AUSTRALASIAN
COUNCIL OF
AUDITORS-GENERAL

4 March 2011

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
Victoria 8007

Dear Mr Stevenson

Exposure Draft ED 208 Hedge Accounting

Attached is the Australasian Council of Auditors-General (ACAG) response to the International Accounting Standards Board in relation to Exposure Draft ED /2010/13 Hedge Accounting.

The views expressed in this submission represent those of all Australian members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

PO Box 275, Civic Square ACT 2608, Australia
Phone/Fax: 1800 644 102 Overseas phone/fax: +61 2 9262 5876
E-mail: soneill@audit.sa.gov.au
Website: www.acag.org.au
ABN 13 922 704 402

ACAG AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

4 March 2011

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

Dear Chairman,

Exposure Draft ED /2010/13 Hedge Accounting

Attached is the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above.

The views expressed in this submission represent those of all Australian members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

cc: Mr Kevin Stevenson, Chairman, Australian Accounting Standards Board

PO Box 275, Civic Square ACT 2608, Australia
Phone/Fax: 1800 644 102 Overseas phone/fax: +61 2 9262 5876
E-mail: soneill@audit.sa.gov.au
Website: www.acag.org.au
ABN 13 922 704 402

EXPOSURE DRAFT ED/2010/13 *HEDGE ACCOUNTING*

ACAG provides the following comments in response to specific questions raised in the above ED.

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?

ACAG supports the proposed objective as we believe the objective establishes an overall principle for hedge accounting that focuses on an alignment of an entity's financial statements with its risk management activities. However, ACAG suggests that the objective should be further refined and focused on financial risks, as risk management may address a wide range of risks that may not be captured in the financial statements of an entity.

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?

ACAG agrees with the proposal as we believe that the change in the eligibility rules will provide increased flexibility for entities in the use of hedging instruments and allow them to align risk management activities and strategies to achieve hedge accounting.

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?

ACAG supports this proposal because this will eliminate the present inconsistency in IAS 39 *Financial Instruments: Recognition and Measurement* that permits derivatives to be designated only as hedging instruments but not hedged items, either individually or as part of a group of hedged items. In addition, we believe this proposal is consistent with the objective of more closely aligning hedge accounting with an entity's risk management activities. Additional guidance with illustrative examples would assist in understanding how this 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 (i.e. a risk component), provided that the risk component is separately identifiable and reliably measureable? Why or why not? If not, what changes do you recommend and why?

ACAG agrees with this proposal because previously under IAS 39 only foreign currency risk could be designated as a risk component for non-financial items. The proposal will allow more flexibility and scope for entities to apply hedge accounting to better reflect their risk management activities.

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?**

ACAG agrees with this proposal and believes that it provides entities with greater flexibility in accounting for these types of hedging arrangements.

(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?**

ACAG agrees with this proposal and concurs with the rationale expressed in the Board's "Basis for Conclusions" document (paragraph BC69).

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?

ACAG supports the hedge effectiveness requirements set out in paragraphs B27 to B39 of the Application Guidance as a qualifying criterion for hedge accounting. ACAG believes there is merit in the proposal to require hedge effectiveness testing to be only conducted prospectively thereby reducing the accounting burden for hedging relationships. In addition, the proposal to eliminate the arbitrary "bright line" 80–125 per cent range effectiveness test in favour of a test that is conducted by reference to the entity's risk management objective should strengthen the relationship between hedge accounting and risk management practice.

However, ACAG recommends that the Board make it clear that in order to apply hedge accounting, a hedging relationship must be aligned with an entity's risk management objectives at inception.

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?**

ACAG supports the proposal to permit the rebalancing of the hedging relationship in circumstances where the risk management objective remains the same. This will serve to more closely align hedge accounting with an entity's risk management activities. The proposal will also remove the lack of flexibility that exists with the current IAS 39 approach of not allowing adjustments to an existing hedging relationship where such adjustments were not envisaged in the prospective assessment at the inception of the hedging arrangement.

(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?**

ACAG has no objection to the proposal to allow voluntary rebalancing of an existing hedging relationship by an entity. As stated in paragraph BC111 of the "Basis for Conclusions" document, the proactive use of rebalancing will strengthen the link between hedge accounting and risk management.

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?**

ACAG agrees with the proposal. We believe this proposal represents an improvement over IAS 39, which does not accommodate the rebalancing of an existing hedging relationship that continues to meet an entity's original risk management objective.

(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?**

ACAG supports the proposal because this ensures that hedge accounting remains aligned with an entity's risk management activities. In other words, it is an entity's risk management activities that should be the driver of hedge accounting.

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?**

ACAG supports the proposed accounting treatment because by presenting the effects of an entity's risk management activities in one place (i.e. in other comprehensive income for both fair value hedges and cash flow hedges), we believe it will improve the usefulness of the reported information for users of the financial statements, and simplify the existing requirements under IAS 39.

(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?**

ACAG agrees with the proposal as we believe this will provide decision–useful information for users of the financial statements. However, where an entity has extensive hedging relationships, there may be value in allowing more detailed information to be provided in a supporting note for that line item.

(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?**

ACAG concurs with the Board's view for the reasons outlined in paragraph BC128 of the "Basis for Conclusions" document. In addition, this form of presentation may be confusing for users of the 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 (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?**

ACAG agrees with the proposal to have an alternative treatment to account for the time value of options because currently IAS 39 does not adequately address this. However, ACAG is of the view that the above proposals appear to be very complex and recommends that consideration be given to simplifying the accounting treatment for the time value of options.

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?

ACAG supports the criteria as we believe these criteria are more aligned to an entity's risk management activities and are less stringent than those currently stipulated in paragraph 83 of IAS 39.

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?

ACAG agrees with this proposal for the reason outlined in paragraph BC175 of the "Basis for Conclusions" document.

Question 13

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

ACAG believes the proposed disclosure requirements are appropriate and should assist users of the financial statements to understand the risks that an entity manages, how the entity's risk management activities are captured by hedge accounting, and the effect that hedge accounting has had on the entity's financial statements.

However, ACAG suggests that the proposed disclosures should be evaluated for consistency with the required disclosures in IFRS 7 Financial Instruments: Disclosures, so that they are based on uniform principles.

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

ACAG has not identified any other disclosures that would provide useful information for users of the financial statements. It is assumed that the disclosure of sensitivity to movements in financial rates will be captured in other standards eg. IFRS 7, and that this disclosure would include the hedged item and the hedging instrument.

However, if IFRS 7 does not capture the sensitivity of movements in the hedged item (as they may be off-balance sheet), then this standard should contemplate disclosure of sensitivities of the hedged item and hedging instrument both individually and in combination to aid the readers' understanding of risk before and after hedging.

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?

ACAG concurs with the proposal as it provides an efficient method of mitigating accounting mismatches that arise in the case of commodity contracts. This issue is currently not within the scope of IAS 39.

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?

ACAG agrees that the three alternative accounting treatments that were initially contemplated by the Board would add unnecessary complexity to the accounting for financial instruments because they involve making exceptions to a principle-based standard on hedge accounting.

Question 16

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

ACAG supports the proposed prospective application of the new standard for all hedging relationships as this would avoid having two different models being applied simultaneously, i.e. one model accounting prospectively only for new hedging relationships, and the other model being maintained in accordance with IAS 39 until such time as hedge accounting is discontinued for the existing hedging relationships established under the IAS 39 requirements.

Additional Comments

ACAG believes it would be useful to include definitions for the following terms in the Exposure Draft:

- Accidental offset
- Close alignment
- Critical terms
- Hedged item
- Hedging instrument
- Hedging relationship
- Intrinsic value of an option
- Layer component
- Rebalancing
- Time value of an option

We believe the inclusion of definitions for these terms will add clarity and enhance readability.