EFRAG

European Financial Reporting Advisory Group

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Dear Sandra,

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

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft of proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement Cash Flow Hedge Accounting of Forecast Intragroup Transactions.

We support the proposed clarification but believe it is workable without the link to the presentation currency. We agree that the group can designate as the hedged item, in a foreign currency cash flow hedge, an external highly probable forecast transaction denominated in the functional currency of the subsidiary entering into the transaction. However, we argue that the condition for this designation should be a link from that transaction to the functional currency of the entity bearing the exposure in accordance with IAS 21. That link would normally operate via an intra-group transaction which causes the exposure.

This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive amendment on the issues.

If you would like further clarification of the points raised in this letter, Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman

Question 1

Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

EFRAG response:

We agree with the proposed clarification in that it is in line with the principle that a cash flow hedge in consolidated financial statements requires designation of a highly probable forecast transaction that involves a party external to the group. We also agree that in the example considered in paragraphs BC2 and BC3 in the Exposure Draft (ED) there is foreign currency exposure at the group level because the group's costs are denominated in a currency different from its sales. However, we find it unnecessary and misleading to invoke the group presentation currency to achieve the correct accounting for the consolidated financial statements.

We accept that the analysis in the ED is one possible way to track the application of hedge accounting in the situation considered in the ED in a multi-functional currency group. However, we are of the opinion that it has serious flaws:

a. The designation via a presentation currency is oversimplified;

b. The proposed solution does not flow naturally from the transactions of the subsidiaries that have undertaken the relevant internal and external transactions; and

c. The rationale based on measuring exposures against the presentation currency will have the effect of undermining the whole philosophy of IAS 21.

The designation via a presentation currency is oversimplified;

Assume that the external sale by Company C and the presentation currency of Group A were both yen: then,

- Company B would have a euro/dollar exposure; and
- Company C would have a dollar/yen exposure;

both summing to a euro/yen exposure.

The proposed guidance in the ED that the euro purchase should be hedged against the presentation currency (yen in this example) would get the right result.

However, if the external sale by Company C was yen and the presentation currency of Group A was pounds, the combined exposures of Company B and Company C would still be euro/yen. At the same time, the proposed guidance seems to require two separate hedging transactions euro/pound and pound/yen to measure the exposure via the presentation currency.

In these examples, and in those used in the ED, the presentation currency is being used as a benchmark against which an exposure caused by two sets of transactions external to the group (euro purchase of materials and labour by Company B and dollar or yen sales by Company C) is measured. Nevertheless, the ultimate exposure is between the currencies of the two sets of external transactions. Therefore, we believe that the presentation currency is not relevant except as a means of linking the external transactions in the proposed model.

The proposed solution does not flow naturally from actual exposures

In practice the hedging exposures of a multi-functional currency group could be numerous and varied. It is important to have a system that builds up the consolidated exposure naturally from the exposures resulting from the actual transactions of the subsidiaries. For instance, in the IASB's own example, it is not clear how the group would become aware, if the group's presentation currency was US dollar that a hedge needed to be designated against some of the euro purchases of Company B, whose functional currency was itself euro. Company B would not be conscious of an exposure and the group would not be aware of Company B's purchases at the time that a hedge needed to be designated. In a more complex example it would be even more difficult to determine which exposures should be hedged.

The proposed solution undermines IAS 21

Even though ways can be found of tracking the multi-functional currency exposures of a group via the group's presentation currency, that solution will be seen as undermining the whole philosophy of IAS 21, which insists that it is functional currencies rather than the presentation currency of the group that determine the basis of measurement in preparing consolidated financial statements. Indeed, the whole argumentation of the proposed Basis for Conclusions seems to subject the functional currency perspective of IAS 21 to the single entity perspective of IAS 27. That relationship was specifically debated at the time that IAS 21 was developed and it was decided that the single entity perspective did not obviate the need for multiple units of measure to be used in preparing the consolidated financial statements.

An alternative way of validating the proposed solution

As mentioned above, we support the proposed clarification but believe it is workable without the link to the presentation currency.

We appreciate that IAS 39 requires that for hedge accounting purposes an identifiable transaction (or group of transactions) external to the entity can be designated as a hedged item provided that this transaction (or group of transactions) is subject to variability in cash flows that is attributable to a particular risk that could affect profit or loss.

Taking into account the above principle, in the example in paragraphs BC2 and BC3, we believe that it would be appropriate if in consolidated financial statements the group could obtain hedge accounting for its highly probable forecast sales denominated in US dollars transacted by Company C with external customers if the group can establish a link from this transaction to the cause of the foreign exchange exposure – the fact that the forecast US dollar sales are to be sourced from Company B, whose functional currency is euro. The designation of that exposure operates through the expected US dollar intragroup sales effected by Company B but requires the expectation of the highly probable external sales of Company C to complete it.

The purpose of establishing the link is that:

- The Group would validate eligibility of a particular transaction external to the Group for hedge accounting, and

- The Group would identify and justify the relevant functional currency against which to measure the results of the hedge.

Thus, we propose that the group can designate as the hedged item, in a foreign currency cash flow hedge, an external highly probable forecast transaction denominated in the functional currency of the subsidiary entering into the transaction. The condition for this designation is a link from that transaction to the functional currency of the entity bearing the exposure in accordance with IAS 21. That link would normally operate via an intra-group transaction which causes the exposure.

By establishing a link in this way, the relevant benchmark currency against which the group designates and assesses the hedge would be the functional currency of the entity whose transactions give rise to foreign exchange gains or losses affecting the measurement in consolidated financial statements in accordance with IAS 21.

This designation in our view would recognise that at the group level there is foreign currency exposure if the group's costs are denominated in a currency different from its sales. Furthermore, this designation will be in accordance with the underlying principle of IAS 21, that consolidated accounts are measured from the perspective of multiple functional currencies of entities comprising the group.

Question 2

Do the proposals contained in Exposure Draft appropriately address the concerns set out in paragraph 3 of the Background on this Exposure Draft? If not, why not, and how would you address these concerns?

EFRAG response:

We believe that the Exposure Draft, if modified along the lnes suggested above, would appropriately address the concerns set out in paragraph 3 of the background section.

Question 3

Do you have any other comments on the proposals?

EFRAG response:

We have no other comments.