PROPOSED AMENDMENTS TO IAS 39
CASH FLOW HEDGE ACCOUNTING OF
FORECAST INTRAGROUP TRANSACTIONS

CL 32

Memorandum of comment submitted in September 2004 to the International Accounting Standards Board in respect of the Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - Cash Flow Hedge Accounting of Forecast Intragroup Transactions, *published in July 2004.*

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to respond to the Exposure Draft of *Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - Cash Flow Hedge Accounting of Forecast Intragroup Transactions*, published by the International Accounting Standards Board in July 2004.

2. We have reviewed the Exposure Draft and set out below a number of comments. We set out first our overall response to the Exposure Draft, and then respond to the specific questions it raises.

OVERALL RESPONSE

3. We welcome the decision of the IASB to address the issue of cash flow hedge accounting of forecast intragroup transactions following the deletion of IGC 137-14. However, we note that the solution proposed in the Exposure Draft is not limited to 'cash flow hedge accounting of forecast intragroup transactions', as implied by the title. It actually goes beyond what we understood was the intention of the amendment, since it would not even require a forecast intragroup transaction to be involved.

4. We agree with the analysis expressed by the Board member in paragraphs AV1 and AV2 of the Exposure Draft that the amendment will allow entities to hedge accounting exposures arising as a result of the selection of a group's presentational currency. This would allow the hedging of the translation of the profit and loss account of a foreign subsidiary from its functional currency into the presentational currency of the group ('profit and loss account translation hedging').

5. However, we welcome the proposed relaxation to allow profit and loss account translation hedging, subject to certain constraints. Such hedge accounting addresses a different problem faced by many entities that seek to hedge the forecast change (profit or loss) in their net investments in foreign operations into a currency that management, and the group's investors, regard as being effectively the functional currency of the group. This is often driven by investors' needs, for example, a sterling parent that pays sterling dividends and has a US subsidiary might wish to hedge all the US profits into sterling to protect the forecast sterling net assets and ensure sterling cash is available for distributions to shareholders. We recognise that this is an economic rather than an accounting hedge but consider that entities should be allowed to obtain hedge accounting essentially for forecast changes in overseas net investments into the group functional currency (and not the presentation currency as defined by IAS 21 (2003)). In practice, many entities hedge a portion of their foreign sales as a proxy for hedging their forecast foreign profits.

6. While we support this extension of essentially net investment hedge accounting, we do not consider that it is appropriate for the IASB to introduce it under the disguise of cash flow hedge accounting. The Board should be frank about the introduction of this newly permitted form of hedge accounting and name it properly in the revised IAS 39.

7. We note that the amendment proposed by the Exposure Draft does not address the difference from US GAAP noted in paragraph BC4(b). Whereas the March 2004 version of IAS 39 is more restrictive than US GAAP on the question of hedging forecast intragroup transactions, the proposed amendment would be more liberal in permitting profit and loss account translation hedging. If the IASB wishes only to achieve convergence with US GAAP on hedging forecast intragroup transactions, we note that IFRIC was provided with a viable solution when this issue was referred to it in March 2004.

8. We have divided our more detailed comments on the proposals in to two sections. These deal with: (i) those comments pertinent to a view that the IASB only wishes to allow cash flow hedging of forecast intragroup transactions; and (ii) those which support profit and loss account translation hedging.

CASH FLOW HEDGING OF FORECAST INTRAGROUP TRANSACTIONS

9. We have difficulty reconciling the proposed amendment with the requirements of IAS 21 (2003) *The effects of changes in foreign exchange rates*. This standard requires the functional currency of each entity in the group to be separately identified, and permits any currency to be selected as the presentation currency of a group's, or individual entity's, financial statements. The proposed amendment is more permissive, in that it would treat a group's presentation currency as if it were a functional currency if it were a single entity. Under IAS 21 (2003), a group does not have a functional currency for the purposes of its consolidated accounts.

10. We note that under IAS 21 (2003), a group can prepare any number of consolidated accounts, each with a different presentation currency. Consequently, Group A, in the scenario in paragraph BC2 of the Exposure Draft, could prepare two sets of consolidated accounts; one has the euro as its presentation currency and the other the US Dollar, which is the functional currency of the subsidiary C with the external sale in US Dollar. Does this mean that hedge accounting would be allowed in the group financial statements in euro presentation currency but not in those prepared in US Dollar presentation currency? IAS 21 (2003).BC16 confirms that the Board believes that the method of translating into a presentation currency should not change the way in which the underlying items are measured. The proposed amendment to IAS 39 seems fundamentally inconsistent with that view.

11. Furthermore, we question the robustness of the rationale for the proposed amendment provided in the Exposure Draft. In particular, it misses part of the definition of a cash flow hedge. The proposals focus on there being an impact on profit or loss, but the first requirement of the definition in IAS 39 (March 2004).86(b) is that there is an exposure to variability in cash flows. A subsidiary with a functional currency that is different to its parent is generally one that operates with a significant degree of autonomy, accumulates cash, etc, in its own currency (IAS 21 (2003).11(a)). This being the case, there is no economic exposure when the subsidiary sells, or forecasts to sell, goods and services in its own functional currency. The exposure only arises if: either (a) the forecast external sale is not in the subsidiary's functional currency; or (b) there is an internal sale through which those cash flows will be passed back to an entity within the group but with a different functional currency. To illustrate, using the scenario in paragraph BC2 of the Exposure Draft, in that case the economic

exposure is with subsidiary B, the 'manufacturer' (and that entity could hedge its risk), but the profit and loss account exposure at the group level is a translation exposure. From an economic perspective, subsidiary B would want to hedge its transaction in the foreign currency. Then on consolidation the profit and loss account exposure of subsidiary B disappears. The question is then whether the group's profit and loss account translation exposure is a good enough substitute for the transaction exposure in subsidiary B. Approaching the hedge accounting at the group level by beginning with subsidiary C, the 'seller' (which has no hedgeable exposure), seems inconsistent with the normal progression from individual to consolidated financial statements.

12. The proposed amendment raises another question. Continuing the example in paragraph BC2 of the exposure Draft, subsidiary C's, the 'seller', functional currency is the US Dollar and Group A's presentation currency is euro. This time subsidiary C's forecast external sale is in euro. Subsidiary C could (and economically may well want to) hedge its exposure. On consolidation, the Exposure Draft's proposals might suggest that Group A may not hedge the transaction, because the hedged transaction is in the group's euro presentation currency. In other words, subsidiary C's (unhedged) income statement exposure is offset by the translation exposure on consolidation. This would clearly be wrong, but would follow from the conclusion that the group's presentation currency has an influence on whether transactions may be hedged at the group level.

13. As noted in paragraph 3 above, the solution proposed in the Exposure Draft is not limited to groups wishing to designate a forecast intragroup transaction as the hedged item in a foreign currency cash flow hedge in consolidated financial statements. No forecast intragroup transaction is necessary. The Exposure Draft proposes that the only requirement would be a forecast external transaction by a subsidiary in its own functional currency. This can be designated as a hedged item, provided that it gives rise to an accounting exposure when remeasured in the group's presentation currency (so the group will be able to hedge its accounting exposures arising from of its choice of presentation currency). Such transactions do not result in any exposure to variability in cash flows when measured against the originating entity's own functional currency; a prerequisite for cash flow hedge accounting under IAS 39 (March 2004).86(b). Furthermore, the proposed amendment does not converge with US GAAP since it goes beyond what FAS 133.36 allows (that is, US GAAP does not permit profit and loss account translation hedging).

14. Our understanding is that the original proposal under US GAAP was to allow the forecast intragroup transaction to qualify as a hedged item as long as a direct linkage to an external transaction could be demonstrated. We believe that is the best conceptual solution. However, we believe the decision by the US standard setter in the final outcome to drop the linkage to an external transaction was made on pragmatic grounds. If the IASB finds this degree of pragmatism too permissive, then the original US GAAP proposal seems superior to what is proposed in the Exposure Draft.

15. Assuming that the IASB does not wish to introduce profit and loss account translation hedging and given the need for a practical solution in the short term, the Board should seek to reinstate the effect of IGC 137-14 while avoiding the conflict with US GAAP.

Such a solution was provided in the March 2004 submission made to IFRIC on this topic. In our view, this solution, which was essentially rejected by the Board, would be preferable. This would entail extending the current exception in paragraph 80 of IAS 39 to highly probable forecast intragroup transactions without the requirement for a corresponding external exposure. Further, if the exception were extended to both consolidated and individual financial statements, the result would be to converge with US GAAP.

16. This solution would not reintroduce the requirement from IGC 137-14 that the intragroup transaction must result in the recognition of an intragroup monetary item that leads to exchange differences not fully eliminated on consolidation. In our view, this requirement does not reflect any economic exposure, but merely imposes an artificial obligation on the group to be able to show a monetary item on the balance sheet before the relevant cash flows occur.

PROFIT AND LOSS ACCOUNT TRANSLATION HEDGING

17. As stated earlier, we would welcome the IASB amending IAS 39 to permit profit and loss account translation hedging. This is essentially an extension of net investment hedge accounting. Many entities seek to hedge the forecast change (profit or loss) in their net investments in foreign operations into a currency that management, and the group's investors, regard as being effectively the functional currency of the group. While this is an economic rather than an accounting hedge we consider that entities should be allowed to obtain hedge accounting for forecast changes in overseas net investments into the group functional currency (and not the presentational currency as defined by IAS 21 (2003)). In practice, many entities hedge a portion of their foreign sales as a proxy for hedging their forecast foreign profits.

18. We therefore believe that the IASB should introduce the principle of 'profit and loss account translation hedging' but restrict it so that it only enables hedging of a highly probable forecast change in a net investment in a foreign operation into the group functional currency. The fact that the group does not have a functional currency under IAS 21 (2003) does not matter as it can still be a valid economic and hedging concept and can be defined in the hedging standard. This would essentially be an amendment to the net investment hedging rules in IAS 39 but the criteria in IAS 39.88 for hedge accounting would still have to be met.

19. In our view many of the difficulties involved with rationalising net investment and profit and loss account translation hedging are caused by the tensions between IAS 21 (2003)'s individual building blocks methodology and the single entity approach to consolidations in IAS 27 *Consolidated and separate financial statements*. In our view, the latter should be the primary consolidation standard and as such a group functional currency would be consistent with the single entity approach. This is the answer that the Board arrives at in paragraph BC14 of the Exposure Draft. Unfortunately, IAS 21 (2003) takes a fundamentally different approach and its consolidation mechanism for foreign operations does not support IAS 27. We urge the IASB to return to IAS 21 (2003) in the near future to carry out a fundamental review with a view to properly integrating it with IAS 27.

20. Our support of profit and loss account translation hedging is predicated on entities making full disclosure and there being sufficient visibility of their earnings.

21. If the Board does intend to permit profit and loss account translation hedging, it should:

    (a) seek to do so overtly rather than by means of a distortion of cash flow hedging;

    (b) consider the effect of the principles of functional and presentation currency in IAS 21 (2003); and

    (c) consider the implications of the divergence from US GAAP.

SPECIFIC QUESTIONS

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

22. We support the proposed amendment if the IASB intended that the outcome should be an extension of net investment hedge accounting by hedging the forecast change (profit or loss) in their net investments in foreign operations into a currency regarded as the functional currency of the group. See paragraphs 17 to 21 above.

23. We do not agree with the proposed amendment if it was intended only to address the ability to cash flow hedge intragroup forecast transactions. We consider that a practical solution to deliver this limited goal in the short-term is for the Board to reinstate the effect of IGC 137-14 while avoiding the conflict with US GAAP. See paragraph 9 to 16 above.

24. In essence, our recommendation would mean that intercompany forecast transactions should be eligible for cash flow hedge accounting on consolidation provided: (a) the criteria for hedge accounting are met (IAS 39 (March 2004).88); and (b) there is an intercompany transaction between group entities with different functional currencies.

25. Such a solution would reflect the reality of the way that many groups that hedge economically the movement of currency from one group entity to another entity with a different functional currency. Such hedging is carried out because one of the entities will receive/pay cash in a currency that does not match its economic and operational needs and therefore it will have to exchange it. Currency is moved between group companies in various ways; for example, by way of sales, purchases, dividends, royalties, etc. We consider that all these transactions should be valid transactions for hedge accounting. For example, although dividends from a foreign subsidiary to its parent do not result in a direct external transaction, this should not mean that they should not hedgeable for accounting purposes - entities are merely economically hedging their cash balances into their functional currencies to meet their operating needs. Intragroup dividends do ultimately result in external transactions: for example, if the money received is used for external purchases or to make a dividend to external shareholders.

26. We therefore recommend that the IASB should:

(a) delete the part of IAS 39 (March 2004).80 that only permits transactions with a party external to the group to be hedged items; and

(b) replace it with the concept that, as an exception to the definition of a cash flow hedge in IAS 39 (March 2004).86(b) that requires an effect on profit or loss, groups can hedge highly probable movements of cash (e.g. intragroup sales, dividends, royalties) between group entities for the foreign currency risk that exists for the group entity that will pay/receive the cash in a currency other than its functional currency (as defined in IAS 21 (2003) and if the hedge meets the criteria in IAS 39 paragraph 88.

The group entity with the foreign currency exposure must be a party to the hedging instrument. The transaction should be accounted for as a cash flow hedge; i.e. the foreign exchange gain or loss on the hedging derivative should be recorded in group equity and released to the group income statement when the hedged intragroup transaction affects the relevant entity's income statement.

Question 2

Do the proposals contained in 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?

27. The proposals do not appropriately address the specified concerns, for the reasons set out in paragraphs 9 to 16 above. As stated, these concerns would be addressed by effectively reinstating the guidance in IGC 137-14 by extending the current exception in paragraph 80 of IAS 39 to highly probable forecast intra-group transactions without the requirement for a corresponding external exposure.

Question 3

Do you have any other comments on the proposals?

28. As previously noted the proposals are outside the putative scope of the Exposure Draft. If they are to be implemented, the development should be more transparent and only carried out after a full consideration of the implications

29. The proposed effective date and transition rules should be reconsidered. We recommend that the amendment should be available for first time adopters that opt not to take advantage of the exemption in IFRS 1.36A from preparing comparatives consistent with IAS 39 (March 2004). As it stands, such first time adopters would not be able to use the proposed amendment in their 2004 comparatives as they would not have the required hedging documentation in place solely because the amendment to IAS 39 was not known about until late in 2004. A similar nonsense would be met by existing users transitioning into revised IAS 39.