

24 February 2011

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

Via "Open to comment" page on www.iasb.org

Dear Sir David

Comments on Exposure Draft ED/2010/13 *Hedge Accounting*

Thank you for the opportunity to comment on the IASB Exposure Draft ED/2010/13 *Hedge Accounting*. CPA Australia, The Institute of Chartered Accountants (the Institute) and the National Institute of Accountants (the Joint Accounting Bodies) have considered this ED and our comments follow.

The Joint Accounting Bodies represent over 190,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

Overall the Joint Accounting Bodies are supportive of the ED as it simplifies hedge accounting, bringing the accounting closer to the entities' risk management strategy. The Board has created a more flexible hedging model which should make hedge accounting easier to assess and apply.

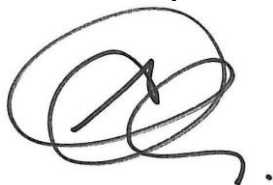
We have highlighted in our attached response specific proposals where further clarity and implementation guidance is required to ensure the context for applying the principles is clear.

We are disappointed that the IASB has been unable to get support from the United States Financial Accounting Standards Board on the proposals. However we do not see this as an impediment to finalising the standard.


Our response to matters on which specific comment is requested is included in the attached Appendix.

If you have any questions regarding this submission, please do not hesitate to contact either Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au, Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au or Tom Ravlic (NIA) at tom.ravlic@nia.org.au.

Yours sincerely



Alex Malley
Chief Executive Officer
CPA Australia Ltd



Graham Meyer
Chief Executive Officer
Institute of Chartered
Accountants in Australia

Andrew Conway
Chief Executive Officer
National Institute of
Accountants

Representatives of the Australian Accounting Profession



cpaaustralia.com.au



The Institute of
Chartered Accountants
in Australia

charteredaccountants.com.au



nia.org.au

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?

We agree with the proposed objective, as looking through the eyes of management has been the approach taken for standard setting since the issuance of IFRS 7 *Financial Instruments: Disclosures* and IFRS 8 *Segment Reporting*. A consistent approach adopted for hedge accounting in aligning accounting and risk management practice places greater onus on entities in sharing their internal information with users of financial reports.

However it is not clear why the link is made to profit or loss given that in paragraph BC16 reference is made to the statement of comprehensive income in describing the focus of the objective. Further clarity is required to explain why the objective's focus is on profit or loss. For example the current definition restricts the ability of an entity to hedge investments that are fair valued to other comprehensive income. An entity may have a risk management practice of hedging any foreign currency risks in such an investment, despite the fact the fair value changes on the investment do not impact the profit and loss account. We fail to understand why such hedge could not be 'allowed' under the standard.

As we have mentioned in previous submissions, the conceptual framework project needs to be completed so that is clear what the distinction is between profit or loss, other comprehensive income and equity.

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?

We agree with this proposal because it is a more principles based approach which will allow entities to achieve hedge accounting due to the alignment with their risk management activities.

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 support this proposal as it will allow more entities to achieve hedge accounting given that it reflects the risk management activities of many entities. Some further guidance with illustrative examples would be useful to understand how it will work in practice.

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?

We agree with the proposal because it aligns with the risk management activities of many entities which will therefore enable them to use hedge accounting. However, we do suggest that the commentary in the standard be amended, as it singles out credit risk as a particular issue, when in principle the issues on credit risk are the same as any basis risk in any imperfect hedge relationship.

We further consider the B18 of the ED is overly prescriptive in precluding non-contractual specified inflation from the hedge relationship. We do not believe a rule should be introduced in such a situation and we consider the general principle should suffice in these circumstances if this risk can be identified and measured reliably.

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?

We agree with both of these proposals, although note that guidance may need to be included on identifying a 'layer component'.

Question 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?

We are supportive of a more principle based assessment hedge effectiveness. In particular we strongly support the removal of the 80/125% 'bright line test' that is currently part of IAS 39's hedge effectiveness requirements.

However, with this removal the proposal brings about judgemental interpretation areas, using phrases such as 'other than accidental offsetting' and 'hedge effectiveness assessment' contained in paragraph 19(c) and producing an 'unbiased result' (paragraph B16). We suggest either rewording these requirements or adding additional guidance to explain the terminology.

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?

We agree with the concept of rebalancing a hedging relationship in such scenarios but further guidance and illustrative examples are required to understand this new term 're-balancing' and how it is different from 'discontinue' to enable the operationalisation of this new concept in practice. We would encourage field testing of these requirements to ensure the increased costs for entities do not outweigh the benefits, given they will require more rigorous documentation leading to more dynamic hedging.

Question 8

(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?

We believe that hedge accounting should be discontinued prospectively if the hedging relationship no longer meets the qualifying criteria. However, we do not agree that this is the only situation that will lead to discontinuation.

(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?

Whilst we appreciate that there needs to be some restriction in allowing entities to exit out of and enter into hedging relationships, we do not agree with this proposal because it does not allow an entity to voluntarily discontinue hedge accounting in certain situations where it may be necessary to do so in order to prevent significant losses. We therefore suggest some guidance to allow for voluntary discontinuation in limited circumstances.

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?

We fail to see a clear principle behind the proposed new treatment. As noted in our response to question 1, the conceptual framework project needs to be completed so that the purpose and use of profit or loss, other comprehensive income and equity is clear.

(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?

We agree with this proposal as it will provide useful information to users of financial statements. However, for entities that have numerous hedging relationships, it may make their statement of financial position quite long and difficult to read resulting in 'information overload'. We therefore suggest that further guidance be included about how to deal with this, such as allowing disclosure to be included in the notes if disclosure on the face of the statement has the potential to confuse users instead of helping them.

(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 agree that linked presentation should not be allowed as we believe it would be confusing for users of financial statements.

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 (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?

We agree with the proposed treatment of the time value of options. We do note that the mechanics are quite complex and whilst the accounting outcome is appropriate, it is unlikely to reduce the administration burden. We encourage the Board to adopt a simpler method of dealing with the time value component of an option whilst achieving the outcome currently contemplated in the standard.

We do not agree with the restriction carried over from IAS 39 in relation to written options not being able to qualify as hedging instruments. Clarification is required to ensure the inclusion of a written option in a net written option strategy, for example collar arrangements, would not preclude designation of the synthetic hedge provided the hedge criteria are met.

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 support this proposal because it will allow an entity to reflect its risk management activities through hedge accounting. We await the distinction between hedging groups of items and the macro hedging proposals due to be released by mid this year.

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?

While we support the need for disclosure for a group of items with offsetting risk positions as outlined in paragraph 37, we consider that it should be the decision of the directors of the entity to determine if this is best reflected in the profit or loss or in the notes to the accounts. We consider that entities should be able to allocate the net gain or loss in a way that reflects the nature of the business and therefore is most meaningful to understanding the results of the entity.

In relation to the proposal in paragraph 38, while we agree with this we have the same concerns as noted in our response to question 9b.

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?

We agree with the objectives of the proposed disclosure requirements but consider that the requirements should be principles based and left to directors to determine the exact content and presentation. This approach will more likely result in meaningful disclosures reflecting the objectives and outcome of hedging as part of the risk management strategy of the entity.

Further, we consider that for entities who do not apply hedge accounting, the requirements in paragraphs 44 and 45 would be important information for users and therefore suggest that these requirements be included in IFRS 7 *Financial Instruments: Disclosures*.

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?

We agree with this for the reasons stated in BC 218 that it will provide more useful information and will be less onerous for entities. Some further clarification is needed on the requirement that contracts be settled 'net in cash' and the justification for such a restriction.

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?

We believe that hedging credit risk should be allowed because we do not consider it to be 'operationally difficult'. The IASB should explore the alternatives through outreach activities for the most appropriate method.

We note that the IASB reached a different view in the 'own credit risk' debate which is required to be measured and put to other comprehensive income. We consider that the IASB needs to be consistent in the area of 'credit risk'.

Question 16

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

We do not understand the 'prospective' transition requirements and request more guidance in this area. We do not agree with the 'prospective application' if transitional requirements are intended only to apply for all practical purposes to new hedging relationships and not accommodate retrospective adjustments to legacy hedge relationships. Any hedge relationship that met the criteria for hedge accounting at transition date should be migrated to the new hedge accounting model to ensure consistency in accounting for strategies distinguished only by their date of designation.

We consider the transition requirements should also allow for retrospective application in certain limited circumstances. For example, due to different interpretations of the existing requirements, some entities use derivatives in synthetic hedges while others do not, while some entities have previously not accounted for the time value of options as is proposed. To allow an even playing field, entities should be allowed to retrospectively apply the new requirements. Another example is where options intrinsic value has been designated in a hedging relationship under the previous standard. The time value has to be retrospectively adjusted to ensure comparable accounting for the same instruments in the entity's financial statements. If some transitional relief such as this is provided, it will also help ensure that such entities are able to meet the proposed objective of hedge accounting.

Other

We note that although an equity method investment and an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge such investments may be structured to enable hedging. We encourage the IASB to reconsider the appropriateness of this prohibition in the context of principles based standard setting.