Smith & Nephew plc
15 Adam Street
London WC2N 6LA
England

T 44 (0) 207 401 7646
F 44 (0) 207 930 3418
www.smith-nephew.com

We are **smith&nephew**

4th October 2004

Ms Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Ms Thompson

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

We are writing to express our concerns at the recent proposals made by the IASB. In particular, we are concerned that a failure to understand the principles proposed in the context of real scenarios will result in an amendment which does not work in practice. We fear that the search for a theoretically rigorous solution to this is at odds with the need to physically run and manage a business.

We have set out below our understanding of the implications this proposal would have on our business practice which is, we believe, fairly typical of a manufacturing operation with worldwide sales.

Within our Group, we see a real implication for the transfer of inventory around the Group for normal trading. Costs are generally incurred in the sterling and dollar environments of the manufacturer and yet need to be sold in the currencies prevailing in the selling country of which there are 35. The sales levels are reasonably predictable although obviously the timing may vary slightly. The intra-group product purchases involved amount to the sterling equivalent of £300m and are covered forward to give certainty over future costs. This is essential for price setting and managing business costs locally with reasonable certainty and for budgeting and forecasting. Purchases are typically covered between 50% and 90% 12 months ahead. Cover is topped up to 100% at the point a firm order is placed on the manufacturer. In this way the currency hedging transactions are matched to, and used to settle, actual purchase cash flows, the effectiveness of which can be easily monitored. We typically hold between 3 and 6 months of inventory, some of which is consigned to customers. Whilst our hedging process is clearly associated to the foreign currency sales to the external customer, we believe that trying to demonstrate this at a detailed documentary level to accord with the proposed amendment to IAS 39 is clearly an impractical convolution.

Were a method adopted as suggested in the IASB's Basis for Conclusions 2, we would be creating contracts to sell local currency based on future sales although management intent is to match the future payments for purchasing foreign currency. These events are independent of each other. Essentially this is asking us to set up a sham external hedge when we have real purchase documentation to support the basis of our purchase hedges. Although contracts could be shown to be effective this is meaningless within the context of management control. We can think of no right-minded businessman institutionalising such a system, with the real worry that it would be open to abuse and error. It is wrong that accounting is forcing us into a sub-optimal control process.

A mechanism to allow business to hedge account for intra-group purchase transactions on a prudent forecast basis needs pressing attention. We believe the suggested solution could not work in practice and that the most effective solution would be to reinstate IGC 137-13. This is an urgent and serious appeal on this matter.

Thank you for this opportunity to provide our comments.

Yours sincerely,

P. Hooley

PETER HOOLEY
Finance Director