

IFRIC INTERPRETATION X

Hedges of a Net Investment in a Foreign Operation

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References

- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 21 *The Effects of Changes in Foreign Exchange Rates*
- IAS 39 *Financial Instruments: Recognition and Measurement*

Background

- 1 Many reporting entities have investments in foreign operations (as defined in IAS 21 paragraph 8). Such foreign operations may be subsidiaries, associates, joint ventures or branches. IAS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in other comprehensive income until it disposes of the foreign operation.
- 2 Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements.¹ The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.
- 3 IAS 39 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognised in other comprehensive income and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.

¹ This will be the case for consolidated financial statements, financial statements in which investments are accounted for using the equity method, financial statements in which venturers' interests in joint ventures are proportionately consolidated (subject to change by Exposure Draft ED9 Joint Arrangements issued by the Board in September 2007) and financial statements that include a branch.

- 4 An entity with many foreign operations may be exposed to a number of foreign currency risks. This Interpretation provides guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation.
- 5 IAS 39 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This Interpretation provides guidance on where, within a group, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting.
- 6 IAS 21 and IAS 39 require cumulative amounts recognised in other comprehensive income relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be reclassified from equity to profit or loss as a reclassification adjustment when the parent disposes of the foreign operation. This Interpretation provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.

Scope

- 7 This Interpretation applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with IAS 39. For convenience this Interpretation refers to such an entity as a parent entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a parent entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.

- 8 This Interpretation applies only to hedges of net investments in foreign operations; it shall not be applied by analogy to other types of hedge accounting.

Issues

- 9 Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. The issues addressed in this Interpretation are:

- (a) *the nature of the hedged risk and the amount of the hedged item for which a hedging relationship may be designated:*
 - (i) whether the parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the parent entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the parent entity's consolidated financial statements and the functional currency of the foreign operation;
 - (ii) if the parent entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate parent entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate parent entity (ie whether the fact that the net investment in the foreign operation is held through an intermediate parent affects the economic risk to the ultimate parent).

- (b) *where in a group the hedging instrument can be held:*
- (i) whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity in the group, regardless of its functional currency, can hold the hedging instrument;
 - (ii) whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.
- (c) *what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation:*
- (i) when a foreign operation that was hedged is disposed of, what amounts from the parent entity's foreign currency translation reserve in respect of the hedging instrument and in respect of that foreign operation should be reclassified from equity to profit or loss in the parent entity's consolidated financial statements;
 - (ii) whether the method of consolidation affects the determination of the amounts to be reclassified from equity to profit or loss.

Consensus

- Nature of the hedged risk and amount of the hedged item for which a hedging relationship may be designated**
- 10 Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency.
- 11 In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated

financial statements of a parent depends on whether any lower level parent of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements.

- 12 The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity (the immediate, intermediate or ultimate parent entity) of that foreign operation. The fact that the net investment is held through an intermediate parent does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate parent entity.
- 13 An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one parent entity within the group (for example, both a direct and an indirect parent entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate parent. A hedging relationship designated by one parent entity in its consolidated financial statements need not be maintained by another higher level parent entity. However, if it is not maintained by the higher level parent entity, the hedge accounting applied by the lower level parent must be reversed before the higher level parent's hedge accounting is recognised.

Where the hedging instrument can be held

- 14 A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the group (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of IAS 39 paragraph 88 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the group should be

clearly documented because of the possibility of different designations at different levels of the group.

- 15 For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognised in profit or loss, in other comprehensive income, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognised in profit or loss or in other comprehensive income. As part of the application of hedge accounting, the total effective portion of the change is included in other comprehensive income. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

Disposal of a hedged foreign operation

- 16 When a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the parent in respect of the hedging instrument is the amount that paragraph 102 of IAS 39 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.
- 17 The amount reclassified to profit or loss from the foreign currency translation reserve in the consolidated financial statements of a parent in respect of the net investment in that foreign operation in accordance with paragraph 48 of IAS21 is the amount included in that parent's foreign currency translation reserve in respect of that foreign operation. In the ultimate parent's consolidated financial statements, the aggregate net amount recognised in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate parent uses the direct or

step-by-step method of consolidation² may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation. The use of the step-by-step method of consolidation may result in the reclassification to profit or loss of an amount different from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by IAS21. However, it is an accounting policy choice that should be followed consistently for all net investments.

Effective date

- 18 An entity shall apply this Interpretation for annual periods beginning on or after 1 October 2008. Earlier application is permitted. If an entity applies this Interpretation for a period beginning before 1 October 2008, it shall disclose that fact.

Transition

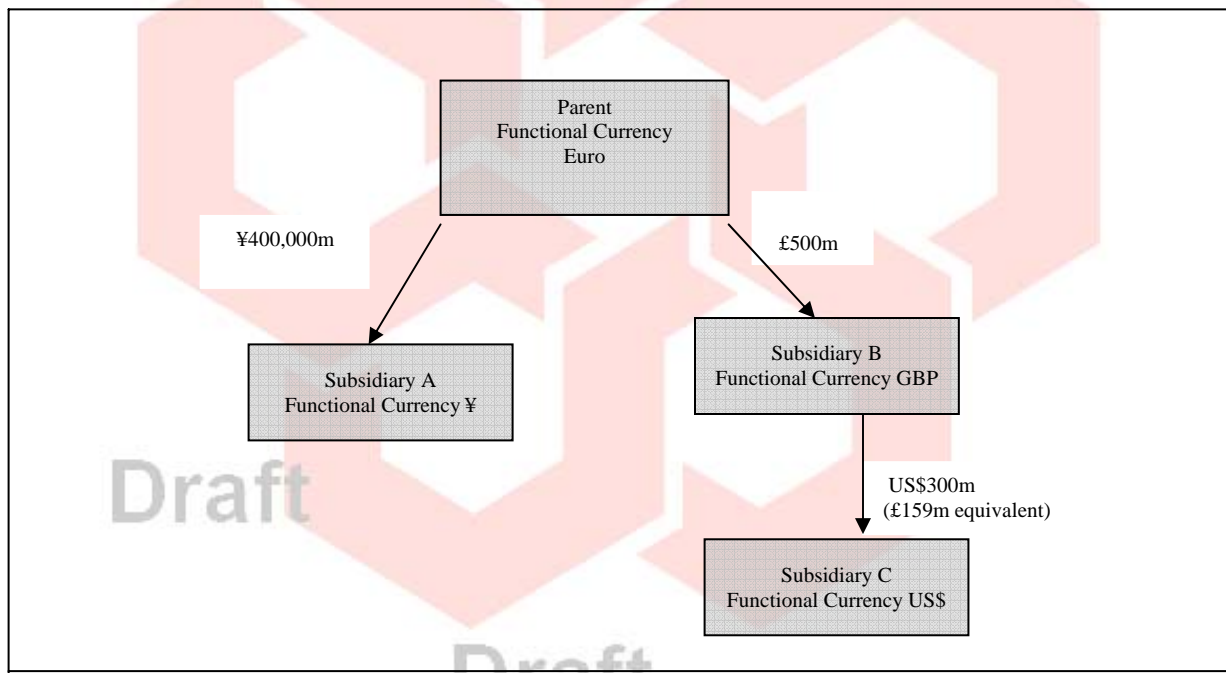
- 19 IAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying the Interpretation. If an entity had designated a hedging instrument as a hedge of a net investment but the hedge does not meet the conditions for hedge accounting in this Interpretation, the entity shall apply IAS 39 to discontinue prospectively that hedge accounting.

² The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate parent. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate parent(s) and then translated into the functional currency of the ultimate parent (or the presentation currency if different).

Appendix Application guidance

This appendix is an integral part of the Interpretation.

AG1 This Appendix illustrates the application of the Interpretation using the corporate structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with IAS 39, although this testing is not discussed in this Appendix. Parent, being the ultimate parent entity, presents its consolidated financial statements in its functional currency of Euro. Each of the subsidiaries is wholly owned. Parent's £500m net investment in Subsidiary B (functional currency Pounds Sterling/GBP) includes the £159m equivalent of Subsidiary B's US\$300m net investment in Subsidiary C (functional currency US\$). That is, Subsidiary B's net assets other than its investment in Subsidiary C are £341m.



Nature of hedged risk for which a hedging relationship may be designated (paragraphs 10-13)

AG2 Parent can hedge its net investment in each of Subsidiaries A, B and C for the foreign exchange risk between their respective functional currencies (¥, GBP and US\$) and Euro. In addition, Parent can hedge the US\$/GBP foreign exchange risk between the functional currencies of Subsidiary B and Subsidiary C. In its consolidated financial statements, Subsidiary B can hedge its net investment in Subsidiary C for the foreign exchange risk between their functional currencies of US\$ and GBP. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Parent could designate the forward foreign exchange risk.

Amount of hedged item for which a hedging relationship may be designated (paragraphs 10-13)

AG3 Parent wishes to hedge the foreign exchange risk from its net investment in Subsidiary C. Assume that Subsidiary A has an external borrowing of US\$300m. The net assets of Subsidiary A at the start of the reporting period are ¥400,000m including the proceeds of the external borrowing of US\$300m.

AG4 The hedged item can be an amount of net assets equal to or less than the carrying amount of Parent's net investment in Subsidiary C (US\$300m) in its consolidated financial statements. In its consolidated financial statements Parent can designate the US\$300m external borrowing in Subsidiary A as a hedge of the Euro/US\$ spot foreign exchange risk associated with its net investment in the US\$300m net assets of Subsidiary C. In this case, both the Euro/US\$ foreign exchange difference on the US\$300m external borrowing in Subsidiary A and the Euro/US\$ foreign exchange difference on the US\$300m net investment in Subsidiary C are included in the foreign currency translation reserve in Parent's consolidated financial statements after the application of hedge accounting.

AG5 In the absence of hedge accounting, the total US\$/Euro foreign exchange difference on the US\$300m external borrowing in Subsidiary A would be recognised in Parent's consolidated financial statements as follows:

- US\$/¥ spot foreign exchange rate change, translated to Euro, in profit or loss, and
- ¥/Euro spot foreign exchange rate change in other comprehensive income.

Instead of the designation in AG4, in its consolidated financial statements Parent can designate the US\$300m external borrowing in Subsidiary A as a hedge of the GBP/US\$ spot foreign exchange risk between Subsidiary C and Subsidiary B. In this case, the total US\$/Euro foreign exchange difference on the US\$300m external borrowing in Subsidiary A would instead be recognised in Parent's consolidated financial statements as follows:

- the GBP/US\$ spot foreign exchange rate change in the foreign currency translation reserve relating to Subsidiary C, and
- the balance in profit or loss.

AG6 Parent cannot designate the US\$300m external borrowing in Subsidiary A as a hedge of both the Euro/US\$ spot foreign exchange risk and the GBP/US\$ spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Subsidiary B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the group comprising Subsidiary B and Subsidiary C.

Where in a group can the hedging instrument be held (paragraphs 14-15):

AG7 As noted in AG5, the total change in value in respect of foreign exchange risk of the US\$300m external borrowing in Subsidiary A would be recorded in both profit or loss (US\$/¥ spot risk) and other comprehensive income (Euro/¥ spot risk) in Parent's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in AG4 because the change in value of both the hedging instrument and the hedged item are computed by reference to the Euro functional currency of Parent against the US\$ functional currency of Subsidiary C, in accordance with the hedge documentation. The method of consolidation (ie direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts reclassified to profit or loss on disposal of a foreign operation (paragraphs 16-17):

AG8 When Subsidiary C is disposed of, the amounts reclassified to profit or loss in Parent's consolidated financial statements from its foreign currency translation reserve (FCTR) are:

- a) in respect of the US\$300m external borrowing of Subsidiary A, the amount IAS 39 requires to be identified, that is, the total change in value in respect of foreign exchange risk that was recognised in other comprehensive income as the effective portion of the hedge; and
- b) in respect of the US\$300m net investment in Subsidiary C, the amount determined by the entity's consolidation method. If Parent uses the direct method, its FCTR in respect of Subsidiary C will be determined directly by the Euro/US\$ foreign exchange rate. If Parent uses the step-by-step method, its FCTR in respect of Subsidiary C will be determined by the FCTR recognised by Subsidiary B reflecting the GBP/US\$ foreign exchange rate, translated to Parent's functional currency using the Euro/GBP foreign exchange rate. Parent's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be reclassified when it disposes of Subsidiary C to be the amount that it would have recognised if it had always used the direct method, depending on its accounting policy.

Hedging more than one foreign operation (paragraphs 11, 13 and 15)

AG9 The following examples illustrate that in the consolidated financial statements of Parent, the risk that can be hedged is always the risk between its functional currency of Euro and the functional currencies of Subsidiaries B and C. No matter how the two hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Parent's consolidated financial statements when both foreign operations are hedged are US\$300m for Euro/US\$ risk and £341m for Euro/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Parent's consolidated profit or loss. Of course, it would be possible for Parent to designate only US\$300m for

changes in the US\$/GBP spot foreign exchange rate or only £500m for changes in the GBP/Euro spot foreign exchange rate and no other hedge.

Parent holds both hedging instruments

AG10 Parent may wish to hedge the foreign exchange risk in relation to its net investment in Subsidiary B as well as that in relation to Subsidiary C. Assume that *Parent* holds suitable hedging instruments denominated in US\$ and GBP that it could designate as hedges of its net investments in Subsidiary B and Subsidiary C. The designations Parent can make in its consolidated financial statements include, but are not limited to, the following:

- a) US\$300m hedging instrument designated as a hedge of the US\$300m of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (Euro/US\$) between Parent and Subsidiary C *and* up to £341m hedging instrument designated as a hedge of £341m of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (Euro/GBP) between Parent and Subsidiary B.
- b) US\$300m hedging instrument designated as a hedge of the US\$300m of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (GBP/US\$) between Subsidiary B and Subsidiary C *and* up to £500m hedging instrument designated as a hedge of £500m of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (Euro/GBP) between Parent and Subsidiary B.

AG11 The Euro/US\$ risk from Parent's net investment in Subsidiary C is a different risk from the Euro/GBP risk from Parent's net investment in Subsidiary B. However, in the case in AG10a, by its designation of the US\$ hedging instrument it holds, Parent has already fully hedged the Euro/US\$ risk from its net investment in Subsidiary C. If Parent also designated a GBP instrument it holds as a hedge of its £500m net investment in Subsidiary B, £159m of that net investment, representing the GBP equivalent of its US\$ net investment in Subsidiary C, would be hedged twice for GBP/Euro risk in Parent's consolidated financial statements.

AG12 In the case of AG10b, if Parent designates the hedged risk as the spot foreign exchange exposure (GBP/US\$) between Subsidiary B and Subsidiary C, only the GBP/US\$ part of the change in the value of its US\$300m hedging instrument is included in Parent's foreign currency translation reserve relating to Subsidiary C. The balance (equivalent to the GBP/Euro change on £159m) is included in Parent's consolidated profit or loss, as in AG5. Because the designation of the US\$/GBP risk between Subsidiaries B and C does not include the GBP/Euro risk, Parent is also able to designate up to £500m of its net investment in Subsidiary B with the risk being the spot foreign exchange exposure (GBP/Euro) between Parent and Subsidiary B

Subsidiary B holds the US\$ hedging instrument

AG13 Assume that *Subsidiary B* holds US\$300m of external debt the proceeds of which were transferred to Parent by an inter-company loan denominated in GBP. Because both its assets and liabilities increased by £159m, Subsidiary B's net assets are unchanged. Subsidiary B could designate the external debt as a hedge of the GBP/US\$ risk of its net investment in Subsidiary C in its consolidated financial statements. Parent could maintain Subsidiary B's designation of that hedging instrument as a hedge of its US\$300m net investment in Subsidiary C for the GBP/US\$ risk (see paragraph 13) *and* Parent could designate the GBP hedging instrument *it* holds as a hedge of its entire £500m net investment in Subsidiary B. The first hedge, designated by Subsidiary B, would be assessed by reference to Subsidiary B's functional currency of GBP and the second hedge, designated by Parent, would be assessed by reference to Parent's functional currency of Euro. In this case, only the GBP/US\$ risk from Parent's net investment in Subsidiary C has been hedged in Parent's consolidated financial statements by the US\$ hedging instrument, not the entire Euro/US\$ risk. Therefore, the entire Euro/GBP risk from Parent's £500m net investment in Subsidiary B may be hedged in the consolidated financial statements of Parent.

AG14 However, the accounting for Parent's £159m loan payable to Subsidiary B must also be considered. If Parent's loan payable is not considered to be part of its net investment in Subsidiary B because it does not satisfy the conditions in paragraph

15 of IAS 21, the GBP/Euro foreign exchange difference arising on translating it would be included in Parent's consolidated profit or loss. If the £159 loan payable to Subsidiary B is considered to be part of Parent's net investment, that net investment would be only £341m and the amount Parent could designate as the hedged item for GBP/Euro risk would be reduced accordingly..

AG15 If Parent reversed the hedging relationship designated by Subsidiary B, Parent could designate the US\$300m external borrowing held by Subsidiary B as a hedge of its US\$300m net investment in Subsidiary C for the Euro/US\$ risk *and* designate the GBP hedging instrument it holds itself as a hedge of only up to £341m of the net investment in Subsidiary B. In this case the effectiveness of both hedges would be computed by reference to Parent's functional currency of Euro. Consequently, *both* the US\$/GBP change in value of the external borrowing held by Subsidiary B and the GBP/Euro change in value of Parent's loan payable to Subsidiary B (equivalent to US\$/Euro in total) would be included in the foreign currency translation reserve in Parent's consolidated financial statements. Because Parent has already fully hedged the Euro/US\$ risk from its net investment in Subsidiary C, it can hedge only up to £341m for the Euro/GBP risk of its net investment in Subsidiary B.