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October 9th 2002

The International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Sir

Re: Proposed amendments to IAS 32 - Financial Instruments: Disclosure and Presentation and IAS 39 - Financial Instruments: Recognition and Measurement

We thank you for giving us the opportunity of commenting on the proposed changes to IAS 32 and IAS 39.

Nokia has a longstanding IAS history having been one of the early implementers of the standard in Europe. Nokia was also one of the first companies to adopt a centralised treasury approach, including hedging of foreign currency exposures. Accordingly IAS 32 and IAS 39 are of significant importance to us. We have, thus, in the past played an active role in both commenting on IAS and in participating in the IGC process to assist the Board in its ongoing efforts to improve the standards and develop a high quality accounting framework.

In general terms we strongly support the underlying principles of IAS 32 and 39, including most importantly those aspects of IAS 39 which deal with hedge accounting. We believe that these principles (including micro-hedging, transparent and well articulated risk management policies, clear documentation at inception, effectiveness testing, and recognition of any ineffectiveness in earnings) are consistent with the processes required by best practice in treasury and risk management. This rigorous approach, which is similar to that already applied by Nokia prior to IAS 39, in general promotes strong internal control and thus should help to limit operational risks.

***Paragraph 134 / 7268 and Treasury Centre FX hedging***

Nonetheless we have a fundamental concern regarding the approach currently adopted in IAS 39 and in the Exposure Draft in respect of treasury centre hedging and the use of internal derivative transactions for hedging foreign currency risk. Whilst this is not one of the items that has been addressed in the Exposure Draft or raised by the IASB as a specific topic on which comments are invited, we strongly believe that it requires further consideration, notably in view of the Board's objectives of easing the implementation burden and promoting convergence with US GAAP. This submission accordingly deals solely with the implications of paragraph 134 of IAS 39 (12GB in the Draft Amendment) for foreign currency hedging via a treasury centre, using internal deals, and with the need for further refining the standard on this point

We also understand that the centralised hedging approach adopted by Nokia is similar to that used in the majority of other major multinationals, and that accordingly our concerns are shared by other large companies, which have a good understanding of the implications of IAS 39 for hedging activities.

The practice of establishing micro—hedges at the business unit level, using intercompany contracts with a treasury centre, which then lays off the aggregate or net exposure in the market, is a sound one fostering good risk control and efficiency in hedging and operational costs. Paragraph 134 / 12GB of IAS 39 however prohibits the use of internal contracts in hedge relationships in consolidated statements, creating difficulties for companies adopting this hedging approach.

The Implementation Guidance Committee, recognising this issue, has sought to find a solution, which is reflected in QQA 134—1-b. However, whilst the objective behind this interpretation is right (i.e. allowing the use of internal contracts as hedges in consolidated statements in specific circumstances), we believe that the interpretation itself is confusing, of only limited applicability and may even be in conflict with the standard itself. In our view, this issue should be resolved via an amendment to the standard, which should provide a limited exception to paragraph 134/ 126B for treasury centre FX hedging.

Under US GAAP, a similar amendment (FAS 138) was needed to enable the resolution of this problem under FAS 133, subject to a number of specific rules. A similar change to IAS 39 would therefore also achieve the objective of convergence with US GAAP, though in keeping with the more principles—based approach of IAS, we would suggest adopting the strong underlying principle in FAS 138 rather than the specific rules.

Based on the above, we believe that a limited exception to paragraph 12GB should be included in the amended standard to embed the principle that internal hedges may only qualify for hedge accounting if the resulting currency exposure has been entirely laid—off externally via a treasury centre.

#### *Alternative wording*

Our suggested wording for paragraph 12GB and for this limited exception would be as follows:

"126B. For hedge accounting purposes, **except as stated under 1268(1) below**, only derivatives that involve a party external to the entity can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any gains and losses on such transactions are eliminated on consolidation. Therefore, such intra— group or intra—entity hedging transactions do not qualify for hedge accounting in consolidation.

**126B(1). Foreign currency derivative contracts that have been entered into with another member of a consolidated group (such as a treasury center) can be hedging instruments in a foreign currency hedge in the consolidated financial statements if such internal contracts fulfill the requirements for hedge accounting at the individual entity level and are aggregated or netted against each other and the foreign currency exposure is fully offset externally with unrelated third parties."**

## **Conclusion**

Once again, we welcome this opportunity to comment on the draft amendment. We hope our comments above are of help to the IASB in the process of improving the rules on hedge accounting. We believe that the limited revision we are proposing satisfies both the objectives of easing implementation for companies with central treasury operations and convergence with US GAAP, and would constitute an important improvement in IAS 39.

We remain at your disposal to discuss our comments in further detail should you so require.

Yours truly,

NOKIA CORPORATION



Olli-Pekka Kallasvuo  
Executive Vice President, Chief Financial Officer



Timo Ihamuotila  
Vice President, Corporate Treasurer

ENCL.

## **Appendix — Analysis of practical and conceptual difficulties with existing IAS 39 requirements for Treasury Centre hedging**

In order to provide further background and reasoning on the need for a limited change to IAS 39, we include in this appendix details on the specific difficulties for treasury centre FX hedging under the current drafts of the standard.

This appendix contains the following sub-headings:

- Centralised FX hedging
- Implications of paragraph 134 (126B in the drafts amendment)
- IGC Interpretation 134-1-b
- Where does US GAAP stand on this point?

### ***Centralised FX Hedging***

Whilst fully supporting the principles of hedge accounting as stated in IAS 39, we believe that the prohibition on the use of internal hedging transactions currently contained in the standard creates limitations, which go beyond best practice in treasury risk management. We believe that these restrictions will in practice imply increases in operational costs and risks as well as an increase in hedging cost. These implications are explored further below.

The use of internal contracts as hedges in consolidated accounts is central to the currency risk management approach adopted by most large international companies, including Nokia. Hedge relationships are created and documented at the level of business units, which hedge themselves with Nokia's Treasury Centre. The Treasury Centre then aggregates or nets these exposures and lays them off in the external market. In order to best reflect this in the consolidated accounts, hedge accounting applied by the business units in their own accounts is maintained on consolidation and the Treasury Centre's own accounting is done on a full mark-to-market basis to ensure any residual mismatch, however minor, is reflected in the Group's Income Statement.

We believe this is the most sensible approach both economically and organisationally. It enables micro-hedge relationships to be maintained by the business units themselves, since they have the best knowledge of their actual exposures and transactions. Treasury's role is then to hedge the exposure externally in the most efficient way possible, limiting the number of external deals and thus reducing both operational risk and hedging cost.

### ***Implications of paragraph 134 (126B in the drafts amendment)***

The prohibition on the use of internal hedging transactions as hedges in consolidated financial statements means that the approach described above cannot be reflected as such in the accounts. Either new hedge relationships must be created at the consolidated level (which differ from the true micro-hedge relationships at the business unit level) or changes must be made to the hedging approach.

Two main alternatives exist:

- Alternative A: External offset of internal transactions on a one-to-one basis by treasury, without aggregation or netting.
- Alternative B: The approach suggested in paragraph 133 of IAS 39, whereby external hedges are allocated to a portion of a particular gross exposure at one or more business units level.



However we believe that each of these alternatives shows significant disadvantages as compared to the approach currently adopted by Nokia.

Alternative A implies a dramatic increase in the number of external transactions, meaning significantly higher operational risk as well as a large increase in the spread cost paid.

Alternative B as suggested in paragraph 133 also has various drawbacks. Firstly it requires the unwinding of business unit hedge relationships and the creation at consolidated level of new, artificial, hedge relationships. These consolidation level hedge relationships do not reflect the economic reality of the underlying hedging activity (since they only apply to a part of the hedged exposure) and as such are an unnecessary and confusing additional layer of internal documentation which exists solely to circumvent paragraphs 133 and 134/ 126B.

Additionally this second approach assumes that the remaining exposures, which are included in hedge relationships at business units but not at group level, are natural offsets of each other in profit a loss terms. Whilst this may be true in risk and cash flow terms, it is not necessarily true in accounting terms (for example a purchase of a fixed asset or stock is not necessarily a natural accounting offset of a sale with the same cash flow date, due to the differing revenue or cost recognition patterns for the different types of transaction).

#### ***IGC Interpretation 134-1-b***

The IGC, recognising the various difficulties referred to above has attempted to find a solution to this issue. However the resulting interpretation, 134-1—b is of only limited application in practice and may lead to widespread confusion as to whether the problem has in fact been resolved.

We do not believe that this issue can be resolved by further interpretation of IAS 39 since paragraph 134 is clear in its wording, which prohibits the use of internal contracts for hedging in consolidated books. However the IGC's objective of allowing hedge accounting for internal hedges reflects a principle which is consistent with modern—day treasury best practices and should accordingly be recognised as a modification to the standard.

#### ***Where does US GAAP stand on this point?***

Under FAS 133 as originally worded, the same prohibition existed as under IAS. However in response to significant concern from the market, the FASB has recognised the problem and has amended FAS 133 in this area via FAS 138. Hedging currency risks on a net basis through a treasury centre using internal deals as hedges in consolidated books is now allowed under US GAAP subject to certain specific rules, which are aimed at ensuring that the resulting exposure has been entirely offset externally by the treasury centre.

Although we believe that the detailed rules in the amended version of FAS 133 are excessively detailed, unnecessary and cumbersome in practice, we support the underlying principle of requiring full external offset. This has been reflected in our proposed alternative wording in the main body of this letter whilst retaining the principles—based approach traditionally adopted under IAS.