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Dear Sandra

Proposed amendments to IAS 39 on Cash Flow Hedge Accounting of Forecast Intragroup Transactions

The Accounting Standards Board is grateful for the opportunity to comment on the proposed amendments referred to above.

We agree with the proposed amendment only insofar as it requires a transaction external to the group to justify recognition of a cash flow hedge in the group financial statements. In our view, the group's presentation currency does not affect the currency exposure. It is fundamental to IAS 21 that exposure to currency gains and losses other than differences arising on translation of a foreign net investment can only derive from a difference between the currency of a transaction and the functional currency of the group company effecting the transaction or on whose behalf the transaction is effected. Where the transaction is between two group companies of different functional currencies the gain or loss is not eliminated in the consolidated financial statements.

Using these IAS 21 principles, our understanding of the hedging transactions in the Board's example is as follows. Company B, in order to fix in euros its expected future dollar settlement proceeds, undertakes with Company C as counterparty a forward sale of dollars for euros. Company C, which does all its trade in dollars, thus becomes exposed and enters into an external forward sale of dollars for euros to cover its commitment to purchase dollars for euros from Company B. The effect of these transactions is that in its own financial statements Company C has a forward sale to the market and an opposite forward purchase from Company B. The gains and losses on these two derivatives will, wholly or partly, cancel out in income. Company B in its own financial statements has a forward sale to Company C, which is eligible for treatment as a cash flow hedge. In the consolidated financial statements of Group A, gains and losses on the internal forward sale and purchase cancel out completely, leaving an external forward sale of dollars for euros. Although that external transaction is undertaken by Company C, the internal transactions link it to Company B. The external transaction can therefore be treated as a cash flow hedge of Company B's dollar sales.

In our view, the Board has misdirected itself by giving too much emphasis to the IAS 27 principle that consolidated financial statements are presented as those of a single entity, while ignoring the functional currency perspective of IAS 21. In particular, BC14, the key paragraph of the Basis for Conclusions, assumes what it attempts to prove by hypothesising a group with a single functional currency. On the facts of the example as given, Group A does not have one functional currency but two. It is understandable that, when dealing with a simplified example such as this, one should be tempted to make the further simplification of a single functional currency for the whole group. But real life is often far more complicated and very much needs the functional currency perspective of IAS 21, which will be severely damaged if the reasoning in this exposure draft is adopted as standard.

We therefore believe that the words in parenthesis *"(ie is denominated in a currency other than the group's presentation currency)"* in the last sentence in AG99A should be deleted. Furthermore, the argument in the Basis for Conclusions should be reworked to show how an external transaction can be linked via internal transactions, which themselves cancel out on consolidation, to identify the functional currency to be used in determining its measurement, as well as its eligibility for cash flow hedge accounting in the group financial statements.

We have been assured by IASB staff that the words in parenthesis will not prevent entities from being able to apply hedge accounting techniques in the circumstances in which they want to apply such techniques, but that is not our point: our concern is that the words, which we think are unnecessary for the correct application of the guidance, could result in future interpretations of the standard that are not consistent with the notions underlying IAS 21. If the IASB has concerns about those notions, it should carry out a comprehensive review rather than simply weaken the notions in this way.

We should be happy to discuss with you further the matters raised above.

The ASB is currently consulting on the proposals contained in the IASB exposure draft. We will pass on to you any views expressed to us that are relevant to your consultation.

Yours sincerely

I. Mackintosh

Ian Mackintosh
Chairman