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30 Cannon Street
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Re: Exposure Draft of Proposed Amendments to IAS 39, Financial Instruments: Recognition and Measurement – Cash Flow Hedge Accounting of Forecast Intragroup Transactions

Dear Sandra,

Citigroup appreciates the opportunity to respond to the Exposure Draft, *Proposed Amendments to IAS 39, Financial Instruments: Recognition and Measurement – Cash Flow Hedge Accounting of Forecast Intragroup Transactions* (Proposed Amendments).

We support the Board's attempt to provide a pragmatic solution to an issue facing many entities. However, while we believe that the Proposed Amendments offer a solution to some of the problems that currently exist with the revised IAS 39 we believe it raises other practical and conceptual problems.

We understand that in practice at least two different views exist on what foreign currency risk shareholders in a consolidated group of entities face and how this risk should be hedged economically. Depending on which view the reporting entity holds it may or may not choose to hedge foreign exchange exposures arising from transactions in a currency different from the group's presentation currency. While we believe both views are valid and we understand that no consensus currently exists in the finance literature or in practice, we believe the Proposed Amendments are inconsistent with the current accounting model in IAS 21 - *The Effects of Changes in Foreign Exchange Rates* on the use of functional currency. We explain in more detail below the two views as we understand them and the basis for our support of one of those views.

We share the dissenting Board member's concern as articulated in paragraphs AV1 – AV2 of the Proposed Amendments and do not support the Proposed Amendments. Moreover, we understand the scope and impact of the Proposed Amendments is possibly broader than hedging intragroup transactions and may lead to dramatic changes in entities being able to hedge foreign currency risk of forecasted external transactions that today would qualify for hedge accounting. We provide examples below. If such changes are unintended we strongly recommend the Board clarify that such hedges remain eligible for hedge accounting.

We recommend the IASB seeks convergence with US GAAP (FAS 133 – *Accounting for Derivative Instruments and Hedging Activities*) on this issue and that the basis for this conclusion be articulated in a similar fashion to that in FAS 133 perhaps with some additional considerations as explained below.

Different views on hedging on a group basis

We believe that there are two different views on what foreign currency exposures a group consisting of entities with different functional currencies face and hence what foreign currency exposures should be hedged. Below we have labeled these as view A and view B. We believe the Proposed Amendments support view A. However, as explained below we find this view inconsistent with the remaining accounting literature in IFRS. We believe this is also the dissenting Board member's existing concern as explained in paragraphs BC12, AV1 and AV2 of the Proposed Amendments. Citigroup supports view B.

View A

Proponents of view A support the concept of a group being considered as "one single economic entity" as explained in paragraph BC11 of the Proposed Amendments. View A holds that the shareholders of the parent company consider all transactions and assets/liabilities denominated in a currency different from the group's presentation currency as carrying a foreign exchange exposure. Groups with this view may hedge on behalf of the parent's shareholders all exposures different from the parent's presentation currency. The basis for this view is well set out in the Proposed Amendments and need not be repeated in this letter.

View B

Proponents of view B believe that investors in a group (be it in the parent company or a subsidiary) are aware of the different currency exposures affecting the different entities within the group. Such investors are focused on hedging transactions denominated in a currency different from each entity's functional currency but not interested in the parent company hedging all transactions different from the group's presentation currency.

Proponents of view B clearly distinguish between an entity's (and a group's) functional and presentation currency. View B believes that the requirements in IAS 21 to adopt a functional currency based on the economic environment in which each individual entity operates is evidence that the functional currency is the determining factor of when an entity has an economic foreign currency exposure. In other words, foreign currency exposures arise whenever a transaction (or monetary asset/liability) is denominated in a currency different from the functional currency of each entity in the group. View B notes that the group's presentation currency is not mandatory but can be chosen by the group. This indicates that the purpose of the presentation currency is simply to enable groups to "add up" the accounting values for consolidation purposes.

Citigroup believes that the current accounting principles in IAS 21 and IAS 39 support view B.
This is evidenced by the following:

- Paragraph 80 of IAS 39 is clear that the foreign exchange exposure on an intragroup balance gives rise to an impact on the income statement. For example, an intragroup loan denominated in Euro between entity A with USD as functional currency and entity B with Euro as functional currency would give rise to a foreign currency gain or loss in entity A if the USD/Euro exchange rate changes. This gain or loss would not be eliminated upon consolidation. We believe this fairly reflects the economic exposure that results from the transaction. Highly probable forecasted transactions generally are eligible hedged items. This is based on the premise that an exposure arises (similarly to when a monetary asset or liability is recorded) already when the entity forecasts its highly probable future transactions. It follows that if the basis for considering foreign currency risk is the exposure at the level of each entity within a group then both intragroup balances and intragroup highly probable forecasted transactions should be eligible hedged items.

- In contrast, foreign currency gains/losses on translation of net investments in foreign operation are currently recorded through equity and not through the income statement under IAS 21. Some argue that this reflects the view that gains/losses on such investments are of an accounting nature rather than real economic exposures.

Other conceptual and practical considerations

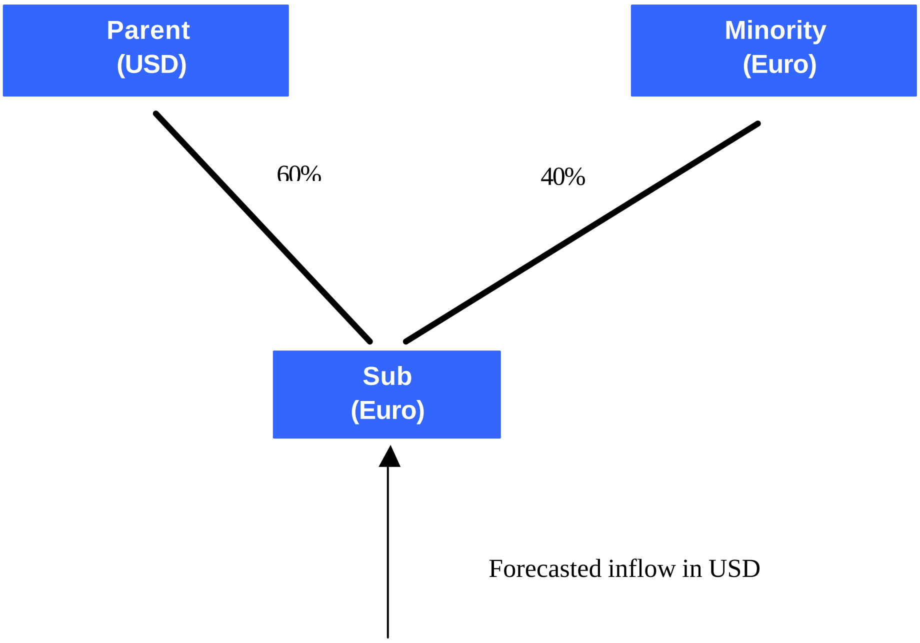
The Proposed Amendments may have some adverse practical implications. We understand that some treasurers consider a forecasted intragroup transaction to give rise to foreign currency risk, and not the forecasted external transaction. While often times approximately the same result may be achieved for accounting purposes (because the forecasted external transaction may be designated as the hedged item), the Proposed Amendments would create yet another difference between how treasurers hedge economically and how hedge accounting is applied.

For treasurers with this view another practical implication also arises when there is a significant difference in timing between the forecasted internal transaction and the forecasted external transaction (see below).

It is not clear from the exposure draft whether a forecasted intragroup transaction is required in order to achieve hedge accounting in the consolidated financial statements. Assume a parent with USD functional currency that has a forecasted sale in Euro to a subsidiary with Euro as functional currency. Assume also that this subsidiary forecasts to sell to an external third party in Euro the goods it will purchase from its parent. Under the previous guidance in IGC 137-14 the forecasted intragroup sale would qualify for hedge accounting. Under the Proposed Amendments the forecasted external sale would. However, it is not clear whether hedge accounting could also be achieved in the consolidated financial statements in a situation where there would be no forecasted intragroup sale but only a forecasted external transaction (the sale made by the subsidiary). We request that the Board clarify this important question.

If a forecasted intragroup transaction is required, we note that significant problems may arise. For example, when a subsidiary buys components from a parent company and uses those components in the production of a final product sold to an external third party there may be timing mismatches and tracking challenges. This is true if entities economically hedge the forecasted intragroup transactions and thus match the maturity of the hedge instruments to the occurrence of these transactions. When there is a significant timing difference between the occurrence of the forecasted intragroup sale and the external sale or the goods sold intragroup cannot be easily tracked to the external products entities may have significant difficulties meeting the hedge accounting requirements (i.e. showing hedge effectiveness and linking the hedging instrument to the hedged item).

We also believe the Proposed Amendments may lead to a change in entities being able to hedge highly probable forecasted external transactions because of the notion that only forecasted transactions denominated in a currency different to the reporting currency are eligible for hedge accounting in the consolidated financial statements. This may create a conflict of interest between minority and majority shareholders in a group. Consider the example below where a group with USD as its presentation currency has a minority shareholder in a subsidiary with Euro as its functional currency. This subsidiary has a forecasted transaction in USD.



The minority shareholder may wish for economic reasons to hedge the foreign currency exposure resulting from the forecasted sale in USD (for example by entering into a USD/Euro forward contract). However, the parent may be less compelled to do so if upon consolidation such a hedge would not qualify for hedge accounting. For the above example we understand that the Proposed Amendments may be interpreted to permit the subsidiary to apply hedge accounting in its own financial statements[1] but that upon consolidation such a hedge would not attract hedge accounting because the hedged currency is identical to the presentation currency of the group. At worst this could lead to under-hedging where it may be economically sensible to do so.

If hedge accounting is permitted in the consolidated financial statements for such a common illustrative transaction, we strongly recommend this be clarified in the final standard.

Consider next a different example where a group with USD as presentation currency includes a subsidiary with Euro as its functional currency. This subsidiary has a forecasted transaction in GBP. If the subsidiary enters into a GBP/Euro forward contract to hedge its foreign currency exposure would this hedge also qualify for hedge accounting in the consolidated financial statements?

An alternative approach

We support the Board's intention to solve this important issue. However, we strongly prefer a solution more aligned with US GAAP. Below we offer our understanding of the basis for why US GAAP allows forecasted intragroup transactions to be hedged items and explain why this is broadly consistent with view B above.

[1] This will depend on where the hedging instrument sits and assumes that the other criteria for hedge accounting in IAS 39 are met.

At the core proponents of view B believe that foreign exchange exposure only exists in the context of an entity's functional currency (as opposed to the presentation currency).

Paragraphs 482-487 of FAS 133 sets out the basis for the FASB's conclusion to allow a forecasted intragroup transaction to be the hedged item in a cash flow hedge. The basis for conclusions explains that forecasted intragroup transactions in substance are no different from any other forecasted transactions. Paragraph 484 explains:

"..pursuant to Statement 52 as amended by this Statement, an intercompany transaction that is denominated in a currency other than the entity's functional currency gives rise to a transaction gain or loss if exchange rates change. A forecasted transaction that is expected to be denominated in a foreign currency can be viewed as giving rise to the same type of risk"

The basis for allowing forecasted transactions (in general) to be hedged items in IAS 39 and FAS 133 is that they often display many similarities with firm commitments and hence with recognized assets and liabilities. As explained in paragraph 80 of IAS 39 a recorded intragroup balance can give rise to a foreign exchange exposure. It follows that if one supports view B and also believes that a forecasted transaction in general gives rise to a foreign exchange risk, then the exposure of a forecasted intragroup transaction should be an eligible hedged item.

Notwithstanding this, the fact remains that the forecasted intragroup transaction does not give rise to an impact on the consolidated financial statements until a transaction with an external third party takes place. This issue is considered under US GAAP in DIG Issue H13 - *Foreign Currency Hedges: Reclassifying into Earnings Amounts Accumulated in Other Comprehensive Income Related to a Cash Flow Hedge of a Forecasted Foreign-Currency- Denominated Intercompany Sale.* DIG Issue H13 requires that any gain/loss deferred in equity be released to the consolidated income statement only once an external transaction is recorded in the income statement.

We see DIG Issue H13 as a practical accounting solution to a complex problem. However, in economic terms proponents of view B would view a hedge of a forecasted intragroup sale as a hedge of the foreign currency denominated intragroup <u>balance</u> that arises as a result of the intragroup sale. So in economic terms view B proponents see the intragroup sale and the resulting receivable as the hedged item. However, as a result of the accounting conventions in IAS 27 this intragroup sale is not recognized upon consolidation. This leaves entities with a practical problem as to when to recognize any gain or loss in the consolidated financial statements. Of importance is that the gain/loss relates to a sales transaction and hence should be presented in the income statement as an adjustment to revenue.

Not subtracting from the conclusion that it is the intragroup sale that is the hedged item, DIG Issue H13 requires that the gain/loss be deferred until an external sale has been recorded. Alternatively one may consider whether such a gain/loss should for conceptual reasons be recorded earlier when the intragroup sale takes place. This may be relevant especially when the intragroup transaction and the external transaction take place some time apart. On balance however, we feel that DIG Issue H13 offers a practical and operational solution that would often times give rise to only a marginally different result to what could be perceived as a more conceptually supportable approach.

Other Matters

The Proposed Amendments have the potential to allow hedging the foreign currency risk of foreign subsidiaries' net profits by the parent instead designating a gross amount of cash flows (e.g. forecasted sales) that make up part of the profit. This was previously not possible under IAS 39.

The Proposed Amendments could give rise to concern for entities currently reporting under IFRS unless transition rules are added. For example, an entity may until recently have designated as the hedged item in a cash flow hedge a forecasted intragroup transaction as allowed by Q&A 137-14. Since this forecasted intragroup transaction would no longer qualify for hedge accounting treatment, IAS 39 would require that any gain or loss deferred in equity be released to the income statement since the hedged item may be considered not to occur. This seems inappropriate in a situation where forecasted external transactions exist and could have been designated as the hedged item instead. We suggest appropriate transition rules be included in the final amendments to address this issue.

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We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Robert Traficanti
Vice President and Deputy Controller
Citigroup