

24 March 2011

Sir David Tweedie Chairman  
International Accounting Standards Board 30 Cannon Street London EC  
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Dear Sir David

Thank you for the opportunity to comment on the recent exposure draft issued by the International Accounting Standards Board ("IASB") titled 'Hedge Accounting' ("the Exposure Draft").

We would like to commend the IASB and Staff on the extent and quality of outreach undertaken over the last two years with regards to this Exposure Draft. Our interactions with Board members and staff on this project over this time resulted in quality discussion and debate and enabled us to provide alternate views and practical examples for inclusion in deliberations and decisions.

We are very pleased to see that the Exposure Draft proposals have addressed our concerns particularly in relation to hedge ineffectiveness requirements, risk component hedging for non- financial items and the accounting treatment for time value of options which are designated as a hedging instrument.

We fully support the following key proposals of the Exposure Draft:

1. That the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management strategies;
2. That an aggregated exposure, that is, a combination of another exposure and a derivative, may be designated as a hedged item;
3. That an entity be allowed to designate as a hedged item in a hedging relationship, changes in the cash flow 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. Specifically this allows risk components of non-financial items to be designated in a hedging relationship where the risk is separately identifiable and reliably measurable (for example, designating one barrel of crude oil for the crude component of one barrel of jet fuel);
4. The requirements for hedge effectiveness no longer includes a prescriptive 'bright line' range but instead require that a hedging relationship:
  - a. meets the objective of hedge effectiveness assessment; and
  - b. is expected to achieve other than accidental offset;
5. That the change in fair value of the time value of an option which is designated as a hedging instrument is deferred in other comprehensive income and recognised in line with the related exposure.



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Notwithstanding our support of the key proposals above, in our view there are a small number of points of clarification or enhancement which would further improve the Exposure Draft proposals. In summary:

1. We propose that the transition provisions allow for retrospective application of the new accounting requirements for continuing hedge relationships. We also propose that at the date of adoption, an entity can designate or redesignate hedging relationships in accordance with the new requirements.
2. We wish to clarify the qualification assessment of derivative instruments that combines written options and purchased options as there appears to be an inconsistency within paragraph 11. In addition, we propose that the IFRS include a definition of 'net written options'.
3. We propose an amendment to paragraph 24 to require discontinuance of hedge accounting where the hedging relationship ceases to meet the entity's risk management objectives.
4. We wish to clarify the hedging treatment of delays of forecast firm commitments.
5. We wish to clarify whether an entity can designate separate components of risk in a hedging relationship with a single hedging instrument.
6. We recommend consistent disclosures with regards to risk exposures between entity's that hedge the risk and apply hedge accounting and entity's that do not hedge the risk.

## **1. Transitional provisions**

*We propose that the transition provisions allow for retrospective application of the new accounting requirements for continuing hedge relationships. We also propose that at the date of adoption, an entity can designate or redesignate hedging relationships in accordance with the new requirements.*

Paragraph 53 proposes that 'an entity shall apply this [draft] IFRS prospectively for annual periods beginning on or after 1 January 2013 with earlier application permitted'.

If the requirements of the Exposure Draft are applied prospectively on continuing hedge relationships involving options, the change in fair value of the time value of the option will be inconsistently recognised in the income statement over different financial periods.

For example, an option has been designated in an existing hedging relationship for the purchase of an item of property, plant & equipment. Prior to the application of the new requirements, the change in fair value of the time value of the option has been recognised directly in the profit or loss. Subsequent to application of the new requirements, the change in fair value of the time value of the option will be deferred in other comprehensive income and recognised in the carrying value of the item of property, plant & equipment.

The amount included in the carrying value of the item of property, plant & equipment will not be equal to the initial premium cost as the change in fair value of the time value up to the application date was recognised directly in the profit or loss. As a result, the amount included in the cost of the item of property, plant & equipment will not represent the true cost of the item. This may have consequential impacts on impairment testing and will distort future depreciation expense.

In our view, where there is a continuing hedging relationship, the accounting outcome should be consistent with the proposals of the Exposure Draft. As such, as a minimum modification to the transition provisions, we propose retrospective application of the proposals for continuing hedging relationships.

In addition, given the significant changes in the requirements to designate hedging relationships included in the Exposure Draft, we propose that an entity be allowed to designate or redesignate hedging relationships at the date of initial adoption in line with the entity's risk management objectives. For example, designation of fuel hedges to specific risk components. Any required adjustment should be recognised within opening retained earnings at the date of adoption with the new designations applied prospectively.

This would result in complete transition to the new requirements rather than a hybrid combination of prior designations and new accounting treatment for existing hedging instruments.

We therefore propose the following transition requirements be included in the final IFRS:

"An entity shall apply this [draft] IFRS for annual periods beginning on or after 1 January 2013 with earlier application permitted.

For hedging relationships that qualified for hedge accounting in accordance with IAS 39 that also qualify for hedge accounting in accordance with this [draft] IFRS (continuing hedging relationships), an entity shall retrospectively apply this [draft] IFRS. An entity need not restate prior periods. If an entity does not restate prior periods, the entity shall recognise any differences within opening retained earnings (and/or another component of equity, as appropriate) of the reporting period of initial adoption.

At the date of initial adoption, an entity may designate or redesignate hedging relationships in accordance with this [draft] IFRS. Such designation shall be made on the basis of facts and circumstances that exist at the date of initial adoption and be applied prospectively. The entity shall recognise any differences within opening retained earnings (and/or another component of equity, as appropriate) of the reporting period of initial adoption.

The disclosure requirements of this [draft] IFRS need not be applied in comparative information provided for periods before initial application of the [draft] IFRS. However, the hedge accounting requirements in this [draft] IFRS can be applied only if all existing IFRS 9 requirements are adopted at the same time or have already been adopted."

## **2. Clarification of apparent inconsistency in paragraph 11 and definition of 'net written options'**

*We wish to clarify the qualification assessment of derivative instruments that combines written options and purchased options as there appears to be an inconsistency within paragraph 11. In addition, we propose that the IFRS include a definition of 'net written options'.*

In our view, there is an inconsistency within paragraph 11. The first sentence of paragraph 11 states that a derivative instrument that combines a written option and a purchased option qualifies as a hedging instrument as long as it is not a net written option. However the second sentence of paragraph 11 states that two or more instruments may be designated as the hedging instrument only if none of them is a written option. By the second sentence not allowing any written options this appears inconsistent with the first sentence that allows written options as long as they are not 'net written options'. This would preclude the use of certain key risk management strategies such as the use of 'zero cost collars'.

Accordingly, we propose the following amendments to paragraph 11: "... a derivative instrument that combines a written option and a purchase option (e.g. an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option. Similarly, two or more instruments (or portions of them) may be designated as the hedging instrument only if they are not ~~none of them is a written option or~~ a net written option."

We also propose that the final IFRS include a definition of 'net written options' given its importance to the qualification requirements. We propose that this definition should be 'a net written option exists where, at the point of designation, the option premium received from a written option exceeds the option premium paid for a purchased option'.

An example where clarification would be beneficial is when an entity restructures a collar to improve the worst case effective rate. An existing collar can be restructured by a subsequent sale of the original bought option and a simultaneous purchase of a new bought option at a more beneficial rate. The sale and purchase of the new bought option will be a net premium cost, however the market value of the combined collar, including the original sold option will reflect a net 'sold' fair value.

## **3. Hedge accounting to discontinue where hedging relationship ceases to meet risk management objectives**

*We propose an amendment to paragraph 24 to require discontinuance of hedge accounting where the hedging relationship ceases to meet the entity's risk management objectives.*

The Exposure Draft outlines that 'the objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities'.

Paragraph 24 requires an entity to discontinue hedge accounting only when the hedging relationship ceases to meet the qualifying criteria.

An entity may change its risk management objectives. Therefore, we propose the following change to paragraph 24.

'An entity shall discontinue hedge accounting prospectively only when the hedge relationship (or part of a hedge relationship) ceases to meet the qualifying criteria or the entity's risk management objectives.'

#### **4. Clarification of the treatment of delays of forecast firm commitments.**

*We wish to clarify the hedging treatment of delays of forecast firm commitments.*

We seek clarification on the treatment of delays of forecast firm commitments. For example, where forecast foreign currency capital expenditure is hedged with a matched terms foreign exchange contract and the expenditure subsequently delayed by the supplier. In this example, the existing foreign exchange contract will be rolled out with a new foreign exchange contract maturing on the new forecast date.

In our view, the original foreign exchange contract, and the contracts necessary to roll the hedging to the new exposure date, should continue to qualify as effective hedges. At the time of entering each hedge relationship, the contracted expenditure was highly probable and in line with the risk management objectives.

The alternative of retrospectively testing the original foreign exchange contract against the new exposure date introduces ineffectiveness that has the benefit of hindsight and does not reflect the facts at the time the hedge was put into place.

Of course, if the capital expenditure was cancelled, the foreign exchange contract would cease to be a hedge and should be accounted for accordingly.

#### **5. Hedging separate risk components with a single hedging instrument**

*We wish to clarify whether an entity can designate separate components of risk in a hedging relationship with a single hedging instrument.*

As stated above, we concur with the proposal to allow an entity to designate as a hedged item in a hedging relationship, changes in the cash flow or fair value of an item attributable to a specific risk, provided that the risk component is separately identifiable and reliably measurable.

The Exposure Draft is however silent on whether this separate risk component designation can be achieved with a single hedging instrument.

For example, an entity holds a 10 year fixed rate foreign currency bond. The entity could hedge the foreign exchange risk of this bond by designating a 10 year fixed (foreign currency) to fixed (local currency) cross currency swap in a cash flow hedge relationship. Separately, the entity could hedge the interest rate fair value risk of the bond by designating a 10 year fixed to floating interest rate swap in a fair value hedge relationship.

A 10 year fixed to floating cross currency swap achieves exactly the same risk management objective as the two separate derivatives included in the above example. Therefore as per the objective of the Exposure Draft, the accounting treatment should result in the same outcome.

In this instance we submit that the entity should be able to bifurcate the fixed to floating cross currency swap into a cash flow hedge of foreign exchange risk (using a hypothetical fixed to fixed cross currency swap) and a fair value hedge of interest rate risk (using the hypothetical synthetic fixed local currency exposure).

We request clarification of whether an entity can designate separately in a hedging relationship the changes in the cash flow or fair value of a hedging instrument attributable to a specific risk, provided that the risk component is separately identifiable and reliably measurable.

## 6. Disclosures specific to risk management objective and activities

*We recommend consistent disclosures with regards to risk exposures between entity's that hedge the risk and apply hedge accounting and entity's that do not hedge the risk.*

The Exposure Draft proposes that an entity should explain its risk management strategies for each category of risk exposure that it decides to hedge and for which hedge accounting is applied. We note, however, that outside of these hedging disclosure requirements, an entity that does not apply hedge accounting is only required by IFRS 7 to disclose its objectives, policies and processes for managing risks arising from financial instruments. These entities would therefore not disclose the risk management objectives for risks not arising from financial instruments.

Additionally, paragraph 46(a) of the Exposure Draft requires an entity applying hedge accounting to disclose the monetary amount or other quantity to which the entity is exposed for each particular risk. An entity that does not hedge this risk and apply hedge accounting would not be required to disclose such information even though that entity may be exposed to exactly the same risk.

In our view, if an exposure is considered a risk, the amount or other quantity of that exposure and how an entity manages that risk exposure is even more important to users of the financial statements if the entity has not hedged that risk.

We therefore propose that such disclosures are not specific to the hedging requirements but should be considered in the general IFRS 7 disclosure requirements. This would therefore disclose to users of the financial statement that the risk exists and the entity has not hedged this risk.

If you have any questions with regards to our comments or alternate proposal above, please don't hesitate to contact me.

Yours sincerely

/s/ Laetitia Spina  
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Officer Qantas Airways  
Limited