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Mr David Boymal
The Chairman
Australian Accounting Standards Board
PO Box 204
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30 November 2007
Our Ref: SC:DR

Dear David

Re: ED 158 Proposed Amendments to AASB 139 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting

Deloitte Australia welcomes the opportunity to comment on the exposure draft ED 158 Proposed Amendments to AASB 139 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting ('ED 158').

Our responses to the questions raised in the IASB ED are set out in an Appendix A to this letter. In addition, our responses to the specific matters for comment requested by the AASB are set out in Appendix B.

We support the IASB's intention to clarify IAS 39 *Financial Instruments: Recognition and Measurement* in the areas of risks eligible for hedge accounting and what can be designated as a hedged item as there is uncertainty within the constituency as to what the original intentions of the IASB were.

We acknowledge that the amendments are more rule-driven than principle-based but see this as an appropriate approach given the intention of the IASB to provide clarifying guidance on these issues.

Although we principally agree with the amendments set out in the exposure draft we have some comments which can be found in the answers to the questions in Appendix A to this comment letter.

Deloitte.

Due to the later IASB submission deadline for the exposure draft, the global firm of Deloitte Touche Tohmatsu has not finalised its views in relation to the matters raised. Therefore, the views presented in this document should be read in this context and may not necessarily represent the view of the global firm of Deloitte.

Yours sincerely

Darryn Rundell
Partner
Deloitte Touche Tohmatsu

Appendix A: Deloitte responses to questions listed in the Invitation to Comment sections of the IASB ED

Question 1 – Specifying the qualifying risks

Do you agree with the proposal to restrict the risks that qualify for designation as hedged risks?If not, why?

Are there any other risks that should be included in the list and why?

Yes, we agree with the proposal to restrict qualifying risks when hedge accounting for other than all risks when hedging financial instruments. We believe a list of risks that qualify for designation as hedged risks will help to clarify the standard's requirements and the IASB's original intentions.

However, we believe the list should be revised to include equity price risk where the currency denomination of the equity security differs to the functional currency of the entity. This is particularly relevant where entities hedge available-for-sale equity securities that are traded only in foreign currencies (as described in IAS 39 IG F.2.19) and the entity has exposure to the fair value of the equity in the currency denomination of the equity security and the fair value in the functional currency of the entity. Without amending paragraph 80Y it would appear an entity can hedge all risks in their entirety, foreign currency risk, but not equity price risk in the currency denomination of the security. We do not believe this was the IASB's intention.

Question 2 – Specifying when an entity can designate a portion of the cash flows of a financial instrument as a hedged item

Do you agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item? If you do not agree, why?

Yes, we agree with the proposal to specify when an entity can designate a portion of the cash flows of a financial instrument as a hedged item. However, we question some of the wording used by the IASB.

Firstly, we think the use of the word 'portion' in the first sentence of paragraph 80Z might lead to unintended consequences with regard to hedging one-sided risks for *non-financial* items (which are outside the scope of this amendment). Paragraph 80Z(c) in combination with this introductory sentence might imply that one-sided risks are always considered portions. IAS 39.82 restricts non-financial items to be designated for foreign currency risks or all risks in their entirety. We believe paragraph 80Z as currently drafted could be interpreted as effectively prohibiting designating one-sided risks arising from non-financial items which we do not believe was the IASB's intention.

Secondly, we believe it would be useful to include a clarification on the interaction of paragraph 80Z(d) and the existence of (non-separable) put or call options within debt instruments. Paragraph 80Z(d) states that "any contractually specified cash flows that are *independent* from the other cash flows of that instrument (for example, the first four interest rate payments on a floating rate financial liability)" may be designated as a hedged item. It could be argued that interest and principal cash flows occurring after the first exercise date of such an option are not independent. Our understanding is that although put or call options could have an impact on the eligibility of designation, for example whether cash flows are highly probable of occurring, and impact hedge effectiveness, we do not think that it is the IASB's intention in principle to prohibit a designation when put or call options exist.

Finally, we welcome the clarification on hedging with options as stated in paragraphs AG99E and BC15 of the ED. However, we believe that the guidance in this area could be made clearer by dealing directly with hedging with options which is the issue IFRIC dealt with and which led to its inclusion in this ED. We would propose changing paragraph AG99E to read as follows:

AG99E When a highly probable forecast transaction is being hedged the entity cannot include the probability of occurrence as a hedged risk. For example, if an entity purchases an interest rate option, an interest rate cap at 8%, to hedge the portion of its issued variable rate debt due to changes in LIBOR above a certain percent, say LIBOR greater than 8%, the entity cannot defer the entire fair value of the option in a fully effective hedge relationship as the fair value of the option includes time value which is not evident in the hedged item. Such an approach would be inferring the time value, being the probability that cash flows may or may not occur, in a non-derivative financial liability.

The proposed wording above would also have the benefit of not being confused with partial-term hedging which is clearly permitted as stated in paragraph 80Z(a) of the ED and in IAS 39:IG.F.2.19. As described in IG.F.2.19 an entity "may be fully effective in hedging interest rate risk for 5 years on a 10 year bond if the swap is designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 *and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap*" [*Emphasis added*]. Paragraph AG99E as currently drafted could be read as prohibiting partial term hedging in this case because of the need to calculate the change in fair value of the 10 year principal cash flow due to changes in the 5 year interest rate curve, even though the principal is not settled in year 5.

Question 3 – Effect of the proposed amendments on existing practice

Would the proposed amendments result in a significant change to existing practice? If so, what would those changes be?

We expect no significant changes in practice on the exposures qualifying for hedge accounting. With regard to the eligible portions for hedge accounting we expect a material impact only for those entities that inferred cash flows from the time value of the option in the hedged item as described in our answer to question 2 above.

Question 4 – Transition

Is the requirement to apply the proposed changes retrospectively appropriate? If not, what do you propose and why?

Yes, we agree from a conceptual point of view. However, we recognise that full retrospective treatment for those entities that previously deferred time value of options in the cash flow hedge reserve, as described in our response to Question 3 above, would result in full restatement of amounts to retained earnings. There would be no ability to restate to the position had they designated intrinsic value only because the very nature of hedge accounting is that is can only be applied prospectively and clearly hedge documentation was not in place that supported that alternative designation.

As IFRIC recognised that there was diversity in practice with respect to designation of time value, we ask the IASB to consider an alterative transition requirement that will allow entities that had designated both time and intrinsic value to restate their cash flow hedge reserve to include intrinsic value only. This transitional approach is similar to concessions that the IASB made when it amended IAS 39 for *Cash flow hedge accounting of forecast intragroup transactions.*

Appendix B: Specific matters for comment

(a) Any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to: (i) not-for-profit entities; and (ii) public sector entities?

We are not aware of any other Australian issues that would affect the implementation of the proposals.

(b) Whether, overall, the proposals would result in financial reports that would be useful to users?

We support the IASB's intention to clarify IAS 39 *Financial Instruments: Recognition and Measurement* in the areas of risks eligible for hedge accounting and what can be designated as a hedged item as there is uncertainty within the constituency what the original intentions of the IASB were.

(c) Whether the proposals are in the best interests of the Australian economy?

We believe that the adoption of IFRS as converged Australian Standards will improve the ability of Australian entities to compete for funds in global capital markets. Accordingly, we believe that there must be no change made by the AASB to the IFRS when issuing the AASB equivalent, other than any amendments applicable to not-for-profit and public-sector entities that are considered absolutely necessary.