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Sir David Tweedie
Chairman IASB
30 Cannon Street

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THE SECRETARY GENERAL

Dear Sir David,

SUBJECT: IAS 21 – NET INVESTMENT IN A FOREIGN OPERATION

We note from the agenda for the June meeting that the Board will discuss paragraph 32 of IAS 21 in relation to exchange differences that arise on monetary items that form part of a reporting entity's net investment in a foreign operation. We would like to take the opportunity to bring to your attention a number of issues which are being caused by the different, and sometimes seemingly perverse, interpretations that are emerging from some quarters in respect of the criteria for equity equivalent treatment at group consolidation level.

Our comments are based, in part, on the fundamental principle in IAS 27 that the consolidated financial statements of a group should be presented "as those of a single economic entity" (IAS 27.4) and the power of the parent to govern the financial and operation policies of an entity so as to obtain benefits from the activities of the subsidiary ("control").

In many groups, the financing of subsidiaries is not limited to the parent, but is delegated to sub-holding or financing/treasury companies (which may or may not have other operations in addition to financing and investment). There are many reasons for this, such as tax-related structures or fund raising in particular territories. These structures do not change the cash flows or balance sheet of the group but a restrictive interpretation of the rules would arbitrarily split the accounting between income and reserve movements. As a consequence, we believe that any group company should be able to treat as equity equivalent loans, long term intra group loans denominated in any currency and not just those denominated in the currency of the lender or that of the borrower. It is our understanding that the third currency regulation will give rise to a GAAP difference to US-GAAP.

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Ultimately we believe that, without appropriate guidance, interpretation of the standard may result in income statement volatility (when there is no economic exposure to the group) being offset by corresponding exchange differences (on the net investment) in equity.

In addition, a group may choose to restructure its monetary items to comply with the requirements of IAS 21, which could give rise to significant economic costs, and also incur administrative and legal expenses. The interpretation could also open the door to abuse because some entities could move loans between the parent and a subsidiary depending on where they would like to have exchange differences classified. We believe that neither of these is an intended consequence of the standard.

Issues

Paragraphs 32 and 33, in conjunction with paragraph 15, of IAS 21 stipulate the requirements for the treatment of exchange differences resulting from intra group monetary items forming part of a net investment in a foreign operation being reclassified to equity in the parent's consolidated financial statements. We believe that there is a lack of clarity over the criteria which enable equity equivalent treatment of the balance, and therefore the related exchange differences, in terms of:

- The relationship between borrower and lender
- The currency denomination of the monetary item; and
- The consequence of a decision to sell or restructure the foreign operation, with consequential settlement of the monetary item.

It is being argued by some that, in order to reclassify exchange differences on the monetary item to equity in the consolidated statements, the intra group monetary item should, *inter alia*, be granted either by the group parent or, possibly, by a sub-holding company that has control, joint control or significant influence over the foreign operation. The argument seems to be based on an, in our view, incorrect interpretation of the language of the last two sentences of paragraph 33. The reference to "*reporting entity*" in paragraph 33 is taken to limit the acceptable currency of the intra group loan to that of the foreign operation, of the ultimate parent or, in some cases, of an intermediate parent. Our belief that this is wrong is supported by the language of paragraph 15 referring to monetary items that are "*in substance, a part of the entity's net investment in* [a] *foreign operation*". This does not imply a parent/subsidiary relationship but is based on the substance of the transaction. The control principle of IAS 27 supports our argument, as the many transactions within a group are based on a group point of view rather than that of a single entity.

We believe that the restrictive interpretation highlights an issue with the term "*entity*" in paragraph 15. The interpretation of this as being the group parent or possibly a sub-holding company seems inappropriate for the consolidated financial statements of a group, which is the main objective of IAS 21 set out in paragraph 1. However, a group does not have a functional currency.

Consequence of a decision to sell

IAS 21.15 allows a monetary item for which settlement is neither planned nor likely to occur in the foreseeable future to be regarded as part of an entity's net investment in a foreign operation. This requirement is open to the interpretation that exchange differences on a monetary item previously regarded as part of a net investment in a foreign operation should be recognised in the income statement from the date of a *decision* to dispose of the net investment (internally or externally) as opposed to the date of the transaction itself, thereby resulting in the possibility of exchange rate differences being recorded in the income statement whilst exchange differences on the net investment continue to be recorded in equity. This interpretation clearly removes the consistency of treatment of an equity investment. We believe that it is more appropriate, providing the monetary item has, at the outset, been properly determined as a component of the net investment to continue to regard the monetary item as a equity equivalent up until the date of disposal regardless of any advance decision to sell.

Summary

We consider that clarification is required in IAS 21 to ensure that the principle on equity equivalent investments in foreign operations is unambiguous and not distorted by possible legalistic interpretations of wording elsewhere. We also consider that more specific guidance is required on certain of the requirements for equity equivalent investments in foreign operations. We would therefore be very grateful if the Board could reflect on how the current unsatisfactory situation can be resolved.

We would be pleased to discuss these issues with you and with your staff. We thank you very much for your attention.

Yours sincerely,

Philippe de Buck