EFRAG
European Financial Reporting Advisory Group

November 25, 2003

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

Re: Cash Flow hedge accounting for offsetting internal derivative contracts used to manage foreign currency risk (IAS 39 – IGC 134-1-b)

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to express our concern about the proposed clarification of the IAS 39 requirements with regard to accounting for offsetting internal derivative contracts used to manage foreign currency risk (IGC 134-1-b). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive amendments to IAS 39 on the issue.

Contrary to our previous understanding, we now understand from the September 2003 Board meeting that the Board will clarify IGC 134-1-b on the accounting for offsetting internal derivative contracts used to manage currency risk. While we fully support the principle that the effects of internal transactions should be eliminated, we strongly believe that underlying internal hedges that are used in the same type of hedge relationship and are offset on a net basis with external contracts to manage currency risk, should be eligible for hedge accounting, as it has been under US GAAP (SFAS 138 *Accounting for certain derivative instruments and certain hedging activities)* since 2000.

The internal hedging derivatives are actually transactions linked with one or more external derivative(s). They exist because they reflect underlying transactions (for instance a forecast purchase of an asset) in a foreign currency for which the entity wants to fix the exchange rate at which it will ultimately have to settle the foreign currency purchase price. When an entity has exposures in the same foreign currency in the opposite direction (for instance forecast sales) for which it also wishes to fix the exchange rate, it will not enter into "gross" external derivatives to hedge both the anticipated purchase and sale but instead a central treasury department will hedge the net position with third parties. When an entity manages its currency risk on a centralised basis as explained, the envisaged amendments to the implementation guidance (IGC 134-1-b) prevent the entity from accounting for the (gross) underlying hedge relationships. Instead, the entity will have to designate the net position to one of the underlying transactions, as a result of which the accounting outcome does not properly reflect the hedging that takes place (see illustrative example in appendix).

At the September 2003 Board meeting it was argued that an exception to allow hedge accounting for offsetting internal derivative contracts used to manage foreign currency risk, implies that if the profit and loss effects cancel each other out, this would not be a breach of hedging rules. Because of the need to impose restrictions and the basic consolidation requirement that internal contracts should be eliminated, the Board agreed in September 2003 not to allow the US GAAP approach, which permits such offsetting.

We believe that this conclusion can be questioned since the internal contracts are only entered into to centralise foreign currency risk, thereby enabling the entity to operate as efficiently as possible by engaging in external hedges for the net position only. In other words, such internal derivatives are actually transactions linked with one or more external derivative(s). Therefore, we think that hedge accounting should be allowed so that the accounting outcome is the same as it would be if the entity had entered into individual (gross) external contracts. As illustrated in the appendix to this letter, the issue is whether "gross" recycling should be permitted, thereby properly reflecting the underlying transactions that are being hedged, and not that internal contracts should not be eliminated. The fact that the Board's position with regard to accounting for deferred taxes can lead to gains or losses arising from the elimination of intercompany transactions should help the Board to accept the US GAAP hedge accounting approach from a conceptual point of view.

Not allowing hedge accounting for the internal hedging derivatives ignores the linkage and leads to the recognition of only a portion of the underlying hedge relationship at the time when one of the underlying hedged transactions becomes more probable. The appendix to this letter illustrates this point.

(Draft) IAS 21 *The effects of Changes in Foreign Exchange Rates* (old paragraph 9, new paragraph 21) states that a foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of transaction. While hedge accounting would normally ensure that the hedged transaction is measured at the agreed forward rate, the problem arises that the accounting outcome of the proposed clarification leads to the recognition of the foreign currency transaction at a rate that is neither the hedged rate, nor the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. We believe that such an accounting outcome is unsatisfactory.

Taking into account the urgent need for a stable platform, we recommend the Board to address the treatment of internal contracts in a future project. However, in the meantime, based on current practices as well as US GAAP, we strongly recommend the Board to adopt the SFAS 138 approach as a practical way forward.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman
EFRAG, Chairman

Illustrative example of hedge accounting for offsetting internal derivative contracts used to manage foreign currency risk by a central treasury centre

The purpose of the illustrative example is to illustrate how we believe the hedge accounting could be done and to indicate the problems caused by the proposed clarifications of IGC 134-1-b.

<u>Situation</u>

(a) foreign exchange risk is hedged at the subsidiary level using internal derivative transactions with a treasury centre; and

(b) the treasury centre nets and fully offsets the foreign exchange risk externally using another external derivative transaction.

Group G comprises operating subsidiaries A and B and parent P. Each entity has the Euro as its functional currency. Except for the internal derivative transactions described below, there are no intra-group transactions. Each entity operates on a 'break-even' basis, so that, if foreign exchange risk is properly dealt with through hedge accounting, no profit or loss should arise in any entity, or in the group, in any reporting period.

The exchange rate at 1 July 2003 between USD and EUR is 1.00. For the purpose of this example, it is assumed that spot and forward rates are the same and the impact of discounting on the valuation of the derivatives has been ignored.

A's revenues are denominated in USD and its costs are in EUR. It forecasts highly probable revenues in September 2003 of USD 80, with the cash inflow being due in October 2003. Its forecast cost of sales related to those revenues is EUR 80, also payable in cash in October. Based on today's exchange rate, it expects a profit of zero in September. To hedge its exposure to USD exchange risk, it enters into a foreign exchange forward contract with P (FC1), at market rates, under which A agrees to sell USD 80 and receive EUR 80 on 31 October 2003. A designates FC1 as a cash flow hedge of its highly probable revenues of USD 80.

B's revenues are denominated in EUR and its costs are in USD. It forecasts highly probable costs in August 2003 of USD 100, with the cash outflow being due in October 2003. Its forecast revenue related to those costs is EUR 100, also receivable in cash in October. Based on today's exchange rate, it expects a profit of zero in September. To hedge its exposure to USD exchange risk, it enters into a foreign exchange forward contract with P (FC2), at market rates, under which B agrees to buy USD 100 and pay EUR 100 on 31 October 2003. B designates FC2 as a cash flow hedge of its highly probable costs of USD 100.

P has no activities other than acting as a treasury centre for the group's hedging activities. Following its internal derivative transactions with A and B (FC1 and FC2), it has a net obligation to deliver USD 20 on 31 October in exchange for EUR 20. It enters into a forward contract with a bank to buy USD 20 and pay EUR 20 on 31 October 2003 (FC3). P will measure all its derivative transactions at fair value with changes in fair value reported in income. It expects these fair value changes to fully offset and therefore expects zero profit in all periods.

In economic terms, G has isolated its expected profit (of zero) from the impact of exchange differences, assuming all transactions take place as forecast.

On 31 July 2003 the Euro has weakened and the forward rate for 31 October is now USD 1 = EUR 1.1. Therefore:

- The Euro value of A's revenue of USD 80 is EUR 88. It has a corresponding loss on FC1 of EUR 8;

- The Euro value of B's expenses is EUR 110, and it has a corresponding gain on FC2 of EUR 10;

- P has a gain on FC1 of EUR 8, a loss on FC2 of EUR10 and a gain on FC3 of EUR 2.

Thereafter there are no further changes in the exchange rate, and all transactions occur as expected.

Journal entries

Journals for the months of July, August and September 2003 are as follows:

31 July 2003

Sub A	Dr	Cash flow hedge reserve	8	
	Cr	Derivative liability		8
Sub B	Dr	Derivative asset	10	
	Cr	Cash flow hedge reserve		10
Parent P	Dr	Derivative asset (FC1)	8	
	Cr	Derivative liability (FC2)		10
	Dr	Derivative asset (FC3)	2	

On consolidation, the internal derivative transactions eliminate and the group balance sheet shows:

Derivative asset (FC3)	2	
Cash flow hedge reserve		2

The net profit of A, B, P and the group is zero.

Conflicts with (amended) IAS 39

None; the intercompany balances have been eliminated and only the external hedge is accounted for.

31 August 2003

The only transaction that occurs in August is that B realises its sale (in EUR) and corresponding purchase (in USD). Since exchange rates have not changed in August, neither P nor A have any journal entries to record.

Sub B	Dr	Cost of sales	110	
	Cr	Trade payables		110
	Dr	Cash flow hedge reserve	10	
	Cr	Cost of sales		10
	Dr	Trade receivables	100	
	Cr	Revenue		100

On consolidation, the group balance sheet shows:

Derivative asset (FC3)	2	
Cash flow hedge reserve	8	
Trade receivables	100	
Trade payables		110

The net profit of B, and of the group, is zero.

<u>Conflicts with (amended) IAS 39</u>

The above proposed “gross” recycling entry of EUR 10 is not allowed under the (amended) IAS 39. Instead, the entity has to make the following entry:

Sub B	Dr	Cash flow hedge reserve	2	
	Cr	Cost of sales		2

Consequently, the result of the month of August is no longer zero but a loss of 8. This is due to the fact that the entity is not allowed to reflect that the cash flow hedge reserve of 2 actually represents a gain of 10 (on the forecasted purchase in USD of entity B) and a loss of 8 (on the forecasted sale in USD of entity A). So, while the hedging is set up to have a zero impact from subsequent changes in the USD exchange rate, the proposed IAS 39 clarifications require an entity to report intermediate results if one of the underlying transactions becomes more probable (in our example the forecasted purchase in USD became an actual purchase) in a different period than the offsetting underlying transactions.

On consolidation, the group balance sheet would show:

Derivative asset (FC3)	2	
Loss of the period	8	
Trade receivables	100	
Trade payables		110

The net profit of B, and of the group, is a loss of 8.

We believe that the accounting outcome is unsatisfactory because it does not report the full hedging activity that is taking place (assuming that the hedge will still be effective – i.e. that both the USD cash in and outflows will take place at the same moment as determined when the hedge was entered into). As a result, the foreign currency purchase is now recorded at a rate that is neither the hedged rate, nor the spot exchange rate between the functional currency and the foreign currency at the date of the transaction, as required by (draft) IAS 21 *The effects of Changes in Foreign Exchange Rates.*

Note that the internal contracts have been eliminated.

30 September 2003

Sub A	Dr	Trade receivable	88	
	Cr	Revenue		88
	Dr	Revenue	8	
	Cr	Cash flow hedge reserve		8
	Dr	Cost of sales	80	
	Cr	Trade payables		80

Since exchange rates have not changed in September, neither P nor B have any journal entries to record. On consolidation, the group balance sheet shows:

Derivative asset (FC3)	2	
Trade receivables	188	
Trade payables		190

The net profit of A, and of the group, is zero.

In October, all balances are settled for cash, leaving, again, no profit or loss to be recognised.

<u>Conflicts with (amended) IAS 39</u>

The above proposed "gross" recycling entry of EUR 8 is not allowed under the (amended) IAS 39. Instead, there will be no recycling amount left following the required "net" entry in August.

Consequently, the result of the month of September is not zero but a gain of 8. This is due to the fact that the entity is not allowed to reflect that the cash flow hedge reserve of 2 actually represents a gain of 10 (on the forecasted purchase in USD of entity B) and a loss of 8 (on the forecasted sale in USD of entity A) as explained above. So, while the hedging is set up to have a zero impact from subsequent changes in the USD exchange rate, the proposed IAS 39 clarifications require an entity to report intermediate results if one of the underlying transactions becomes more probable (in our example the forecasted purchase in USD became an actual purchase) in a different period than the offsetting underlying transactions.

On consolidation, the group balance sheet would show:

Derivative asset (FC3)	2	
Trade receivables	188	
Trade payables		190

The net profit of A, and of the group, is a gain of 8.