



Madrid, 9 March 2011

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

Re: ED 2010/13 *Hedge Accounting*

Dear Sirs,

I am writing on behalf of Telefónica, S.A. one of the world's largest telecommunications companies by market cap. Its activities are mainly focused on the fixed and mobile telephony businesses, while its broadband business is the key growth driver underpinning both. It operates in 25 countries and its customer base exceeds 288 million globally. Telefónica's growth strategy is focused on the markets in which it has a strong foothold: Spain, rest of Europe and Latin America. Further information about the Telefónica Group and its activities is available on our website: www.telefonica.com

Telefónica is very pleased to provide comments to the International Accounting Standards Board on its ED 2010/13 *Hedge Accounting* (the "ED").

Telefónica supports the work carried out by the IASB and appreciates its efforts to develop a new approach to enhance hedge accounting, addressing the many limitations and application weaknesses that currently arise under the existing model in IAS 39 *Financial Instruments: Recognition and Measurement*. We generally welcome the objective to align hedge accounting with risk management activities, introducing a principles-based hedge accounting model.

The proposals make hedge accounting significantly more flexible, and will help to increase the appropriate use of hedge accounting. In appendix A to this letter we have included our responses to your detailed questions. However, we would like to highlight our main concern regarding the proposals:

- Discontinuing hedge accounting should follow an entity's risk management strategy. We are concerned that the proposals may not be flexible enough to allow for the discontinuation in certain instances. We believe that further clarification is required on what is meant by changes in risk management objective leading to discontinuation of the hedging relationship.

In our view, the principles-based proposals in the ED require application of more judgment than IAS 39. We therefore believe that for transparency and comparability purposes the disclosures should help users to understand an entity's overall risk management approach.



We encourage the IASB to further enhance the proposed model by addressing these concerns in its redeliberations.

If you would like to discuss any of the issues described herein, please do not hesitate to contact Marta Soto, Head of Accounting Practice, at +34.914.828.534 or by e-mail to marta.sotobodi@telefonica.es.

Thank you for your attention and we look forward to your reaction on the concerns raised in this letter.

Yours sincerely,

Marta Soto

Telefónica's responses to the questions asked in ED 2010/13 Hedge Accounting**Question 1 — Objective of hedge accounting**

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

Telefónica agrees with the proposed objective of hedge accounting to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss. However, in our view, it is also possible to engage in meaningful management of the risks that are reflected in other comprehensive income or equity. The following are examples of items that may be hedged in accordance with an entity's risk management: foreign currency payments related to equity transactions, such as non-controlling interests, foreign currency cash flows related to future expected dividends from subsidiaries or equity investments measured at fair value through other comprehensive income. In our view, the restriction to apply hedge accounting to risks that affect profit or loss only does not accurately depict the effects of an entity's risk management activities. We therefore encourage the IASB to revisit the possibility of allowing entities to apply hedge accounting for items that affect other comprehensive income or equity as well.

Question 2 — Instruments that qualify for designation as hedging instruments

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?

Telefónica agrees with the proposal because it enables an entity to bring hedge accounting closer to its risk management objectives. Furthermore we also believe that the nature of the hedging instrument should not preclude an entity from applying hedge accounting provided that it reflects the entity's risk management strategy, and therefore non-derivative financial instruments that are not at fair value through profit or loss should also be eligible as hedging instruments if appropriate.

Question 3 — Derivatives that qualify for designation as hedged items

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?

Telefónica welcomes this proposal, as it results in a more relevant accounting picture of an entity's risk management practices.

Question 4 — Designation of risk components as hedged items

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?

Telefónica supports the proposed changes to allow the designation of risk components, regardless of the financial or non-financial nature of the item being hedged. This approach further aligns hedge accounting to current risk management practices for those entities that hedge individual risk components. However we believe that the Board should explain further the notions of “separately identifiable” and “reliably measurable” and provide additional practical guidance on this issue.

Moreover, Telefónica supports the eligibility of non-contractual inflation risk for hedge accounting, as inflation may be an input observable in the market and thus reliably measurable. The restriction contained in B18 seems to be inconsistent with a principle-based approach as proposed in the ED.

Question 5 — Designation of a layer component of the nominal amount

(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?

Telefónica agrees with the IASB's proposed change that an entity should be allowed to designate a layer of the nominal amount (or volume) of an item as a hedged item either in a

cash flow or fair value hedge relationship. This approach is aligned with the way many entities manage their risk exposures (under-hedging practices).

We do not agree that a prepayment option is not eligible to be designated as a hedged item under a fair value hedge as provided by B23. This exclusion would not align with the economic risk management activities of entities that are considering prepayment options in their business and, accordingly, does not properly reflect the effect of a prepayment option in the financial statements.

Question 6 — Hedge effectiveness requirements to qualify for hedge accounting

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?

Telefónica welcomes the removal of the 80 to 125 effectiveness threshold. The elimination of this arbitrary requirement simplifies the implementation of hedge accounting and aligns it closer to an entity's risk management practices.

Telefónica supports the introduction of a method to assess effectiveness based on an entity's internal risk management strategy (objectives-based effectiveness assessment). We believe that a principle-based qualifying criterion and a qualitative or quantitative assessment of the effectiveness depending on the complexity of the hedge relationship as proposed in the ED are appropriate.

Moreover, we agree with the removal of the retrospective hedge effectiveness test.

However, in order to better understand the notion of “unbiased result” and “more than accidental offset” and therefore avoid inconsistencies in the hedge accounting practices, we encourage the IASB to include additional guidance regarding those criteria in the final standard.

Question 7 — Rebalancing of a hedging relationship

(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?

Telefónica believes that the ED is not clear on when rebalancing the hedging relationship is required, when it is acceptable not to do so and when the criteria regarding the proposed requirement are met as well as what the consequences are when an entity does not rebalance. We believe that the rebalancing and discontinuation model as proposed requires a significant degree of judgment, increasing complexity rather than reducing it. An example would be how to deal with a gradual change in the hedge ratio. Gradual changes in the hedge ratio can entail discontinuation when the hedge ratio has to be lowered, or entering into a new hedge when the hedge ratio needs to be increased.

We therefore consider that it is unnecessary to introduce mandatory rebalancing requirements when an entity proactively adjusts its hedging relationship from a risk management standpoint.

In our view, the distinction between rebalancing and discontinuation is not clearly defined (please refer to our response to Question 8).

Question 8 — Discontinuing hedge accounting

(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?

Telefónica supports that hedge accounting should be flexible to reflect an entity's risk management activities, and that an entity should discontinue hedge accounting when it no longer reflects the risk management strategy. However, we are concerned that the proposals may not be flexible enough to allow for the discontinuation in instances where external derivative instruments – acquired in accordance with a risk management strategy based on matching internal derivatives – continue to be held while the relationship between the hedged item and the internal hedging instrument ceases to exist. For example, an entity may enter into a cash flow hedge for forecasted sales in foreign currency, being the risk management strategy to protect projected cash flows. In this case, from the risk management perspective the hedging time frame would be until settlement of the sales invoice, whereas hedge accounting would only be applied until the moment the sales invoice becomes a balance sheet item (receivable), because after this moment and upon discontinuation of the hedging relationship, the entity obtains a natural offset in the income statement through the remeasurement of both the hedged item and the hedging instrument. Would this example fit in what is meant by a “change in the risk management objective”? We believe that this example should be eligible for

discontinuation according to risk management; however the wording of the ED is not clear enough to arrive to a straightforward conclusion.

The same rationale can be applied to situations where net investment hedges are designated. We support that discontinuation should be allowed for net investment hedges upon partial/total reduction of the hedging relationship. If an entity has a foreign operation and, for whatever reason, the amount of the investment is reduced, then the entity should be allowed to discontinue and unwind the hedging instrument in order to avoid an impact in profit or loss. Furthermore, if the risk management objectives change and the entity decides to reduce the amount of net investment hedges in place, it should be allowed to discontinue these hedging instruments and then unwind them. Under proposed model in the ED, would these be examples of a “change in the risk management objective” and qualify for discontinuing hedge accounting? For practical reasons, in these cases a company may decide to enter into an opposite derivative position (rather than unwinding the original one, as this may be costly) and at the same time de-designate the hedging relationship (under the voluntary de-designation option currently available in IAS 39), in order that changes in the fair value of both derivative instruments are offset in the income statement. An additional example would be that, considering the last example, instead of unwinding the derivative or entering into the opposite derivative, upon discontinuation, the derivative could be used by the entity to naturally offset other risks that are recognized in profit or loss. Could this example be considered as a change in the risk management objective and strategy?

We believe that it is not clear whether these examples would constitute a change in risk management objective and therefore lead to discontinuation of the hedging relationship. We kindly request the Board to include guidance on what is meant by a change in the risk management objective in the final standard, and to further clarify the notions and consequences of rebalancing vs. discontinuing, and continuing vs. restarting a hedging relationship.

Question 9 — Accounting for fair value hedges

(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?

We think that classifying all the gains or losses on fair value hedges into other comprehensive income and simultaneously reclassifying the ineffective portion to profit or loss (i.e. ultimately reporting all ineffectiveness in profit or loss as under current IAS 39) would only create additional practical complexity for preparers without adding value to the information for the users of financial statements. Moreover, adding three lines in the statement of other comprehensive income (change in fair value of the hedged item, change in fair value of the hedging instrument and ineffectiveness transferred to profit or loss) may undermine relevance of the financial statements by reflecting an aggregation of different types of hedging transactions with different degrees of effectiveness. The information necessary for users to assess the effectiveness of an entity's risk management strategies should instead be disclosed in the notes to the financial statements.

In addition to this, we consider that the proposed requirement to add separate lines on the face of the statement of financial position next to the line item that includes the hedged asset or liability will reduce the usefulness of reported information, especially in the case of multiple hedge relationships. Given the potential diversity of hedged items, this requirement is likely to expand the number of line items presented in the face of the income statement, without necessarily enhancing understandability for users of the financial statements. We would therefore suggest providing information in the notes at a level that would allow users to identify the hedged items and the associated gains or losses related to those items.

Telefónica does not support linked presentation where gross assets and gross liabilities that are related by way of a fair value hedge are presented together on the same side of the statement of financial position. Rather, we believe that the risk management strategy of an entity should be explained in the notes to the financial statements.

Question 10 — Accounting for the time value of options for cash flow and fair value hedges

(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?

Telefónica considers that these are positive changes, as they address an important practical issue regarding hedging with options and enhance convergence between IFRS and US GAAP. However, we believe that the detailed treatment and application guidance regarding the time value of options could be simplified.

Regarding the reclassification from other comprehensive income to profit or loss of the time value component accumulated in other comprehensive income regarding period-related hedges, Telefónica believes that an allocation over the life of the underlying item taking into account the amortizing schedules would be appropriate.

Hedges of a group of items

Question 11 — Eligibility of a group of items as the hedged item

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?

Telefónica supports that hedge accounting must be consistent with the risk management policy of an entity and for this reason we agree that a hedged item could be designated on a gross or net basis, as well as on an individual or portfolio basis, provided this is consistent with an entity's risk management practices.

We agree with some of the new criteria for the eligibility of groups of items as hedged items, especially that requiring that the items in the group are managed on a group basis for risk management purposes (ED paragraph 34(b)). Such criteria highlight the link between hedge accounting and risk management activities. However, we believe the additional condition for cash flow hedges, requiring offsetting cash flows to affect profit or loss in the same reporting period is too restrictive (ED paragraph 34(c)). We believe that is not in line with the way entities actually manage their risk in practice and should be more flexible. For instance, entities with foreign activities usually manage their risk at the group level on a net basis in a defined period. These entities are not able to match all cash flows in the same period and may manage their cash flows over several periods. Following the overall objective to align hedge accounting with the risk management strategy, net position hedge accounting should be permitted even where items impact profit or loss in different reporting periods.

Question 12 — Presentation

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?

We agree that the effect of any hedging instrument for a hedge on a net basis of a group of items that affects different line items in the income statement should be presented in a separate line. This would avoid reflecting in each line, on a gross basis, transactions that do not actually exist. Moreover, we consider that an artificial gross-up of the financial statement of position is not appropriate in the case of hedging financial assets and financial liabilities on a net basis.

Finally, as explained in our response to Question 9, we consider that where an entity is hedging a net position, the split presentation of the adjustment of the assets and liabilities would be quite artificial and not representative of the entity's risk management approach.

Question 13 — Disclosures

(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?

Although we believe that the proposed disclosures meet the objective of providing transparency into an entity's risk management policies and strategies, and the extent and effects of an entity's hedging activities, there is a general concern regarding the disclosure of commercially sensitive information.

Accounting alternatives to hedge accounting

Question 14 — Accounting for a contract for a non-financial item that can be settled net in cash as a derivative

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?

Telefónica will continue its assessment of the implication of the proposals regarding the 'own use' scope exception of IAS 39. Therefore, we do not express a view at this time.

Question 15 — Accounting for credit risk using credit derivatives

(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?

Telefónica believes that the IASB should address the issue of hedging credit risk in the hedge accounting ED, as this issue significantly impacts entities.

According to the ED, credit risk is not an eligible hedged component as it is not separately identifiable and reliably measurable. However, entities are currently managing this risk in practice. The use of credit derivatives as hedging instruments for hedge accounting should be allowed, provided that the hedging relationship meets the general requirements for qualification and is consistent with the risk management activities. This would be consistent with the main objective of the ED of bringing hedge accounting closer to an entity's risk management activities.

Question 16 — Effective date and transition

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

In its comment letter on the IASB's Request for Views on Effective Dates and Transition Methods, Telefónica suggested that the standards resulting from the major projects currently under the consideration of the IASB (including all the phases of IFRS 9 *Financial Instruments*) should have a single effective date of 1 January 2015 at the earliest, because considering the significant impact that these standards are likely to have on the financial statements, this would allow companies an appropriate implementation period in order to: understand the new accounting requirements and their implications, collect data and prepare systems for the collection of comparative information, as well as accomplish the necessary staff training and management and analyst education. Also, in certain jurisdictions, such as Europe, the new

standard needs to be translated and endorsed. Delaying the effective date would give the EU more time to cover its endorsement due process.

Telefónica considers that the effective date should be aligned with the new macro hedge accounting model still to be exposed.

Telefónica agrees that first-time adopters should be permitted to adopt the new and revised IFRSs early, in order to avoid them having to adopt standards that are about to be replaced (i.e. for practical reasons). However, we believe that this should not result in a mandatory acceleration of effective dates for existing preparers.

Regarding transition, we agree with the IASB that prospective application of the proposals would be appropriate. Telefónica would welcome additional guidance on particular transition issues such as the measurement of existing options under the new model.

Additional issues

We kindly ask the Board to address the eligibility of the following risks as hedged items under the new hedge accounting model:

- Floating-Floating Interest Rate Hedging (Liquidity Risk) –

As new developments in the interest rate market took place after 2007, there has been a new idiosyncrasy arising from the difference in the market quotes the difference between floating indices, e.g. 3m Euribor vs. 6m Euribor. Historically this difference has been close to nil, but since the financial crisis in 2007 the distortion in the short term portion of the curve due to the lack of liquidity has widened this difference, making it attractive for entities to hedge such difference. The problem is that since it is a floating- floating hedge there is no room in the current standard to allow for this transaction to be eligible for hedge accounting, impacting profit or loss. We would like the Board address the possibility of considering this as an eligible risk for hedge accounting.

- Acquisition of non-controlling interests –

We would like the Board to address the case in which a company decides to acquire outstanding non-controlling interests in a subsidiary. Under the current requirements in IAS 39 any transaction executed in order to hedge the risk exposure resulting from this transaction is not eligible for hedge accounting since the acquisition of non-controlling interests is deemed to be an equity transaction. As commented in Question 1, we would support to apply hedge accounting also to items that affect other comprehensive income or equity.

In addition, we suggest the Board to consider the following issue: from a risk management point of view it would make sense to hedge highly probable intragroup transactions in order to immunise cash flow variability in the consolidated cash flow statement due to foreign currency risk. The current problem is that under IAS 39 intercompany transactions can only be hedged from the moment in which the exchange differences arise in profit or loss, but the risk exists or is known before the transaction takes place. In these situations it is desirable that an entity that considers such risks within its risk management objectives have the possibility of hedging such risks from inception, i.e. when intragroup transactions are highly probable.