot element and the basis risk element of a swap.
- 13 Respondents stated that the change in fair value of the basis risk should be recognised in OCI and amortised through the profit or loss. This would be more closely related to the risk management strategy.
- 14 It was unclear to one respondent whether accounting for the forward element as a hedge also applied to commodity forwards, as their behaviour is different from forwards on interest rates.

*Own use exception*

- 15 Respondents commenting on this point came from the utility sector, the consumer goods sector and the industrial sector.
- 16 Even when some contracts are recognised (IAS 39) and other are not (own use), risk management is often performed on an overall basis and looked at the counterparty exposure on a net basis. This had a number of consequences:
- (a) As many net agreements cover both recognised and unrecognised positions this raised a number of issues in terms determining fair value (with or without offsetting benefit) and measurement of the effectiveness of hedges that involved either the recognised or unrecognised contract. In accordance with paragraph 6.4.1(c)(ii) of the Review Draft, the company had to determine the effect of credit risk movements on the hedge relationship and might need to discontinue hedge accounting if this effect became significant.
  - (b) In cases where the net position of the recognised and unrecognised contracts (both subject to the same netting agreement) were not nil, a question arose on how to treat the credit risk effect on the net balance (e.g. account for the effect on the net balance or otherwise).
- 17 Furthermore, the interaction of paragraphs 6.4.1(c)(i) and 6.5.6 of the Review Draft raised concerns, because the latter paragraph required prospective discontinuation if the hedge criteria were no longer met. An energy sector respondent questioned whether it should discontinue the hedges prospectively in the case of extraordinary events that it expected to be temporary in nature. The same respondent was also concerned that it ought to prove prospectively that the hedge would not be affected significantly by credit risk developments.

**Requests for additional guidance**

*Hedge ratio and rebalancing*

- 18 Respondents commenting on the points below came from the oil and gas sector, the banking sector, the industrial sector and a national standard setter.
- 19 Under the Review Draft, rebalancing is a requirement rather than an accounting choice. Respondents noted that indicators and examples on rebalancing situations are needed in order to develop standardised procedures. Application of the rebalancing concept was not considered to be entirely clear, especially when it came to the interdependencies regarding hedged items and changes in those

hedged items, and the relation with the effectiveness test. Respondents believed that more guidance was needed to clarify these issues.

- 20 A respondent commented that the IASB should include an example explaining how hedge effectiveness testing should be performed for hedges of foreign currency exposures and hedges of a commodity risk exposures. The respondent noted that the Basis for Conclusions and Implementation Guidance mainly focus on risks and products typical to the financial sector and did not sufficiently address other sectors.
- 21 Another respondent asked for an example of rebalancing that includes identification as well as documentation, something that is missing in the Review Draft.
- 22 Paragraph B6.1.4 of the Review Draft also mentions derivatives with non-zero fair value at hedge inception but it was not clear what impact this would have on the effectiveness testing. Respondents believed that further guidance should be included that explains how this should be applied in practice.
- 23 A respondent asked for clarification on whether the Review Draft requires re-designating the elements of a hedged portfolio every time the effectiveness of the hedge is assessed and whether rebalancing could include new operations. This would clarify the notion of ‘group’ of items in a closed portfolio environment.
- 24 A national standard setter and a respondent asked for clarification of the difference between rebalancing and partial discontinuation (paragraphs 6.5.5. and 6.5.6. of the Review Draft).

*Eligible hedged items*

- 25 Respondents commenting on the points below came from the insurance sector, the utility sector and the banking sector.
- 26 One respondent noted that the Review Draft is not sufficiently clear whether non-financial items such as insurance liabilities, provisions under IAS 37 and real estate investments, could qualify as hedged items.
- 27 One respondent believed the IASB should clarify paragraph 6.6.1(c) of the Review Draft. As further explained in paragraphs 14 to 16 of Appendix 3, respondents believed that the IASB should explain why hedged items in cash flow hedges of foreign currency risk qualify for different accounting treatments when compared to hedges of commodity risk.
- 28 The guidance in paragraphs B6.3.13 and B6.3.14 of the Review Draft, which explain when inflation risk is separately identifiable and measurable, was difficult to understand. Therefore, one respondent believed that the IASB should include an example to clarify the requirements.
- 29 One respondent asked for clarification of the guidance on aggregated exposures, when these aggregated exposures are hedged by means of different hedging relationships, for example one hedge for commodity risk and one hedge for foreign currency risk of the aggregated exposure.
  - (a) The respondent asked whether or not different hedging relationships of an aggregated exposure need to be related to different risks.



- (b) The respondent also asked whether or not it would be allowed to hedge an aggregated exposure without discontinuation of one of several of the hedge relationships created.

30 The Review Draft prohibits cash flow hedging of hedged items that do affect profit or loss (except for those items that impact OCI). The Review Draft explicitly allows the foreign currency risk on a firm commitment to acquire a business in a business combination to be designated as a hedged item. However, it was not clear whether entities are allowed to designate the foreign currency risk on highly probable forecast transactions to purchase (or sell) non-controlling interests as a hedged item. While both strategies are entered into to reduce foreign currency risk, the respondent has observed diversity in practice even in IAS 39 and urged the IASB to clarify this issue.

*Open and closed portfolios*

31 Although the Review Draft stated that it does not address accounting for open portfolios, confusion existed amongst respondents which requirements could be applied to closed portfolios (whether or not these are continuously re-designated) on the one hand, and open portfolios on the other hand. Based on this input, EFRAG is concerned that this confusion might lead to inconsistent accounting for portfolios of hedged items. We therefore urge the IASB to clarify in a more detailed way the appropriate treatment for open and closed portfolios of hedged items.

32 Some respondents questioned whether reference in the Review Draft to a group of items (as a hedged item) was meant as a reference to a closed portfolio or not. They noted that an open portfolio seems consistent with paragraph 6.6.6 of the Review Draft which states ‘the hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity’.

33 Another respondent concluded that the guidance in paragraph B6.6.9 of the Review Draft was inappropriate as it did not allow him to align the hedged net position with the impact of OCI of the cash flow hedge.

*Eligible hedging instruments*

34 Respondents commenting on the points below came from the industrial sector, the utility sector and the banking sector.

35 The Basis for Conclusions and/or the Implementation Guidance should be more explicit on which non-derivative assets and liabilities measured at fair value are eligible as hedging instruments. In addition, a respondent asked for an illustrative example that explains this for corporate entities.

36 Another respondent noted that the rationale for excluding written options as eligible hedging instruments should be explained better.

37 A respondent noted that paragraph BC6.415 of the Review Draft states that the impairment model and the ‘deemed credit approach’ would be competing mechanisms and could present a danger of double counting of credit losses. The respondent believed that double-counting could be avoided and it would be possible to preserve alignment with the risk management strategy.

*Other issues*

38 Respondents commenting on the points below came from the industrial sector, the utility sector and the banking sector.

- 39 One respondent asked how forward points should be presented in profit or loss as the Review Draft was not clear on this. When hedging the spot rate, the change in the fair value of the forward points should be recognised in OCI, and the forward points at inception should be amortised over the period of the hedge. The respondent stated that the amortisation of the forward points could be presented in the same line item as the effective portion of the change in the fair value of the hedging instrument. This would result in forward points being recognised as part of the operating activities, generating a mismatch between the recognition of the forward points and the hedged item.
- 40 Another respondent stated the ‘all in one hedge’ guidance in paragraph IG F2.5 of IAS 39 should be carried over to the Review Draft.
- 41 A respondent stated that the following wordings in the Review Draft should be explained better:
- (a) the term ‘dominates’ in paragraph 6.4.1(c)(ii) on the effectiveness requirement regarding credit risk effects;
  - (b) the scope of the term ‘value change’ in the effectiveness requirement paragraph 6.4.1(c)(ii) is to be explained. The respondent understood that this term was used to capture cash flow changes for cash flow hedge accounting and hence not to limit to fair value changes in the case for fair value hedge accounting;
  - (c) the risk management objective in paragraph 6.5.5; and
  - (d) paragraph 6.6.6 on nil net positions.
- 42 According to paragraph BC6.38 of the Review Draft, a non-derivative financial instrument (such as a cash instrument) may be designated as a hedging instrument in a hedge of foreign currency risk even if they are not measured at fair value through profit or loss. However, paragraph 6.2.4(c) of the Review Draft (which allows foreign currency risk components of non-derivative financial instruments to be designated as a hedging instrument) could be read as still being subject to the requirements in paragraph 6.2.2 of the Review Draft (which allows non-derivative financial instruments only to be used as hedging instruments if they are measured at fair value through profit or loss). A respondent believed that either paragraph 6.2.2 or paragraph 6.2.4(c) of the Review Draft should be amended to articulate more clearly that non-derivative financial instruments are eligible as hedging instrument for foreign currency risk, even if they are not measured at fair value through profit or loss.
- 43 The use of ‘may’ in the first sentence of paragraph 6.5.16 of the Review Draft implies that an entity may continue to record changes in the fair value of forward points through profit or loss when only the change in the spot element of a forward contract is designated. A respondent believed that this would be clearer if the first sentence in paragraph 6.5.16 were amended.
- 44 This respondent would find it helpful if the definition of a firm commitment would clarify that the ‘specified date(s)’ referred to in the definition might be specified by reference to events (e.g. the date when a power station is completed) rather than just fixed dates.

## Appendix 3 – Input to the IASB’s effect analysis

*In developing the general hedge accounting model, the IASB set for itself the objective of reflecting the effect of an entity’s risk management activities in the financial statements of that entity. The results of the field-test have confirmed that this goal is not fully achieved by the Review Draft as several hedge strategies are not able to be addressed under the requirements of the general hedge Review Draft. EFRAG acknowledges that this objective can only be addressed taking into account possible constraints given the inherent characteristics and different practices of risk management. Nevertheless, EFRAG wishes to ask the IASB to clarify in the effects analysis why the points mentioned in this Appendix could not be addressed.*

### Credit risk

- 1 The Review Draft includes an option to designate a credit exposure as measured at fair value through profit or loss (further referred to as the elective fair value option).
- 2 Most of the respondents commenting on this point came from the banking sector, the insurance sector and a few were utilities.
- 3 EFRAG acknowledges that the pricing in credit derivative markets and cash markets are not always strongly correlated and thus it can be questioned whether the elective fair value option is the appropriate tool to address credit risk. Some respondents mentioned that when hedging the credit risk in an instrument, the focus should be if the hedging instrument will compensate the holder for the loss it will incur if the hedged item enters into default.
- 4 Some respondents did not support the introduction of the elective fair value option, which is based on the presumption that credit risk is not reliably measurable, as they consider this presumption to be inconsistent with IFRS 13 *Fair Value Measurement*. They believed the IASB should reconsider the possibility to designate the credit risk component as a hedged item and to apply fair value hedge accounting so as to reconcile its business model with its risk management policy. A respondent in the insurance industry believed that hedging of credit risk should be resolved through fair value hedge accounting.
- 5 Some respondents considered that a solution that would account for the premium on the credit derivatives in a similar way as the time value of options or as a guarantee should be explored. It was questioned to which extent the IASB had dealt with the requirement to reverse into profit or loss at designation dates the cumulative differences between the carrying amounts and the fair values of the loans. The fair value option for credit risk would be helpful in this regard but as it changes the profit or loss impacts, its use is limited. Respondents believed that the credit risk component of a financial asset could be measured using the related credit default swap curve adjusted to take into account the asset’s particularities (e.g. prepayment option, recovery rate different to that of the credit default swaps).
- 6 Some respondents mentioned it was operationally difficult to apply credit risk the requirements (e.g. regarding the back-tracking of the fair value adjustment).
- 7 A respondent reported not being able to identify the effect of collateral or netting agreements at the contract level, which is essential to determine the credit risk implications within the hedge. The respondent believed that the Review Draft should clarify this point. Another respondent believed that the eligibility criteria – which require name matching of the credit default swap reference entity – should be extended to include the parent entity that guarantees a subsidiary’s debt.

### Sub-LIBOR issue

- 8 Most of the respondents commenting on this point came from the banking sector and a few were utilities.
- 9 The Review Draft confirms the Board’s view with regard to the sub-LIBOR issue as defined under IAS 39. In paragraph BC6.127 of the Review Draft the Board notes that negative interest is not consistent with the economic phenomenon that it relates to. However, EFRAG would like to observe that of late negative yields have become more common as evidenced by the discussion the IFRS Interpretations Committee had in September 2012.
- 10 Some respondents noted that they did not support the restrictions regarding sub-LIBOR hedges (paragraph B6.3.22 of the Review Draft) as this was not consistent with the core definition of a risk component (paragraph 6.3.7). Some respondents also noted that the sub-LIBOR issue did not only arise on financial liabilities, but also on some highly liquid sovereign bonds that were held for liquidity purposes. Therefore, they believed it should be possible to designate the LIBOR component in a fair value hedge relationship, regardless of whether it was a sub-LIBOR financial instrument or not. This would align accounting with risk management practice.

### Open and closed portfolios

- 11 Respondents commenting on this point came from the banking sector and the industrial sector.
- 12 One respondent mentioned that the open portfolio approach raises a number of application issues:
  - (a) How to account for changes in the net position. The Review Draft requires that the items in the portfolio are identified. This raised the question as to whether an amount should be recycled from OCI if the net position decreases due to a change in one of the gross positions (the gross hedged volume would no longer be highly probable).
  - (b) How should the reclassification from OCI be performed when hedging net positions? Several respondents noted that requirements on the reclassification of gains or losses when hedging a net position are unclear. It seemed that the gain or loss should be reclassified so that the hedged sales/purchases are recognised at the hedged rate. Consequently, the gain or loss on the transaction in the early phases should be deferred in OCI. As this is a new concept, one respondent stated that the final standard should include a numerical example on the reclassification of gains or losses when hedging a net position comprising transactions occurring in different time periods (e.g. quarters).
  - (c) How to account for a cash flow hedge of a net position. Paragraph B6.6.9 of the Review Draft requires an entity to compare (a) the aggregate fair value changes of the hedging instrument and one portion of the hedged item with (b) the fair value change of the other portion of the hedged item. This requirement is compared with the lower of test for a cash flow hedge as described in paragraph 6.5.11 of the Review Draft. This test requires a comparison between the fair value changes of the hedged item with those of the hedging instrument. The respondent believed that this discrepancy is neither explicitly addressed nor explained, so creates confusion as to how paragraphs 6.5.11 and B6.6.9 of the Review Draft relate to each other.

Furthermore, the respondent doubted how applying the guidance in paragraph B6.6.9 of the Review Draft will lead to acceptable results.

- 13 As explained in paragraphs 31 and 32 of Appendix 2, respondents also asked for clarification of some of the requirements affecting open and closed portfolios.

#### **Treatment of foreign currency risk compared to other risk components**

- 14 The respondent commenting on this point came from the utility sector. Similar comments for other hedge relationships than a net position were received from respondents in the industrial sector and banking sector.
- 15 In applying cash flow hedges for net positions to many different types of risks, paragraph BC6.332 of the Review Draft states that such an application ‘*might have unintended consequences for some risks. The Board noted that foreign currency risk was the risk most commented on by respondents and the risk that the Board intended to address by this type of hedge.*’ The Review Draft also refers to concerns about earnings management in this context as being an issue.
- 16 A respondent challenged why the application of hedge accounting to a net position as the hedged item depended on whether it involved foreign currency risk or a commodity risk. Reference was made to paragraph BC6.332 of the Review Draft where the IASB Board states that foreign currency risk was the most commented on. According to the respondent, the fact that foreign currency risks were more common did not justify the application of a different accounting treatment compared to commodities.
- 17 EFRAG believes that the IASB should explain more fully the underlying reasoning for not allowing hedging of other types of risks in the same way as for foreign currency risk.

#### **Disclosures**

- 18 Respondents commenting on this point came from the banking sector, the insurance sector, the technology sector, the industrial sector, the healthcare sector and the utility sector.
- 19 EFRAG noted that the disclosure requirements add to the operational complexity of the requirements in the Review Draft. As the information required is not for all companies already internally available, it will be necessary to allow a sufficient implementation period for companies.
- 20 Given the detailed disclosures on amount, timing and uncertainty of future cash flows, many respondents were concerned about the commercial sensitivity of some of the information that may need to be disclosed.
- 21 A respondent was concerned about the disclosure requirements in paragraphs 23A and 23B of IFRS 7, they believed it could lead to disclosure of commercial sensitive information about future company profits. Also, another respondent felt that it was not appropriate to provide information on the level of individual financial instruments in the disclosures (e.g. a description of any forecast transaction for which hedge accounting had been used in the previous period, but which was no longer expected to occur (paragraph 23E of IFRS 7) or a breakdown of profile of timing of nominal amount of hedging instruments if no dynamic hedging strategy was used.