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Dear Geoffrey and John

IAS 39: “INTERNAL” CONTRACTS AND HEDGES

At our meeting with the IASB on June 27th we agreed to set out example entries for hedges put in place through a treasury centre or otherwise on an aggregate or net basis with regard to paragraph 134 IAS 39.

We continue to have the concerns about process, risk, cost and reporting in companies achieving hedges as set out in our letter of June 6th (copy herewith) and in previous correspondence.

The purpose of this letter is to exemplify our proposed approach which we believe is fully consistent with the principles involved, which we support.

In particular we understand and accept the Board's position that no gain or loss should be generated at the group level through internal derivatives. The paper below shows that no 'internal' profit is generated by any entity in any period under our suggested treatment.

The first suggested remedy for our concerns that we propose is adding brief language into paragraph 134 (ED 126B) to recognise that hedge accounting at a group level may be achieved by adding an additional layer of documentation and effectiveness assessment to complete the chain of hedge documentation from the hedged cash flows to an external hedging instrument.”

The alternative remedy is to retain IGC 134-1-b (plus appendix) in its present form - many corporates rely on this, and amending or deleting it would be a significant change (and may of course require re-exposure).

We hope that the attached paper will clarify the matter and look forward to hearing further from you on this important point.

Yours sincerely

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Illustrative example of the process for hedging/hedge accounting using a central treasury centre

The purpose of this paper is to set out an example showing the journal entries necessary for hedge accounting within a simple group of companies in which:

- (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 derivative transaction.

The IASB Board has discussed the ‘internal derivatives’ issue and has reconfirmed its position that internal derivatives eliminate on consolidation, and that any internal profits or losses created by the use of internal derivatives must be eliminated on consolidation.

One concern of Board members has been that the use of internal derivative transactions in the process described in this paper creates internal profits and losses that must be eliminated on consolidation. This paper seeks to address that concern.

If it can be demonstrated that the process does not give rise to internal or artificial gains and losses, the remaining issues in developing a solution are largely practical. The second part of the paper suggests alternative ways in which the cost/risk/benefit concerns of corporates might then be addressed without compromising the Board’s principles.

Background

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 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.

31 August 2003

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

Since exchange rates have not changed in August, neither P nor A have any journal entries to record. 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.

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.

Summary of impacts

No profit or loss is recognised by any entity in any period. No profit or loss is 'created' by the use of internal derivatives. The only income statement impact of the internal derivatives is the deferral and release into income of hedging gains and losses to offset corresponding losses and gains on properly designated hedged cash flows. The external derivative fully offsets the internal derivatives and ensures that no gain or loss occurs in the treasury centre.

The impact of hedge accounting claimed at the subsidiary level is properly reflected in the consolidated financial statements with no duplication of effort and following the group's normal risk management/hedging/hedge accounting procedures.

Under IAS 39.134, however, an internal derivative eliminates on consolidation and cannot qualify as a hedging instrument. Therefore, in the consolidated financial statements, FC3 should be identified or designated or linked into the hedge documentation, so as to validate the hedge accounting claimed in subsidiaries A and B. The alternative is to unwind the hedge accounting claimed in A and B and designate a new hedge at the group level. Possible ways in which this might be achieved are set out below.

Possible approaches to hedge accounting in consolidated financial statements

There are four possible solutions:

1. Retain IGC 134-1-b (and its appendix) in the amended IAS 39. Following that guidance, it is sufficient for G to demonstrate that the risk passed to P through FC1 and FC2 are fully offset by FC3. Since there would then be no accounting impact from designating FC3 as the hedging instrument, no formal designation of FC3 as a hedging instrument is required;
2. Add a further layer of hedge documentation for the purposes of consolidated financial statements, formally designating FC3 as the hedging instrument and documenting the link, for hedge accounting purposes, between FC3 and the group of internal derivatives that comprises FC 2 and FC1. The documentation already in place at the subsidiary level completes the chain of hedge documentation between FC 3 and the hedged revenues and costs in A and B. FC 1 and FC 2 are not hedging instruments in the group financial statements, but they form part of the documentation of G's hedging relationships. In addition to the effectiveness testing carried out by A and B, G needs to demonstrate that no further ineffectiveness is created in P. If P is always required to fully offset its risk, no further detailed testing would be required.
3. Unwind all the documentation, effectiveness testing and hedge accounting that A and B have put in place, and separately designate, in consolidated financial statements, FC3 as a hedge of the first 20 of USD cash outflows from subsidiary B. This is the approach envisaged in IAS 39.133. G would separately test this relationship for effectiveness. Because of the difference between the timing of expenses in B and revenues in A, this method will produce a loss of EUR 8 in subsidiary B (and in the group) in August and a gain of EUR 8 in subsidiary A (and in the group) in September. It produces a hedge accounting result that does not reflect the way that the group manages its risk.
4. Mirror FC1 and FC2 with two external transactions from P, or require A and B to enter into FC1 and FC2 directly with a bank. G would be faced with the additional cost and risk associated with doubling the number of derivative transactions it has outstanding, and/or the cost of unwinding its subsidiary-level documentation and effectiveness testing and duplicating that effort at the group level. The additional cost and/or risk has no substantive business purpose. Its only purpose would be to achieve an accounting result.

Conclusion and recommendations

The above example demonstrates that the treasury centre netting process described does not create internal profits and losses that need to be eliminated on consolidation. It can produce an accounting result that meets the Board's principles for hedge accounting, without the need to unwind hedging relationships within the group and designate new relationships at the group level.

It also shows that following the arbitrary designation approach in IAS 39.133 (see alternative 3 above) can produce an accounting result that is counter-intuitive given the actual hedging/hedge accounting processes used in the group. Requiring a treasury centre to gross-up its external derivative transactions to mirror its internal transactions (alternative 4) seems to be unnecessary from an accounting perspective and to involve unnecessary additional cost and risk.

One approach that would address the concerns of corporates following the approach described is to ensure that the guidance in IGC 134-1-b (and appendix) is retained in the amended IAS 39. In doing so, it would be important not to amend the guidance to prevent netting where the timing of income statement recognition of hedged cash flows is different. The example shows that such an amendment is unnecessary, and it would likely make it impractical for many corporates to make use of it.

Another approach is to add additional language into paragraph 134 (ED 126B) to recognise that hedge accounting at a group level may be achieved by adding an additional layer of documentation and effectiveness assessment to complete the chain of hedge documentation from the hedged cash flows to an external hedging instrument (see alternative 2 above).

The appendices to this paper considers two further issues. Appendix A shows the journals required when the purchase in B is not recognised immediately in income but represents inventory that is sold at a later date or equipment that is depreciated over a number of periods. It shows that, as in the 'base case', no internal gain or loss is created.

Appendix B addresses the impact when one of the hedged cash flows (in this case the revenue in A) is no longer expected to occur. It shows that, in these circumstances, an additional adjustment seems necessary at the group level to achieve the appropriate accounting. In finalising the Standards, the Board might consider adding guidance to this effect.

Appendix A

Purchase of inventory by B

Assume that B's forecast cost of USD 100, still payable in cash in October 2003, represents the purchase of inventory that is sold for EUR 100 in December 2003. Assume that B chooses to apply basis adjustment in respect of such cash flow hedges. B's journals for August 2003 are:

31 August 2003

Sub B	Dr	Inventory	110	
	Cr	Trade payables		110
	Dr	Cash flow hedge reserve	10	
	Cr	Inventory		10

On consolidation, the group balance sheet shows:

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

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

In September, B has no transactions and A's journals are as before. The group balance sheet shows:

Derivative asset (FC3)	2	
Trade receivables	88	
Inventory	100	
Trade payables		190

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

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

31 December 2003

Sub B	Dr	Receivables	100	
	Cr	Revenue		100
	Dr	Cost of sales	100	
	Cr	Inventory		100

As before, no gain or loss is recognised in any entity, or in the group, in any period.

Note that B could have chosen not to apply basis adjustment. In that case the credit of 10 would have remained in equity until December, when it would have been released into cost of sales.

As a further illustration, the purchase by B may have been not of inventory but of a piece of equipment. Either basis adjustment could be applied, resulting in reduced depreciation expense in income over the life of the equipment, or the credit of 10 could be released into income to match the depreciation expense over the life of the equipment.

Appendix B

Hedged revenue cash flow is no longer expected to occur

In the main example, the group balance sheet at 31 July shows:

Derivative asset	2	
Cash flow hedge reserve		2

The net gain deferred in the cash flow hedge reserve consists of a gain of EUR 10 arising from the hedge of B's expected purchases of USD 100 and a loss of EUR 8 arising from the hedge of A's expected revenues of USD 80.

Assume now, that a revised forecast is made on 1 August and it is determined that A's USD revenue is no longer expected to occur.

A no longer needs FC1 and therefore terminates it. P no longer has FC1 offsetting the risk it has taken through FC2 and therefore enters into a further external derivative (FC4) to purchase, on 31 October, the additional USD 80 that the group needs to hedge B's USD purchases.

Under IAS 39.163, when the hedged transaction is no longer expected to take place, any accumulated deferred gain or loss on that transaction should be transferred immediately to income. Therefore A makes a further journal entry to:

Dr	Income statement expense	8	
Cr	Cash flow hedge reserve		8

The group balance sheet now shows:

Derivative asset	2	
Cash flow hedge reserve		10
Income/retained earnings	8	

The question is whether any further journal is required on consolidation. With the benefit of hindsight, it is clear that B's purchases of USD 100 were only partially hedged during July. It therefore seems inappropriate that the cash flow hedge reserve should continue to include the deferral of 10 as if the economic hedge had been in place. Therefore it seems that a further journal entry is required on consolidation that would:

Dr	Cash flow hedge reserve	8	
Cr	Income statement		8

At this point, both B and the group recognise a loss of 8, reflecting the unhedged portion of its USD purchases.

In August, when Sub B incurs its USD cost of sales, Sub B will release 10 from its cash flow hedge reserve into the income statement (as in the main illustration) to reflect the impact of its hedge. On consolidation, the journal entry above should be released. Therefore the group financial statements will reflect the fact that, at the group level, because P chose to net FC1 and FC2, the cash flow in B was only partially hedged. At this point, the group recognises a loss of 8, representing the unhedged portion of its USD purchases.