

9 March, 2011

International Accounting Standards Board
30 Cannon Street
London EC4M6XH
United Kingdom

Dear Sir David,

Response to ED/2010/13 Hedge Accounting

Hindalco Industries Limited, the metals flagship company of Aditya Birla Group is the world's largest aluminium rolling Company and one of the biggest producers of primary aluminium in Asia. We operate 51 units in 13 countries world over. Our copper smelter is the world's largest custom smelter at a single location. The acquisition of Novelis Inc in 2007 positioned us among the top five aluminium majors worldwide and the largest vertically integrated aluminium company in India. Our consolidated turnover was USD 13 billion during 2009-10.

We thank the IASB (the Board) for the opportunity to comment on the aforementioned Exposure Draft (ED). We are pleased that the Board has issued this ED on hedge accounting under the final phase of its project to replace IAS 39. In our opinion this ED has in a number of aspects, correctly identified and effectively addressed the key weaknesses of the hedge accounting model under IAS 39.

In terms of the specific changes proposed in this ED, we think that the Board has hit the right notes in the following areas:

- Allowing risk components (other than foreign currency risk) of non- financial assets or liabilities to also be eligible for designation as hedged items, subject to the "separately identifiable" and "reliably measurable" criteria.
- Allowing aggregated exposures to be designated as hedged item
- Allowing group of items to be eligible hedge items and thereby permitting net position hedging
- Eliminating the arbitrary IAS 39 hedge effectiveness "Bright Line" criteria of 80-125 percent

In general the changes proposed by the Board are welcome, however there are a few concerns that we would like to highlight:

- **Outstanding conceptual differences with the FASB-** We observe that the IASB and the FASB continue to have divergent views on various technical issues on financial instruments accounting. The work to reach consensus in these contentious areas has been further impeded by different project approaches and timelines. As reported in the last quarterly progress update issued by both Boards in November 2010, the FASB plans to re-deliberate hedge accounting only in the second quarter of 2011. In the broader interest of realising high quality global accounting standards, we urge the Boards to continue to work together to resolve outstanding conceptual differences
- **Definition of Firm Commitment** – We have noted that the Board has not made any change in the definition of Firm Commitment and retained the existing definition under IAS 39. We feel that the existing definition of Firm Commitment under IAS 39 is restrictive and at times difficult to achieve in real life business. We

HINDALCO INDUSTRIES LIMITED

Aditya Birla Centre, 'A' Wing, Ground Floor,
S. K. Ahire Marg, Worli, Mumbai 400 030, India

Telephone +91 22 66525000, 24995000
Fax +91 22 66525043, 24995043

Website www.adityabirla.com

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therefore, request the Board to have a relook at the definition of Firm Commitment and provide some more practical guidance.

- **Highly probable forecast transaction** - Companies like Hindalco often face risks whose ultimate occurrence involves some uncertainty (highly probable forecasted cash flows, firm commitments, etc.) Our risk management policies require that we hedge these risks based on projected scenarios believed to be "most likely". Existing rules do not make sufficient accommodation for the uncertainty of business.
- **Designating gross position**- We believe that IASB should clarify that hedge accounting can be applied to a gross position, even if the risk is managed at a net level. Although volatility is not eliminated due to timing differences that may exist within a net exposure, designation of one side of the net exposure is still preferable to no hedge accounting in such scenarios.
- **Voluntary De-designation** - We do not believe that entities should discontinue hedge relationships that are effective and continue to meet the risk management object, except in only limited situations. We encourage the IASB to converge to the FASB's exposure draft on this subject, namely that hedge relationship be de-designated prematurely in only limited situations, including a termination of the derivative either by closing the position or by taking an opposite position with a separate instrument.

Our response to specific questions posed in the ED is as follows:-

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?

None

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?

None

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?

We agree and welcome this proposal. In case of Indian companies dealing in commodities, any future sale transaction has got the commodity price risk and the foreign exchange fluctuation risk which are managed separately by taking commodity and Forex derivatives. In order to achieve Hedge Accounting, we designate both the derivatives separately against Highly Probable Forecast sales for all pricing risks (other than forex risk) and for forex risk. Any downward movement of LME would lead to over designation in the Forex front and thereby require de-designation. This ultimately leads to volatility in the Income Statement which is not consistent with our Risk Management objective.

In such cases a combination of LME derivatives and the foreign currency exposure will provide the much needed stability to the hedge programme which is also consistent with our risk management objective.

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?

A long awaited need of certain companies has finally been addressed. So far, IAS 39 had a huge bias against the commodity hedges. This ED has made an attempt to rectify that.

Now the companies in the commodity business will be allowed to designate only the commodity price risk if separately identifiable and reliably measurable against the commodity derivatives if consistent with the risk management objective of those companies. Typically the prices of the products produced by Aluminium and Copper producers are driven by LME which constitutes the largest portion of the price though the ultimate price of the product contains other price elements like conversion premium, duties etc. Companies in such business do hedge the commodity price risk through Aluminium and Copper LME derivatives which is consistent with their Risk Management objective.

Under IAS 39, it is very difficult to achieve hedge accounting since "All risk other than Foreign Currency Risk" only can be designated. Since conversion premium, though only a small portion of the price varies product to product, it is extremely difficult to build in this element in the hedge accounting model and thereby achieve hedge accounting. These companies will now be able to designate the LME component included in such exposure since such risk is separately identifiable and reliably measurable.

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?*

None

Question 6:-

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what changes do you recommend and why?

Broadly, we are supportive of the proposed hedge effectiveness criteria in paragraph 19 of the ED. In particular we think the removal of the IAS 39 hedge effectiveness "bright line" criteria of 80-125 percent would significantly reduce the challenges faced by preparers in applying hedge accounting. However, we believe that, this is susceptible to a varying degree of interpretation, depending on an entity's risk management threshold. Although the Board has made an attempt to clarify this notion in paragraph B31 of the ED, we believe that there is a need for further clarification.

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?*

None

Question 8:-

- (a) *Do you agree that an entity should discontinue hedge accounting prospectively only when the hedge relationship (or part of a hedge 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 hedge 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?*

We do not believe that entities should discontinue hedge relationships that are effective and continue to meet the risk management object, except in only limited situations. We encourage the IASB to converge to the FASB's exposure draft on this subject, namely that hedge relationship be de-designated prematurely in only limited situations, including a termination of the derivative either by closing the position or by taking an opposite position with a separate instrument.

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?*

None

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 (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?*

We 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, because we believe that it is appropriate to consider the option's time value as part of the basis of the hedged item and the Board is right in interpreting the general perception of the Risk Managers while entering into an one-sided option.

We also 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. We agree with Board's basis of conclusion that this would bring in consistency in accounting in line

with Insurance premiums paid to cover time period related risks for existing Assets like Plant and Machinery, Building etc.

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?

We agree with the Board's criteria for the eligibility of groups of items as a hedged item. We believe that these criteria are more aligned to risk management practices of an entity. Current provisions in IAS 39 are more stringent and rule based. We also welcome the proposal to permit the net position of hedging of a group of items, and consider it as another improvement over the current requirements of IAS 39.

However, we have concerns on the Board's rationale for not allowing cash flow hedge of a net position, if the offsetting cash flow would affect profit or loss in different reporting periods. This will restrict application of Hedge accounting for accounting purpose even though the entity might be economically hedged since the risk management activities are not necessary guided by the timing of recognition in Income Statement. We have tried to elaborate this in the following paragraph.

Companies in commodity business do hedge net position of the pricing risk - for example, if the pricing for input and the finished product they sell are on the same basis say Average CSP of LME of the same period, they would hedge the net position of such input and output for that particular month. Now, since the value of the input priced in that period may not hit the Income Statement in the same period (due to processing time involved), these companies will be restricted to apply hedge accounting on such net position hedges as per the current restriction proposed by the board though they are perfectly hedged economically.

Thus this proposal may contradict the Board's objective of aligning external reporting with internal risk management policies.

Further, we would like to mention here that the Board should clarify whether Gross position designation is allowable under such situation since gross level designation will be still preferable rather than no designation.

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?

We believe that this proposal has a sound and conceptual basis and we also agree with the Board's justification, that adjusting or grossing up all the affected line items could lead to recognition of gross gains or losses that do not exist. Thus we think that separate presentation in the income statement of the OCI re-classified hedging instrument gains or losses would better reflect the economic substance of net position hedging.

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?*

None

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?

None

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?*

None

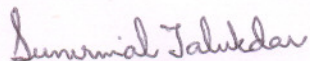
Question 16

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

We agree that the new hedge accounting model should be applied prospectively. The retrospective application principle would be inconsistent with the hedge accounting principle that a hedge accounting relationship can only be designated prospectively. We believe that the proposed transition requirement is conceptually sound and internally consistent.

Thanking you,

Yours very truly,



Sunirmal Talukdar
Group Executive President & CFO
Hindalco Industries Limited