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Ms Sandra Thompson
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8 October 2004

Dear Ms Thompson

Amendments to IAS39 Financial Instruments: Recognition and Measurement
Cash Flow Hedge Accounting of Forecast Intragroup Transactions

We have reviewed the above exposure draft, issued in July this year, and would make the following comments:

It would appear that the inclusion of the new paragraph AG99A will allow cash flow hedge accounting for only certain forecast intragroup transactions. It seems to us that transactions which involve the purchasing company hedging an exposure relating to its cost of sales are not covered by these proposals.

In an attempt to explain our concerns, we are setting out below two types of forecast intragroup transactions that regularly take place between subsidiary companies in a group. One concerns the purchase of materials used in production and the other relates to the export of finished goods.

In the first instance, one subsidiary company will purchase, in its local (functional) currency, raw material from local suppliers and sell to another subsidiary company, say in US dollars. Where the purchasing company's functional currency is not the US dollar but say the euro, it is likely to hedge the cost of the materials by means of a forward exchange contract. Under UK GAAP the cost of the raw material is determined by reference to the exchange rate in the forward contract. Similarly, if such a purchase was from an external supplier, then by using the 'basis adjustment' allowed under IAS39 the same cost for the materials would be achieved. However, these proposals will apparently not permit hedge accounting in the group's consolidated accounts, as in this example it is not possible to designate an external transaction as the hedged item.

The second example is a situation where the exposure arises in the seller rather than the purchaser. For example a US subsidiary is exporting finished goods to another group company which sells them externally in its own market. The goods are invoiced in the purchasing company's functional currency. If the US company wishes to hedge its currency exposure through the selling forward of the foreign currency receivables for US dollars, hedge accounting apparently will be able to be used in the group's consolidated accounts by designating external sales by the purchaser as the hedged item. However it should be noted that even in this case the accounting treatment will necessitate the creation of a tracking system purely to satisfy external reporting requirements.

In both cases it is entirely logical for the relevant group companies to hedge their foreign currency exposures in order to provide stability in their own operating results and, furthermore, would apply cash flow hedge accounting in their own IFRS financial statements.

IAS27 (Consolidated and Separate Financial Statements) describes the consolidation procedure as the combination of the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses. It also requires the use of uniform accounting policies by all group companies.

Given these requirements of IAS27, is it reasonable to then adopt the exposure draft's proposals which would seem to require re-examination of some of the group companies' hedging transactions? In producing the group consolidated results, these proposals will not only require the reversal of the hedge accounting relating to cost of sales (i.e. the materials purchase example above), but it will also be necessary to adjust that relating to internal sales (i.e. the export of finished goods example above) to reflect timing differences between the internal sales and the related external sales.

In the basis for conclusions, in particular paragraph BC7, it would seem that the failure to identify a valid conceptual rationale is critical. However, in turn, it is difficult to understand the rationale for the Board's comments in BC7. How is it logical to exclude the currency risk arising from highly probable transactions but then allow it when the transactions become inter company balances (paragraph 80 of IAS39)? The necessity to ignore certain hedge accounting by subsidiary companies will result in unrealistic volatility in the consolidated profit and loss account in the period leading up to the intragroup transactions taking place.

Moreover, in connection with BC7, we find the Board's comments very dismissive of due process. It is not sufficient to just say the exclusion of the exemption in the revised IAS39 was not a mistake but a deliberate change made in the light of comments received from constituents. We would point out that

- many constituents supported the exemption but they were apparently irrelevant to the Board's decisions.
- companies are faced with a major task to implement IAS in Europe by 2005 and everyone recognises the need for planning and lead times; this is not helped by changes to what is meant to be a stable base.
- the change made by the IASB was done without warning or the due process/exposure required for such changes.

Consequently we would strongly urge the Board to reconsider this amendment on the grounds that we believe that it leads to misleading information being produced for users of financial statements in that it fails to reflect in the consolidated results the actual results of individual group companies and the hedging activity being operated by a group. We believe that it would be preferable for the guidance previously set out in IGC 137-14 to be incorporated into IAS39.

We hope that you will find our comments useful and thank you for the opportunity of being able to comment on the Board's proposals.

Yours sincerely

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