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International Accounting Standards Board
30 Cannon Street
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Attention: Sandra Thompson,
Senior Project Manager

CL 33

October 8, 2004

ED of Proposed Amendments to IAS 39 – Cash Flow Hedge Accounting of Forecast Intragroup Transactions

Dear Ms. Thompson,

We welcome very much the opportunity to comment on the above-mentioned ED.

Paragraph BC7 of the ED states that the deletion of the IGC 137-14 guidance on issuing IAS 39 (revised December 2003) was a deliberate change made to the June 2002 ED of proposed changes to IAS 39 in the light of comments received from constituents questioning the conceptual rationale for that guidance. In our view, it is highly unsatisfactory that a change of this nature was not re-exposed. The fact that some constituents questioned an existing IFRS treatment when commenting on an ED does not exempt the IASB from the need to follow due process in making a subsequent change in that treatment. We cannot see how due process can be fully observed in this type of situation unless the subsequent change is re-exposed. We urge the IASB to consider this in relation to its "fatal flaw" review procedure, as part of the deliberative process review it announced on 24 March.

On balance we support the proposals in the ED on cash flow hedge accounting, subject to the points detailed in this letter.

The two most important points that we raise concern:

a) transitional arrangements
b) no substantial amendments to the ED without re-exposure of the ED.

a) An extremely important area on which clarification is required is how the transition from IGC 137-14 to the proposals in the ED should be treated. We request that the IASB make an <u>immediate</u> statement on this issue. Without this, preparers who are continuing to apply IAS 39 (December 1998 version) in 2004, and who entered into hedging contracts during 2004 of forecast transactions to occur in 2005, will not know whether the hedging relationships they designate on the inception of the hedging instruments will be valid in 2005. The validity of those designations will impact 2005 reported profit or loss, in some cases materially. We would point out that there has been considerable confusion on this issue since IAS 39 (revised December 2003) was first published. Initially, many preparers did not read paragraph 80 of that version of IAS 39 as precluding forecast intercompany transactions from being designated as hedged items. This became clear only when the minutes of subsequent IASB meetings were published. In our view, the IASB has the responsibility and the authority to end uncertainty on this point now, by stating that hedging relationships designated before the adoption of the proposals in the ED will be “grandfathered”.

b) Our support indicated above is based on our understanding that although the title of the ED refers to cash flow hedge accounting of forecast intragroup transactions, the ED is actually more far reaching in its consequences as indicated in paragraphs BC 13 - 15. These paragraphs indicate that the group’s presentation currency is in effect to be considered its functional currency, and therefore all external forecasted transactions other than those in the presentation currency can be hedged. Should the Board continue to have this view then we consider that consequential changes to IAS 21 will be required.

   Should the Board in its subsequent deliberations decide to amend the Application Guidance and paragraphs BC 13 -15 and restrict the scope to intragroup transactions if they are lower than the external transactions as outlined in paragraph BC 10 then we would disagree and strongly request a re-exposure of this ED as it would represent a substantial change to the ED as currently written.

   We would then rather support re-instating the IGC 137-14 guidance instead of amending IAS 39 to treat only intragroup transactions as outlined in paragraph BC 10.

Specific questions in invitation to comment

Q1. *Do you agree with the proposals in this Exposure draft? If not, why not? What changes do you propose and why?*

Q2. *Do the proposals contained in the ED 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?*

Subject to the points outlined in the above paras, we agree with the proposals. However, we would like to make the following points:

<u>Worked example</u>

The example set out in paragraph BC2 of the ED should be moved from the Basis for Conclusions into the Application Guidance. Also, the example is highly simplified compared to the structure of many large multinational IFRS preparers, and involves only two currencies, one of which is the group presentation currency. For greater clarity, a more complex example should also be provided, in which the two transacting subsidiaries each have functional currencies different from the group presentation currency.

<u>Documentation</u>

A valid hedge accounting relationship may be desired at the level of the subsidiary's separate financial statements as well as the consolidated financial statements. Preparers will have to designate different transactions as hedged items at these two different levels. Two sets of hedge documentation, one for each level, may therefore have to be prepared. This highlights the need not to complicate further the documentation requirements for hedging relationships in the future, and if possible to reduce them.

<u>The absence of specific transition requirements will lead to problems</u>

The ED is silent on the issue of transition from IGC 137-14. This is a surprising omission, given that the ED allows early adoption, and preparers are still allowed to apply the December 1998 version of IAS 39, and therefore IGC 137-14, for annual periods beginning before 1 January 2005. Many entities may move directly from that version of IAS 39 to the one which will incorporate the ED proposals. In the absence of a specific transition requirement, the principle of retrospective application applies under IAS 8. Without guidance on how this principle should be applied, hedging relationships established under 137-14 in previous periods could conceivably be treated in any of the following very different ways:

a) Existing hedging relationships are invalidated prospectively as from the date of adoption. Under a common sense approach, previous relationships are not restated because they were valid under the rules in force at the time. New hedge documentation is produced to show hedging relationships which comply with the new rules, and hedge accounting is applied prospectively to them.

b) Hedging relationships which ended before the adoption date are not restated if an external transaction in the relevant period could have been validly designated as a hedged item under the new rules, because the entity would have done that had the new rules been in force then. Hedging relationships which incepted before adoption and still exist on adoption are not restated if a highly probable forecast external transaction exists which could have been designated as the hedged item on inception of the hedge under the new rules, and existing hedge documentation is revised to show this new relationship.

c) Hedging relationships which ended before the adoption date are restated as if hedge accounting had never been permitted, because hindsight cannot be used to designate an external transaction retrospectively as the hedged item. Hedging relationships which incepted before adoption and still exist on adoption are not restated if a highly probable forecast external transaction exists which could have been been designated as the hedged item on inception under the new rules, because the use of hindsight is not required in this case, and existing hedge documentation is revised to show this new relationship.

d) The hedging relationship is retrospectively regarded as never having been valid, because it is not permitted under IAS 39 as revised by the ED. Income statements and statements of movements in shareholders' equity for all periods presented are restated as if hedge accounting had never been permitted.

We suggest that the most sensible way to resolve the transition issue is to insert a specific "grandfathering" clause under which previously documented hedging relationships continue to be treated as valid until those hedging relationships end. The proposals should apply only to new hedging relationships documented after the adoption date. Otherwise, preparers transacting hedging instruments during 2004 to hedge transactions forecast to occur in 2005 will not know whether the hedging relationships they designate at inception will continue to be valid under the version of IAS 39 which will be applied in 2005.

Linking the validity of a hedging relationship at consolidated level to the group presentation currency

The ED does not allow an external transaction denominated in the group presentation currency to be designated as a hedged item if the functional currency of the transacting entity is also the group presentation currency. This raises the following practical issues:

a) Groups preparing under IFRS may decide to change their presentation currency. In this situation, are existing hedging relationships where the hedged item is denominated in the new presentation currency, to be considered as invalidated by the change? We suggest a specific "grandfathering" clause under which previously valid hedge accounting would not be restated if a group changes its presentation currency.

b) Some preparers have a dual stock market listing structure, and may wish to present consolidated financial statements in two currencies - the currencies of the countries in which they are listed. It would appear that hedges designated by these preparers may not qualify for hedge accounting in both sets of consolidated financial statements.

IFRS/US GAAP convergence is highly desirable

The proposals are divergent from FAS 133, which permits forecast intragroup transactions to be designated as hedged items, in that the hedged item would be different under IFRS and US GAAP. This suggests that IFRS preparers who are listed on US stock exchanges and have to present IFRS US GAAP reconciliations under SEC rules may have to show a reconciling item for their hedge accounting because their valid IFRS hedging relationships may be considered invalid under US GAAP. Such an outcome would clearly be incompatible with the convergence project to which the IASB and FASB have jointly committed. Nor would it be reasonable to expect these preparers to cover two divergent sets of IFRS and US GAAP rules in their hedging documentation to avoid a reconciling item! In our view, convergence could be achieved through the SEC agreeing a specific exemption from reconciliation on this point, similar to the existing exemption which allows IFRS preparers not to show a reconciling item for the difference between the IAS 29 and FAS 52 treatment of hyperinflation. Anything the IASB can do to bring about such a solution would be very much appreciated.

Q3. *Do you have any other comments on the proposals?*

We would like to reiterate that a solution to the issue is urgently required. We urge the IASB to continue to devote sufficient priority to this issue by considering comments at the earliest opportunity and proceeding to a resolution of the issue. We strongly support the principle in the ED that early adoption of the solution should be allowed.

We thank you for your attention to the above.

Yours sincerely,

NOVARTIS INTERNATIONAL AG

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