ACT

The Association of Corporate Treasurers Ocean House 10-12 Little Trinity Lane London EC4V 2DJ
Tel 020 7213 9728 Fax 020 7248 2591

Wayne Upton
Director of Research
International Accounting Standard Board
30 Cannon Street
London EC4 6XH

17th June, 2005

Dear Wayne,

IAS 21 issues for discussion at 22nd June Board

We are aware that the June meeting of the Board includes on the agenda a discussion of IAS 21.32 regarding exchange differences on monetary items that form part of an entity's net investment in a foreign operation. The application of this paragraph, taken together with paras 33 and 15, is something that has been giving concern to many treasurers when they come to account for their normal group funding arrangements.

We would appreciate it if you are able to copy this letter to the Board members prior to the meeting and can then factor into the Board debate the experiences mentioned here. This letter is not confidential and may be made freely available elsewhere if you so wish.

The concerns of treasurers are twofold. Firstly, and most importantly, that the accounting outcomes of the rules in IAS 21 seem to be at odds with displaying in the accounts a true picture of the normal commercial activities carried on by companies' treasury operations; and secondly that there seems to be some difference of opinion as to the interpretation of the rules as written.

Internally generated FX balances

The problems in this area have been reported back to the ACT by many of our members. One major UK company has explained in detail to us how it has encountered problems with the treatment of uneliminated FX differences on consolidation caused when there is a monetary payable or receivable between 2 group companies which have different functional currencies. As this is an internal balance (which is eliminated in the Group balance sheet) it does not impact Group net assets (ie shareholder funds). However, unless there is a basis for taking the FX revaluations in each of the group companies to group equity on consolidation, it is in the position in which one side of the FX ends up in Group P&L and the other (the consolidation adjustment) is in Group equity. This is wholly illogical as well as misleading.

IAS 21 addresses this to a limited extent via para's 15, 32 and 33 however this requires the intra-group monetary item to form part of the net investment in a foreign operation and it must also be long term. Where the monetary item can be treated as being part of the entity's net investment in a foreign operation and where the currency of the item is the functional currency of one of the parties then para 33 allows the FX difference to be reclassified to equity so that there is no overall group P&L distortion.

However this does not provide a solution with respect to balances which cannot be termed long term (even if they are non-trading).   Furthermore para 33 contains the peculiar rule that if the inter-company item is in a currency other than the functional currency of either of the two parties involved the reclassification to equity is not allowed. It seems perverse that the accounting treatment in the consolidated accounts should vary depending on the functional currencies of the borrowing and lending entities in relation to the currency denomination of the loan. The same economic purpose of group funding is occurring irrespective of currency, and there is no economic exposure for the group in either case, so surely the basis of accounting should be the same? It is misleading if an internal transaction that causes no change in shareholder net assets still causes a Group P&L effect.

Having recognised that this issue over internal balances exists for long term funding loans it is unclear why IAS 21 treats intra-group trading balances in a different manner. Like the long term balances forming part of the net investment in a foreign operation, they are internal so do not impact the value of the Group, nor should they impact group P&L.

Defining the 'capital' in subsidiaries by reference to the term structure of the instruments used is archaic both from the perspective of the risk involved and from the perspective of the economic reality of the position. The Group Treasurer determines the external "net investment" hedging position of the Group. If commercially a clear position on external consolidated net debt has been taken for net investment hedging purposes, then all differences on intergroup positions belong in reserves on consolidation irrespective regardless of whether that investment is funded through long-term debt or perpetually rolled three month borrowings, or just leaving trading balance unsettled.

Further, many modern group treasuries have instigated daily efficient global cash pooling in the USA and Europe. This creates a position where daily movements in these current accounts end up designated as short term - and therefore to be marked to market in the P&L (since the current rules do not allow consolidation differences to go to reserves). However, movements on these current accounts are a combination of equity items (generated profit) and working capital volatility. These cannot be easily separated. The equity element should not create a consolidated P&L expense. The working capital element should not create a consolidated P&L item where the Treasurer has already determined the external net debt position for net investment hedging purposes.

We believe that the standard as written should be changed to allow the reclassification into equity on consolidation of FX differences on intergroup balances irrespective of the currency of the parties and the loan balance, and irrespective of whether the balance is a current or longer term balance.

Interpretations

We also mentioned that interpretations of the existing wording vary. Para 15 covers monetary items that are receivable from or payable to a foreign operation. To qualify for the reclassification of FX differences into equity in accordance with paras 32 and 33 the item must be one "for which settlement is neither planned nor likely to occur in the foreseeable future and is in substance a part of the entity's net investment in that foreign operation." The narrow interpretation is that the funding has to be directly between a parent and its subsidiary or at any rate down the direct ownership chain. However the wider interpretation would consider that looking at the situation "**in substance"** means that funding between sister companies should also qualify. To reinforce that wider interpretation consider a Parent A with subsidiaries B and C. A funding from subsidiary B to the parent A, plus an on lending from A to the other subsidiary C clearly qualifies. However the narrow interpretation would not allow a loan directly from B to its sister company C to qualify, when in economic substance there is absolutely no difference between the two alternatives.

We have a further point of detail. The standard is not explicit on exactly when a term loan is designated as such i.e. is such designation subject to periodic re-evaluation. The wording in the standard "for which settlement is neither planned nor likely to occur in the foreseeable future and is in substance a part of the entity's net investment in that foreign operation" could give rise to a problem where, say, in the last year of a ten year intergroup loan, the auditors look upon it as short term, since it has less than a year to run.. Once a loan is designated long term, it should remain long term until expiry.

We would appreciate guidance on what should be regarded as "in substance part of the entity's net investment in that foreign operation."

Functional Currency

Although not included on the agenda for consideration this month we would also like to draw your attention to another closely related issue within IAS 21 where a narrow interpretation being taken in some quarters is causing practical difficulties for our members. The point at issue concerns the functional currency applicable to a treasury funding entity. It is not unusual for groups to fund a treasury company with equity and the treasury company then funds group operations via loans or other appropriate means. There may be a policy that even with a UK and sterling based parent the treasury operation denominates all group loans in US $. In this case the treasury company may wish to chose US$ as its functional currency.

There are various indicators of functional currency in IAS 21 paras 9 to 13. In this example the assets and income of the treasury company will be in US$, and it may be that if the company is located in say the Netherlands its low level of operating costs will be in Euro. Management may follow para 13 and use "its judgement to determine" that the US$ is "the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions." The counter argument in para 11(a) is that "the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy," so that the functional currency is taken to be that of the parent, i.e. sterling in this example.

Our members are reporting that there are differing interpretations of the relative importance of the various indicators of functional currency.

We would be very grateful if the Board can take note of the concerns raised in this letter and give them due consideration in the discussions to be held next week.

Yours sincerely,

Richard Raeburn
Chief Executive