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Your ref Comment letter

Our ref EL/813

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Dear Sandra

Comment letter – ED of proposed amendments to IAS 39 *Cash Flow Hedge Accounting of Forecast Intragroup Transactions*

We appreciate the opportunity to respond to the invitation to comment on the Exposure Draft of proposed amendments to IAS 39 *Cash Flow Hedge Accounting of Forecast Intragroup Transactions*. This letter expresses the views of KPMG International[1].

While we welcome the decision of the Board to address the issue of cash flow hedge accounting of forecast intra-group transactions, we do not support the proposals of the resulting exposure draft. We believe that the proposals are in conflict with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. We are concerned that the proposals will in effect allow a group to hedge its exposure to accounting risk, arising from the translation of the profit or loss of a foreign operation, rather an economic exposure to risk.

In the interest of providing a pragmatic approach to hedge accounting forecast intragroup transactions, we recommend that the Board reinstate the guidance that was previously provided in IGC 137-14 *Forecasted intra-group foreign currency transactions that will affect consolidated net income*, possibly excluding the requirement that such transaction results in the recognition of an intra-group monetary item. We believe that this will, to a large extent achieve convergence with US GAAP.

[1] KPMG International is a Swiss cooperative that provides no client services. All professional services are performed by its member firms. As used herein, "KPMG" refers to KPMG International and/or its member firms, as appropriate.

Question 1 – Do you agree with the proposals in this exposure draft? If not, why not? What changes do you propose and why?

We do not agree with the proposals of the exposure draft to allow hedge accounting of highly probable forecast external transactions, which may be denominated in the functional currency of the subsidiary undertaking the transaction, as long as the currency used is not the same as the group's presentation currency and thus has an effect on consolidated profit or loss. We believe that the situation described does not fully meet the definition of a cash flow hedge. The proposals focus on there being an impact on profit or loss, but the first requirement of a cash flow hedge is that there is an exposure to variability in cash flows.

Forecasted transactions that are denominated in a subsidiary's own functional currency do not result in an economic exposure to foreign exchange risk for that subsidiary. Consequently, the 'variability in cash flows' requirement is not met and cash flow hedge accounting would ordinarily not be appropriate. An economic exposure, and thus a variability in cash flows, results if either (i) the forecast external transaction is not in the subsidiary's functional currency; or (ii) there is an internal transaction through which the original cash flows will be passed back to another group entity that has a different functional currency.

Furthermore, the Board acknowledges in paragraph BC 12 that under IAS 21 a group does not have a functional currency, but rather that it has a presentation currency into which the results of all of the individual entities comprising the group are translated and then aggregated. Economic exposure to foreign exchange risk arises only where transactions are undertaken in a currency different from an entity's functional currency. Where transactions are undertaken in currencies different from an entity's presentation currency, it is accounting risk that results. We do not believe this to be a hedgeable risk. Paragraphs BC 13 and BC 14 seek to justify the approach taken by viewing the group as a single entity with a single functional currency. We believe that this cannot be offered in justification since it contradicts a principle of IAS 21, namely that a group has only a presentation currency.

At noted above, the proposals require only that the transaction has an effect on the consolidated profit or loss. In the absence of an economic exposure to foreign exchange risk, the consolidated profit or loss will only be affected by the translation of the subsidiary's profit or loss from its functional currency into the group's presentation currency. We note that IAS 21 permits the presentation currency of a reporting entity to be any currency (currencies). Consequently, the proposals in effect enable a group to hedge its selection of presentation currency rather than its economic exposure to foreign exchange risk. Furthermore, since IAS 21 permits a reporting entity to have more than one presentation currency, we understand that the proposals would allow the forecast external transaction to be hedge accounted in one presentation currency but not another, which is the same as the currency of the underlying transaction.

We draw your attention to the relevance to this issue of paragraph BC 16 of IAS 21, which states that presenting the financial statements in a different currency should not change the way in which the underlying items are measured. Rather, the translation method should merely express the underlying amounts, as measured in the functional currency, in a different currency. The proposals of the exposure draft seem to be inconsistent with the view expressed in BC 16.

IAS 21 has introduced two different foreign exchange exposures, namely (i) arising from transactions; and (ii) arising from the translation of foreign operations. Accordingly, IAS 39 has introduced the cash flow model or fair value model for foreign exchange risk arising from transactions and the net investment model for foreign exchange risk arising from the translation of foreign operations. At group level, however, any foreign exchange risk arising from transactions of the subsidiary is considered for accounting purposes to be a translation risk. Consequently, in principle the net investment model should be used.

To illustrate, consider the following example:

The parent company has been asked to build a plant abroad – contract value $100 million. It is group policy for all such contracts to be entered into with the foreign subsidiary, while the parent company provides a guarantee if necessary. The group presentation currency is the Euro, while the functional currency of the subsidiary is the US Dollar. The parent manufactures parts to the value of $50 million, while the rest of the contract is performed by the subsidiary. The overall profit margin on the contract is 10%. The contract has not yet been signed. At group level, there is a foreign exchange exposure (net) of $55 million – i.e., revenue of $100 million, less costs incurred by the foreign subsidiary of $45 million, given the 10% profit margin. $50 million is the risk arising from the transaction between the parent and the foreign subsidiary, while $5 million is the expected gain of the subsidiary, therefore arising on translation. Based on the approach followed in IGC 137-14, the transaction risk of $50 million could be hedged, but the expected gain of the subsidiary could not be hedged. Under the proposals of the ED, $55 million could be hedged using the cash flow model. This would also create a US GAAP difference. It should be noted that if the parent intends to enter into the contract directly (rather than via the subsidiary as in the example above), it could also hedge all of the risk exposure arising from a forecast transaction.

Question 2 – Do the proposals contained in the exposure draft appropriately address the concerns set out in paragraph 3 of the Background to the exposure draft? If not, why not, and how would you address these concerns?

The exposure draft acknowledges that paragraph 80 of IAS 39 creates a difference with US GAAP, as SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* permits hedge accounting for foreign currency risk on forecast intragroup transactions. We would like to point out that the proposed amendment does not fully eliminate the difference. If the Board intended to eliminate the difference, further amendments are necessary. SFAS 133 paragraph 40 requires that:

- the hedged transaction is denominated in a currency other than the hedging unit's functional currency; and

- all of the criteria in paragraphs 28 and 29 [of SFAS 133] are met, except for the criterion in paragraph 29(c) that requires that the forecasted transaction be with a party external to the reporting entity.

In particular US GAAP does not require the highly probable forecast transaction to be an external transaction.

We do not believe that the proposals provide an appropriate solution for the specific concerns raised. We believe a more pragmatic approach would be for the Board to reinstate the guidance that was previously provided in IGC 137-14 *Forecasted intra-group foreign currency transactions that will affect consolidated net income*, possibly excluding the requirement that such transaction results in the recognition of an intra-group monetary item. We believe that this will, to a large extent achieve convergence with US GAAP.

Questions – Any other comments

Both the Background (paragraph 5) and paragraph BC 15 characterise this exposure draft as a clarification. This seems to imply that the hedged transaction that is the subject of this exposure draft is currently allowed under revised IAS 39. However there are also specific statements (in Background paragraph 2, BC 1, BC 7) noting that this type of transaction does not qualify for hedge accounting in revised IAS 39. We found these different statements confusing and contradictory, and suggest that the IASB harmonize the wording of these paragraphs so as to not leave any doubt about whether this hedging approach is acceptable.

Please contact Mark Vaessen at 020 7694 8089 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG International

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