

Accounting Standards Board of Japan (ASBJ)

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9 March 2011

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir or Madame,

Comments on the Exposure Draft *Hedge Accounting*

We appreciate the efforts made by the International Accounting Standards Board (IASB) in the Financial Instruments Accounting Project and welcome the opportunity to express our comments on the Exposure Draft on Hedge Accounting (hereinafter referred to as “the ED”). The following views are those of the Financial Instruments Technical Committee within the Accounting Standards Board of Japan.

1 . General Comment

We support the objective of the IASB’s project which is to comprehensively review the existing hedge accounting requirements to provide users of the financial statements with information useful in their investment decision making.

In particular, we appreciate the efforts to reflect an entity’s risk management activities in the financial reporting as much as possible in response to criticisms that the hedge accounting under IAS 39 does not reflect an entity’s risk management activities or represent the extent to which those activities are successful in achieving their objectives. We also appreciate the proposed objective-based approach to hedge accounting, because we agree that the requirements under IAS 39 are too much rule-based and result in arbitrary consequences.

On the other hand, the hedge accounting is an exception to general rules, and therefore there must be some disciplines in its application. The ED relies on risk management as well for those disciplines (i.e. hedge accounting requirements), as a flipside of incorporating an entity’s business realities into financial accounting. However, there is an inevitable operational concern that too much reliance on risk management might give rise to abuse of hedge accounting.

Therefore, we suggest several improvements, including additional requirements to predetermine the order in which hedged items of a group should be deemed to be sold in designating a layer component, and further clarification of the relationship between risk management and hedge effectiveness assessment, which is critical in the application of rebalancing and discontinuation.

Although the ED does not address open portfolios, we request that requirements for open portfolios be developed so early that it would be applied at the same time as this ED in order to ensure consistency. Given that risk management activities in many entities including financial institutions are conducted on an open portfolio basis, we have to say that the relevance of the ED would be quite limited unless open portfolios are addressed. In addition, confusions in practice might be caused if the requirements once finalised following this ED would be amended when requirements for open portfolios are added later.

Lastly, we would like to highlight that this project is one of MoU projects with Financial Accounting Standards Board and request that global convergence be achieved as early as possible, including the points we raise in this comment letter.

2 . Comments on specific questions

Our comments on questions set out in the ED are as follows:

Question 1

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

- 1 . We basically agree with the approach to focus on an entity's risk management activities and better reflect those in the hedge accounting. However, we have a practical concern about too much reliance on risk management. We also request that the treatment of equity instruments designated as at fair value through other comprehensive income (hereinafter referred to as "FVTOCI") be reconsidered.
- 2 . We agree with the proposal because the objective stated in the ED, which is "to represent ... the effects of an entity's risk management activities", is consistent with the objective of this project to better reflect in financial reporting an entity's risk management activities.
- 3 . However, on the other hand, we have a practical concern that too much reliance on risk management might give rise to abuse. Given that hedge accounting is an exception to general

rules, there must be some disciplines in its application. For example, it is necessary to further clarify the relationship between risk management and hedge effectiveness assessment and add some requirements (for further details, see our comments on Questions 4, 5(a), 6, 7, 8, 11 and 14).

- 4 . We consider it appropriate that the ED limits its scope to the accounting related matters, by the phrase “represent in the financial statements”. Although we agree that the exposure that could affect profit or loss should be within the scope, further consideration is needed about whether it is appropriate to limit the scope to only what could affect profit or loss.
- 5 . In actual risk management practice, there are strong demands to hedge against the changes in equity, such as changes in fair value of investments in equity instruments designated as FVTOCI. Management manages the changes arising from those investments in the same manner as the changes recognised in profit or loss. However, under the ED the hedge accounting shall not be applied to those investments designated as FVTOCI, for the reason that gains or losses arising from those investments will affect only OCI, but not profit or loss (i.e. non-recycling) .
- 6 . The rationale for not allowing recycling is based upon the notion that there are no distinction between profit or loss and OCI. On the other hand, hedge accounting is based upon the notion that there is distinction between profit or loss and OCI. The problem results from such a conflict between the two notions on the treatment of profit or loss and OCI.
- 7 . An alternative to meet the needs of hedge accounting for those equity instruments designated as FVTOCI and resolve the above conflict would be to allow recycling for those instruments. We suggest that recycling for those instruments be allowed, because it would be consistent with the proposed new hedge accounting model that aims at reflecting an entity’s risk management activities in financial reporting as much as possible.
- 8 . Considering the strong demands to hedge against the changes in equity, as mentioned above, we believe that hedge accounting should be also applied to exposures that would affect the changes in OCI associated with investments designated as FVTOCI, until recycling would be allowed.

Question2

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?

- 9 . We basically agree with the proposal. However, it should not be applied to an instrument designated as at fair value through profit or loss using the option provided in paragraphs 4.1.5 and 4.2.2 of IFRS 9 (hereinafter referred to as “Fair Value Option” or “FVO”).
- 10 . We basically agree with the proposal because there are needs in practice to use a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss as a hedging instrument. And we do not foresee a problem that would be caused by the extension of eligible hedging instrument to a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss as a hedging instrument.
- 11 . However, an instrument to which the FVO has been applied should not be eligible as a hedging instrument. The FVO does not allow de-designation after its application, in order to prevent abuse. Applying hedge accounting to an instrument to which the FVO has been applied might create a loophole in this prohibition. In addition, it might also lead to conflict with the criteria for the FVO at the inception.
- 12 . On the other hand, we agree that the eligibility should not be extended to non-derivative financial instruments in categories other than at fair value through profit or loss, because its needs and benefits would not outweigh the resulting operational issues (i.e. an unintended risk components would be included in a hedging relationship if such an instrument were designated in its entirety, whereas bifurcation of risk would be difficult).

Question3

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?

- 13 . We agree with the proposal because it would better reflect in hedge accounting an entity’s risk management activities.
- 14 . It is quite common in risk management practice that one transaction generates more than one risk (eg foreign currency exchange risk and interest rate risk) and hedging operation for those risks are conducted sequentially. In this case a derivative (eg a foreign currency swap) that has been used as a hedging instrument (eg for the foreign currency risk) at the first hedge will be a hedged item as part of the aggregated exposure from economic perspective when the second hedging (eg for the interest rate risk) is conducted. The proposal would treat the aggregated exposure as a hedged item for hedge accounting purpose as well, and thus better

reflect an entity's risk management activities.

Question4

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?

- 15 . We basically agree with the proposal. However, we have two operational concerns as stated below (the first is discussed in paragraphs 17-21 and the second in paragraphs 22-24).
- 16 . The proposal would result in hedge accounting better reflecting an entity's risk management activities. It is a common risk management practice to hedge risk components for both financial instruments and non-financial items. The proposal would extend the application of hedge accounting to economically hedged non-financial items, in addition to financial instruments.
- 17 . However, the first of our concerns is that, for non-financial items, the level of compliance might become lower than that for financial instruments, because by nature it would be difficult to determine whether the criteria of being "separately identifiable and reliably measurable" is met or not.
- 18 . For financial instruments such as derivatives, identification and measurement of risk components is relatively easy, objective and verifiable since there are markets corresponding to their risk components. However, it is undeniable that identification and measurement of risk components for non-financial items is much more difficult than for financial instruments, unless there are markets corresponding to their risk components like some commodities, although paragraph BC59 of the ED says that the Board learned from its outreach activities that the entities are able to identify and measure with sufficient reliability many risk components (other than foreign currency risk) of non-financial items.
- 19 . Accounting for by risk component is, in itself, an exception to the general principle of accounting for by unit of account. For financial instruments, it seems that such an exception has been permitted because it is relatively easy, objective and verifiable to determine whether the requirement is met, owing to existence of markets corresponding to their risk components, as stated above. In order to extend this exception to non-financial items, the same level of objectivity and verifiability as financial instruments should be ensured.

- 20 . On the other hand, we understand that appropriate risk components of non-financial items (if they are not contractually specified) can be determined only in the context of the particular market structure regarding that risk, and consequently, determination of appropriate risk components requires an evaluation of the relevant facts and circumstances (i.e. careful analysis and knowledge of the relevant markets), as stated in paragraph BC59 of the ED). We also agree that the setting up a bright line would lead to inflexible application and opportunities for abuse.
- 21 . On balance, we suggest inclusion of a precaution clause, such as “for non-financial items, it is necessary to ensure that the same level of objectivity and verifiability as financial instruments will be maintained” in the Basis for Conclusion, while keeping the proposed criteria of being separately identifiable and reliably measurable in the requirements of the IFRS.
- 22 . Another concern is that the ED is not clear as to how a residual portion (i.e. a portion that is not being hedged) is taken into consideration when identifying a portion that is being hedged.
- 23 . We believe that “separately identifiable and reliably measurable” should be interpreted as meaning that a portion attributable to a specific risk can be isolated from the rest and be reliably measurable. In the context of a residual portion, it could be expressed that the risk component will affect only the portion being hedged, and not the residual. We believe that this point should be clearly articulated in the IFRS, because no hedge ineffectiveness would be recognised if the risk component affects the residual portion.
- 24 . It is our understanding that paragraphs BC69 and IN22 already imply that the criterion of being separately identifiable includes the requirement that a risk component will not affect a residual portion. However, since the main subject of both paragraphs is designation of a layer component for a contract that includes a prepayment option, it would be better to clarify the requirement that a risk component will not affect a residual portion in the paragraphs after B13, which specifies the requirement for risk component.
- 25 . Some argue that account should be taken of practical difficulties in strict identification of the effects of risk components and a requirement for correlation with a hedging instrument on the short-term basis.

Question5

- (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?

(Comments on Question 5(a))

26 . We agree with the proposal, subject to clarification that an entity should predetermine the order in which components are deemed to be sold in the case of partial sales.

27 . A hedge of a layer component has become a common practice in risk management to deal with uncertainty related to hedged items. IAS 39 has allowed, in effect, designation of a layer component as a hedged item for forecast transactions. The proposal in the ED would extend this treatment to existing transactions. We appreciate this extension because it would result in hedge accounting better reflecting an entity's risk management activities.

28 . As stated in paragraph BC67, there is uncertainty for both forecast transactions and existing transactions, and therefore there is no need to distinguish between them for the purpose of designating a layer component. From this perspective, we do not foresee a problem in extending the designation of a layer component to existing transactions.

29 . Traceability of the elements included in a layer component would be ensured by the requirement that if a layer component is designated in a fair value hedge an entity shall specify it from a defined nominal amount (paragraph B22). However, in the case of partial sale, determination of the amounts to be derecognised and therefore the amount of gains or loss on the sale would depend on whether the sale relates to the layer component. Therefore, in designating a layer component, it is necessary to predetermine the order in which components are deemed to be sold. With such predetermination, there would be no abuse of designation of a layer component.

(Comment on Question 5(b))

30 . We suggest that this issue should be considered in conjunction with open portfolios, in order to ensure consistency.

31 . We acknowledge the rationale that a layer component of a contract that includes a prepayment option is not eligible as the hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk, since it would be tantamount to identifying a risk component that is not separately identifiable, as stated in paragraph BC69.

32 . However, the IASB continues discussions about open portfolios, including a discussion on designation of a layer component of a contract that includes a prepayment option. We have a concern that confusions in practice might be caused, if the requirements once finalised following this ED would be amended when requirements for open portfolios are added later. Therefore, we suggest that this issue should be considered in conjunction with open portfolios, in order to ensure consistency.

Question6

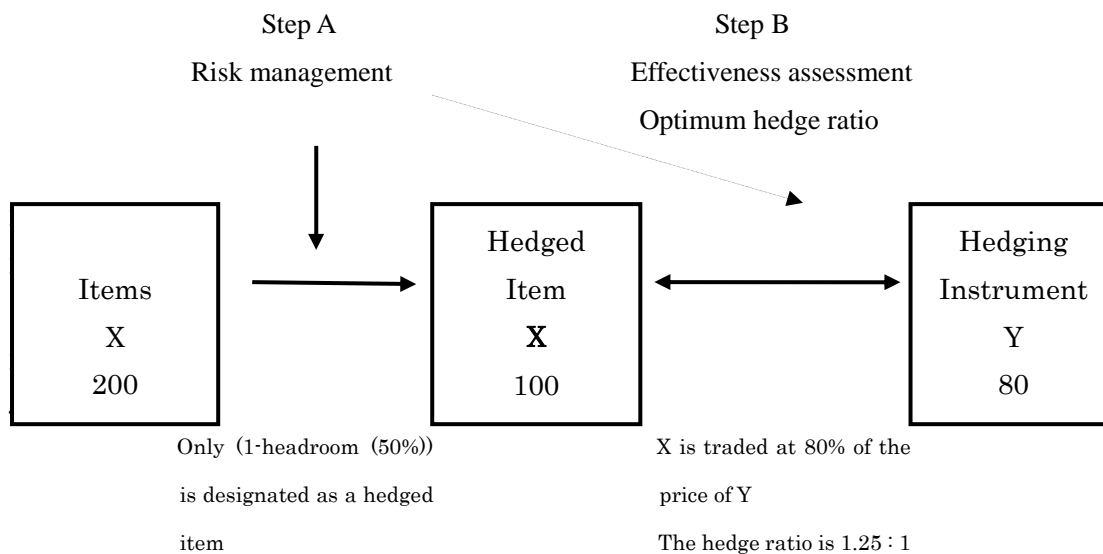
Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

33 . We agree with the proposal, on the premise that it is based upon the two-step approach shown in Agenda Paper 4 for the IASB Board meeting held on 24 August, 2010 (hereinafter referred to as “the AP”) as we interpret. We suggest incorporation of the explanations in the AP into the IFRS and further clarification of the requirement “to produce an unbiased result and minimise expected hedge ineffectiveness”.

34 . We support the proposal to eliminate the bright line and introduce the objective-based criteria for hedge effectiveness assessment, given that the bright line criteria had brought about disconnection between hedge accounting and risk management. We also agree with the requirement that hedging relationship should be expected to achieve other than accidental offsetting, since hedge accounting is based upon the notion of offsetting gains and losses.

35 . However, the ED does not describe clearly enough what is meant by “to produce an unbiased result and minimise expected hedge ineffectiveness”. We express our views on this issue based upon certain assumptions as mentioned below.

36 . First, it is necessary to clarify an overall picture of hedge effectiveness assessment (i.e. the relationship between risk management and hedge effectiveness assessment) and roles of a hedge ratio. To this end, the explanation in the AP is useful. The following diagram is our further elaboration on what the AP states.



37 . In the AP, the process is separated into two steps. One is to determine the ratio¹ of the hedged item designated out of a population of the potential hedged items (the designation ratio). The other is to determine the volume of the hedging instrument to hedge the designated hedged item. The AP uses the term “headroom” for the first step and “hedge ratio” for the second step. Under this two-step approach, risk management relates to the first step and effectiveness assessment relates to the second step. A hedge ratio is a ratio between the volume of hedged items and that of hedging instruments, given the volume of the hedged items determined in the first step taking account of headroom.

38 . Next, regarding the expression “to produce an unbiased result and minimise expected hedge ineffectiveness”, paragraph BC82 of the ED explains that some ineffectiveness may be inevitably involved but there should be no expectation of ineffectiveness arising systematically. This can be further plainly described that “an entity is required, within the extent of reasonable estimates, to determine a hedge ratio which will result in the average of expected ineffectiveness being zero (but actual results can be other than zero).” We believe that this expression is aligned with risk management activities and reasonable as a key criterion for hedge effectiveness assessment.

39 . On the premise of our interpretation as mentioned above, we agree with the ED’s proposal because we can then support the proposed requirement to produce an unbiased result and minimise expected hedge ineffectiveness by focusing on a hedge ratio.

¹ This letter assumes for simplicity that the volume of a hedged item is designated as at a percentage of the total population. However, there are some cases in practice when the absolute volume is determined (eg. A=100). What we discuss here for designation as at a percentage can be said of the designation as at the absolute amount.

- 40 . In addition, we suggest that the explanation in the above-mentioned AP be incorporated into the IFRS and a plain expression be used to the effect that an entity is required, within the extent of reasonable estimates, to determine a hedge ratio which will result in the average of expected ineffectiveness being zero (but actual results can be other than zero).
- 41 . We consider that the first step of the designation ratio (i.e. the step of determining the headroom) is a matter of risk management rather than that of hedge effectiveness assessment. We will further comment on this issue in Question 7 and Question 8.

Question7

- (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?

- 42 . We agree with the proposal, on the premise of the two-step approach as mentioned above. We suggest that the IFRS clearly state that adjusting only headroom is not regarded as rebalancing.
- 43 . It is a common risk management practice to adjust a hedge ratio to restore the minimisation of ineffectiveness, when the hedge ratio that originally minimised the hedge ineffectiveness no longer achieves that goal due to the change in relative prices between the hedged item and the hedging instrument. In this case, it would better reflect the entity's risk management activities to discontinue only a part of a hedging relationship for which ineffectiveness has arisen and continue the rest, rather than discontinuing the entire hedging relationship as under IAS 39. (Comment on Question 7(a))
- 44 . Also, if an entity is expected to adjust a hedge ratio when it expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it would better reflect the entity's risk management activities to permit the entity to proactively rebalance the hedge relationship. (Comment on Question 7(b))
- 45 . Under the two-step approach discussed in Question 6, rebalancing mainly relates to the second step (hedge ratio). In order to clarify this point, we suggest that adjusting headroom while the

ineffectiveness remains to be minimised is not regarded as rebalancing but as the change in the risk management policy.

Question8

- (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?

46 . We agree with the proposal, on the premise of the two-step approach as mentioned above. We suggest incorporation of the explanations using the four patterns as stated below into the IFRS.

47 . The qualifying criteria can be divided into those related to risk management objective and all other criteria, giving the following four combinations as shown in the table below. Based upon the diagram in Question 6, we assume that “whether the headroom is unchanged or changed (Step A)” represents the risk management criteria and “whether the original hedge ratio continues to keep ineffectiveness within the boundary set under the risk management policy as a trend” represents all other criteria.

Condition		Risk management objectives (Step A)	
		Met (remains the same)	Not met (changes)
Other criteria (Step B)	Met	(1) Continue	(2) Discontinue
	Not met	(3) Rebalancing	(4) Discontinue

48 . In the case (1), the headroom is unchanged and the original hedge ratio continues to keep ineffectiveness within the specified boundary. In this case, we believe that continuation is appropriate. To permit discontinuation in this situation would result in allowing de-designation at an entity’s will. (Question 8(b))

49 . In the case (3), the headroom is unchanged but the original hedge ratio ceases to keep ineffectiveness within the specified boundary. We have already discussed this case in

Question 7 as a rebalancing issue.

- 50 . In the case (4), the headroom has been changed and the original hedge ratio ceases to keep ineffectiveness within the specified boundary. In this case, there is no way other than discontinuation, because the entity's risk management behaviour has completely become apart from hedge accounting.
- 51 . In the case (2), the headroom has been changed but the original hedge ratio continues to keep ineffectiveness within the specified boundary. In this case, further analysis is needed as follows:
- (a) In the case of a reduction of headroom (an increase in the designation ratio)², if all other criteria remain the same, the entity would designate additional volume of X as hedged item and purchase additional Y (or designate additional volume of Y already held as hedging instrument). This case should be considered as establishment of a new hedge relationship between additional volume of X and Y.
- (b) In the case of an enlargement of headroom (a decrease in the designation ratio, that is, discontinuation), if all other criteria remain the same, the entity would like to de-designate a volume of X and Y corresponding to the increased headroom. Under the ED, this portion of hedging relationship would be partially discontinued because the risk management policy has been changed (the remaining portion would be continued). Given the hedge accounting based on risk management policy, we acknowledge that conceptually there will be no way other than discontinuing the hedging relationship, once the risk management policy is changed. On the other hand, there is a concern that it will give an entity a free choice, because the entity would be able to discontinue the hedging relationship by asserting that it has changed the risk management policy. However, we expect that the proposed enhanced disclosure on risk management policy would prevent abuse of risk management policy, including its unreasonable changes.
- 52 . We suggest that the above discussion using the four patterns be incorporated in the IFRS, since we believe it will be helpful in understanding not only discontinuation but also the relationship between risk management policy and hedge effectiveness assessment and rebalancing.

Question9

- (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the

² Although this is a case of an increase in the designation ratio and therefore is not discontinuation to be considered in this paragraph, we analyse this case for comparison with the cases of a decrease in the designation ratio.

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?

(Comment on Question 9(a))

53 . We disagree with the proposal for the reasons shown in paragraphs 55 and 56.

54 . We suppose that the purpose of the requirement referred to in Question 9(a) (for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognised in other comprehensive income (OCI) with the ineffective portion of the gain or loss transferred to profit or loss) is, as stated in paragraph IN30(c), to present in one place (i.e. OCI) the effects of risk management activities (for both cash flow and fair value hedges).

55 . We acknowledge that the proposed approach would enable centralisation of the effects of hedges in OCI, regardless of whether cash flow hedge or fair value hedge is used. However, useful information about the effects of hedge accounting would not be provided by only presenting them in one place. Detailed information about the movements of OCI would be essential and that is why the ED proposes the enhanced disclosure of the detail of OCI. Even under the existing fair value hedge accounting, users could have as useful information as provided by the proposal of the ED, if sufficient details of gains and losses recognised in profit or loss on fair value hedges would be disclosed. Thus, centralisation in OCI would not be in itself a key factor in providing useful information about the effects of hedge accounting.

56 . Both the proposed method and the current method for fair value hedge would produce the same outcome, in a sense that the effective portion of hedging relationship would have no net effect on profit or loss, and only the ineffectiveness would affect profit or loss. For fair value hedges, we believe that the current method better reflects the concept of offsetting profit or loss. The proposed method would require that all the gains or losses be recognised in OCI first, and then the ineffectiveness be reclassified from OCI to profit or loss. However, we cannot find a clear reason why the use of OCI as a transition account should be always required. Conceptual

reconsideration about the use of OCI should be conducted before such a significant expansion of its use.

(Comment on Question 9(b))

- 57 . We disagree with the proposal for the reasons as mentioned in paragraphs 60 and 61.
- 58 . We suppose that the purpose of the requirement referred to in Question 9(b) (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) is, as described in paragraph IN30(a), to eliminate the mixed measurement for the hedged item (eg an amount that is a amortised cost with a partial fair value adjustment).
- 59 . We acknowledge that presenting the gain or loss on the hedged item in a separate line item would avoid the mixed measurement attribute for the hedged item (eg an amount that is an amortised cost with a partial fair value adjustment).
- 60 . However, the proposed treatment would have the following deficiencies.
- (a) The separate line item is an adjustment to the hedged item, and is not in itself an asset or a liability.
 - (b) Hedge accounting is itself a mixed measurement accounting. It is meaningless to disallow the presentation of a mixed measurement, while allowing the accounting on the mixed measurement basis.
 - (c) The separate line item need be derecognised together with the associated hedge item, when the hedge item is sold. Traceability would be better ensured by incorporating the gain or loss in the carrying amount of the hedged item rather than recording it as a separate line item.
 - (d) From the viewpoint of users of financial statements, adjusting the hedged item would be easier to understand than using a separate line item.
- 61 . When a hedged item is measured at amortised cost, amortisation is needed for both the hedged item itself and the effects of hedge accounting. This is the most cumbersome treatment in hedge accounting. However, this is mainly because of the difficulty in tracing the periodical amortisation amount. Presenting in a separate line item would not resolve this difficulty.

(Comment on Question9(c))

- 62 . We agree with the proposal because linked presentation would be misleading. As stated in paragraph BC128 of the ED, the linked presentation would show assets and liabilities as if they

were fully offsetting each other, resulting in zero balance, although they are offsetting only the risks being hedged. In addition, we do not believe that the total assets and liabilities shown by linked presentation would be most suitable for the ratio analysis.

Question10

- (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 (eg 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?

- 63 . We basically agree with the proposal, but we have some concerns as mentioned in paragraphs 65-67.
- 64 . We generally support the ED's proposal because we agree that an entity's risk management activities are not properly reflected by the current treatment under IAS 39 that the undesignated time value of the option is accounted for as at fair value through profit or loss.
- 65 . The first of our concerns is unclearness about how to distinguish "transaction related" and "time period related". Further clarification is needed about this, although paragraph B67 of the ED describes that the time value of an option relates to a transaction related hedged item if the nature of the hedged item is that of transaction costs, and that it relates to a time period related hedged item if the nature of the hedged item is the cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of transaction cost).
- 66 . Additionally, we disagree with the proposal that an entity should apply a basis adjustment without recognition in OCI if a transaction related hedged item subsequently results in the

recognition of a non-financial asset or non-financial liability, or a firm commitment for which fair value hedge accounting is applied. We believe that there should be recognition in OCI (see paragraphs 91-94 for the details of our rationale).

- 67 . Some have expressed practical concerns, including allocation of the aligned time value of a time period related hedged item.

Question11

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?

- 68 . We basically agree with the proposal. However, we believe that whether to retain a restriction for a net position should be considered in conjunction with the issues about open portfolios.
- 69 . Since an entity's risk management is conducted on a group basis (in particular, on a net basis) in practice of many entities, there are strong demands for hedge accounting for groups of items. We appreciate the proposal in the ED to allow the application of hedge accounting to them would achieve hedge accounting better reflecting an entity's risk management activities.
- 70 . Items included in a net position would be traceable, because paragraph B73 of the ED requires that when a group of items that constitute a net position is designated as a hedged item, an entity shall designate the overall group of items that includes the items that can make up the net position. However, as noted in our comments on question 5(a), there should be a new requirement to predetermine the order in which hedged items of a group should be deemed to be sold in the case of partial sale.
- 71 . Further consideration is needed about whether to allow the application of a cash flow hedge accounting when a net position affects profit or loss in different reporting periods.
- 72 . A group of items may contain items which offset each other. In practice, an entity often makes use of natural offsetting effects and hedges only the residual portion using a hedging instrument. This is one of the primary reasons for risk management on a group basis. Such a hedge of a net position should be allowed broadly to achieve hedge accounting better reflecting an entity's risk management activities. In practice, a net position may have effects on profit or loss in different reporting periods. When an entity hedges on a net basis by each time span (eg several months or a half a year), eligibility as a hedged item would depend on whether the time span falls within only one accounting period. If the time span falls within only one period, the net position may be eligible as a hedged item, but it would not be eligible if the time span

stands across the year-end. This would result in inconsistency between an entity's risk management and accounting outcome. The most noticeable inconsistency is that passage of time would give rise to sudden disqualification as a hedged item when the time span steps across the year-end. For open portfolios, there may be stronger needs for hedging a net position.

- 73 . On the other hand, to realise natural offsetting when a net position affects profit or loss in different reporting periods, it would be necessary to gross up the hedging instruments or defer changes in value of some hedged items until subsequent recognition of gains or losses in other hedged items. We acknowledge that these are departure from the current framework of hedge accounting.
- 74 . There are discussions going on about open portfolios. We have a concern that confusions in practice might be caused if the requirements once finalised following this ED would be amended when requirements for open portfolios are added later. We suggest that this issue should be considered in conjunction with the issues about open portfolios in order to ensure consistency.

Question12

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 (eg 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?

- 75 . We agree with the proposal because, as described in paragraph BC175 of the ED, grossing up all the affected line items in the income statement would result in the recognition of gross (partially offsetting) gains or losses that do not exist.

Question13

- (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?

- 76 . We basically agree with the proposal, but we suggest two modifications as mentioned below.

77 . We agree that the proposed disclosures provide relevant information that enhances the transparency regarding an entity's hedging activities. As described in our comments on question 8 (see paragraph 51), we consider it appropriate to enhance disclosures of an entity's risk management policy to prevent its abuse.

78 . In particular, we suggest addition of the following disclosure requirement to paragraph 44 of the ED to prevent arbitrary hedges.

(d) the content and the reason if entity's hedge strategy is changed.

79 . However, as described in our comments on Question 9, we disagree with the proposal that for a fair value hedge the gain or loss on the hedging instruments and the hedged item should be recognised in OCI and 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. Therefore, we suggest the following modifications regarding paragraphs 50(a)(i), 51(a), and 51(b). IE2 and IE3 of Illustrative examples of the ED would be modified accordingly.

(The modifications we suggest)

Paragraph 50

(a) for fair value hedges:

(i) the amount of the accumulated gains or losses on the hedged item included in the carrying amount of that hedged item in the statement of financial position, separating assets from liabilities; and

Paragraph 51

(a) for fair value hedges:

(i) changes in the value of the hedged item and the hedging instrument;
(ii) hedge ineffectiveness recognised in profit or loss;
(iii) a description of the line item(s) in the income statement in which hedge ineffectiveness is included.

(b) for cash flow hedges and hedges of a net investment in a foreign operation:

(i) - (iii) (paragraph 51(a)(i) - (iii) of the ED)
(iv) - (vi) (paragraph 51(c)(i) - (iii) of the ED)

Question14

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?

- 80 . We basically agree with the proposal, but further clarification is needed.
- 81 . We appreciate that the IASB has understood the strong demands to hedge commodity price fluctuations by processors of commodity and agree with the proposal to meet those demands by extending the derivative accounting, taking account of restrictions in hedge accounting.
- 82 . On the other hand, this may give rise to a concern that the scope of the fair value accounting might be unreasonably expanded. Further clarification is needed about what is meant by "if a commodity contract is in accordance with the entity's fair value-based risk management" (BC214(b)). Although types of expected risk management are described in paragraph BC213 of the ED, meanings of "management on a net position basis" and "net position to nil" need further clarification, by making use of the examples in Agenda Paper 18A (paragraphs 5-11) for the IASB Board meeting held on 19 October 2010.
- 83 . Some argue that the scope of the fair value accounting should be extended to physical assets such as commodities, not only commodity sales contracts, to achieve hedge accounting better reflecting an entity's risk management activities.

Question15

- (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?

- 84 . We disagree with the proposal for the reasons as mentioned below.
- 85 . The ED states that hedge accounting cannot be applied to credit risk because it is operationally difficult to isolate and measure that risk as a component. However, this rationale seems inconsistent with the requirement of IFRS 9 that the own credit risk of the financial liability measured at fair value should be recognised in OCI, not profit or loss, which assumes that the effect of the own credit risk can be isolated and measured. In addition, for certain instruments

such as total return swaps, a whole risk including the credit risk can be isolated and measured.

- 86 . It is a common risk management practice to manage credit risk by using credit derivatives. In the light of the objective of this project that hedge accounting should better reflect an entity's risk management activities, we suggest that qualifying criteria for hedge accounting on credit risk should be reconsidered to reflect such an economic hedge relationship.
- 87 . We also believe that accounting alternatives to hedge accounting should be further considered from a perspective of hedge accounting better reflecting an entity's risk management activities, even though it would introduce complexity into accounting for financial instruments. Some constituents have expressed their preference for alternative 2 or alternative 3.

Question16

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

- 88 . We basically agree with the proposal. However, we request that requirements for open portfolios be developed early.
- 89 . We agree with the proposed transition prohibiting retrospective application because a hedge accounting relationship can be designated only prospectively.
- 90 . Provided that the standard will be finalised in June 2011, the proposed effective date (1 January, 2013) would provide a reasonable preparation period. However, we have a concern that confusions in practice might be caused if the requirements once finalised following this ED would be amended when the requirements for open portfolios are added later. We request that requirements for open portfolios be developed so early that it would be applied at the same time as this ED in order to ensure consistency.

3 . Additional issue

- 91 . We disagree with the proposal in paragraph 29(d)(i) of the ED that the effect of a basis adjustment does not affect OCI. We believe that the effect of a basis adjustment should be recognised in OCI.
- 92 . Paragraph 29(d)(i) of the ED states that if a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a forecast transaction for

a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability (basis adjustment), and this is not a reclassification adjustment which is described in IAS 1.

- 93 . Paragraphs BC139 and BC140 of the ED describe the reasons for having decided to apply a basis adjustment without going through OCI. According to those paragraphs, although one type of distortion of OCI is inevitable (i.e. either in the period of the basis adjustment or over the total period) and hence there is a trade-off, the effect of a reclassification adjustment in the period of the basis adjustment would be more misleading than the effect on the total period of not using a reclassification adjustment.
- 94 . However, if a cumulative hedging gain or loss is removed from the cash flow hedge reserve and directly applied to the recognised non-financial item without going through OCI, it would give rise to inconsistency with the definition of comprehensive income. This is because total comprehensive income would not be equal to the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. Additionally, it would result in the sum of the total profit or loss and the total OCI across periods being unequal to the sum of the accumulated OCI and retained earnings.

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We hope our comments will contribute to the forthcoming deliberations in the project.

Yours sincerely,



Atsu Kato
Chairman of the Financial Instruments Technical Committee
Vice Chairman of the Accounting Standards Board of Japan