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EFRAG's draft response on the IASB's Exposure Draft *Hedge Accounting*

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered through its Standing Committee on Corporate Reporting EFRAG's draft response to the IASB's Exposure Draft (ED) *Hedge Accounting*. We thank you for this opportunity to contribute to EFRAG's due process and to comment on your draft response.

The existing IAS 39 hedge accounting requirements are excessively complex, arbitrary and rules-based. The ED represents a move to more objective and principles-based requirements, and ESMA supports and welcomes it. While some elements of the ED are complex, we recognise that the hedging itself can be a complex area and so complexity in related accounting requirements is, to some degree, unavoidable.

The ED will enable more of the hedging activities that entities already currently undertake to be accounted for as hedges in the financial statements, and as such will better reflect existing risk management practices. This will enhance the relevance and comparability of the financial statements for users and should mean less of a need for the information therein to be supplemented by, for example, non-GAAP disclosures or management commentary, neither of which are likely to be subject to the same level of objectivity (in preparation) and comparability (in use) as disclosures in IFRS financial statements themselves.

Our detailed comments are set out in the appendix to this letter but to summarise some of them:

— *The concept of 'reliably measurable'*

ESMA agrees that risk components should be 'separately identifiable' and 'reliably measurable' but believes that there is a strong need for additional guidance illustrating very clearly when risk components can be regarded as 'reliably measurable' and when they can not. In this regard, it may

helpful to consider whether the fair value measurement guidance in IAS 39 – *Financial Instruments: Recognition and Measurement* could be a useful starting point;

— *New concepts underlying hedge effectiveness assessments*

ESMA is concerned that the ED’s hedge effectiveness requirements are not articulated clearly enough, particularly with regards to the requirements for an ‘unbiased’ approach and to ‘minimise ineffectiveness’, both new terms in IFRS. We are concerned that these will not be applied in a consistent manner and as intended by the ED. Similarly, the term ‘achieve other than accidental offsetting’ is not clearly articulated and is a negative definition which may suggest that any economic relationship, no matter how weak, may qualify as being ‘other than accidental’;

— *Distinction between rebalancing and discontinuation*

ESMA agrees with the concept of rebalancing but believes that the distinction between rebalancing and discontinuation could be ‘blurred’ by management and thus result in a free choice between the two. To prevent this, there should be a requirement for hedge accounting to follow pre-defined and comprehensively documented risk management strategies, and – importantly - disclosure of the rationale for, and timing of, any changes to risk management strategies that impact the entity’s approach hedge accounting.

Disclosures and links to risk management activities

One key aspect where ESMA believes that the proposals in the ED need to be developed further is in the area of disclosures, where we have some significant concerns.

Firstly, ESMA supports hedge accounting being an optional accounting treatment, given that it is an exception to the normal recognition and measurement requirements in IFRS. However, information about hedging activities, regardless of whether such activities are hedge accounted for or not, is useful information for investors from the perspective of understanding the entity’s risk exposures. Hence the ED should include requirements for all entities to disclose qualitative and quantitative information about such ‘economic’ hedging, including significant exposures and which risks are covered by the economic hedging. Similarly, where an entity’s hedging activities could be recognised through hedge accounting but are not, disclosure about management’s rationale for not applying hedge accounting, including an indication of the impact on the financial statements, can help investors to better understand management’s perspective as well as the risk exposures of the entity.

ESMA agrees with the ED’s objective that hedge accounting should represent the effect of an entity’s risk management activities - indeed, as explained in our detailed responses, it is not clear to us why this should be limited to items that affect profit or loss – but we do not believe that the ED’s proposals require sufficient disclosures about those risk management activities. Such disclosures are important, because without

them it may difficult for users (and enforcers of IFRS) to understand the relationship between risk management and hedging. It may also allow scope for management to undertake inappropriate changes to hedge accounting on the premise that such changes have arisen from changes in risk management activities. Given these concerns, ESMA believes that the following additional disclosures should be required:

- Comprehensive information about the entity's risk management strategy, including the level at which the assessment of the risk strategies is performed, the definition of the hedge effectiveness, and detail of the risks hedged, the frequency of the hedge effectiveness assessments (see question 1, 4 and 7);
- Detail of the reasoning behind the assessment that a risk is separately identifiable and reliably measurable, including in cases where the risk is not contractually specified (see question 4);
- Detail of the levels of tolerance that the entity would consider (at hedge inception) as falling within the constraints of 'unbiased' and 'minimising ineffectiveness' (see question 6);
- Where the hedging strategy is modified, specific disclosures should be required to justify this judgment (see question 7 and 8);
- In case of proactive rebalancing, the impacts should be disclosed to allow users to understand the sources of ineffectiveness (see question 7);
- Qualitative explanations on the source of hedge ineffectiveness and the frequency of hedge effectiveness assessments (see question 7 and 9); and
- For fair value hedges, a detail of the single net amount of the fair value hedge permitting to identify and understand the hedged items and their associated gains and losses (see question 9).

Macro hedging

ESMA's comments as set out in this letter do not preclude ESMA from reconsidering its views in light of any aspects of macro hedging that have an impact on the proposals in this ED. This is particularly the case for certain aspects of the ED, such as the criteria for the eligibility of groups of items, which are very closely related to macro-hedging.

Our detailed comments on the ED and EFRAG's draft response are set out in the Appendix to this letter. I would be happy to discuss all or any of these issues further with you.

ESMA has, on a number of occasions, highlighted in its comment letters to the Board and to EFRAG that the distinction between what constitutes 'performance' (and therefore could be recognised in profit or loss) and what does not (and therefore could be recognised in OCI) is not clear and that there is a need for the Board to consider this as a separate project. This would provide a sounder basis to decide where items should be recognised as well as when and if recycling between profit or loss and OCI is appropriate



Yours sincerely,

A handwritten signature in black ink, appearing to be "F. Restoy". The signature is written over two horizontal lines. A long, sweeping underline extends from the end of the signature across the page.

Fernando Restoy
Chairman of ESMA's Corporate Reporting Standing Committee

APPENDIX – ESMA’s detailed answers to the questions in the IASB Exposure Draft *Hedge Accounting*

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?

1. ESMA welcomes the inclusion of an explicitly stated objective in the ED because this leads to a better understanding of what that standard is aimed at achieving. This is a particularly important element for principles-based standards that, by definition, cannot prescribe the exact treatment to be adopted in every conceivable scenario.
2. ESMA notes that hedge accounting is optional (an approach that we agree with) and, where it is applied, it is likely that some types of hedging activities will fall outside of the scope of the hedge accounting requirements in any case. Yet information about hedging activities, regardless of whether they are hedge accounted for or not, is useful for investors from the perspective of understanding the entity’s risk exposures. That is why ESMA believes that the ED should include requirements for all entities to disclose, where material:
 - Qualitative and quantitative information about economic hedging, including significant exposures and which risks are covered by the economic hedging; and
 - Management’s rationale for not applying hedge accounting, including an indication of the impact of such a position on the financial statements.
3. ESMA notes that the objective as set out in the ED is limited to risks that affect profit or loss. In justifying this boundary, the ED refers to (a) operational problems and (b) inconsistency with decisions made in the earlier stages of IFRS 9 – *Financial Instruments: Classification and Measurement*. ESMA’s view is that this position needs a better conceptual basis to be justified, and:
 - With regard to operational problems, it would be helpful to understand precisely what these operational problems would be and whether they are so significant as to justify the proposed restriction.
 - With regard to inconsistencies with IFRS 9, while ESMA can understand the IASB’s pragmatism in addressing the revision of IAS 39 in stages, such an approach should not automatically preclude the IASB from considering the need for specific, limited exemptions to principles or concepts established in earlier stages, provided that the rationale for such exemptions is clear and robust.

4. For example, it is not clear to ESMA why hedge accounting should not also be permitted for, say, equity instruments measured at fair value through other comprehensive income (FVTOCI). ESMA's understanding is that entities *do* hedge items that are measured at FVTOCI, and hence not allowing hedge accounting for such items results in fair value changes in the hedging instruments going through profit or loss whilst the fair value changes in the hedged item goes through Other Comprehensive Income (OCI). This does not sit well with the first part of the stated objective in paragraph 1 of the ED, *'[t]he objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities'*.
5. Should the IASB decide to maintain the current objective in the final standard, it is important to properly explain the rationale for the 'boundaries' to hedge accounting, which should specifically include the rationale for not allowing hedge accounting for hedge items measured at FVTOCI. From a user perspective, it could be argued that such a boundary limits a user's view and understanding of the risk management techniques used by management.
6. One area where ESMA agrees with the IASB on the boundary for hedge accounting is on the subject of hedging using internal derivatives – ESMA agrees that internal derivatives should not be permitted in a hedging relationship. Internal derivatives are frequently used to manage exposures internally so that a centralised treasury function or hedging desk can transact with the market, effecting the hedge. However, from the perspective of the reporting entity, the market facing transaction is the only transaction that is recognised and therefore eligible for hedge designation – internal activities are not relevant from this perspective.
7. ESMA notes that there does not appear to be a sound conceptual basis for not permitting risk components of instruments to be designated as hedging instruments (for example, components that may currently be embedded derivatives). In fact, although paragraph 8 of the ED allows only two exceptions to the principle that a hedging instrument must be designated in its entirety in a hedging relationship, paragraph B6 permits a single hedging instrument to be designated as a hedging instrument of more than one type of risk provided that the different risk positions are designated as hedged items. Hence we would invite the Board to justify why a single hedging financial instrument cannot be designated as hedging different risks related each to a different hedging relationship or even to designate only one component of the hedging instrument as hedging one particular risk in a hedging relationship, provided that the hedging component can be separately identifiable and reliably measurable.

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?

8. ESMA agrees that eligible hedging instruments should include non-derivative financial assets or non-derivative financial liabilities measured at fair value through profit or loss (FVTPL). This is also consistent with the proposed objective of hedge accounting (as set out in the ED) to represent the effect of an entity's risk management activities. Such items are in fact used as hedging instruments by entities, and thus it would seem appropriate to be able to account for them in this way.

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?

9. ESMA agrees that aggregated exposures as described in the ED should be eligible for designation as a hedged item, on the basis of the rationale for this approach as set out in the ED (paragraphs BC48-BC51) and also because it is consistent with the proposed objective of hedge accounting as set out in the ED.

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 (ie 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?

10. ESMA agrees that an entity should be allowed to designate as a hedged item changes in the cash flows or fair values of risk components, as this better reflects the way that many entities actually manage their risk exposures through hedging. ESMA recognises that the application of this concept will inevitably require a significant degree of management judgement. In this regard, the requirement for risk components to be 'separately identifiable' and 'reliably measurable' has the potential to provide appropriate objectivity to this judgement and thus could help to achieve consistent application, interpretation and enforcement. However in order for this to be effective, ESMA believes that there is a strong need for additional guidance in the ED to illustrate very clearly when risk components can be regarded as 'reliably measurable' and when they can not. In this regard, it may helpful

to consider whether the fair value measurement guidance in IAS 39 (paragraphs AG69-AG82) could be a useful starting point.

11. There is of course a distinction between *reliable* measurement and *certain* measurement – just because a measurement is less than fully certain it does not necessarily mean that it is unreliable and therefore unusable. Indeed the uncertainty of some fair value measures is reflected in the 3-level hierarchy for fair values in IFRS.

Designation of risk components as hedging instruments

12. The ED permits designating risk components of financial instruments as hedged items, but prohibits the same from being designated as hedging instruments. The rationale for this prohibition is set out in paragraph BC33 of the ED and states that *‘such an approach would be a significant expansion of the scope of the hedge accounting project because the Board would need to address the question of how to disaggregate a hedging instrument into components. In order to be consistent, a similar question would need to be addressed regarding non-financial items [...]. The Board did not want to expand the scope of the hedge accounting project beyond financial instruments because the outcome of exploring this alternative would be highly uncertain, could possibly involve a review of other standards and could significantly delay the project’*. We agree that developing accounting requirements for designating components of non-financial items as hedging instruments would likely be a large project and take time. However we encourage the IASB to develop accounting rules to allow risk components of financial instruments to be designated as hedging instruments given the fact that this is how hedging strategies are already being applied in practice.

Non-contractually specified risk components as hedged items (e.g. inflation or credit risk)

13. ESMA notes that the ED specifically prohibits non-contractually specified inflation to be designated as a risk component, and suggests a similar restriction on credit risk. Whilst ESMA is persuaded that in very many cases non-contractually specified risk components would fail to meet the criteria of being separately identifiable and reliably measureable, ESMA does not understand why it is necessary to include a specific prohibition in a principles-based standard (notwithstanding the fact that specific prohibitions can aid enforcers of IFRS). ESMA believes that additional guidance on ‘reliably measureable’ as noted earlier in this letter, would further negate the need for specific prohibitions such as this. This could also be further enhanced by the requirement for additional disclosures about how the ‘specifically identifiable’ and ‘reliably measureable’ criteria have been met in cases where the risk component is not contractually specified.

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?

14. ESMA agrees that entities should be permitted to designate a layer of an item as the hedged item, on the basis of the rationale set out in the ED (BC68-BC69).
15. The prohibition with respect to prepayment options presumes that prepayment risk and interest rate risk cannot be separately measured. This may not necessarily be the case for traded instruments where prepayment risks are observable in the market, or for entities which have modelling techniques for prepayment risk at portfolio level.
16. In addition, it appears inconsistent for the existence of a prepayment option to lead to ineligibility for a layer to be hedged item but still allow the entire nominal amount to be a hedged item. ESMA believes that the Board should set out more clearly the rationale as to why prepayment risk would not be separately identifiable and reliably measurable in the context of layers.

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?

17. ESMA agrees that hedge effectiveness is an important qualifying criterion for hedge accounting. ESMA supports the removal of the 'bright line' for hedge effectiveness that is in IAS 39 as it is inconsistent with a principles based approach.
18. ESMA also supports the removal of retrospective testing as a qualifying criterion for hedge accounting. Such testing becomes less important given the requirement for rebalancing and the requirement that hedge accounting should be linked to the entity's risk management objectives.
19. However ESMA has concerns that the proposed hedge effectiveness requirements and objectives are not articulated clearly in the ED. In particular, ESMA is of the view that the 'unbiased' approach and the requirement to 'minimise ineffectiveness' – both new concepts - are not clear enough and therefore we are concerned as to whether the concepts will be applied in a consistent manner and as intended by the ED.

20. With regard to ‘minimise ineffectiveness’, this is a negative definition and as mentioned above, the ED does not properly explain its meaning. Both these factors may make consistent application, interpretation and enforcement more difficult. ESMA’s understanding is that the term means that hedge ineffectiveness is minimised with the hedge ratio as far as possible given the nature of the relationship between the selected hedging instrument and the hedged item. This would not preclude, for example, a situation where ineffectiveness may be relatively high, but is the best that can be achieved with the given instrument.
21. Similarly, the term ‘achieve other than accidental offsetting’ is also a negative definition and it may be better that this is rephrased using positive terms which suggest that the relationship must achieve the desired level of offset given the underlying economic drivers. Otherwise, it could be argued that any economic relationship, no matter how weak, may qualify as being ‘other than accidental’.
22. ESMA believes that the ED should include a requirement for entities to document and disclose, as part of their hedge accounting related risk management objectives, the levels of tolerance that, at the inception of the hedging relationship, would be considered consistent with minimising ineffectiveness and being unbiased. These levels of tolerance could differ across different types of hedges and would not necessarily need to be purely quantitative – but documentation of these at hedge inception, and disclosure thereafter in the financial statements, is important to ensure consistent application, interpretation and enforcement.

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?**
23. ESMA agrees with the concept of rebalancing as explained in the ED but is concerned that the distinction between rebalancing and discontinuation can be ‘blurred’ by management and thus result in a free choice between rebalancing and discontinuation. This could occur if the entity retrospectively manipulates risk management strategies to achieve its desired accounting outcome. To prevent this, there should be a requirement for hedge accounting to follow pre-defined and comprehensively documented risk management strategies, and – importantly – if disclosure were required of the rationale for, and timing of, any changes to risk management strategies that impact the entity’s approach hedge accounting.

24. The ED states that the hedge effectiveness assessment should be carried out at inception and then on an ongoing basis, at a minimum at “each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first”. ESMA believes that there should be a requirement for entities to document and also disclose their policy regarding the frequency of their hedge effectiveness assessments, as this would better assist users in understanding when hedge ineffectiveness affects profit or loss. It would also allow users to follow management’s thinking and be aware of any changes to that thinking.
25. ESMA agrees that where an entity expects a designated hedging relationship to fail to meet future hedge effectiveness assessments (but the risk management objectives remain unchanged), the entity should be allowed to proactively rebalance the hedge relationship. ESMA’s rationale for this view is that such an approach is consistent with the objective of hedge accounting as set out in the ED. In contrast, requiring an entity to de-designate the hedge would be in conflict with this objective and would likely result in more frequent – and artificial - discontinuations and restarts of hedging relationships. That said, ESMA believes that entities should be required to disclose the reasons, extent and impact of proactive rebalancing, to allow users to better understand the sources of hedge ineffectiveness in profit or loss.
26. The concept of rebalancing is new and as such leads to a greater risk of inconsistencies in application and interpretation. Whilst the guidance set out in the ED (paragraphs B46-B60) is helpful in explaining the concept of rebalancing, ESMA believes that this guidance should also include practical illustrative examples of how the concept might be applied in practice.

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?**
27. ESMA believes that the ED’s proposals on discontinuation of hedge accounting are in line with the ED’s stated objective to represent the effect of the entity’s risk management activities in its accounting. ESMA agrees 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. An en-

tity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy, and that continues to meet the qualifying criteria in order to achieve a desired result.

28. In view of the above, ESMA believes that a hedge accounting standard where reliance is placed on an entity's risk management should include a requirement, for an entity discontinuing hedge accounting due to a change in risk management objectives, to provide disclosures about that particular risk management policy change, explaining why the objectives have changed and the impact of such changes.

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?**
29. The ED proposes a change in the fair value hedge mechanics: to recognise in OCI the impacts from remeasuring the hedged item and the hedging instrument and transfer of the ineffective portion to profit or loss.
30. ESMA has, on a number of occasions, highlighted in its comment letters to the Board and to EFRAG that the distinction between what constitutes 'performance' (and therefore could be recognised in profit or loss) and what does not (and therefore could be recognised in OCI) is not clear and that there is a need for the Board to consider this as a separate project. This would provide a sounder basis to decide where items should be recognised as well as when and if recycling between profit or loss and OCI is appropriate.
31. That said, ESMA agrees with the proposed mechanism for fair value hedges and does not share EFRAG's view that this information is not necessarily useful for users and may undermine the understandability of this statement. ESMA considers that more disclosures should be required on the ineffectiveness in order to explain the amount of ineffectiveness and its relationship with the entity's risk management objectives.

32. Moreover, according to the ED, the gain or loss on the hedged item shall be presented in a separate line in the balance sheet, this separate line being next to the line item that included the hedged item. ESMA considers it appropriate to separate the fair value adjustment for the hedging risk and to avoid using a measurement that is neither amortised cost nor fair value but, as explained in the next paragraph, believes that it would be unhelpful to clutter the balance sheet with multiple additional lines.
33. In its draft comment letter, EFRAG suggests aggregating all fair value hedge adjustments of the hedged items into a single net amount reported on the face of the balance sheet and to disaggregate this amount through disclosures. ESMA understands EFRAG's view in this regard because, in cases of multiple hedge relationships, the understandability of the balance sheet may be undermined by the number of new lines added. However ESMA would propose that, rather than a single net amount as proposed by EFRAG, the gross asset and liability amounts should be presented separately on the balance sheet, i.e. that the balance sheet should have two additional lines rather than one additional line proposed by EFRAG (or more than two as could be the case under the ED's proposals). This approach would also be more consistent with the netting principles set out in the IASB's ED *Offsetting Financial Assets and Financial Liabilities*.
34. Appropriate disclosures should be required to allow users to clearly identify and understand the hedged items and their associated gains and losses.

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 (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 (ie 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?**

35. For options contracts, an entity can designate only the component whose fair value is expected to react to changes as the hedged risk (the intrinsic value). According to IAS 39, the residual component (the time value), is measured at fair value through profit and loss.
36. ESMA welcomes the Board's proposal to address this issue and to provide a sound solution that better reflects the economics of the transaction. Indeed, the time value component of an option declines as the exercise date approaches and is nil at the exercise date.
37. ESMA agrees with the underlying principle of the Board's approach and considers that the distinction between period and transaction related options is rather clear and that divergence in practice is not expected. ESMA also supports the recognition of ineffectiveness in profit or loss. Hence, overall we consider that the benefits of solving the issue outweigh the complexity added. However, we have some concerns with the clarity of the proposed accounting treatment in some particular cases:
 - For a transaction related hedged item that subsequently results in the recognition of a non-financial asset or non-financial liability, it is not entirely clear to us why the time value should be included in the initial cost or carrying amount of that asset or liability. Hence we would invite the Board to expand its rationale;
 - If the Board decides to confirm its tentative decision, we think further inconsistencies can arise in some circumstances, for example if the option can be exercised at different dates. Assuming the options terms are aligned perfectly with those of the hedged item, the time value at the effective exercise date can be higher than the initial time value at the inception of the hedge (e.g. because the volatility of the underlying asset has substantially increased). This higher amount recognised in OCI is not tantamount to an insurance premium paid for protection and it should not form part of the cost of the non-financial asset or non-financial liability. It is not clear if that is the Board's intention and we would invite the Board to clarify this issue.
 - For a time period related hedged item, the impact of sharp changes in the time value component (particularly increases) on the amortisation pattern is not clear to us. We note that such changes might cause, in specific circumstances, the accumulated amount amortised through profit or loss to be higher than the total accumulated amount recognised in OCI.
38. ESMA is not clear as to whether there is a difference between the concept of aligned time value and the already known hypothetical derivative and would suggest that the Board use the same word if the concepts are identical, or explain how they differ if they are not identical. Clarification of the notions of *transaction related hedge item* and *period related hedged item* would also be welcomed.
39. Paragraph 8 of the ED indicates that it is possible to designate as the hedging instrument only the spot element of a forward contract. The ED does not clearly mention whether the interest element of

a forward contract should follow the same treatment as the time value of options. ESMA suggests the Board should clarify this point.

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?

40. The ED indicates that a group of items can be the hedged item if this is consistent with the risk management strategy and if the individual items of the group are individually eligible to the hedging. For cash flow accounting the ED adds that the offsetting cash flows should affect the profit and loss in the same period.
41. ESMA appreciates the link made between the hedge accounting and the risk management policy and therefore agrees that a hedged item could be designated on an individual or portfolio basis that could include a net position.
42. Regarding criteria for hedging a group of items, the ED explains that permitting cash flow hedge accounting of net positions with flows that occur in different reporting period would be inconsistent with the general hedge accounting requirements. As far and without knowing the macro-hedging proposals, ESMA agrees with this statement and considers that criteria proposed by the Board are appropriate.

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 (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?

43. ESMA agrees with the proposition of the Board regarding profit and loss presentation. Indeed, this presentation of the impact of the hedge instrument in a separate line would avoid an artificial gross up of gains and losses and better represents the risk management approach.

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?**

44. Like EFRAG, ESMA is convinced that disclosures play a fundamental role in providing useful information to investors and that this role is even more important as hedge accounting will be linked to risk management. Hence, disclosures should allow investors to properly understand the entity's risk management policies and strategies, and changes thereto.
45. ESMA believes that the ED's proposals on disclosures on the risk management strategy, the effects of hedge accounting on the future cash flows and the impacts of hedge accounting on the financial statements are useful but they do not go far enough. The level of disclosures required should allow a user to have a comprehensive understanding of the hedging activities of the entity and their effect on financial performance and position. That is why ESMA considers that the following additional disclosures should be required – ESMA believes that they will enhance users' understanding of the way the entity manages and hedges its risks and mitigate against the risk of manipulation of the hedge accounting requirements to achieve desired accounting results:
- If hedge accounting is not applied, the management rationale and an indication of the impacts should be disclosed (see question 1);
 - Comprehensive information about the entity's risk management strategy, including the level at which the assessment of the risk strategies is performed, the definition of the hedge effectiveness, and detail of the risks hedged, the frequency of the hedge effectiveness assessments (see questions 1, 4 and 7);
 - Detail of the reasoning behind the assessment that a risk is separately identifiable and reliably measurable (see question 4);
 - Where the hedging strategy is modified, specific disclosures should be required to explain the rationale for this modification and the judgements underlying it (see questions 7 and 8);
 - In case of rebalancing (including proactive rebalancing), the impacts should be disclosed to allow users to understand the sources of ineffectiveness (see question 7);
 - Qualitative explanations on the source of hedge ineffectiveness (see questions 7 and 9); and
 - For fair value hedges, a detail of the single net amount of the fair value hedge permitting to identify and understand the hedged items and their associated gains and losses (see question 9).
46. In addition, the Board should carefully consider the interaction between the current IFRS 7 disclosures and the disclosures proposed in any final Standard on hedging. It is important that areas of

overlap, duplication or close similarity in disclosure be avoided, so as to limit the risk of ‘information overload or lack of clarity in disclosures.

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?

47. IAS 39 excludes from its scope contract to buy or sell non-financial items when some conditions are met (own use exception). The ED proposes that an entity could apply hedge accounting to these contracts in order to eliminate accounting mismatch when an entity enters into a derivative to hedge some exposures arising from these contracts.
48. Like EFRAG, ESMA supports the proposals as it better reflect the underlying of the contract.
49. In March 2010, the Interpretations Committee declined to add an issue to its agenda a request to provide guidance on whether a contract that (a) obliges an entity to deliver (sell) at a fixed price a fixed number of units of a non-financial item that is readily convertible to cash and (b) that provides the counterparty with the option to purchase also at a fixed price a fixed number of additional units of the same item can be assessed as two separate contracts for the purpose of applying paragraphs 5-7 of IAS 39. The Interpretations Committee declined to add the issue to its agenda because the Board had accelerated its project to replace IAS 39 and the project would include considering the scope of IAS 39, including guidance about contracts to buy or sell non-financial items in IAS 39.5-7. While the ED proposes a change to the “own use” exception, we observe that the proposed change does not appear to provide guidance on the issue that was raised.

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?**

50. The Board considers that the hedging of the credit risk is not achievable as it is complex to assert that credit risk is a separable element (i.e. separately identifiable and reliably measurable). Nevertheless, the Board considers three alternatives treatments to account for credit risk in the basis for conclusions.
51. ESMA supports the Board efforts to try to solve this issue, as we do not believe that there are conceptual arguments that would preclude the possibility of hedge accounting for credit risk. Indeed, for banks and other financial institutions the possibility to hedge the credit risk is a key issue.
52. Like EFRAG, ESMA is persuaded that the standard should be consistent and not add specific rules for specific issues. Hence, ESMA supports the IASB's rejection of the proposed accounting alternatives 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?

53. Because IFRS 9 provides for a long transition period (three years), ESMA fears that it may undermine comparability during a long period of time. As a result, ESMA is not in favour of permitting early-adoption in this case.
54. As regards transition requirements, ESMA generally supports retrospective application. However, in the specific case of hedging, ESMA agrees with EFRAG that a prospective application is appropriate as it would be difficult to provide the necessary documentation to assess the hedging relationships.