July 2004

EXPOSURE DRAFT OF PROPOSED

Amendments to IAS 39 Financial Instruments: Recognition and Measurement

Cash Flow Hedge Accounting of Forecast Intragroup Transactions

Comments to be received by 8 October 2004

International Accounting Standards Board®

Exposure Draft of proposed

AMENDMENTS TO
IAS 39 FINANCIAL INSTRUMENTS:
RECOGNITION AND MEASUREMENT

CASH FLOW HEDGE ACCOUNTING OF FORECAST INTRAGROUP TRANSACTIONS

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All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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ISBN: 1-904230-66-0

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Contents

	Page
Background	4
Invitation to Comment	6
Proposed Amendments to IAS 39	7
Basis for Conclusions	8
Alternative View	13

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Background

1. In July 2001, the International Accounting Standards Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. In June 2002, the Board published its proposed improvements as an Exposure Draft and, in December 2003, it issued a revised version of the two Standards.

2. A principle in IAS 39 is that entities can obtain hedge accounting only for transactions that involve a party external to the entity. Among the revisions to IAS 39 made in 2003 was the inclusion of an exception to this principle. This exception, previously contained in Guidance on Implementation (IGC) 137-13 *Intra-group monetary item that will affect consolidated net income*, allows the foreign currency risk in an intragroup monetary item to be designated as the hedged item in consolidated financial statements as long as the intragroup item results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation under IAS 21 *The Effects of Changes in Foreign Exchange Rates*. However, the revised IAS 39 does not allow a forecast intragroup transaction to be designated as the hedged item in a foreign currency cash flow hedge in consolidated financial statements. This was allowed by the previous version of IAS 39 as interpreted by IGC 137-14 *Forecasted intra-group foreign currency transactions that will affect consolidated net income*.

3. After the revised IAS 39 was issued, constituents raised the following concerns:

    (a) it is common practice for entities to designate a forecast intragroup transaction as the hedged item. Also, previously, IGC 137-14 (now deleted) permitted the designation of the forecast intragroup transaction as the hedged item in a foreign currency cash flow hedge, provided the conditions prescribed in the IGC were met.

    (b) some entities using IFRSs and entities that are planning to adopt IFRSs in 2005 have established a practice of designating forecast intragroup transactions as hedged items and have entered into derivative instruments to hedge the resulting exposures.

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(c) the revised IAS 39 creates a difference from US GAAP because SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* permits hedge accounting for foreign currency risk on forecast intragroup transactions.

4. The Board noted that the revised IAS 39 permits entities that had designated a forecast intragroup transaction as the hedged item to obtain hedge accounting by designating a highly probable forecast external transaction as the hedged item. The Board noted that if the hedge is designated in this way, entities can use the forecast intragroup transaction as part of the tracking mechanism (or 'audit trail') for associating the hedging instrument with an external transaction. Also if, as is often the case, the external transaction is for a higher amount than the intragroup transaction, the entity could designate a part of the highly probable forecast external transaction as the hedged item.

5. However, the Board also noted that there was confusion among constituents about whether the designation outlined in paragraph 4 is permitted by the revised IAS 39. Accordingly, the Board decided to clarify that in consolidated financial statements a group can designate as the hedged item, in a foreign currency cash flow hedge, a highly probable forecast external transaction denominated in the functional currency of the entity (eg subsidiary) entering into the transaction, provided that the transaction gives rise to an exposure that will have an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency).

6. The Board also decided to propose that the effective date of the proposed amendment would be accounting periods beginning on or after 1 January 2006, with earlier application permitted.

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Invitation to Comment

The International Accounting Standards Board invites comments on the changes to IAS 39 proposed in this Exposure Draft. It would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than **8 October 2004**.

Question 1

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

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?

Question 3

Do you have any other comments on the proposals?

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In the Standard, [draft] paragraph 110 is added.

Effective Date and Transition

110. An entity shall apply [draft] paragraph AG99A for annual periods beginning on or after 1 January 2006. Earlier application is permitted.

In the Application Guidance paragraphs AG99A and AG99B are renumbered AG99B and AG99C respectively, and [draft] new paragraph AG99A is added, as below.

Appendix A

Application Guidance

Hedged Items (paragraphs 78–84)

Qualifying Items (paragraphs 78-80)

AG99A. In consolidated financial statements a group can designate as the hedged item, in a foreign currency cash flow hedge, a highly probable forecast external transaction denominated in the functional currency of the entity (eg subsidiary) entering into the transaction, provided the transaction gives rise to an exposure that will have an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency).

In the Basis for Conclusions, in the heading above paragraph BC135A "AG99A and AG99B" is replaced by "AG99B and AG99C".

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft amendments.

Background

BC1. A principle in IAS 39 is that entities can obtain hedge accounting only for transactions that involve a party external to the entity. Among the revisions to IAS 39 made in 2003 was the inclusion of an exception to this principle. This exception, previously contained in Guidance on Implementation (IGC) 137-13 *Intra-group monetary item that will affect consolidated net income*, allows the foreign currency risk in an intragroup monetary item to be designated as the hedged item in consolidated financial statements as long as the intragroup item results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation under IAS 21 *The Effects of Changes in Foreign Exchange Rates*. However, the revised IAS 39 does not allow a forecast intragroup transaction to be designated as the hedged item in a foreign currency cash flow hedge in consolidated financial statements. This was allowed by the previous version of IAS 39 as interpreted by IGC 137-14 *Forecasted intra-group foreign currency transactions that will affect consolidated net income*.

BC2. These requirements can be illustrated by the following example. Group A comprises Company B, a manufacturing subsidiary whose functional currency is the euro, and Company C, a selling subsidiary whose functional currency is the US dollar. Company B incurs most of its production costs in euro. It sells most of the product it makes, in US dollars, to Company C, which sells the product to external customers, also in US dollars. Consequently, Group A has a foreign currency exposure between its external purchases (in euro) and its external sales (in US dollars). On consolidation, if Group A selects the euro as its presentation currency, this exposure will be reflected by consolidated sales revenue varying with movements in the US dollar/euro exchange rate[*] while consolidated cost of sales will not.

[*] This is because IAS 21 requires the US dollar sales recognised in the income statement of Company C to be translated into euro (ie the group presentation currency) at actual or average rates.

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BC3. Continuing the example in paragraph BC2, assume that on 1 January, Company B forecasts it will sell goods to Company C for US$100, with delivery on 31 March and payment on 30 June in order to meet a sale that Company C forecasts it will make to external customers for US$120, with delivery in early April and payment in early July. Assume the transactions are highly probable. The revised IAS 39 does not permit Group A at 1 January to designate the forecast intragroup sale from Company B to Company C as the hedged item in a foreign currency cash flow hedge.

The Rationale for the Proposed Amendments

BC4. After the revised IAS 39 was issued, constituents raised the following concerns:

(a) it is common practice for entities to designate a forecast intragroup transaction as the hedged item. Also, previously, IGC 137-14 (now deleted) permitted the designation of the forecast intragroup transaction as the hedged item in a foreign currency cash flow hedge, provided the conditions prescribed in the IGC were met.

(b) some entities using IFRSs and entities that are planning to adopt IFRSs in 2005 have established a practice of designating forecast intragroup transactions as hedged items and have entered into derivative instruments to hedge the resulting exposures.

(c) the revised IAS 39 creates a difference from US GAAP because SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* permits hedge accounting for foreign currency risk on forecast intragroup transactions.

BC5. The Board considered the following ways to address these concerns:

(a) Permit a highly probable forecast intragroup transaction to be the hedged item provided that the transaction will result in the recognition of an intragroup monetary item for which exchange differences are not fully eliminated on consolidation.

(b) Permit a highly probable forecast external transaction to be the hedged item.

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Permit a highly probable forecast intragroup transaction to be the hedged item provided that the transaction will result in the recognition of an intragroup monetary item for which exchange differences are not fully eliminated on consolidation

BC6. The Board noted that a simple solution would be to extend the current exception in paragraph 80 of IAS 39* to highly probable forecast intragroup transactions without the requirement for a corresponding external exposure. In the example in paragraphs BC2 and BC3, this would have the effect that the forecast intragroup sale from Company B to Company C could be designated as the hedged item. This would essentially reinstate the guidance previously in IGC 137-14.

BC7. The rationale for the exception in IAS 39 (from the general principle that entities can obtain hedge accounting only for transactions involving a party external to the entity) is that the hedged intragroup item results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation under IAS 21. This rationale does not hold for a forecast transaction—such a transaction is not recognised in the financial statements and, hence, does not result in amounts that are not fully eliminated on consolidation under IAS 21. In addition, the Board could not see another valid conceptual rationale for permitting a highly probable forecast intragroup transaction to be designated as the hedged item. Consequently, in revising IAS 39, the Board decided not to allow the designation of a highly probable forecast intragroup transaction as the hedged item in consolidated financial statements. Also, the Board noted that the exclusion from the revised IAS 39 of a specific exemption for forecast intragroup transactions was not a mistake. Rather, it was a deliberate change made in the light of comments received from constituents questioning the conceptual rationale for such an exception.

BC8. Consequently, the Board decided not to extend the current exception in IAS 39 to highly probable forecast intragroup transactions.

Permit a highly probable forecast external transaction to be the hedged item

BC9. For cash flow hedge accounting to be used, IAS 39 paragraph 86(b) requires that the hedge is of "the exposure to variability in cash flows

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* Paragraph 80 permits, in consolidated financial statements, an intragroup monetary item that results in an exposure to foreign exchange gains or losses that are not fully eliminated on consolidation to be designated as the hedged item.

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that (i) is attributable to a particular risk associated with … a forecast transaction and (ii) could affect profit or loss". The Board noted that, from the perspective of the group, such an exposure arises from the forecast external transaction. Using the example in paragraphs BC2 and BC3, from the perspective of the group whose presentation currency is the euro, such an exposure arises from the forecast sales denominated in US dollars by Company C to external customers. Accordingly, in consolidated financial statements the group could obtain hedge accounting by designating the hedge as a hedge of this highly probable forecast external transaction rather than as a hedge of the forecast intragroup transaction.

BC10. With this approach, the forecast intragroup transaction could form part of the tracking mechanism (or 'audit trail') for associating the hedging instrument with an external transaction. Also if, as is often the case, the external transaction is higher in amount than the intragroup transaction, the entity could designate a portion of the external transaction as the hedged item. In the above example it could designate the first US$100 of the US$120 sale proceeds. This would broadly achieve the same accounting result as designating the intragroup transaction although the timing of the reclassification from equity to profit or loss of amounts initially recognised in equity might differ.

BC11. The Board noted that this interpretation is consistent with the definition of consolidated financial statements in IAS 27 *Consolidated and Separate Financial Statements*. IAS 27 defines consolidated financial statements as the financial statements of a group presented as those of a single economic entity. Under this definition the group, being a single economic entity, has an exposure it can hedge.

BC12. The Board also considered whether this interpretation is consistent with IAS 21. It noted that under IAS 21 the group does not have a functional currency. Rather, it comprises a number of entities each of which has a functional currency. Some constituents argue that this implies that the group has a hedgeable exposure only if that exposure is denominated in a currency other than the functional currency of the entity entering into the transaction. Accordingly, they argue that in the example in paragraphs BC2 and BC3, there is no hedgeable exposure because both the external sales and the external purchases are denominated in the functional currency of the entity that has the exposure (ie US dollars for Company C and euro for Company B).

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BC13. Others argue that the group in the example has an economic and an accounting exposure. They arise because the group's costs are denominated in a currency different from its sales. Furthermore, the exposures affect profit or loss whatever presentation currency the group chooses (ie in the above example, whether it is US dollars, euro or a third currency).

BC14. In addition, if the group in the above example were to operate as a single economic entity, its functional currency would be either euro or US dollars depending upon the facts of the case. In these circumstances either the forecast purchase in euro or the forecast sale in US dollars could qualify for hedge accounting. IAS 27 defines consolidated financial statements as the financial statements of a group presented as those of a single economic entity, which implies that hedge accounting should similarly be permitted for the group in the above example.

BC15. The Board was persuaded by the arguments in paragraphs BC13 and BC14. Accordingly, it decided to clarify that in consolidated financial statements a group can designate as the hedged item a highly probable forecast external transaction denominated in the functional currency of the entity (eg subsidiary) entering into the transaction, provided the transaction gives rise to an exposure that will have an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency). The Board decided that it would be preferable to clarify the interpretation of IAS 39 in this manner rather than create an exception by reintroducing the guidance in IGC 137–14. Accordingly, it decided to include this clarification in the Application Guidance section of IAS 39. The Board noted that this clarification facilitates the use of cash flow hedge accounting at the group level without altering any of the hedge accounting requirements in IAS 39.

BC16. Finally, the Board considered what should be the effective date of the proposed clarification. The Board is committed to maintaining a 'stable platform' of unchanged Standards during the period to 2005 when many entities adopt IFRSs for the first time. Accordingly, it decided that the effective date of the proposed amendment would be accounting periods beginning on or after 1 January 2006. However, given the widespread and practical relevance of the issue, it also decided to permit earlier application.

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Alternative View on Proposed Amendments to IAS 39—Cash Flow Hedge Accounting of Forecast Intragroup Transactions

AV1. One Board member voted against the publication of the Exposure Draft of Proposed Amendments to IAS 39 *Financial Instruments: Recognition and Measurement—Cash Flow Hedge Accounting of Forecast Intragroup Transactions.* The member's alternative view is set out below.

AV2. The Board member disagrees that entities should be permitted to designate a forecast external transaction as the hedged item in the absence of an economic exposure. This situation arises when the forecast external transaction is denominated in the functional currency of the entity (eg subsidiary) entering into the transaction, but not in the group's presentation currency. In such a case, this Board member believes that there is no economic exposure, but only an accounting exposure. Furthermore, this Board member believes that the Exposure Draft's proposals would treat the group's presentation currency as if it were a functional currency, which is contrary to IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The member also believes that it would be possible for an entity to obtain hedge accounting for forecast transactions in the absence of an economic exposure, by changing its presentation currency.

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