



LARSEN & TOUBRO LIMITED

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Ref. : CA/MAR11/ED/IASB 13

March 9, 2011

The International Accounting Standards Board,
1st Floor, 30 Cannon Street,
London EC4M 6XH, United Kingdom.

Dear Sirs,

Sub: Our Comments on Hedge Accounting (ED/2010/13)

With reference to the above, we thank you for giving us an opportunity to share our views. Our response to specific questions set out in the document containing the exposure draft is enclosed vide **Annexure A**.

Thanking you,

Yours faithfully,

For **LARSEN & TOUBRO LIMITED**

Vaishali P. Koparkar
Joint General Manager
Corporate Accounts

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Encl: Annexure A

Annexure A

Comments on Comments on Hedge Accounting (ED/2010/13)

No.	Question	Response
1.	Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?	<p>Yes, we agree with the board's proposed objective of hedge accounting.</p> <p>The objective of hedge accounting is 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. This approach aims to convey the context of hedging instruments in order to allow insight into their purpose and effect.</p> <p>We agree with the board that the proposed objective of hedge accounting reflects a broad articulation of a principle based approach with a focus on the purpose of the entity's risk management activities. In addition, the objective also provides for a focus on the statement of financial position and the statement of comprehensive income reflecting the effects of the individual assets and liabilities associated with the risk management activities.</p>
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?	<p>Yes, we agree with the board's proposal to permit the use of non-derivative financial assets and non-derivative financial liabilities measured at fair value through profit or loss as eligible hedging instruments in its entirety.</p> <p>The proposal widens the scope of availability of hedging instruments which presently is restricted to hedging of only foreign currency risk. This flexibility will result in a cost-effective and principle based risk management strategy for the entity.</p> <p>Moreover, the said change in accounting principle will reflect the true substance by bringing out the purpose and impact of the risk exposures involved in a transaction.</p>



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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?	<p>No. Conceptually we do not agree with the proposed change as the same is not in line with the principles of hedge accounting.</p> <p>Taking the example given in BC50, it is clear that the entity has no interest rate exposure at the first place since it is fixed rate debt. By entering into a 10 year "receive fixed and pay floating" cross currency interest rate swap, the fixed interest rate exposure has been converted into a floating interest rate exposure. If the intention of the entity was to hedge its currency risk, it could have entered into a "receive fixed and pay fixed" cross currency swap thereby converting its exposure from fixed rate foreign currency debt into fixed rate domestic currency exposure.</p> <p>In the aforesaid example, the entity already has the option to designate the "receive fixed and pay floating" portion of the cross currency swap as a fair value hedge of its fixed rate debt and apply hedge accounting. If the entity enters into another "receive floating and pay fix" interest rate swap for two years, it is a form of de-hedging the fair value hedge (taken for 10 years) for 2 years. To call this subsequent action as a "hedging" activity is not justified. In effect, it is "de-hedging" and should not be made eligible for hedge accounting.</p> <p>The current hedge accounting norms on this issue should not be diluted as they not only facilitate "risk management" but also provide an evaluation platform for the "risk management" activities.</p>
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 (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?	<p>Yes, conceptually we agree with the board's proposal to allow designation of a risk component of hedged item subject to "separately identifiable and reliably measurable" criteria.</p> <p>The proposal adopts the principle of "separately identifiable and reliably measurable" for designation of risk component irrespective of whether an item is financial or non-financial. It</p>



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		<p>aligns the hedge eligibility of risk components of non-financial items with that of financial items.</p> <p>Practical implementation of the guidance raises challenges as to fulfillment of “separately identifiable and reliably measurable” conditions especially for non-financial items that are not contractually specified.</p> <p>We also request board to incorporate more examples in the implementation guidance for determining “separately identifiable and reliability” criteria covering non-financial items that are not contractually specified into separately identifiable and reliably measurable risk components.</p>
5.	<p>(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?</p> <p>(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?</p>	<p>(a) Yes, principally we agree with the board’s proposal that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item. Transactions (anticipated/existing) are generally surrounded by the uncertainty as to amount and timing. Thus, the proposal will facilitate alignment of economic reality of businesses and accounting practices.</p> <p>(b) Yes, we agree with the board’s view. For applying hedge accounting principles, risks of a hedge item should be separately identifiable and reliably measurable. In case of a layer component of a contract that includes a prepayment option, it difficult to satisfy the condition of risks being separately identifiable if the prepayment option’s fair value changes in response to the hedged risk.</p>
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?	<p>Yes, we agree with the board.</p> <p>Present IAS 39 prescribes 80-125% window for achieving hedge effectiveness. It makes hedge accounting difficult to understand in the context of the risk management strategy of the entity.</p>

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		<p>The proposed objective based effectiveness assessment model will strengthen the relationship between hedge accounting and risk management practices.</p> <p>We also wish to submit that as per para B 27 Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item (eg when the hedged item is a risk component the change in fair value or cash flows of an item) attributable to the hedged risk.</p> <p>It may be clarified that attribution to hedged risk as mentioned in para B 27 could be either for a particular risk or for a particular time period for which such risk is being hedged. In the absence of such clarification, there are divergent practices for assessing hedge effectiveness including one which deems the six month period forward exchange contract as ineffective (to some extent) to hedge a nine-month period highly probable forecast transaction denominated in FCU. However, ideally there should be no ineffectiveness as the fair value changes in the hedge item should be evaluated with reference to the hedged risk which is documented as the risk for the period of 6 months and not for the entire period of 9 months.</p> <p>Another issue as regards hedge ineffectiveness arises on account of different measurement basis adopted for hedged item and hedging instrument. Though para B43 of the ED states that time value of money should be considered when measuring hedge ineffectiveness, it is not possible to eliminate the accounting mismatch if the hedged item is measured on different measurement base.</p> <p>For eg., if foreign currency risk of a debt denominated in foreign currency debt is hedged by entering into long tenor forward exchange contract, the foreign currency debt is translated using spot rate as per para 23(a) of IAS 21. However, the fair value of the hedging instrument is determined using forward rates after applying</p>



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		<p>present valuation technique. This creates two types of mismatches (a) one relating to volatility in interest rates which affects forward rates; and (b) the other relating to present valuation of the gain/loss of the hedging instrument (gain /loss of hedged item is not fair valued pursuant to IAS 21). To address this mismatch, it should be clarified that IAS 39 would override para 23 (a) of IAS 21 wherever fair value hedge accounting is applied. The implementation guidance in para E.3.4 should be modified accordingly.</p>
7.	<p>(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?</p> <p>(b) Do you agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge</p>	<p>(a) Yes, conceptually we agree with the board's view of rebalancing the existing hedge relationship. Present IAS 39 does not allow adjustments that were not documented at the inception of the hedge. For such adjustments, IAS 39 required discontinuation of the present hedging relationships and restarting of a new hedging relationship. This onerous requirement impacted profit and loss account without considering the substance of the adjustment and company's risk management policy.</p> <p>If the original risk management objective remains unchanged, then the proposal ensures alignment with the substance of the transaction and its accounting in the financial statement (allows rebalancing). However, if the adjustment tantamount to overhaul of the existing hedging relationship, then rebalancing is not permitted.</p> <p>However, we are of the opinion that implementation of rebalancing requirement would require lot of judgement and documentation. Thus, we request board to issue practical implementation guidance for the same.</p> <p>(b) Yes, we agree with the board's proposal to proactively rebalance the ineffective hedge relationship as the same will strengthen the</p>



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	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?	link between hedge accounting and risk management.
8.	<p>(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?</p> <p>(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?</p>	<p>(a) Yes, we agree with the board' proposal to 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).</p> <p>Prohibition of voluntary discontinuation of hedging relationship will ensure consistency in accounting practices and adherence of risk management policy. The step will also prevent opportunistic use of derivatives (between hedging and trading).</p> <p>(b) Yes, we agree with the board as the same will bring out true spirit of hedge accounting which will be in line with the company's risk management objective and strategy.</p>
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?	(a) No, we do not agree with the board's proposal 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. We are of the opinion that the proposal does not enhance in any way the established practice of present IAS 39, (i.e. fair value hedges accounting in profit & loss) in terms of information to users and results in similar outcome. In fact, it will



No.	Question	Response
	<p>(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?</p> <p>(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?</p>	<p>put operational burden on companies to change the existing practice without any benefit.</p> <p>The only benefit will be that the extent of offsetting achieved for fair value hedges will be evident. However, this can be achieved thru" additional disclosure requirement also.</p> <p>(b) No, we do not agree with the board's proposal 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 as the same will increase the number of line items in the statement of financial position. We agree that presently there are mixed measurement problems. However, the same can be avoided thru' an appropriate disclosure in notes to financial statements.</p> <p>(c) Yes, we agree with the board's view of not allowing the linked presentation for fair value hedges. Linked presentation may not reflect the true risk relationship of a hedge item and a hedging instrument as the link may portray the complete risk coverage of the relationship, however, in reality only a part of the risk would have covered in the hedging relationship.</p> <p>We also agree with the board that the disclosures about hedging would be a better alternative to provide information that allows users of financial statement to assess the relevance of the information for their own analysis.</p>
10.	(a) Do you agree that for transaction related hedged items, the change in fair value of	<p>(a) Yes, we agree with the board's proposal.</p> <p>Under IAS 39 the undesignated time value of</p>



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	<p>the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (e.g. 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?</p> <p>(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?</p> <p>(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?</p>	<p>option is treated as held for trading and is accounted for as at fair value through profit & loss, which gave rise to significant volatility in profit & loss account.</p> <p>Treating the undesignated time value option as a premium for protection against risk ("insurance premium risk") and accounting the changes in the fair value of such option for transaction related hedge items, in other comprehensive income, will not only reduce the volatility in P&L but also reflect true substance of the transaction.</p> <p>(b) Yes, we agree with the board's proposal.</p> <p>(c) Yes, we agree that the specific accounting treatment should apply only to the extent the time value related to the hedged item.</p>
11.	<p>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?</p>	<p>Yes, we agree with the board's criteria for the eligibility of groups of items as a hedged item.</p> <p>Paragraph 84 of IAS 39 explicitly forbids net position hedging, and this has created a gap between the IAS 39 hedge accounting model and actual risk management practice. The proposed change will reflect objective based hedge accounting well aligned with risk management</p>



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		<p>strategy.</p> <p>We also request the Board to provide implementation guidance on similar lines as given in para F.5.6 of IAS 39-IG.</p>
12.	<p>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 (e.g. 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?</p>	<p>Yes, we agree with the board's proposal to present reclassification adjustment (in a net position hedge) as a separate line in profit or loss account.</p> <p>Moreover, we agree with the board's contention as given in BC 175 that to adjust (gross up) all the affected line items in the income statement would result in the recognition of gross (partially offsetting) gains or losses that do not exist, and that this would not be consistent with general accounting principles.</p>
13.	<p>(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?</p> <p>(b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?</p>	<p>(a) Yes, we agree with the proposed disclosure requirements as the same would ensure transparency between entity and users of financial statements. We believe that hedge accounting based on entity's risk management strategy would be well appreciated only if it is supported by detailed disclosures for user's understanding.</p> <p>(b) Please refer our response on question 9(a) and (b) above</p>
14.	<p>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?</p>	<p>Yes, we agree with the board's proposal as it is in line with the entity's risk management strategy and will reflect the true pattern in which the businesses are transacted.</p>

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15.	<p>(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?</p> <p>(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?</p>	<p>(a) Yes, we agree with the board that 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.</p> <p>The methodology/rules suggested for accounting such credit risk tantamount to be inconsistent with the principle based standard setting philosophy.</p>
16.	Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?	<p>We agree that the new hedge accounting model should apply only prospectively. The retrospective application principle in IAS 8 (which would otherwise be applicable) is not relevant in this context, considering that it would not be in line with the proposed principle that a hedge accounting relationship can only be designated prospectively.</p> <p>As for the proposed effective date of the new hedge accounting model, we concur with the Board that it should be aligned with the effective date for IFRS 9, and that earlier application should be permitted provided all existing IFRS 9 requirements have already been adopted or will be adopted together with the new hedge accounting requirements.</p>