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Exposure Draft: Proposed amendments to IAS 39
International Accounting Standards Board
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UNITED KINGDOM

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Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting

The Australian Accounting Standards Board (AASB) welcomes the opportunity to comment on the IASB's Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting.

The AASB is aware of the IASB's long term project to replace the current financial instruments standard and supports its initiative to clarify when an entity may designate an exposure to a financial instrument as a hedged item in the interim. The AASB considers, however, that introducing lists to the body of IAS 39 is inconsistent with the IASB's objective of providing principles-based standards. As such, the AASB has provided some suggestions as to how the lists might be dealt with in respect of the designation of risks within a financial instrument and the portions of cash flows of a financial instrument (refer to the responses to Questions 1 and 2).

The AASB is also concerned with the application of these requirements to non-financial hedged items, and considers that if these proposals proceed that the IASB's intention regarding non-financial hedged items should be stated clearly (refer to the response to Question 2).

The AASB has a number of specific concerns which are discussed in detail in its responses to the specific questions accompanying the Exposure Draft in the attachment to this letter. In formulating its views, the AASB sought and considered the views of Australian constituents.

If you have any queries regarding any matters in this submission, please contact Natalie Batsakis (nbatsakis@iasb.org) or myself.

Yours sincerely

A handwritten signature in black ink that reads 'David Boymal'.

David Boymal
Chairman

Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting

Specific comments

The AASB provides the following responses to the IASB's Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* – Exposures Qualifying for Hedge Accounting.

Q1. The proposed amendments restrict the risks qualifying for designation as hedged risks to those identified in paragraph 80Y.

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?

No. The AASB does not agree with the proposal to restrict the risks that qualify for designation as hedged risks. The AASB considers that the proposed guidance clarifies the IASB's original intention regarding the risks that qualify for designation as hedged risks and improves the consistency, understanding and application of IAS 39 in practice.

The AASB considers, however, that the list provided in the proposed guidance follows a rules-based approach instead of a principles-based approach. The AASB is aware that other risks may exist within a financial instrument, such as equity price risk, which under the current requirements of IAS 39, can be designated as a hedged risk in an effective hedging relationship. Equity price risk can be a separate risk within a financial instrument such as equity securities held in a foreign currency. This will expose the entity to foreign exchange risk (i.e. translating the security from its foreign currency to the entity's functional currency) and equity price risk (i.e. the movement in the fair value of the equity security in its foreign currency). Under the current proposals in the Exposure Draft, equity price risk would not be eligible for designation as a hedged risk.

Another example of a risk that could be eligible for designation as a hedged risk is profit risk. The AASB was advised that Islamic entities are exposed to profit risk, which arises because such entities are not only bound by the laws of the jurisdiction in which its business operates, but also by the Islamic laws of commerce. Profit risk is in substance interest rate risk, however, it cannot be labelled as such, or even be linked to interest rate risk due to the strict requirements of Islamic law which does not allow these businesses to earn passive income, such as interest income, and they should therefore not be exposed to interest rate risk. The proposed list in paragraph 80Y would appear to limit these businesses from undertaking hedging transactions in accordance with IAS 39 because of the terminology. If the IASB expects IFRSs to apply globally, then consideration must be given to the different commercial practices that exist in various jurisdictions.

A principles-based approach is more conducive to wider application and the IASB should consider this in its redeliberations, and unless the IASB has undertaken thorough research to identify all possible risks that may exist within a financial instrument, the AASB considers that principles should be developed (refer below) to assist users in ascertaining the type of risk within a financial instrument that can be designated as a hedged risk, rather than only providing a list. The AASB suggests that the guidance in proposed paragraph 80Y could be added to the Application Guidance, rather than being included in the body of IAS 39, and that an additional

list of risks that may exist within a financial instrument, but that are ineligible for designation as a hedged risk, could also be included.

In determining the principles to assist users in assessing the risks within a financial instrument that can be designated as a hedged risk, the IASB might consider the following:

- (i) whether the risk exists within the financial instrument;
- (ii) whether the risk is measurable; and
- (iii) whether the risk poses a threat to cash flows or whether fluctuations in fair value may impact the income statement.

In addition to the above comments, some constituents have raised a concern that the wording of the first sentence of paragraph 80Y is potentially confusing. It states:

“Subject to the restrictions in paragraph 79, a financial instrument may be designated as a hedged item with respect to all of its risks.”

Constituents have read this sentence to mean that any risk within a financial instrument may be designated as a hedged item. This appears inconsistent with subparagraphs (a) to (e) of paragraph 80Y, which detail the risks that can be designated as a hedged item (therefore limiting the risks that exist within a financial instrument that can be designated as a hedged item) and that paragraph BC6 in the Basis for Conclusions states that the IASB concluded that specifying the eligible risks would help clarify the Board’s original intention.

The AASB has interpreted the first sentence to mean that a financial instrument can be designated as a hedged item in its entirety, subject to the restrictions of paragraph 79 of IAS 39, and that the second sentence goes on to say that if an entity wishes to do so, a financial instrument can be designated as a hedged item for any of the risks listed in subparagraphs (a) to (e) of proposed paragraph 80Y. The AASB considers that this distinction could be more clearly articulated.

Q2. The proposed amendments specify 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?

Are there any other situations in which an entity should be permitted to designate a portion of the cash flows of a financial instrument as a hedged item?

No. The AASB does not 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. The AASB considers that the proposed guidance is useful in clarifying the requirements of IAS 39 for users, especially in respect of hedging with options in clarifying the appropriate treatment of the time value of money of options and the use of hypothetical written options, as there is diversity in practice at the current time. However, as discussed in Question 1 above, the AASB is concerned that the list provided in the proposed guidance follows a rules-based approach instead of a principles-based approach. The AASB suggests that such guidance (proposed paragraphs 80Z and 81) could be added to the Application Guidance rather than being included in the body of IAS 39. The AASB also considers that some examples could be included in the hedging section of the Implementation Guidance, as discussed below.

In addition to the above, the AASB has identified the following issues:

(i) *Possible misinterpretation of proposed paragraph AG99E*

Proposed paragraph AG99E may be interpreted as prohibiting the partial term hedging example found in the Implementation Guidance IG.F.2.19, despite the wording of proposed paragraph 80Z(a). This would result in the existence of contradictory guidance in IAS 39 and its Implementation Guidance. AG99E currently states:

In designating as a hedged item a portion of a financial instrument, an entity cannot specify as the hedged item a cash flow that does not exist in the financial instrument as a whole.

When undertaking partial term hedging, it is common practice to impute cash flows in assessing hedge effectiveness in order to achieve an effective hedge. The imputed cash flows are also included in assessing the fair value of the hedged item and the hedging instrument, which under the proposed guidance would not be allowed. This would render most partial term hedging relationships ineffective.

If it is the IASB's intention to clarify the treatment of the time value of options (for example – entities cannot defer the entire fair value of an 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), the AASB suggests that the IASB reconsider the wording of the proposed paragraph to more clearly articulate that intention and thereby avoid any unintended consequences (as discussed above).

In addition, the use of the hypothetical written option example as part of AG99E may confuse readers about the IASB's intended meaning of that paragraph. The AASB suggests that an example be added to the hedging section of the Implementation Guidance. The AASB would support the inclusion of other examples in the Implementation Guidance to assist understanding of the IASB's intention.

(ii) *Possible misinterpretation resulting from the use of the word 'portion' in proposed paragraph 80Z*

The AASB considers that the word 'portion' in proposed paragraph 80Z might lead to unintended consequences, particularly when read in conjunction with paragraph 82 of IAS 39, which states:

If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate *portion* of the cash flows or fair value changes attributable to specific risks other than foreign currency risks. [Emphasis added.]

For example, it has been highlighted that proposed paragraph 80Z(c), read in conjunction with paragraph 82 of IAS 39, could possibly be interpreted as prohibiting the designation of one-sided risks arising from non-financial items and the AASB seeks clarification as to whether this is the IASB's intention.

- (iii) *Possible misinterpretation resulting from the use of the term ‘independent’ in proposed paragraph 80Z(d)*

The current wording of paragraph 80Z(d) may mean that certain instruments cannot be designated as hedged items because they will fail to meet the independence criteria. For example, put or call options within debt instruments could be seen to be dependent after the exercise date of the option and therefore would not meet the requirement of paragraph 80Z(d). The AASB requests clarification as to whether this is the IASB’s intention.

In addition, IAS 39 currently has guidance on embedded derivatives (e.g. options within a host contract) and whether they are closely related to the host. The AASB suggests that the IASB consider the use of the term ‘closely related’ within IAS 39 and its interaction with, or the implications, if any, of the use of the term ‘independent’ in proposed paragraph 80Z(d).

Q3. The aim of the proposed amendments is to clarify the Board’s original intentions regarding what can be designated as a hedged item and in that way to prevent divergence in practice from arising?

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

Whilst the AASB does not expect this amendment to have widespread effects, some entities may be impacted with a resulting change to existing practice where:

- (i) the imputed time value of options used as hedging instruments of one-sided risks was deferred in a cash flow hedging relationship; and
- (ii) the effects of inflation on fixed rate financial assets were designated as the hedged risk;

and less commonly, entities that have hedged risks in respect of equity price risk or commodity price risk may be impacted by the proposals, but this is not expected to be widespread.

Q4. The proposed changes would be required to be applied retrospectively.

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

The AASB considers that whilst retrospective application is conceptually the best answer, full retrospective application may result in the requirement for entities to amend the designation and documentation surrounding the hedged risk formally documented at the inception of the hedge. Paragraph 88(a) requires formal designation and documentation at the *inception* of the hedge, for a hedging relationship to qualify for hedge accounting, including identification of the hedged item and risk being hedged. The current requirements of IAS 39 do not allow amendments to the documentation created at the inception of the hedge, and as such, this amendment may be seen to contradict those requirements.

In addition, the effectiveness calculations are required to be performed on an ongoing basis both retrospectively and prospectively. This requirement might be considered onerous by any entities that are impacted by the amendment, as undue costs may be incurred in meeting the revised hedging requirements of IAS 39.

Whilst this amendment is not expected to have widespread effects, some entities may be impacted, as discussed in the response to Question 3 above, and as such, the AASB does not consider it necessary to apply the requirements to existing contracts on a fully retrospective basis. Instead, the requirements should be applied on a partially retrospective basis, similar to the transitional requirements in the June 2005 amendment to IAS 39: Amendment to Cash Flow Hedge Accounting of Forecast Intragroup Transactions, that allowed an entity to reconsider its hedges at the mandatory application date and make amendments as at that date, rather than recording changes in retained earnings which would be a result of full retrospective application.