Unilever

October 8th, 2004

Exposure Draft : Proposed Amendments to IAS 39 - Cash Flow Hedge Accounting of Forecast Intragroup Transactions

Question 1:

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

We do not with the proposals in the Exposure Draft, for the following reasons:

1. The proposals do not reflect the way in which companies actually manage their risks

Many multinational companies operate using large production facilities in one country that produce goods for an entire region. Manufacturing units invoice local selling units either in the currency of the manufacturing unit or in the currency of the selling units. As a result, either the manufacturing unit or the selling unit has a currency exposure that will be hedged using forward foreign exchange (FX) contracts. For selling units it is especially important to hedge this exposure since such units compete in local markets against local competitors that typically are not subject to the same foreign exchange risks. Should the manufacturing unit invoice in the currency of the selling units, it will cover the resulting FX risks in order to protect its margins. As a practical matter, in competitive markets it is not possible to adjust selling prices in the short term to compensate for currency fluctuations and exposed units will therefore cover forecasted FX flows for a period of up to 12 months forward.

As demonstrated above, the FX exposure and the FX cover contract exist in a single operating unit. By restricting hedge accounting to external transactions that do not eliminate on consolidation a link must be made between the FX contract in one operating unit and an external transaction in another operating unit. This is extremely complex, if not wholly impractical, to apply in practice and is inconsistent with the reality of the actual risk management practices. It is also a divergence with US GAAP.

2. The proposals discriminate between manufacturing arrangements that are in substance the same

The examples in BC2 and BC3 allow company B (European manufacturing unit) to apply hedge accounting by linking its FX contract (selling US$/buying EUR) with the external US$ sale in company C. An equally plausible example is where the manufacturing unit resides in the US and invoices the European selling unit in EUR. Interpreting AG 99A[1] it appears that hedge accounting would not be permitted in this case because the external transaction (EUR sales in Europe) to which the US$/EUR contract (buying US$, selling EUR) must be linked happens to be in the functional currency of the Group. This is inconsistent.

3. The proposals create a divergence with US GAAP

For dual listed companies like Unilever convergence between IFRS and US GAAP is a fundamental goal. In this regard the proposals are a step in the wrong direction.

[1] *"…provided that the transaction is denominated in a currency other than the group's presentation currency." AG 99A*

As an alternative to the proposals we believe that the Board should extend the scope of paragraph 80 of IAS 39 to permit an intra-group forecasted transaction to be designated as a hedged item for FX risk in a cash flow hedge for consolidated financial statements. This will align IFRS with US GAAP (para 36 of FAS 133 is the corollary).

Question 2:
Do the proposals contained in the 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?

We do not consider that these concerns are appropriately addressed.

Deletion of IGC 137-14 means that companies can no longer designate forecast intragroup transactions as the hedged item. We acknowledge that paragraph 99A permits FX contracts taken out to hedge intragroup positions to be linked to external transactions arising elsewhere in the Group. However, we believe this is approach is conceptually flawed, since the underlying purpose of the FX contract is not to hedge the foreign currency risk on this specific external cash flow. Moreover, from a risk management point of view this external cash flow may be a flow that does not involve a foreign currency risk. Creating an artificial hedge relationship does not reflect the reality of the risk management practices and requires unnecessarily complex hedge accounting documentation.

These concerns can best be addressed by aligning IFRS to US GAAP (FAS 133 para 36).

Question 3:
Do you have any other comments on the proposals

The proposals acknowledge that intra-group transactions lead to FX exposures that affect the consolidated P&L and that recognized intra-group transactions can be hedged items. If it is acknowledged that intra-group transactions lead to FX exposures, we believe that hedge accounting should not be limited to recognized monetary items as hedged items but should also include future (forecasted) FX intra-group cash flows. Such exposures are real economic risks and indeed from a risk management perspective are often the more relevant risks.

Business models cannot adjust immediately to currency movements in the short term and hedging future cash flows gives businesses the time needed to adjust their product pricing accordingly. IFRS acknowledges this by proposing AG99A as a “work around” solution for companies that hedge future cash flows but would no longer be able to define these future flows as hedged items under the proposals. In our view, it is an impractical and potentially hazardous option that allows companies to define hedge relationships between derivatives and cash flows that are in substance unrelated from a risk management perspective.