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18 February 2011

Dear Kevin

#### **AASB ED 208 & IASB ED 2010/ HEDGE ACCOUNTING**

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ED 208 which is a re-badged copy of the International Accounting Standards Board's (the Board) Exposure Draft ED 2010/13 (the ED). We have considered the ED as well as the accompanying draft Basis for Conclusions, and set out our preliminary comments in the Appendix.

Grant Thornton's response reflects our position as auditors and business advisers both to listed companies and privately held companies, and public and private businesses, and this submission has benefited with some initial input from our clients, Grant Thornton International which is working on a global submission to the IASB, and discussions with key constituents.

The views expressed here are preliminary in nature, and a more detailed Grant Thornton global submission will be finalised by the IASB's due date of 9 March 2011.

#### **Support for the overall project**

The requirements for hedge accounting currently contained in IAS 39 *Financial Instruments: Recognition and Measurement* have been widely criticised as being overly complex and rules based. As a result, numerous operational problems have been encountered when applying those requirements in practice. We therefore welcome the Board's efforts to address these problems by simplifying the current requirements, and bringing the accounting more into line with entities' risk management strategies.

#### **Support for a more flexible and principles-based approach**

We support the Board in its proposals to allow greater flexibility in the designation of both hedging instruments and hedged items. By creating a more flexible model, the Board's proposals should make it easier for entities to apply hedge accounting. While the complexity attached to measuring hedge effectiveness will remain, the overall benefits from the

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proposals seem likely to outweigh the additional costs from changing the current requirements.

In particular, we welcome the removal of the 80/125% bright line test for hedge accounting eligibility. This test is very much rule-based in nature, and its removal will not only simplify the Standard but also make it more principles-based.

#### **Concern over divergence with US GAAP**

Despite our support for a new approach to hedge accounting that would remove some of the complexity found in the current requirements; we are concerned that the proposals are not aligned with those of the Financial Accounting Standards Board. At present, IAS 39's requirements for hedge accounting are in fairly close alignment with those of US GAAP. While we wish to see the current requirements simplified, we do not want this to be at the expense of divergence with US GAAP. We therefore recommend that the Board work closely with its counterparts at the Financial Accounting Standards Board so that a converged solution is reached.

#### **Doubts over the proposed change to fair value hedge accounting**

We are concerned that the costs to entities from having to change the way in which they account for and present fair value hedges will exceed the benefits from the proposed change. The proposed changes would also result in divergence from US GAAP.

#### **Greater clarity needed for hedge effectiveness requirements**

We are also concerned that the wording of the proposed hedge effectiveness requirements is not sufficiently clear. Some of the terms used appear vague to us and could be interpreted in different ways by different entities, leading to application problems. At an overall level, we suggest that the effectiveness criteria should encapsulate the premise that there should be the expectation of a significant offset of risk when entering into a hedging relationship.

#### **Effective date and transition**

We agree with the Board's proposal for prospective application of the suggested new approach. In line with our response to the Board's *Request for Views on Effective Dates and Transition Methods* however, we believe that the effective date for the Board's overall project to replace IAS 39 should be 1 January 2015. This is because of the high overall impact of the changes proposed by the three phases of the Board's financial instruments project.

We expand on these remarks in more detail in our responses to the Invitation to Comment questions, set out in the Appendix to this letter.

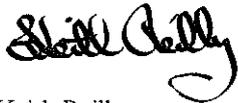
We note that the IASB has not indicated whether it will amend the existing requirements for non-publicly accountable entities, and on that basis we believe the IASB should not consider any decisions on RDR disclosures until the IASB has considered this further, given that the RDR is 'loosely' based on IFRS for SMEs disclosures.

Grant Thornton does not believe that at this time amendments to the existing financial instruments standard should mandatorily apply to non-publicly accountable entities. Instead

Grant Thornton believes that the AASB should allow the IFRS for SMEs accounting standard as an option for non-publicly accountable entities. Adoption of IFRS recognition and measurement principles which the AASB believes necessitates an increase in disclosures compared to IFRS for SMEs, does add significant complexity and costs that would not be borne by similar structured overseas entities.

If you require any further information or comment at this time, please contact me.

Yours sincerely  
GRANT THORNTON AUSTRALIA LIMITED



Keith Reilly  
National Head of Professional Standards

## Appendix 1: Preliminary Comments

### ED questions

#### 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 support the Board in its wish to introduce an objective for hedge accounting. Having an objective for hedge accounting should help make the Standard more principles-based and avoid the need for detailed rules, as entities will be able to fall back on the objective when faced with questions of interpretation.

In terms of the objective set out in the ED itself, we think it is good as far as it goes but could be improved. Our main concern is that the current phrasing implies that if an entity chooses not to apply hedge accounting and instead follow the normal accounting for financial instruments, then its financial statements will not properly reflect its risk management activities. This would seem to imply that the normal accounting for financial instruments is somehow inappropriate. We suggest then that reference to the fact that hedge accounting is voluntary be integrated into the objective.

#### 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 have no objections to this proposal. Extending the range of eligible hedging instruments, should make hedge accounting more flexible and align it more flexibly with entities' risk management strategies. Having said that, we are not aware of any significant demand among our client base for the increased use of cash instruments as hedging instruments.

We support the proposed approach of requiring non-derivative financial assets or liabilities to be designated in their entirety (with the exception of foreign currency risk components which are already identified under IAS 21) as this will avoid the need for developing an approach to disaggregating such instruments, which could be problematic.

**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 have no objections to this proposal. We understand that the proposal will enable some entities to better reflect their risk management strategy, where they manage different risk components independently. Having said this, we are not aware of any significant demand for hedging synthetic exposures among our client base.

**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 measurable? Why or why not? If not, what changes do you recommend and why?**

We agree that it should be possible for an entity to designate a risk component as a hedged item provided that that component is separately identifiable and measurable. Permitting risk components to be designated in this way will facilitate hedge accounting for those entities that enter into transactions that give rise to a combination of different risks, thus allowing them to more closely reflect their risk management practices.

We believe that the wording of the proposal, with its requirement for risk components to be 'separately identifiable and reliably measurable', is in keeping with a move towards a more principles-based Standard. Although questions are bound to arise over how to interpret the requirements in specific situations, we believe this is an inevitable consequence of having principles-based Standards and should not be considered a problem.

Having said this, we believe that B18 of the ED is overly prescriptive in stating "inflation is not separately identifiable and reliably measurable and cannot be designated as a risk component of a financial instrument unless it is contractually specified". Although we agree that it will be very difficult to separately identify and reliably measure inflation as a risk component, we do not think that this justifies the introduction of what is essentially a rule into the proposed Standard. We would prefer a less prescriptive tone to be adopted, for instance by saying "in most circumstances, inflation is not separately identifiable and reliably measurable..."

**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 support the Board in its proposal to permit an entity to designate a layer component of a nominal amount of an item as the hedged item. Doing so will eliminate issues for entities that manage layer components as part of their risk management strategies.

For the proposed change to be effective in practice, however, the new wording will need to be capable of being clearly interpreted. For instance, when a particular transaction occurs, it will need to be clearly evident whether the transaction which has occurred was the one that was being hedged or not. In relation to this, it may be useful to include a definition of a 'layer component' in the final Standard as well as including the guidance in B19-B23 of the ED.

#### **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 the Board's efforts to make the requirements for hedge effectiveness more principles-based. In particular, we support removing the 80/125% 'bright line test' or 'rule' that is currently part of IAS 39's hedge effectiveness requirements. We do however have some concerns over the clarity of the eligibility criteria proposed in the ED.

While we acknowledge that the requirement in paragraph 19(c) of the ED for a hedging relationship to be "expected to achieve other than accidental offsetting" is intended to be principles-based, we feel this phrase is likely to lead to many interpretational questions in practice. We say this because the effectiveness test proposed does not appear to encapsulate any requirement for there to be a significant offset of risk as a result of entering into a hedge relationship. In the absence of such a requirement, a marked, albeit small, degree of correlation between economic variables might still be deemed substantive. While we do not advocate the use of 'bright-lines', we suggest that the principle that there should be the expectation of a high degree of offset over the life of the hedge be integrated into the wording of the effectiveness test.

We also have some concern over the wording used in B29 of the Application Guidance in relation to the objective of the hedge effectiveness assessment. The phrase "minimise expected hedge ineffectiveness" used in this paragraph, implies that entities must identify and select the least ineffective designation possible. Such an approach would not only be impractical given the extent of possible alternative designations but also inconsistent with the principle of alignment with an entity's risk management strategy. We feel that it would be better to refer to an expectation of reasonable effectiveness.

As an aside, we note that should the ED's proposals for simplifying the eligibility requirements for using hedge accounting succeed, then the issue of how to determine hedge ineffectiveness is likely to become relevant for an increased number of entities. Given that determining hedge ineffectiveness is and will remain a complicated matter, it may be worth emphasising this within any final Standard, so that entities are able to make an informed choice when deciding whether or not to use hedge accounting.

**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 that the current accounting requirements under which an entity may be forced to discontinue hedge accounting because of a spike in one of the variables, may not properly reflect an entity's risk management practices where the hedge is otherwise still expected to be highly effective over the life of the instrument. We therefore think that the concept of rebalancing a hedge relationship is in principle a useful one.

We are concerned however, that there does not seem to be a clear principle behind when an entity needs to rebalance. We think it should be clarified that entities do not routinely need to determine whether or not the original hedge ratio remains optimal (and rebalance if not) at each reporting period, ie every six months for those entities preparing interim reports. As currently worded, the proposals seem more complex than the current approach under IAS 39. This could result in increased costs for entities and outweigh any benefits from simplifying other aspects of hedge accounting. We recommend that the Board undertakes field testing here to ascertain whether this is the case or not.

Given that the concept of rebalancing a hedge relationship is a new one, we also suggest that further implementation guidance will be needed in order to ensure that it is properly understood and applied. At the moment the Application Guidance contains just one example (B49 of the ED) illustrating when rebalancing will be required. We recommend that further ones, addressing more complicated situations, are added so that companies will have greater clarity over when rebalancing is needed.

**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?
- 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?

We are generally supportive of the proposed requirements in this area. Should the project succeed in its overall aim of reducing the burden of applying hedge accounting, then it would appear reasonable for companies to be required to continue to apply hedge accounting where the qualifying criteria are still met.

The inability to prospectively de-designate a hedge relationship when the qualifying criteria are still met could however be criticised on practical grounds. For example, in some cases a change in circumstances may result in the process of just measuring hedge ineffectiveness becoming highly onerous. Prohibiting hedge de-designation in such circumstances might impose costs that exceed the benefits from simplifying the overall hedge accounting requirements. We recommend the Board considers this point when making their final conclusion.

Finally, if the wording in paragraph 23 of the ED is retained, the eventual Standard will need to be very clear on what will constitute a change in risk management objective and therefore result in discontinuation of the hedging relationship.

#### **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 have doubts over the merits of this proposal. Changing the way that fair value hedge accounting is accounted for and presented will increase the costs for those entities currently using this method of hedge accounting. We are not sure that the benefits from the proposed change will exceed those costs. Furthermore, we struggle to see a clear principle behind the proposed new treatment, which will also result in divergence from the requirements of US GAAP.

- 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 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.

Where fair value hedge accounting is applied to an instrument that would otherwise be accounted for at amortised cost, the current requirements of IAS 39 result in the hedged item being measured at a mixture of amortised cost and fair value. Such a measurement basis is difficult for the user of the financial statements to understand. The ED's proposed approach of not adjusting the hedged item for the gain or loss on the risk being hedged, and instead presenting that gain or loss as a separate line item, should add transparency to the

statement of financial position and make the financial statements more understandable to the user.

- 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 do not support the use of a linked presentation for fair value hedges under which gross assets and liabilities related through a fair value hedge would be presented together on the same side of the statement of financial position. We feel that such a presentation would be confusing for the user of the financial statements and would make comparability between different sets of financial statements more difficult. We therefore feel that this information would be better presented in the notes to 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 (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 that the current requirements of IAS 39, under which the undesignated time value of an option is treated as held for trading and is accounted for at fair value through profit or loss, do not necessarily reflect entities' risk management strategies and could be improved.

Having said this, we consider the ED's proposals in this area to be overly complex and unlikely to reduce the administrative burden of applying hedge accounting for those companies that are affected by this proposed change. We would therefore encourage the Board to develop a simpler method of dealing with the time value component of an option. If the premium paid for a purchased option is viewed as an insurance premium it would be simpler to treat this amount as a prepayment and amortise it to profit or loss over the life of the cover period.

**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 have no strong objections to these proposals although we struggle to see a clear logic behind them, and question whether they will result in a more principles-based Standard. It will be easier to evaluate the Board's thinking in this area alongside its proposals on macro hedging once those proposals have been published.

**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?

We agree with the proposals to present any hedging instrument gains or losses in a separate line for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement. To do so will avoid the artificial grossing up of gains or losses that would be necessary if all the affected line items were otherwise adjusted.

**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 support the objectives expressed in the ED relating to the disclosure of an entity's risk management structure and the effects of its hedging activities. We are concerned however that the disclosure requirements proposed in paragraphs 49 to 52 of the ED are overly prescriptive. While the information specified may well be useful, we feel that entities should be given greater freedom in deciding how much detail to disclose.

**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 support the Board's proposal that a commodity contract held for own use can be accounted for as a derivative in certain circumstances. Such an approach will remove an accounting mismatch by enabling those entities that manage their exposures to commodities contracts on a fair value basis to better reflect their risk management strategy.

**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 do not consider the accounting for hedges of credit risk using credit derivatives to be a major issue for our client base and we therefore have no strong views on this question. We would note though that while introducing possible alternative approaches to hedge accounting might solve a practical issue for some financial institutions, it is likely to result in a more complicated and a more voluminous overall Standard. Such an outcome would impact negatively on the majority of entities that use hedge accounting but do not hedge credit risk using credit derivatives. We would therefore suggest that if this issue is to be addressed, it would be best to do it as a separate project at a later date.

**Question 16**

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

We agree with the proposed transition requirements but believe the proposed effective date should be later.

While we generally support full retrospective application of new IFRSs on the basis that it improves the comparability of financial statements between periods, we agree that on this occasion such an approach would be inappropriate. We say this because it would be very difficult for entities to implement the ED's proposals on a full retrospective basis. As a result it is likely that the benefits from such an approach would be outweighed by the additional costs that would need to be incurred.

We also support the Board in rejecting an approach of using prospective application of hedge accounting only for new hedging relationships. We agree that such an approach would be onerous as entities would need to maintain IAS 39's hedge accounting model for existing hedge relationships until those relationships are discontinued as well as applying the requirements of the new approach. We therefore support the Board in proposing prospective application of the ED's requirements for all hedging relationships.

In line with our response to the Board's *Request for Views on Effective Dates and Transition Methods* however, we believe that the effective date for the Board's overall project to replace IAS 39 should be 1 January 2015. We say this because of the high overall impact of the changes proposed by the three phases of the Board's financial instruments project. We believe that entities should be given a minimum period of three years from publication of the final version of IFRS 9 to its effective date in order to allow for the modification of systems and collection of data that will be necessary to apply the new Standard. Given the

final version of IFRS 9 is not expected to be published till the second half of this year, and assuming the Board continues with its recent practice of setting most effective dates as either 1 January or 1 July, we therefore suggest 1 January 2015 should be the effective date.

We support the Board however in its proposal that entities should be able to early adopt any new requirements on hedge accounting.

### **Specific AASB questions**

**1 Whether, overall, the proposals would result in financial statements that would be useful to users**

Apart from our earlier comments, we are not aware of any issues that may impact users. We also reiterate that for non-publicly accountable entities the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities, and hence would not result in financial statements that would be useful to users.

**2 Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:**

- a not-for-profit entities; and**
- b public sector entities**

Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals for publicly accountable entities. We believe that there are regulatory and other issues arising in the Australian environment for non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.

**3 Whether there are any implications for GAAP/GFS harmonisation**

Apart from our earlier comments, we support the implementation of the proposals for publicly accountable entities. However we accept that there will be a need to provide detailed commentary for GAAP/GFS harmonization given the fundamental differences in accounting.

**4 Whether the proposals are in the best interests of the Australian and New Zealand economies**

Apart from our earlier comments, we are not aware of any reasons that would impact on the interests of the Australian economy for publicly accountable entities. Our New Zealand firm may wish to comment direct to the AASB if there are any New Zealand implications. We also reiterate that for non-publicly accountable entities the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities, and hence would not result in financial statements that would be useful to users nor are they in the best interests of the Australian economy.

**5 Unless already provided in response to specific matters for comment 1 – 4 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative.**

As detailed earlier in our submission we believe that the overall benefits from the proposals seem likely to outweigh the additional costs from changing the current requirements.. However for non-publicly accountable entities, the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.