

9 March 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC 4M 6XH
UNITED KINGDOM

Dear Sir David

ED/2010/13 'HEDGE ACCOUNTING'

The Group of 100 (G100) is an organization of chief financial officers from Australia's largest business enterprises with the purpose of advancing Australia's financial competitiveness. We are pleased to provide comments on the Exposure Draft.

The G100 is in broad agreement with, and supports, the adoption of the risk management strategy approach to hedge accounting as proposed in the ED. This approach better reflects a principles approach to addressing the issue and removes a number of the rules-based impediments which characterize the existing requirements. Accordingly, it will enable management to achieve a better alignment of hedge accounting and its risk management strategy and will result in more relevant and useful information being provided to shareholders and other users. However, the G100 believes that the proposals would be improved if the following matters were addressed:

- a. accepting that net foreign income from subsidiaries should be eligible for treatment as a qualifying hedged item;
- b. permitting foreign investments accounted for on the basis of fair value through other comprehensive income to be hedged for foreign currency risk;
- c. permitting a once-only adjustment to realign hedge relationships on transition to enable companies to respond to the flexibility in the proposals;
- d. the specification of disclosure principles to be applied by management rather than specifying matters to be disclosed; and
- e. eliminating the inconsistency which currently exists when calculating ineffectiveness under the fair value and cash flow hedging models.

Q1 *Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?*

The G100 agrees that the proposed objective that hedge accounting should faithfully represent the economic consequences of the risk management activities of the entity including achieving a risk management objective. However, hedging activity may be undertaken to provide protection from the risk of changes in the carrying amount of balance sheet items and capital expenditure outcomes. While it may be argued that the effect of changes in the amount of, say, property, plant and equipment, will ultimately be reflected in profit and loss, the G100 suggests that all risk management activities for which hedging is undertaken should be addressed directly.

Q2 *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?*

Yes. The G100 agrees it is appropriate that non-derivative instruments measured at fair value through the profit or loss qualify as hedging instruments because this would be consistent with the risk management strategies of some entities. However, if an instrument/item operates as an effective hedge instrument consistent with an entity's risk management strategy the G100 believes that it should also qualify for hedge accounting.

Q3 *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?*

Yes. This approach also enables hedge accounting to better reflect the risk management strategies of the entity than occurs under the present requirements. As such, the removal of the impediment means that hedge accounting will better reflect the application of the risk management strategies of the entity.

Q4 *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?*

Yes. The proposal will result in a better alignment of hedge accounting and the entity's risk management strategy. The G100 suggests that the commentary be amended to recognize that, in principle, issues relating to credit risk are the same as any basis risk in an imperfect hedge relationship.

Q5 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?*

Yes because it achieves alignment of the risk management strategy and its representation in financial reports.

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?

Yes. However, there maybe circumstances where this prepayment option aligns with the risk management strategy of the entity and therefore should be included.

Q6 *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?*

Yes. The G100 believes that this proposal will remove a major practical impediment to the operation of hedge accounting. The 80:125 rules for assessing hedge effectiveness precluded the use of hedge accounting even though the risk management objectives of the entity were being achieved.

Q7 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?*

Yes. However, we suggest that an entity be permitted rather than be required to rebalance in the aforementioned circumstances. This proposal introduces a flexibility which is present in the management of ongoing hedging relationships where entities would 'rebalance' their hedge book in response to changing circumstances. This approach would remove the frustrations, inefficiencies and costs associated with re-designation and re-classification of hedging relationship.

However, the current drafting may inhibit rebalancing in practice. For example, in a cross-currency swap designated as a fair value hedge of interest and foreign exchange risk on foreign currency denominated borrowing unavoidable ineffectiveness is likely to arise due to currency basis risk. In these cases requiring rebalancing would be inappropriate as the unavoidable ineffectiveness will reverse to zero over the term of the hedge.

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?

Yes.

Q8 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?*

The G100 agrees with discontinuation in these circumstances. However, we believe that an entity should be able to discontinue hedge accounting where this reflects the application of its risk management strategy in response to changing circumstances.

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?

Yes. However, this should not preclude an entity from revisiting/reviewing its risk management objective and strategy. It is important that the accounting reflects the operational flexibility of the hedge strategies as the entity responds to changing circumstances.

Q9 *a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized 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?*

Yes.

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?

No. The gain/loss on the hedge transition should, consistent with the objective of the entity's risk management strategy, be included in the measurement of the hedged item. However, if retained, determining an appropriate meaningful description for this line item is needed so that users understand its meanings and implications.

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?

Yes. The G100 believes that linked presentation will confuse the users of financial statements in most circumstances. However, in limited circumstances a linked presentation may provide relevant information to users where a foreign currency borrowing has been hedged for interest rate and foreign currency risk. In these cases a linked presentation may assist understanding of, and better reflect, the debt position of the company.

Q10 *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 capitalized 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?*

Yes.

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?

Yes.

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?

Yes.

Q11 *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?*

The G100 supports an approach which is consistent with the risk management strategies of the entity and the outcome of the Board's deliberations on macro hedging. However, the distinction between hedging groups of items and macro hedges needs to be explained. We believe that the Board should finalise these requirements in a timely fashion so that entities affected can implement the new requirements in an orderly fashion.

Q12 *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 recognized 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?*

No. The G100 does not support the separate presentation of the outcome (net position) in the profit and loss. Companies should be permitted to allocate the gain or loss in a manner which best contributes to an understanding of their results. Separate presentation of items in the balance sheet would be confusing to users of financial statements.

Q13 *a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?*

No. The G100 agrees with the specification of the disclosure objective. The G100 believes that disclosure principles should be outlined in the standard and that the content and presentation is a matter for the directors to determine. Application of this approach is more likely to result in cost-effective disclosures reflecting the objectives and outcome of hedging as part of the risk management strategy of the entity.

b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?

The G100 believes that these are best left to the directors in meeting the disclosure principles and objectives outlined in the resulting standard and providing transparency of the hedging activities.

Q14 *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?*

Yes. The G100 supports these proposals which remove some of the practical problems under the existing requirements. However, a number of practical issues remain to be addressed. For example, many physical commodity contracts may not satisfy the net cash settlement requirements in the ED. This will reduce the potential benefits of the amendments. It should also be noted that as the wording of paragraphs 5 and 6 are not provided in the ED the full impact of this amendment cannot currently be properly assessed as to the breadth of operation.

Many commodity contracts – such as coal contracts, will not satisfy the 'readily convertible cash' definition due to the significance of transport costs to the closest market but they are nevertheless often hedged on a fair value basis. For example, major mining companies have a policy of converting fixed price contracts to floating such that they have a floating price profile for results.

We believe that this restriction is inconsistent with the treatment of embedded derivatives in IAS 39.

Q15 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?*

The G100 believes that the accounting treatment should be that which best reflects the economic consequences of the entity's hedging of credit risk. However, application of the requirements would face similar measurement issues to those addressed in dealing with 'own credit risk'.

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?

See response to Q15(a).

Q16 *Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?*

No. The G100 believes that the effective date should be at least three full years after the issue of the Standard to enable entities to apply all of the phases of the financial instruments standards at the same time with earlier adoption permitted. However, for practical reasons the G100 believes that the hedging proposals should be applied on a prospective basis.

It is also likely that some companies will use implementation of the proposed Standard to review and restructure their hedge relationships. For example, to take advantage of the new requirements entities may wish to de-designate all hedges prior to transition and re-designate post transition. However, under such an approach, previous hedge gains and losses would remain in a hedge reserve until the hedges mature which is likely to be confusing to users. This unsatisfactory outcome could be avoided if companies were permitted to make a one-off adjustment to realign their hedge books on transition with the new requirements.

Yours sincerely
Group of 100 Inc

Peter Lewis
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