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Mr Simon Peerless
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
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Dear Sir,

**FRED 30, THIRD SUPPLEMENT: FURTHER AMENDMENTS TO THE PROPOSED STANDARDS ON FINANCIAL INSTRUMENTS**

The Association of Corporate Treasurers (ACT) is pleased to be able to comment on FRED 30, third supplement. The use of Financial Instruments falls within the responsibilities of the Treasurer in most companies and therefore the accounting treatment applicable is of keen interest to the ACT. We have responded below to the parts of the exposure draft which are generally most relevant to treasurers. Please note that the ACT comments from the corporate and not the financial services standpoint

**Response to Questions**

**The Fair Value Option**

***Q1*** *The ASB is concerned that the effect of the IASB's proposals on the fair value option might be to prevent the option from being used in circumstances where its use would be appropriate and would make implementation of IAS 39 easier. Do you believe that will be the case? If so, please give examples of the types of circumstances involved.*

**A1** The ACT wholeheartedly agrees with your reservations. In responding to the IASB's Exposure Draft we were opposed to the introduction of restrictions on the circumstances where the fair value option can be applied. We support retention of the original wording whereby <u>any</u> financial asset or financial liability may be taken at fair value through the profit and loss account.

The existence of the fair value option was exceedingly useful in that there can be many occasions where an entity takes on an asset and a counter-balancing liability for risk management purposes. Even if the movements in the value of asset and liability are only partially correlated there can be a degree of natural offset. The correlation may be insufficient to meet the stringent requirements for documentation and effectiveness testing to achieve hedge accounting, so the ability to use the fair value option gives a good common sense solution. It would be unhelpful were this option to be removed or restricted.

By way of example one of our members, who is the Treasurer of a large multinational, has explained that his organisation owns a financial asset in the form of cumulative redeemable fixed rate preference shares issued by an independent holding company which owns an operating company which the multinational sold. The shares were received as part of the sale process. Although the dividend has a fixed rate coupon the timing of payment on the preference shares depends on the dividends paid by the operating company to the holding company. The multinational's treasury policy is to have floating rate investments. Hence the owner of the financial asset has taken out an interest rate hedge which estimates timing of flows.

This hedge will not meet the IAS 39 tests for hedge effectiveness and what is more it appears that the IASB's Fair Value Option Exposure Draft proposals would mean that its more stringent verifiable test allied with the need to prove 'substantially offset' (which is not clear and would need testing) may prevent this instrument being allowed to be fair valued, with consequent creation of P&L volatility. Since the actual timing of coupon flows simply cannot be predicted then it seems impossible to prove whether it 'substantially offsets' as in some situations it will and in others it will not.

***Q2*** *The ASB is proposing, in implementing the IASB's proposals to adopt the same effective date and transitional arrangements as the IASB is proposing to adopt (accounting periods beginning on or after 1 January 2005 with earlier adoption permitted). Do you agree with this proposal? If not, why not?*

**A2** We do not support the IASB's proposals, however if they do decide to proceed with them we believe the their timetable for implementation is acceptable.

**Cash flow hedging of forecast intragoup transactions**

***Q5*** *The ASB has expressed some concerns about the proposals on cash flow hedge accounting of forecast intragroup transactions. Do you share those concerns? If not, why not?*

**A5** We note that the ASB is concerned that the IASB's proposals cover the exchange difference that arises by reference to the presentation currency of the group. We agree that this is a departure from the fundamental principle in IAS 21 that all measurements are done against the functional currency, but we do not share your concerns to the same extent. In the IASB's proposals a forecast cashflow, denominated in the functional currency of a subsidiary, can nonetheless be a hedged item within the consolidated accounts if the functional currency of those accounts is different from the group's presentation currency. On the face of it this is strange since within the subsidiary there is no foreign exchange exposure.

We agree with the logic of BC13 in the Exposure Draft that there can be a true economic and accounting exposure for the group in intragroup transactions. For a transaction between two subsidiaries, this exposure can be thought of as any transactional exposure by each subsidiary measured against its functional currency, plus the economic and accounting exposure of the parent to the profit element from the transaction of any subsidiary whose functional currency is different from that of the parent.

In the example given one $ reporting (and functional currency) subsidiary is forecasting external sales in $ and is forecast to source itself from another group company which has a Euro cost base. If the group presentation currency is Euro there is an accounting (and economic) exposure for the group in that the value of the eventual $ sales that will be reported on consolidation will vary with exchange rates. If an external transaction is done with a bank to hedge this effect it seems only fair that cash flow hedge accounting should be permitted.

Suppose the $ sale were made from a $ costed non-group source. There is a group accounting exposure on consolidation and a group economic exposure to the net $ profits of the subsidiary. However when the Euro cost base of the selling subsidiary is factored into the equation then it is clear that the Group has a very real economic exposure to the Euro / $ exchange rate on the entire sales proceeds, not just the profit element, and therefore we believe that it is quite proper that this exposure can be hedged and accounted for as a valid hedge, in group terms.

In making our comments to the IASB we noted that there was an inconsistency with IAS 21, but nonetheless the ACT was supportive of their proposals, since they do achieve the objective of being able to get hedge accounting for the exposures arising from forecast intragroup transactions. We regarded the solution provided as something of a work around solution. The proposed treatment effectively takes an external transaction denominated in the functional currency of the entity entering into the transaction and regards this as the hedged item when of itself there is no exposure generated in that entity. We were surprised at this rather radical approach and would have preferred the less radical route of allowing the intragroup item itself to be the hedged item.

We understand your concerns, but believe that in the final analysis the IASB approach is nonetheless acceptable.

***Q6*** *The ASB is proposing, in implementing the IASB's proposals, to adopt the same effective date and transitional arrangements as the IASB is proposing to adopt (accounting periods beginning on or after 1 January 2006 with earlier adoption permitted). Do you agree with this proposal? If not, why not?*

**A6** We support this proposed timetable.

These comments are on the record and may be freely quoted and made available for public inspection.

We hope these responses are helpful for your deliberations and if you need any further information or clarifications please contact any of the people listed below.

Yours faithfully,

Martin O'Donovan
Technical Officer

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## The Association

The Association of Corporate Treasurers was formed in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field. Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally. A professional body and not a trade association, it has over 3,400 Fellows, Members and Associate Members. With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education. Members of the Association work in many fields. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions.


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| *The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address* | |