Unilever

Unilever House Blackfriars London EC4P 4BQ
Telephone 020-7822 5252 Telex 28395 Facsimile 020-7822 5951/5898

direct line 020-7822 6478
facsimile 020-7822 6266

Mr Paul Ebling
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
LONDON
WCIX 8AL

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Dear Mr Ebling

FRED 30 Financial Instruments

We are responding to the ASB's invitation to comment on Financial Reporting Exposure Draft 30 issued by the ASB in July. Unilever, being an international group that reports under UK and Dutch GAAP, and reconciles to US GAAP in our 20-F filing with the SEC, welcomes all moves towards international harmonisation of accounting standards. Furthermore, we support efforts towards a set of high quality accounting standards aimed at transparent and comparable financial reporting and we believe that the ASB should play an important role in this process. Thus, we believe the ASB should work with the IASB to improve IAS 39 and not introduce its own standards on this topic.

Attached to this letter are our responses to the detailed questions. Overall, we believe the basic principles of the standard are appropriate, however we do have some concerns in respect of this standard. Our key concerns are as follows:

1. The change in treatment of hedges of unrecognised firm commitments'. We believe that they should be treated as cash flow hedges rather than fair value hedges.

2. The change in the treatment of 'basis adjustments'. We believe that they should be included in the measurement of the asset or liability and not remain in equity with subsequent releases.

3. The standard does not permit the use of hedge accounting for internal hedges. Whilst we recognise that allowing internal hedges in general could be open to abuse, we believe that under very strict conditions (similar to those included in FAS 138) internal hedges should be allowed.

There has been much external debate as to whether piecemeal adoption of new UK standards which are similar to IAS standards is helpful or not. In the case of the financial instrument proposal, it should be noted that the proposed introduction of FRED 23 and FRED 30 would mean the accounting, for those hedges that are not formally documented or tested for effectiveness will change three times between now and 1 January 2005 and for those that are, twice. We do not believe that multiple accounting changes on the same subject matter will assist shareholders' abilities to understand company results.

If you require further clarification of our views please do not hesitate to contact me.

Yours sincerely

Lysanne Gray
Group Chief Accountant

Questions for respondents

30 The ASB is requesting comments by 14 October 2002—the same date as the IASB has requested comments on its proposed revisions to IASs 32 and 39. Many of the concepts in the proposed standards—particularly the proposed measurement standard—are new to the UK. It is therefore important that those interested in accounting for financial instruments read and consider the proposed standards with care. Comments are invited on *any* aspect of the FRED, although paragraphs 31 and 32 set out some specific issues on which comment would be particularly welcome.

31 The ASB would particularly welcome comments on the following issues:

ASB (i) *Treating IASs 32 and 39 as a package (Appendix III, paragraph 15)*—The ASB has concluded that it is best to view the requirements in IASs 32 and 39 as a single package of requirements that should, as far as is practicable, be implemented in the UK at a single point in time. Do you share this view?

Answer: Yes.

ASB (ii) Implementation in 2004 (Appendix II, paragraphs 1 7-20)—Notwithstanding the general approach referred to in (i) above, the ASB is proposing to implement, at a single point in time, some parts of the standards in mandatory form, some in non-mandatory form and some not at all for the time being. At the same time, it is proposing to withdraw FRSs 4 and 13 (and related UITF Abstracts) and keep in place most parts of FRS *5*. Do you believe that, in the circumstances, this represents the best possible approach of implementing in the UK the international requirements in this area?

Answer: No. We believe that FRED 30 should not be mandated as per 1st January 2004. In our opinion it would not decrease the burden of implementing IAS 39 and we therefore prefer implementation as per Pt January 2005 with the possibility of voluntary earlier adoption.

First of all with implementation as per 1st January 2004 we would be required to change twice as FRED 30 is not exactly the same as IAS 39 (in fact, three times as the ASB has also proposed to implement FRED 23 Hedge Accounting in 2003). We would therefore have to do a lot of work, including restating comparatives, twice. Furthermore, dealing with continuous change can be confusing for preparers as well as users of financial information and we are therefore in favour of a ‘big bang’ change as per the 1st January 2005.

Finally, IAS 39 is by far the most complex accounting standard that has ever been introduced and it will take us to midst 2004 to complete our implementation plan, involving training, revising systems and procedures and gaining experience, properly. Those companies who have to file 2 years of comparison figures with the US Securities and Exchange Commission would already be too late to comply with IAS 39 in 2002.

ASB (iii) *Recognition and derecognition (Appendix III, paragraphs* 23-29)—The FRED proposes that the proposed new IAS 39 approach to recognition and derecognition should not be implemented in the UK at the present time. Instead, when the direction of international convergence on this subject becomes clearer, a further consultation document will be issued. Do you agree with this approach?

Answer: We agree that the UK requirements for recognition and derecognition as set out in FRS *5* are better than those set out in IAS 39 but also note that derivatives are not included in the scope of FRS *5*. Nevertheless we believe that there shouldn't be any difference between a UK Standard and IAS 39 and we believe that the proposed standard should not be implemented as per 1st January 2004.

ASB (iv) *Measurement (Appendix III, paragraphs 30-49)—The* ASB is proposing that, prior to 2005, companies should be required to adopt IAS 39's measurement requirements only if they choose to adopt the fair value accounting rules that will be set out in companies legislation. Entities that do not choose to adopt those rules will not initially be required by UK standards to adopt the measurement requirements at all.

(a) Do you agree with this approach?

Answer: Yes.

(b) Do you agree that the recycling requirements of IAS 39 should not be implemented in the UK pending completion of the project on reporting financial performance and do you agree with the alternative treatment proposed in the FRED? (Appendix III, paragraphs 50-52)

Answer: We agree that recycling should not be introduced in UK standards in 2004. However assuming that the amended IAS 39 will be mandatory as per 1 January 2005 without any further changes, we believe that there should be no differences between a UK Standard and IAS 39. The IAS does not have a STRGL and we believe that once the IASB introduces a single performance statement the issue of recycling will disappear.

ASB (v) *Hedge accounting—The* ASB is proposing a similar approach to IAS 39's hedge accounting requirements as to its measurement requirements. *(Appendix Ill, paragraphs 57-63 69 and 70)*

(a) Do you agree with this approach?

Answer: Yes, however we feel that IAS 39 could be improved in a number of areas.

Paragraph 142E hedge effectiveness testing

We feel that companies should not be forced to perform ongoing effectiveness tests for so called 'perfect hedges with an interest rate swap'. This option, called 'assumption of no ineffectiveness' is included in the United States FAS 133 (Implementation guidance paragraph 68) because the FASB has recognised that fair values of bonds and swaps could deviate slightly after inception whereas in substance nothing has changed and the hedge will still be perfect. The 'assumption of no ineffectiveness' significantly simplifies the calculations to be made for the accounting entries.

Paragraph 126B - use of internal derivatives

When certain group companies have several long and short positions in the same foreign currency and with similar maturity profiles enter into an internal hedge with a central treasury function and this central treasury function hedges the net position in the market, leaving the net fx position close to 0, than IAS 39, in order to allow hedge accounting for the group, requires the company to designate the external hedging instrument to one of the internal underlying positions because IAS 39 does not permit the hedge accounting for internal hedging transactions (Implementation Guidance 134-1-b is not consistent with paragraph 126B in this respect). However if the underlying positions are of a different nature (for example some are related to debtors/creditors and others are related to capex) then the timing of the ultimate recognition of the changes in the fair values in the profit and loss account can deviate from the theoretically correct timing. Allowing intemal derivatives would lead to correct basis adjustments.

In United States GAAP this has been resolved by FAS 138 (paragraph 40B), issued in 2000, that does allow hedge accounting for internal hedges under some strict conditions (including the 3-day rule, the 31-day rule). We feel that IAS 39 should also give this flexibility.

(b) Do you agree that the approach being proposed in place of recycling? *(Appendix Ill, paragraphs 64-68)*

Answer: We agree with the ASB that there should be a single performance statement which would eliminate the practice of recycling. However, given the fact that such a single statement does not yet exist we feel that a UK standard should not deviate from IAS 39 even if the single performance statement is introduced soon after implementation of a standard on financial instruments.

ASB (vi) *Unlisted entities and individual financial statements*

(a) The FRED proposes that, prior to 2005, entities should be required to comply with IAS 39's measurement and hedge accounting provisions in certain circumstances only. That will change in 2005 for the consolidated financial statements of listed entities but, the FRED suggests, not for other entities or other types of financial statement. Thus, from 2005 listed entities that do not prepare consolidated financial statements and unlisted entities will not be required to adopt IAS 39's measurement and hedge accounting provisions unless they choose to adopt the fair value accounting rules set out in the Companies Act 1985. Similarly, listed entities that prepare consolidated financial statements will not be required to adopt IAS 39's measurement and hedge accounting provisions in their individual financial statements unless they adopt the fair value accounting rules in those financial statements. Do you agree with this approach?

Answer: Yes.

(b) ERS 13's disclosure requirements apply only to entities, other than insurance entities, that are listed or have publicly-traded securities and all banks. The ASB is proposing to revise the disclosure requirements on 1 January 2004 and to apply those new requirements to all listed entities, all other entities that have publicly-traded securities and all banks (in other words, the exemption for listed insurance entities will be removed, but otherwise the scope will be unchanged). Do you agree with this approach or do you believe that, from 2004, the requirements should apply to some other entities (for example, unlisted insurance companies) or, alternatively, to a narrower range of entities?

Answer: Yes.

(c) FRS 13's disclosure requirements apply both to consolidated financial statements and to individual financial statements, except that they do not need to be applied in the individual financial statements of entities that are preparing FRS 13-compliant consolidated financial statements. The FRED proposes to retain a similar exemption. Do you agree with this approach?

Answer: Yes.

32 The ASB would also welcome comments on the questions that the IASB has asked in its exposure draft, which are as follows:

IAS 32 (i) *Probabilities of different manners of settlement (paragraphs 19 22, and 22A)- Do* you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

Answer: We have difficulty in understanding how the substance of a transaction can be judged without looking at the probability of the manner of settlement. We are of the opinion that if an obligation is very likely to be settled by transferring equity instruments it should be classified as equity.

IAS 32 (ii) *Separation of liability and equity elements (paragraphs 28 and* 29)—Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

Answer: Yes, because equity is defined as the residual interest in assets after deducting all liabilities.

IAS 32 (iii) *Classification of derivatives that relate to an entity's own shares (paragraphs 29C* 29G)—Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

Answer: Yes, we agree with the guidance except is noted below. We would also like to point out that paragraph 29A is in conflict ‘with UITF 17 which would require an enterprise to record a loss if treasury shares which are purchased to satisfy option schemes, are purchased for an amount higher than the future contribution from the employee (sometimes enterprises grant options at market value but purchase the corresponding shares over a certain period after that date in which period the share price could have gone up). We believe this issue should be addressed in paragraph 96 A and B.

With respect to paragraphs 29C and 29F, sometimes an enterprise enters into derivative contracts based on its own equity instruments as a hedge for obligations arising from share options granted to employees. We feel that this aspect should be given consideration to because the current standard only accounts for one leg of the hedge. In our opinion if a company enters into a derivative based on its own equity instruments, for example a forward share repurchase, changes in the fair value of these derivatives should not be recognised in the financial statements if they effectively offset the change in the fair value of the obligation to deliver shares to option holders (eg employees).

IAS 32 (iv) *Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard*— Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the IASB Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

Answer: Yes we prefer a single comprehensive standard with a single implementation date.

IAS 39 (i) *Scope: loan commitments (paragraph 1(i))*- Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

Answer: Yes.

IAS 39 (ii)) Derecognition: continuing involvement approach (Appendix I, paragraphs 35-5 7)Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

Answer: Yes.

IAS 39 (iii) Derecognition: pass-through arrangements (Appendix I paragraph 41)—Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

Answer: Yes.

IAS 39 (iv) *Measurement: fair value designation (paragraph 100D)*—Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

Answer: Yes.

IAS 39 (v) *Fair value measurement considerations (paragraphs 95* 100D)-Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95 100D of the Exposure Draft? Additional guidance is included in paragraphs A32 - A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

Answer: We agree with the requirements and have no further suggestions.

IAS 39 (vi) Collective evaluation of impairment (paragraph 112 and 113(a(-113(d))- Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs ll3A-ll3D?

Answer: Yes.

IAS 39 (vii) *Impairment of investments in available-for-sale financial assets (paragraphs 117 119)*—Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

Answer: No, if impairment is no longer found to be required than the loss should be reversed and reported on the same line where it was originally recorded.

IAS 39 (viii) *Hedges of firm commitments (paragraphs 137 and 140)*—Do you agree that a hedge of an unrecognised fu-m commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

Answer: No we are of the opinion there should be an exception to this rule.

Under the original IAS 39 hedges of firm commitments were treated as cash flow hedges. We believe that the IASB has changed this treatment to fair value hedge in line with FAS 133. However, the United States FASB has reviewed its position and has! allowed, under FAS 138, that hedges of foreign exchange exposures within firm commitments can also be treated as cash flow hedges.

We support the amendment included in FAS 138. The reason for this being that if an entity hedges the foreign currency risk of a forecasted transaction with a derivative and this forecasted transaction then becomes a firm commitment, the entity has to redesignate the cash flow hedge as a fair value hedge which we believe is highly impractical.

Given the fact that ultimately the net-outcome for the profit and loss account is the same for both alternatives we believe that treatment of a hedge of a foreign currency risk within a firm commitment as a cash flow hedge is to be preferred. This would also increase convergence with US GAAP.

IAS 39 (ix) *'Basis adjustments' (paragraph 160)*— Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

Answer: No, we are of the opinion that this should be included in the measurement of the asset or liability. This change to the original IAS 39 adds serious impracticalities and complexities. Leaving the gains and losses in equity would lead to a build up of large numbers of balances within equity that are linked to, for example, inventory (production and sales), fixed assets (fixed asset and depreciation ledgers), goodwill etc. which will be very difficult to manage. Transferring such assets or liabilities from one group company to another will also be very complex, in particular when one of these is not wholly owned.

Given the fact that also in this case the ultimate net-outcome for the profit and loss account is the same for both alternatives we believe that releasing from equity compared to inclusion in the underlying asset/liability only adds complexity and we therefore do not agree with the proposed change.

IAS 39 (x) *Prior derecognition transactions (paragraph 1 71B)—Do* you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

Answer: We are of the opinion that such assets should be recognised on transition if it meets the criteria of an asset as included in the conceptual framework.