ED 158 sub 3

Telstra

28 November 2007

The Chairman
Australian Accounting Standards Board
Level 7, 600 Bourke St
Melbourne VIC 3000

Dear Sir/Madam

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

General Comments

We are pleased to respond to your invitation to comment on the above exposure draft, published in October 2007. We agree with the proposed amendments to clarify the requirements of IAS 39 regarding what can be designated as the hedged item when applying hedge accounting to financial items - specifically what risks can be hedged and what portion of fair value or cash flows may be hedged. Hedging portions of financial instruments is common in practice and IAS 39 has always permitted an entity to hedge a portion of fair values or cash flows of a financial item as opposed to hedging all of the fair value or cash flows. Allowing designation of a portion of a financial instrument as the hedged item can assist in reducing ineffectiveness. However, we note that IAS 39 contained little guidance on exactly what portions of a financial instrument were eligible for hedge accounting. In this regard, we support the aim of the exposure draft to clarify original intentions, without resulting in significant changes to existing practice.

The scope of the proposed amendments does not extend to non-financial hedging relationships such as hedges of forecast purchases or sales. Requirements for hedging portions of non-financial items should be reviewed at a future date.

We note that the proposed approach to these amendments is rules based which is inconsistent with the objective of implementing a principles based approach to standard setting. Notwithstanding this, in the interests of expediting the proposed amendments to ensure consistency in the application of the requirements relating to hedged portions we support the exposure draft. Developing a principle for determining what portions can be designated as hedged items could be reviewed as part of the IASB's longer term objectives.

Our comments to the specific questions outlined in the exposure draft are detailed below.

Request for comments

Question 1 – Specifying the qualifying risks

We support the proposal in the exposure draft that the hedged risk of a financial instrument may include one or more of: interest rate, foreign currency, credit or prepayment risk, or the risks associated with the contractually specified cash flows of a recognised financial instrument. We also strongly support the proposal to allow any market interest rate to be designated as the hedged risk rather than restricting the hedged risk to a benchmark interest rate. Consequently, this should not result in significant changes to existing practice with regard to hedging interest rate risk.

We note that the exposure draft does not discuss some of the less commonly hedged risks of financial items such as equity price risk or financial contracts which may be subject to commodity price risk. The exposure draft should be amended to incorporate situations for hedging other risks and portions.

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

The exposure draft proposes that the following portions of financial instruments can be hedged:

- The cash flows of a financial instrument for part of its time period to maturity;
- A percentage of the cash flows of a financial instrument;
- The cash flows of a financial instrument associated with a one-sided risk;
- Contractually specified cash flows of a financial instrument that are independent from the other cash flows of that instrument;
- The portion of cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a risk-free rate; and
- The portion of the cash flows of an interest-bearing financial instrument that is equivalent to a financial instrument with a quoted fixed or variable inter-bank rate (e.g. LIBOR).

We agree with the proposal to permit a portion of the cash flows of a financial instrument to be hedged as outlined above.

The exposure draft attempts to clarify a previous IFRIC discussion on cash flow hedge effectiveness using options. The IFRIC was asked whether an entity could compare all changes in the fair value of a purchased option with changes in the fair value of a hypothetical written option that has the same maturity date and notional amount as the hedged item. The requests noted that such an approach would minimise hedge ineffectiveness. We agree with Paragraph AG99E of the exposure draft which supports the IFRIC's tentative conclusion that IAS 39 does not permit such an approach. In particular, we agree that:

- If an entity hedges a non-optional exposure with an option the entity may not be able to claim that the underlying instrument has optionality that is equivalent to that in the option and hence cannot defer all the fair value movements of the option in equity under a cash flow hedge. In this situation an entity should not consider changes in the time value component of an option in determining changes in the fair value of the hedged item for assessing and measuring hedge effectiveness because such a time value component is hypothetical and does not exist in the hedged item. Accordingly, changes in the time value of the purchased option would be recognised in profit or loss immediately; and
- In accordance with IAS 39 a written option (hypothetical or actual) cannot be designated as a hedged item.

Paragraph AG99E should be expanded to include other approaches to minimise hedge ineffectiveness when hedging one-sided risks of forecast transactions with options. For example, an entity which has exposure to cash flow variability arising from a highly probable future sale denominated in foreign currency purchases an average rate or European-style option to hedge against a 'downside foreign currency' risk. The purchased option gives the entity the right to convert a fixed amount of foreign currency at a pre-determined rate (the 'strike price') to its functional currency. The hedged item (i.e. variability in future cash flows attributable to a decrease in the foreign exchange rate) does not include any optionality feature. An entity could designate the intrinsic value of a purchased option (excluding the time value) as a hedging instrument. Perfect effectiveness could be achieved provided that the hedging instrument and the forecast transaction have the same maturity dates and notional amounts. Changes in the fair value of the purchased option would be compared with changes in the fair value of the hypothetical as reflected by the underlying forecast transaction. Changes in the time value component of the purchased option would be fair valued to profit or loss.

Question 3 – Effect of the proposed amendments on existing practice

In our opinion, current practice is, in general, unlikely to be significantly affected by the proposals in the Exposure Draft, subject to the following exceptions:

- Entities that have designated options as hedging instruments of one-sided risks and which include imputed time value; and

- Entities that have designated the effects of inflation on fixed rate financial assets as the hedged risk.

In relation to the above scenarios, we note that the exposure draft is likely to lead to recognition of ineffectiveness or disqualification of certain hedges. Also, entities that have less commonly hedged risks such as equity price risk or commodity price risk may be affected by the proposed amendments.

Question 4 – Transition

The exposure draft contains transitional provisions that require retrospective application, with restatement of the opening balance of shareholders' equity for the earliest period presented. We do not support retrospective application of the proposed changes on the basis that the changes could lead to the recognition of ineffectiveness or the disqualification of hedges that entities may currently have in place. Accordingly, we propose the changes are applied prospectively from the effective date.

AASB 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

(ii) public sector entities

No issues noted.

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

The proposed amendments explain in more detail, firstly, what risks can be hedged and, secondly, what portions of fair value or cash flows are permitted to be hedged. The objective of the exposure draft is to provide clarification on these issues and in so doing address divergence in current practice across entities. The guidance should also assist entities in designating their hedges in a manner that will minimise hedge ineffectiveness. Hence, we support the proposals.

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

We support harmonisation with international accounting standards in order to achieve more comparable and transparent financial reporting on a global basis. The purpose of the proposed changes is to clarify the original intentions of the IASB when drafting IAS 39 and not to significantly change existing practice.

Please contact me on +61(3) 9634 6470 if you need any further explanation on any of the comments made in this submission.

Yours sincerely,

David Anderson
Director Corporate Accounting and Planning