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STORAENSO

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The International Accounting Standards Boards
30 Cannon Street
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CL 28

Comments on proposed amendments to:

IAS 32 - Financial Instruments: Disclosure and Presentation
IAS 39 - Financial Instruments: Recognition and Measurement

Dear Sir,

Stora Enso appreciates the opportunity to comment on the proposed amendments to IAS32 and IAS39.

Our company has a turnover of approx. 13 billion EUR with production and sales in more than 40 countries and consist of more than 300 legal units. Stora Enso Oyj is listed on the stock exchanges in Helsinki, Stockholm and New York, and is reporting under both IAS32/IAS39 and FASB Statement No. 133/138.

We believe that the major principles behind both IAS 39 and FAS 133 (clear risk management policies, documentation at inception, linkage between hedges and exposures, and monitoring of effectiveness) are appropriate and consistent with the existing internal control and risk management practices of most corporate treasury operations, however many companies feel that the rules as they currently stand are unnecessarily complex and may in practice lead to confusion amongst both preparers and users of financial statement. In particular, the anomalies posed by the mixed measurement model lead to inconsistencies in the recognition and measurement of financial instruments and may in practice reduce the transparency of financial statements as well as unintentionally increase volatility in the income statement.

There are a number of critical issues that must be re-addressed before the final standard is released. We believe that a re-assessment and clarification in these areas will significantly ease the implementation burden for many corporate and will contribute to a better alignment of IAS 39 with modern-day treasury practices. Our comments in this submission focus on the following issues:

1. The present netting rules in IAS39 (paragraph 133) and the rules for documentation of hedge accounting (paragraph 142) needs to be simplified. Furthermore the present draft favours a certain corporate set up where the organisation is organic grown, have a simple structure and one accounting system. Therefore the following issues have to be considered:

a. Only external purchases and sales after consolidation need to be documented.
b. All transaction reducing risks in a group at consolidated level should be allowed as a part of a hedge even though it do not qualify for hedge accounting. The result of the non-hedge accounted parts should still go mark-to-market via the income statement.
c. It most be allowed to split hedges under hedge accounting to all units according to the participants share. Designation a hedge to only one group company creates a tax risk due to the fact that local tax authorities could claim that gains/losses are transferred to the most favourable unit in order to avoid taxation.
d. The present draft is made for big item transactions and not a bulk number of smaller transactions.

2. Treasury centre netting for foreign exchange hedging transactions (paragraph 134 of the current draft of IAS 39 and IGC item 134-1-b). We strongly suggest that this area be clarified in the standard itself and that a limited exception to paragraph 134 (126B in the exposure draft) should be allowed for foreign currency hedging via a treasury centre, consistent with the principle in US GAAP and with the objective behind IGC interpretation 134-1-b

3. Hedge effectiveness (paragraph 146). Small changes in fair values course problems with in-effectiveness. We believe that these rules most be changed in order not to course problems.

4. The treatment of hedges of foreign currency denominated firm commitments as either Cash Flow or Fair Value hedges. We suggest that the same choice of either hedging model be made available under IAS as exists under FAS 133.

5. The use of the “basis adjustment” for gains and losses deferred under certain types of Cash Flow hedge. We believe that in many situations a “basis adjustment” approach is significantly easier to implement in practice and that the additional operational cost for many companies of not allowing this approach outweighs any benefit to users of financial statements.

6. Hedging with options – the applicability under IAS of DIG issue G20. We believe that clarification is needed in this area to confirm that the approach to effectiveness testing with options suggested under the DIG’s interpretation of FAS 133 is also available under IAS 39. This could be achieved via an IGC or IFRIC interpretation rather than via an amendment to the standard.

7. Availability under IAS of the short cut method for hedges involving interest rate swaps. We would strongly support allowing the US GAAP approach in this area, since this would both significantly ease the implementation burden for simple hedging strategies and would achieve convergence with the FAS 133 approach.

8. Hedging, with the use of financial derivatives, of stock option programs and other pension liabilities related to the performance of a companies shares most be allowed under IAS39. Companies that are hedging their liabilities are under the present rules not able to avoid volatilities in the income statements because the hedging instruments cannot obtain hedge accounting. We suggest that this would be allowed the new draft.

You will find our more detailed comments on each of these issues in the appendix to this letter.

We hope that you find our comments to be both useful and constructive and would welcome the opportunity to discuss them in further detail if needed. Once again we thank the Board for the opportunity to comment on the proposed amendment in an area, which is of great importance and concern to Stora Enso.

Yours faithfully

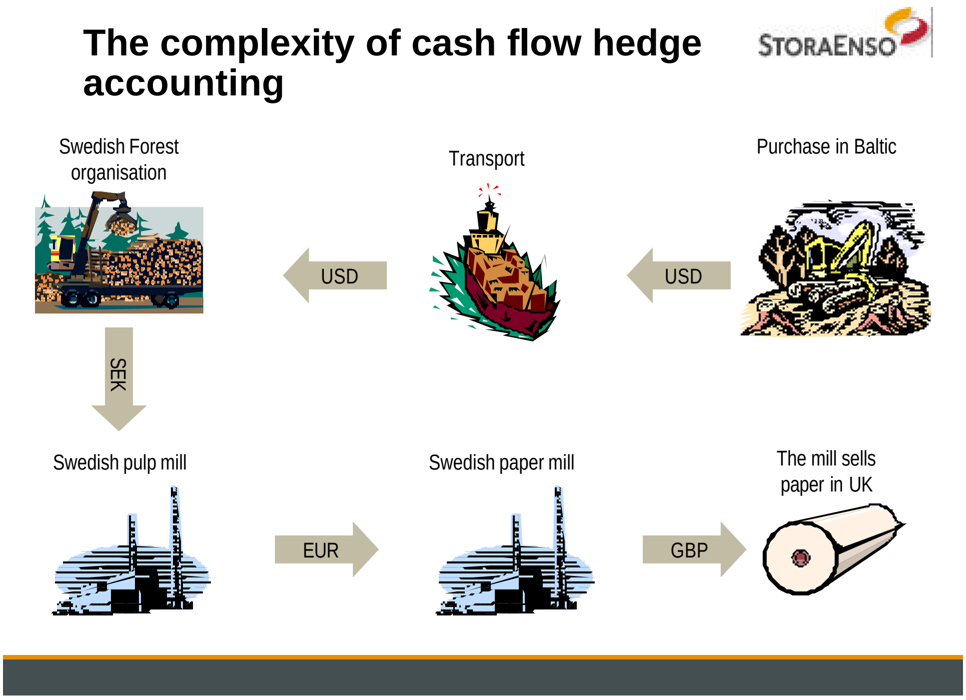
On behalf of Stora Enso

Gustav Jensen
Vice President, Stora Enso Financial Services S.A.

Appendix

<u>Netting rules and hedge documentation – paragraph 133 and 146</u>

The chart shows the complexity that many companies may face in order to obtain hedge accounting under the present draft of IAS39.



In the chart each picture is one separate legal unit with their own accounting and information system. Many units are doing business in other currencies than there reporting currencies. Tracking all internal sales and purchases from the first company, in one of the Baltic states, until the final sales in the United Kingdom, would require many resources in order to receive hedge accounting for external hedges that are covering the foreign exchange risk for the Group.

Many companies face similar problems as we do. Most international companies consist of a number of legal entities, documenting internal sales and purchase between different legal entities in Group do not increase transparency. We recommend that only external purchases and sales need to documented due to the fact that all internal purchases are eliminated at consolidation.

Furthermore the present draft has severe tax implications for many companies. Let us assume that that in a Group there exist 3 legal units; unit A has an exposure to USD of 100 the same as unit B, while unit C has a negative exposure to USD of 100. The net position of the Group is USD 100, which the Group choose to hedge. Under the present draft of IAS39 this hedge have to be designated to either unit A or B. The Treasury choose randomly that the hedge belong to unit A. When the hedge matures a loss of 10 is recorded at Unit A.

Let us further for simplicity assume that unit A for a tax year has been profitable, while unit B has a zero result. Unit A and B are now examined by the tax authorities. The Group now has to justify to the tax authorities why unit A was chosen and not unit B, when the loss of 10, the result of the entire Groups hedging, was allocated to the profitable unit A and not unit B that was at break-even, and at the same time claiming that all legal units where following the Groups hedging policy.

We strongly recommend that the netting rules will be changed to avoid possible problems with the tax authorities.

Treasury centre netting – Implementation Guidance Committee issue 134-1b

This topic is of special concern to companies with centralised corporate treasury operations. The practice of hedging using internal contracts through a treasury centre, which then lays off the exposure on a net basis in the market is the approach used by most international groups.

Paragraph 134 of the current version of IAS 39 (126B in the exposure draft) explicitly prevents internal contracts from qualifying as hedges in consolidated statements. In spite of this, IGC interpretation 134-1-b concludes that such an approach should be allowed. The IGC interpretation, whilst it's objective is laudable, is unclear and appears to be in conflict with the standard itself. Nonetheless we fully agree with the principle behind this interpretation and believe that this should be integrated into the standard as a limited exception to paragraph 134. This exception should clarify that under IAS, internal hedges can qualify as hedges of foreign currency risk in consolidated financial statements to the extent that these have been appropriately laid off externally via a treasury centre, on an aggregate or net basis.

Not only would such an exception clarify the current situation and ease the burden of implementation, it would also achieve the objective of alignment with the principle behind FAS 138, whereby treasury centre hedging for foreign currency risk is allowed based on specific rules. In line with the principles-based approach of IAS we would not recommend adopting the precise rules in FAS 138 on this point, but would suggest that the strong underlying principle be reflected in the amendment to IAS 39.

Hedging with Options – Derivatives Implementation Group issue G20

We are proposing that the alternative approach to hedge accounting for option contracts taken under US GAAP DIG issue G20 should be explicitly recognised under IAS. We do not believe that this would require any amendment to the standard, but rather that an IGC or IFRIC interpretation would be sufficient to clarify the matter.

DIG issue G20 shows that, to the extent that the hedged risk in a Cash Flow hedge where a purchased option is used as the hedging instrument is defined a being one-side (for example hedging only the terminal value of the cash flow for rates above the strike price), the value of the exposure so-defined contains the same time value as is inherent in the option itself. This approach enables time value to be deferred in equity as an effective element of the Cash Flow hedge relationship.

We believe the same interpretation must apply under IAS in the absence of any difference between the relevant provisions of the two standards, but feel that there is a need for clarification on this point under IAS.

Hedge effectiveness testing

In paragraph 146 of the current version IAS39 gives an example of an effective hedge. The financial derivative have a loss of 120 while the underlying exposure has a gain of 100, which gives an effectiveness of 83 per cent. In the following period hardly anything happens in the prices development, the hedging instrument has a gain of 2, while the underlying exposure has a loss of 1. Testing of hedge effectiveness gives 1/2 equal 50 per cent – and the hedge is ineffective.

We propose that a method in implemented that is consistent and thereby takes into account the effect of small changes.

Short cut method for Interest Rate Swaps

We propose that a simplified form of effectiveness testing and accounting should be available for interest rate hedges involving interest rate swaps whose terms perfectly match the exposure from a particular asset or liability. The approach taken by US GAAP in this area (the so-called "short cut" method) is pragmatic and simple to apply in practice.

In the interests of easing the implementation burden for companies using only basic hedging strategies we believe that the short cut method should be allowed under IAS. Such a change would also achieve the objective of convergence with US GAAP.

We suggest that the short cut method should be allowed under IAS 39 via an amendment which incorporates similar guidance to that in FAS 133.

The treatment of hedges of foreign currency denominated firm commitments as either Cash Flow or Fair Value hedges

Whilst we understand the conceptual basis for requiring that hedges of firm commitments should be treated as Fair Value hedges, we believe that an exception to this rule should exist in respect of firm commitments denominated in a foreign currency and hedged for foreign currency risk. Although the proposed improvement to IAS 39 achieves the objective of aligning with the general rule under FAS 133, it creates a new difference with US GAAP, since for foreign currency hedges of firm commitments, FAS 133 (as amended by FAS 138) allows a choice of either the Fair Value or Cash Flow hedge model in this area.

The conceptual basis for this choice of treatment was initially outlined in DIG issue H5 ("Hedging a Firm Commitment or Fixed-Price Agreement Denominated in a Foreign Currency"), where it was recognised that although a firm commitment creates a Fair Value exposure, foreign currency denominated firm commitments also create a cash flow exposure in the company's own functional currency.

Not allowing this choice under IAS would also pose very significant implementation problems for many companies. Indeed the proposed change would imply that companies applying Cash Flow hedging to hedges of foreign currency forecasted transactions would need to re-designate these as Fair Value hedges once they reach the firm commitment stage. From a practical operational and systems perspective this would prove extremely difficult to achieve in practice.

We therefore believe that in the interests of both convergence and ease of implementation a choice should be allowed in the standard to enable hedges of the foreign currency risk in a firm commitment to be hedged under either the Cash Flow or Fair Value model.

The use of the "basis adjustment" for gains and losses deferred under certain types of Cash Flow hedge

Whilst we understand that a modification to the current approach in IAS 39 would achieve alignment with US GAAP, we feel that this would create an unnecessary additional implementation burden for many companies and would increase the risk of recycling error.

We believe that flexibility is required here and that companies should be allowed a choice between the 'basis adjustment' approach and the US GAAP approach of amortisation of the deferred gains and losses directly out of equity. This flexibility is required to ease the implementation burden, recognising that:

- for 'simpler' amortisation patterns on items such as inventory, the 'best practice' would be to leave the deferred gains and losses in equity and amortise them from there;
- for more 'complex' items such as fixed assets, we believe that the 'basis adjustment' is the best way to amortise the deferred gains and losses whilst minimizing the risk of recycling errors.

This alternative would also make it easier for companies reporting under both IAS and US GAAP by enabling them to apply the same treatment in both frameworks if needed.