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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **3 November 2006, London**

Project: **Hedging of a Net Investment in a Foreign Operation (Agenda Paper 6)**

INTRODUCTION

1. The IFRIC received a request to provide guidance on the accounting for a hedge of a 'net investment in a foreign operation' (a NI) in group financial statements. The IFRIC Agenda Committee discussed the issue briefly in June 2005 prior to the staff having considered and analysed the issue. The conclusion at the June meeting was that accounting for a hedge of a NI is a widespread practice issue that the Agenda Committee should consider. Further to this, the Agenda Committee believed there were a number of inter-related issues, and therefore the staff should look further than the request received, to ensure all related issues are deliberated.

2. The Agenda Committee discussed the issue again in July 2006 and recommended that a paper be taken to IFRIC proposing to add the project to its agenda.

3. This paper details:

   (a) the staff recommendation;

   (b) background information on the submission and other related issues;

   (c) discussion of relevant existing guidance;

   (d) discussion and analysis of what the hedged risk is and where the hedging instrument can be held; and

   (e) conclusions and suggested recommendations.

4. Appendix A includes a number of worked examples for discussion purposes.

STAFF RECOMMENDATION

5. The staff conclude that the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 27 *Consolidated and Separate Financial Statements* are unclear about how to account for a hedge of a NI. The staff believe the IFRIC should attempt to resolve the accounting for a hedge of a NI by interpreting these standards. If it becomes clear that interpretation will not resolve the issue and it is likely that there will need to be an amendment to a standard, the staff will take the issue to the Board with recommended amendments.

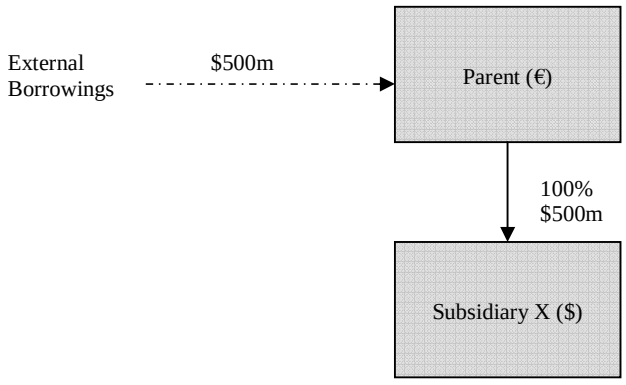
6. The staff's initial thoughts are that any interpretation should be designed to implement proposals similar to those set out in paragraphs 66 to 67.

BACKGROUND AND OTHER RELATED ISSUES

Simple Example of a Hedge of a NI

7. First, consider a simple example:

> On 31 December 2004, Parent entity holds a 100% investment in Subsidiary X ($500m). Parent entity has a functional currency and presentation currency of Euro (€) and Subsidiary X has US Dollar ($) as its functional currency. Parent entity has funded its investment in Subsidiary X by taking out a loan of $500m. Parent entity wishes to hedge the foreign exchange risk arising from its net investment with the external borrowings. The exchange rates applicable are 31 Dec 04 $ 1 = € 0.80 and 31 Dec 05 $ 1 = € 0.90. See diagram below for details:



8. In this simple example, it is difficult to argue that the external borrowings would *not* qualify as a hedge of a NI under current IFRS guidance[1]. Parent entity is directly exposed to fluctuations in the exchange rate between $ and the €, to the extent of its investment in the net assets of Subsidiary X. Stated differently, the amount included in equity on consolidation,[2] is the amount offset against the changes in the fair value or cash flows of the hedging instrument (in this case the fair value of the external borrowings of $500m).

9. From the example above (assuming there was no change in the $ value of the net assets of Subsidiary X) the exchange gain included in equity at 31 December 2005 on translation of the net investment is €50m[3]. The external borrowings were $500m (€400m) at the start of the year and at the end of the year there are borrowings of $500m (€450). This loss of €50m offsets the gain on the investment in Subsidiary X making the hedge 100% effective. If the hedge is designated and documented correctly, hedge accounting can be achieved.

Complex Example of a Hedge of a NI

10. Following on from the simple example, the staff illustrate a more complex example highlighting issues raised in the submission and other related issues:

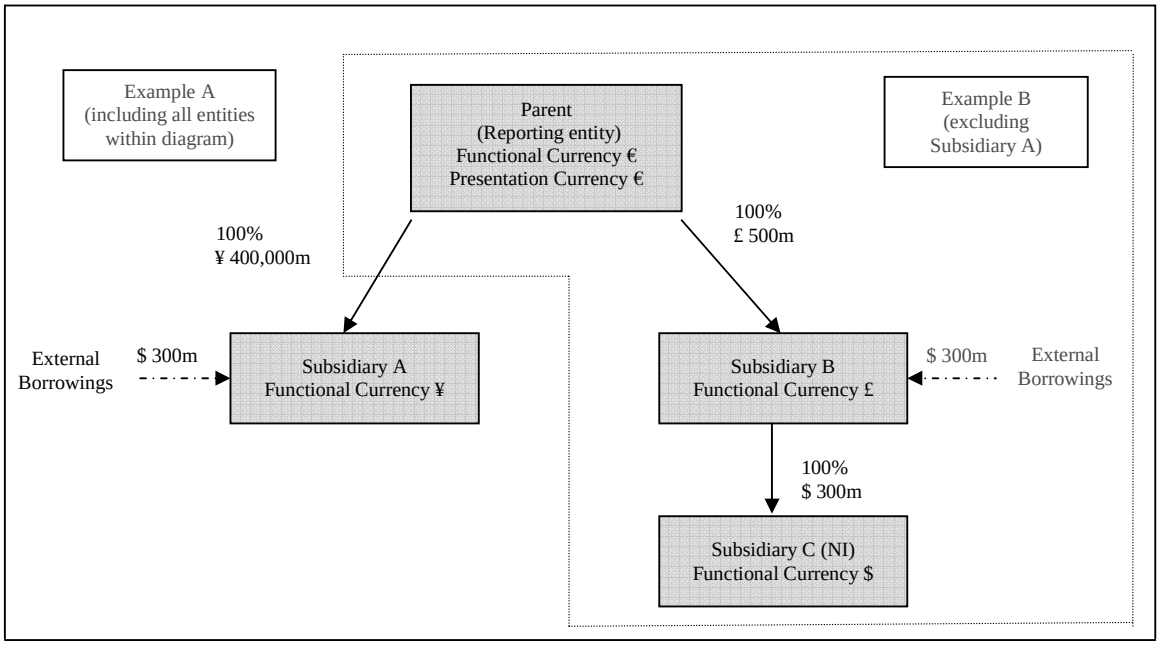
> On 1 January 2005, Parent entity, which presents consolidated financial statements in €, holds a 100% investment in Subsidiary A (¥400,000m) and a 100% investment in Subsidiary B (£500m). Subsidiary B also holds a 100% investment in Subsidiary C ($300m). Parent entity has a functional currency of €, Subsidiary A has a functional currency of Japanese Yen (¥), Subsidiary B has a functional currency of Pound Sterling (£) and Subsidiary C has a functional currency of $. Parent entity

[1] IAS 39 paragraph 102.
[2] The amount included in equity on consolidation is made up of two parts. Firstly, it is the *difference* between translating opening net assets of the NI at opening rates and at closing rates. Secondly, it is the *difference* between the income and expenses of the NI for the reporting period translated at average rates (or rates at the date of the transactions) and at closing rates. The sum of these amounts will be the exchange gain or loss recognised in equity on consolidation. See IAS 21 paragraph 41.
[3] Opening net assets of $500 translated at opening rates is €400 and closing rates is €450. There was no income or expense for the year thus no foreign exchange gain or loss is recorded on income or expenses. The total foreign exchange gain on the NI is €50.

wishes to fund its investment in Subsidiary C and hedge its foreign exchange exposure. See diagram below. There are two examples:

(a) Funding the investment in Subsidiary C through external borrowings of $300m made by Subsidiary A (*Example A*); or

(b) Funding the investment through external borrowings made by Subsidiary B (*Example B* which ignores Subsidiary A)



11. In the simple group structure example in paragraph 7 with a parent and only one subsidiary, the exposure and the offsetting instrument, which the Board require to qualify for hedge accounting under IAS 39, are fairly straightforward to identify. However, when group structures become more complex with multiple levels of investments, all with different functional currencies, the conflicting principles included in IAS 21 become more evident.

12. The submission received discussed a situation similar to Example B above. It questions whether hedge accounting can be achieved in Parent's consolidated financial statements. Depending on the order of consolidation (either consolidation of Subsidiary C into Subsidiary B and then Subsidiary B into Parent (step consolidation) or consolidation of Subsidiary C into Parent and Subsidiary B into Parent separately (direct one step method)) the constituent

believed different results would be obtained when trying to hedge the exposure created by Subsidiary C with the borrowings held by Subsidiary B.

13. The staff believe that the examples above and the submission received raise the following general questions:

ONE – What is the hedged risk?

In the simple example set out in paragraph 7 there are only two currencies to consider, therefore the hedged risk is simple to identify. In the more complex example, there are three currencies which could create an exposure against the functional currency of the NI (Subsidiary C). The first question is what is the hedged risk? Is it:

(a) the difference between two entities with different functional currencies within a group; or

(b) the translation to a group presentation currency?

The two options would identify the hedged risk as either an *economic exposure* between two functional currencies (Subsidiary B and Subsidiary C or Subsidiary C and Parent), or an *accounting exposure* arising from consolidation into the presentation currency (Subsidiary C and the presentation currency €).

TWO – Where in the group can the hedging instrument be held?

Again, in the simple example the entity exposed to the risk holds the hedging instrument. In Complex Example A, three different entities could hold the hedging instrument. How does this affect the ability to achieve hedge accounting in consolidated financial statements?

Further, in Example A the functional currency of the entity holding the hedging instrument is different from the functional currency of the entity with the NI. Does this affect the ability to achieve hedge accounting?

14. This section has set the scene and briefly identified the issues that the staff believe need to be resolved. Below is a discussion of these issues and an analysis of how current literature attempts to deal with them.

EXISTING GUIDANCE

IAS 21 and IAS 39

IAS 39

15. IAS 21 is the standard that deals with foreign currency transactions and translation of financial statements. IAS 39 however details the hedging rules for the hedge of a NI. IAS 39 identifies three types of hedge relationships, fair value, cash flow and NI hedging. Guidance (however limited) on accounting for the third option, was originally included in IAS 21. It was moved to IAS 39 to ensure that the rules for hedge accounting regarding designation, documentation and effectiveness also apply to NI hedging. NI hedging was included as a third type of hedge relationship because it did not correspond directly with the definition of either a cash flow or fair value hedge.

16. Difficulties arise when applying IAS 39 to the hedging of a NI because the requirements of IAS 39 focus on either fair value or cash flow hedges. For example, to qualify for hedge accounting an entity must meet the requirements of paragraph 88 (b) of IAS 39 which state:

> 'the hedge is expected to be highly effective in achieving offsetting changes in *fair value* or *cash flows* attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.' [Emphasis added]

17. A NI hedge is not trying to offset changes in fair value as the investment is not recorded at fair value, it is either equity accounted or consolidated[4]. Further, in the staff's view, a NI hedge cannot effectively offset changes in cash flows because the cash flows arising from the NI (ie dividends or future sale of the investment) are unknown at inception.

18. However, IAS 39 includes a hedge of a NI as a qualifying hedging relationship. Thus, the staff have continued their discussions on the basis that a NI hedge is achievable (in some form) under IAS 39.

[4] IAS 39 paragraph AG 99.

IAS 21 – translation exposure

19. IAS 21 distinguishes between two types of currency exposure. For convenience, in this paper these are called 'translation exposure' and 'transaction exposure', though these terms are not used in IAS 21 itself.

20. IAS 21 paragraph 17 requires each entity in a group to identify its functional currency and to measure its results and operations in that functional currency. Each economic entity within a group should reflect its results, including the effects of any foreign currency exposure, in the currency of the 'primary economic environment in which it operates'. The group financial statements should also reflect each of these environments.

21. Because of the need to reflect the different environments in which operations are conducted, it is impossible to report results and operations in a functional currency that is applicable for all entities within the group (unless each entity has the same functional currency). As a consequence a group that operates in more than one economic environment will not have a single *functional currency*[5]. To obtain consolidated financial statements, individual entities are translated to a group *presentation currency*.

22. IAS 21 paragraph 18 specifically states:

> 'Many reporting entities comprise a number of individual entities…… It is necessary for the results and financial position of each *individual entity* included in the reporting entity to be translated into the currency in which the reporting entity *presents* its financial statements. This standard permits the presentation currency of a reporting entity to be *any* currency.' [Emphasis added]

Paragraphs 38 to 50 of IAS 21 then detail how this translation is completed. Briefly, all assets and liabilities are translated at the closing rate and all income and expenses are translated at the rate available at the date of the transaction (or an average rate).

23. This translation method ensures that translation of the financial statements into a different currency will not change the way in which the underlying items are

[5] Basis for Conclusions in IAS 21 paragraph BC 19.

measured. The translation method should express the underlying amounts, as measured in the various functional currencies, in a single currency, the presentation currency.[6] The presentation currency is merely a standard numerical unit used to present the financial statements.

24. The amount recorded in equity is the translation adjustment recognised on consolidation to the presentation currency. IAS 21 does not discuss in detail this translation adjustment. However, FAS 52 *Foreign Currency Translation*[7] discusses the translation adjustment in the Basis for Conclusions. There are two views of the nature of the translation adjustment recorded in equity. One is that the translation adjustment reflects the effect of a change in exchange rate by either increasing or decreasing the parent's NI. This amount is unrealised until the NI is sold or liquidated; accordingly it is recorded in equity. The second view is that the amount is 'merely a mechanical by-product of the translation process, a process that is essential to providing aggregated information about consolidated enterprise'[8]. Because it is only an accounting entry with no economic impact on the group the amount is included in equity, until the investment is sold or liquidated.

25. There was no consensus reached on which view should prevail because both result in the amount being included in equity. Further, both situations indicate that there is no immediate economic impact on the cash flows of the entity. The staff believe these two views are important when trying to identify what the hedged risk is in a hedge of a NI.

IAS 21 – transaction exposure

26. Transaction exposure arises when an entity enters into a transaction that is denominated in a currency other than its functional currency. Transaction exposure creates a real exposure to changes in value or cash flows (a real economic risk). It arises at the entity level and is measured based on the

[6] IAS 21 paragraph BC 16.
[7] Refer to paragraphs 30 to 33 for further discussions on FAS 52. FAS 52 was written on the same basis as IAS 21.
[8] FAS 52 BC 114.

functional currency of the entity entering into the transaction. Any change in the exchange rate will affect the cash received or paid by the entity.

IAS 27

27. The submission received by IFRIC places considerable emphasis on the order of consolidation. The submission detailed three scenarios, specifically:

    (a) 'Hedge accounting for a hedging instrument exchanging the functional currency of a second tier subsidiary for the functional currency of a first tier subsidiary and designated as hedging the first tier subsidiary's net investment in the second tier *is not* possible at the group level (i.e. parent consolidated financial statements) if the parent's *presentation currency* is different from the functional currency of the first tier subsidiary.

    (b) Hedge accounting for a hedging instrument exchanging the functional currency of a second tier subsidiary for the functional currency of a first tier subsidiary and designated as hedging the first tier subsidiary's net investment in the second tier *is* permitted in the consolidated financial statements of the first tier subsidiary, and such hedge accounting is not reversed in the consolidation of the first tier subsidiary in the parent's consolidated accounts.

    (c) Hedge accounting depends on the company's policy with regard to the *consolidation procedures* applied to its subsidiaries. That is, the company may choose to consolidate all subsidiaries in a single step or consolidate in multiple steps based on its tiers; however, hedge accounting must be consistent with the policy chosen.'[9] [Emphasis added]

28. IAS 27 does not specifically state the required mechanics of consolidation (ie either direct one step method or step by step). What IAS 27 paragraph 22 (a) states is:

[9] IFRIC Submission.

> 'to create a set of consolidated financial statements… the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated'.

This could be interpreted in several ways. It could mean the ultimate parent's investment in each of its subsidiaries (including those it holds through other subsidiaries) will each be eliminated at the ultimate parent level. Alternatively, it could be argued that a parent entity is simply an entity with one or more subsidiaries (Subsidiary B is also a parent in the example in paragraph 10). Thus, consolidation could happen at sub-group levels first.

29. The staff reason that the order of consolidation is not specified in IAS 27 because it should have no impact on the results. Absent hedge accounting, when a group includes entities with different functional currencies, the group financial statements will be the same regardless of the mechanics of the consolidation. The purpose of the translation mechanism for foreign operations described above in paragraphs 19 to 25 ensures that this is the case. Therefore, should the order of consolidation determine what can and cannot qualify as an effective hedge? The staff do not think it should. Discussion should focus on more conceptual issues, for example, the nature and location of the exposure that is being hedged.

US GAAP Literature

30. FAS 52 and IAS 21 are based on the same underlying principles. However, there are some subtle differences. Additionally, the FASB has issued implementation guidance that applies to a hedge of a NI which IAS 21 and IAS 39 do not include.

31. FAS 133 *Accounting for Derivative Instruments and Hedging Activities* requires the entity holding the hedging instrument to have the same functional currency as the entity with the hedged item. Specifically FAS 133, paragraph 40(a), which is applied by paragraph 42 to the hedging of a NI states:

> 'for the purposes of the consolidated financial statements, either (1) the operating unit that has the foreign currency exposure *must be a party to the hedging instrument* or (2) another member of the consolidated group that has *the same functional currency* as the operating unit must be a party to the hedging instrument. To qualify for applying the guidance in (2) above, *there may be no intervening subsidiary with a different functional currency*' [Emphasis added]

32. The effect is that a parent entity that has a different functional currency from its first tier subsidiary (which is holding the NI), cannot itself hedge the exposure arising from that NI. This is because the parent is not directly exposed to the risk of changes in exchange rate between the functional currency of the first tier subsidiary and the functional currency of the NI (which is the only risk that US GAAP allows to be hedged)[10]. Subsequent implementation guidance was issued for FAS 133, however, which allows the first tier subsidiary to enter into an inter-company hedge contract with its parent. FAS 133 allows this inter-company hedge contract to be used as the hedging instrument by the first tier subsidiary to hedge its NI in the consolidated financial statements of the group. This is allowed only if the parent company that holds the opposite leg of the inter-company transaction enters an offsetting contract with an unrelated third party[11].

33. In contrast however, IAS 39 does not allow an entity to use internally generated contracts as hedging instruments in consolidated financial statements, when the contracts are eliminated on consolidation.[12]

[10] FAS 52 paragraph 40 (a)
[11] Statement 133 Implementation Issue No. H1.
[12] IAS 39 paragraph 73.

WHAT IS THE HEDGED RISK?

34. The staff will now consider the first question in paragraph 13 – what is the hedged risk? In the simple example, where there are only two functional currencies – the parent's and the subsidiary's (and the presentation currency is the same as the parent's functional currency) – the hedged risk is easy to identify. In the more complex example, the difficulties in identifying the hedged risk are emphasised.

Functional currency and presentation currency

35. Some believe that the hedged risk arises from the difference between the presentation currency and the functional currencies of the component entities of the group. This is most readily explained in terms of a consolidation undertaken as a single step, where each entity is translated directly to the presentation currency for consolidation purposes. By contrast, a consolidation undertaken as a series of sub-consolidations would give rise at each stage to exchange differences between the functional currencies of the component entities of each sub group and the functional currency of their immediate parent.

36. At the top level, there could also be a difference on translating from the functional currency of the group parent to the presentation currency. However, issues arising from that difference are not addressed in this paper.

37. Others believe that a hedged risk should only be recognised in respect of the economic risk which arises from an exposure between two or more functional currencies. Within a group, the functional currency of the NI and the functional currency of the entity holding the NI will fluctuate over time. Everything else being equal, the value of a NI will increase or decrease in the investor's own functional currency, based on these fluctuations. However, because the NI is not carried at fair value the full extent of the economic exposure is not recognised. Further, there is no immediate impact on the cash flows arising from the NI; this will occur when it is sold or liquidated.

38. The amount of the gain or loss included in equity is an estimate of the economic gain or loss based on the carrying value of the NI. Assuming that the entity has provided for any impairment of its investment, the fair value of the NI must be at least as much as the carrying value. Thus, the hedge of a NI should be effective for the portion of the investment recognised in the financial statements.

39. Those holding this view believe that an entity should be able to hedge this economic exposure between functional currencies regardless of the presentation currency of the group. The presentation currency of the group should have no effect on the results of the group. It is merely a standardised numerical unit used to present the group's financial statements and does not create an economic exposure.

Discussion and analysis

40. The staff believe problems arise when hedging a NI because the NI creates a translation exposure, but to hedge this exposure, entities will enter into financial instruments that create a generally far more immediate, transaction exposure. Further, as one view maintains in FAS 52, if holding a NI creates merely an accounting entry necessary for the aggregation of the financial statements, why would an entity then hedge this accounting entry with a real transaction exposure? The translation exposure created by the NI may, or may not, have economic implications for the group, but the impact is quite different from any direct cash flow gain or loss experienced on the financial instrument taken out to hedge the exposure.

41. The staff believe there is an element of truth in both the presentation and the functional currency arguments. The presentation currency creates an accounting entry on consolidation (if the presentation currency is different from the functional currency of the subsidiary) and a difference between the functional currency of the subsidiary and that of its parent creates an economic exposure. This economic exposure does not represent an immediate cash flow risk and is indeed indeterminate in its ultimate economic effect. However, it is an initial estimate of the possible future cash flows for the entity at a point in

time. In contrast, the amount recorded based on the presentation currency will never give rise to cash flows to the entity and is merely an accounting entry.

42. IAS 21 paragraph 18 states:

> 'It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity *presents* its financial statements.' [Emphasis added]

Some suggest that this indicates that consolidation occurs in one single process. Each individual entity records its results and operations in its individual functional currency. It then translates its financial statements directly into the presentation currency of the group for consolidation. In their view, this one step process is fundamental to the presentation currency concept because it indicates that the exposure only arises on translation to the presentation currency and not at an individual level between functional currencies.

43. The staff note however the comment in IAS 21 BC 18 that the concepts included in IAS 21, for translation and consolidation, ensure that the consolidation mechanism does not matter. IAS 21 BC 18 specifically mentions of the translation mechanism included in IAS 21:

> 'This method results in the same amounts in the presentation currency regardless of whether the financial statements of a foreign operation are:
>
> (a) first translated into the functional currency of another group entity (eg the parent) and then into the presentation currency; or
>
> (b) translated directly into the presentation currency.

The staff question why the choice of consolidation mechanism should determine the arrangements qualifying for hedge accounting in group financial statements, if the translation mechanism has no impact on the financial statements.

44. When IAS 21 and FAS 52 were first issued it was unusual for the presentation currency to differ from the functional currency of the group parent. It is therefore reasonable to assume that in allowing a hedge of a NI, the Board

envisaged some sort of exposure, and not just the artificial exposure that would result from fluctuations against *any* selected presentation currency. This view is indeed stated explicitly in FAS 52, where BC 94 states:

> 'Fundamental to the functional currency approach to translation is the view that, generally, a US enterprise *is exposed to exchange risk* to the extent of its net investment in a foreign operation. This view derives from a broad concept of economic hedging' [Emphasis added]

Therefore, US GAAP indicates that the entity that holds a NI is exposed to foreign currency fluctuations which are measured based on the entity's functional currency and gives weight to the functional currency argument.

45. Further, IAS 39[13] and FAS 52[14] both indicate that a hedge relationship only qualifies for hedge accounting if it is expected to be highly effective in achieving offsetting changes in fair value or future cash flows (FAS 52 says, as an *economic hedge).* To achieve this, the staff believe that the entity must be hedging the economic exposure to movements in the functional currency of its NI against its own functional currency. Hedging the presentation currency will not create an effective economic hedge because there will never be an economic impact on the operations from the presentation currency.

46. This conclusion is reinforced when considering the nature of the presentation currency. Allowing an entity to hedge its presentation currency seems to give undue importance to the presentation currency. It tends to imply that the presentation currency is actually the functional currency of the *group*, and exposures against the group's functional currency can be hedged. However, as discussed above, the presentation currency should not have this effect. IAS 21 is clear in stating that a group does not have a functional currency. The presentation currency should be considered as no more than a standardised numerical unit. It can be chosen at the entity's discretion and be changed at any time.

[13] IAS 39 paragraph 88 (b)
[14] FAS 52 paragraph 20 (a)

WHERE CAN THE HEDGING INSTRUMENT BE HELD TO CREATE A VALID HEDGING RELATIONSHIP?

47. The staff will now consider where the hedging instrument must be held to obtain hedge accounting. In the simple example in paragraph 7, there is only one entity that can hold the hedging instrument. However, in the more complex examples (both A and B) in paragraph 10, the hedging instrument can be held by a number of entities each with a different functional currency.

Hedging instrument held by the specified parent entity

48. The functional currency argument indicates that an exposure arises between the functional currencies of the entity and its NI, ie from holding an investment in a foreign currency. Based on this, the staff argue that another parent, higher than the immediate parent, up to the ultimate parent entity, could hedge the exposure to that investment, based on its own functional currency exposure. The parent is exposed to an economic risk arising from its investment in the first tier subsidiary which is then investing in the second tier subsidiary. IAS 39 allows discretion on what the risk being hedged is, and the staff believe this should apply to a NI hedge also.

49. Therefore, in the staff's view, a hedging instrument in a hedge of a NI could be held by any specified direct or indirect 'parent' entity that is exposed to the risk that is being hedged. The entity would need to specify which foreign currency exposure is being hedged, ie which NI is being hedged and against which parent's functional currency. This will be documented and the hedging instrument will be designated at inception of the hedge.

50. Consider the complex example above. Looking at Example B only, if Subsidiary B chooses to hedge its exposure to £/$ fluctuations this would be documented at inception. The external borrowings held by Subsidiary B would meet the hedge effectiveness tests and hedge accounting could be achieved at this level. Any fluctuation between Subsidiary B's functional currency and Parent's functional currency (€ and £) is not hedged, but the fluctuations in the £ and $ will remain hedged on consolidation.

51. The group could instead choose to hedge the exposure between Parent entity's functional currency (€) and the NI's functional currency ($). The hedging documentation would need to designate and document the hedge risk and Parent entity would need to hold the hedging instrument to ensure the hedge was effective.

Hedging instrument held by any entity within the group

52. To extend this argument the staff now consider what the consequences would be if the hedging instrument was held by an entity that was not the parent or ultimate parent of the NI. Provided that the instrument hedged an exposure between the same two currencies as the functional currency of the NI and that of its [specified] parent, should this be allowed?

53. The hedging instrument might take the form of external borrowing or a derivative whose counterparty was external to the group. In both cases, the gains and losses, absent designation as a hedge, would be reflected in consolidated profit or loss. If the hedging instrument was a borrowing or a derivative with one leg denominated in the functional currency of the entity holding it, the functional currency of the entity holding it would have to correspond with that of the specified parent. If the hedging instrument was a swap, the two currencies of the swap would have to correspond to the functional currencies of the specified parent and the net investment.

54. Some believe that there is no reason why such instruments should not qualify to be designated as a hedge of a net investment. They point out that gains and losses on the instruments, absent designation as a hedge, are reflected in consolidated profit or loss in the same way as similar instruments held by the specified parent. Furthermore, IG F2.14 of IAS 39, which discusses a hedge of future cash flows, specifically draws attention to the fact that IAS 39 does not require the operating unit that is exposed to the risk being hedged to be a party to the hedging instrument.

55. However, the staff believe that, if a 'transaction' exposure is to be used to hedge a 'translation' exposure, the link between the two should be stronger

than merely that the 'transaction' exposure was measured at the same amount as if it had been undertaken by the [specified] parent.

56. Perhaps the strongest justification for a link between the hedging instrument and the net investment would be for a borrowing used by the [specified] parent to finance its net investment. The staff believe that it would be reasonable to extend that justification to finance introduced after the original investment had been made and also to a programme of rolled over derivatives that continuously modified the currency element in the [specified] parent's interest in its net investment. However, all these transactions would have to be undertaken by the [specified] parent itself, either directly with parties external to the group or with other group entities that had engaged in such external transactions.

57. When the effect of the required external hedging transaction had to be passed on to the [specified] parent by one or more intra-group transactions, the staff believe that all gains and losses on the intra-group transactions should be reflected in consolidated profit or loss. That requirement would exclude from the hedging chain an intra-group monetary item qualifying as part of a net investment under paragraph 15 of IAS 21. The requirement is necessary to ensure that the amount of the external exposure is transmitted to the specified parent holding, directly or indirectly, the net investment.

CONCLUSIONS, ALTERNATIVE VIEWS AND PROPOSED RECOMMENDATIONS

58. The staff believe it is important to recognise that a NI hedge is hedging an economic exposure that arises between two functional currencies. An entity does not have an economic exposure to its presentation currency and thus it should not be able to hedge its presentation currency.

59. When considering where the hedging instrument is held in a hedge of a NI, the staff believe that an important concept to remember is the difference between the two offsetting exposures. The exposure from the NI is included in equity either because it is just an accounting exposure, or because it is an estimate of an economic exposure. This is only recognised in profit or loss on sale or liquidation of the NI. The real cash flow risk arising on the hedging

instrument without hedge accounting would normally affect profit or loss immediately. However, because it has been designated as a hedging instrument the amount is taken to equity directly or to the statement of recognised income or expense.

60. The concern with allowing any transaction exposure to offset a translation exposure, simply because they are measured at the same amount, is that NI hedging will be used as a shelter for real transaction risks. This possibility can be significantly mitigated if a better link is established between the risk of the hedging instrument and that of the net investment. The staff have considered three different possible views in applying the standards to answering the questions raised in paragraph 13. These are detailed below.

View A – The consolidation method should determine when hedge accounting is achieved.

61. The different options for resolution under this viewpoint are outlined in paragraph 27. If the IFRIC believe the consolidation mechanism should be a factor in deciding whether hedge accounting can be achieved, it will need to consider further which mechanism (direct or step by step) the standard intended to achieve, and based on this, situations when hedge accounting can and cannot be achieved.

62. In the staff's view, the mechanics of the consolidation are not relevant to any aspect of the financial statements.

63. The staff believe the submission highlights similar issues as raised above in paragraphs 34 to 46. However, a more robust principle that reflects the intended purpose of hedging a NI, rather than making an arbitrary determination based on the mechanism of consolidation, should obtain a more suitable answer.

View B – Hedge accounting is permitted based on rules included in US GAAP.

64. Since FAS 52 and IAS 21 are based on similar underlying principles, to use the guidance provided by the FASB appears to be a logical progression. Further, issuing guidance in accordance with FAS 52 would ensure convergence and not divergence from US GAAP.

65. The staff believe the requirements of US GAAP are too restrictive in one respect but too permissive in another (refer to discussion below in paragraphs 68 and 69). However, the staff acknowledge that consideration should be given to US GAAP because IAS 21 and FAS 52 are both based on the same underlying principles.

Staff Proposals – Foreign currency exposure arises at the entity level between two functional currencies.

66. As noted in the discussion, the staff believe a conceptual basis for the accounting for a hedge of a NI could be arrived at from the guidance in IAS 21 and IAS 39. From the discussion above, the staff believe the way forward for determining what the hedge risk is and where the exposure arises should be based along the following lines:

    (a) the existence of a NI gives rise to an economic exposure arising at the entity level measured against the functional currency of the (direct or indirect) parent entity;

    (b) the presentation currency can not give rise to an economic exposure;

    (c) designation and documentation must indicate the exchange movements that are being hedged;

    (d) the hedged risk can only be the risk between the NI and any parent up to the ultimate parent;

    (e) any entity within the group can hold the third party hedging instrument as long as it is passed, through intra-group transactions, to the specified parent; and

(f) gains and losses on these intra-group hedges must be recognised in profit or loss.

67. To consider further the proposals and the situations that would or would not qualify for hedge accounting, the staff have included in Appendix A some examples for discussion. Examples 1 and 2 show the calculations for complex Example A in paragraph 10. Examples 3 to 6 show less complex examples using different hedging instruments. They begin with a cash instrument and progress to situations where the hedging instrument is either a one legged instrument (a forward) or two legged instrument (a swap), in order to illustrate the effect this may have on the hedge relationship.

Comparison of US GAAP and the Staff Proposals

68. The staff proposals are similar to US GAAP. However there are some important differences. Firstly, US GAAP would allow any entity within the group that has the same functional currency as the parent with the NI to hold the hedging instrument (as long as there was no intervening entity with a different functional currency). The entity that holds the hedging instrument does not need to be in the chain of parent entities, as required in the staff's proposals. Thus, US GAAP is more permissive on where the hedging instrument can be held.

69. Secondly, the staff proposals allow any risk between an ultimate parent and the NI (or a risk of any parent in between the immediate and the ultimate parent) to be hedged. In contrast, the US GAAP model only allows an entity to hedge the risk between the functional currency of the NI and the functional currency of the immediate parent (or any higher parent as long as there is no intervening entity with a different currency). Thus, US GAAP is more restrictive on exactly what the hedged risk is.

70. In considering US GAAP and the staff's proposals, the staff acknowledge that the two differences noted in paragraphs 68 to 69 are not fundamental. Both views are based on the underlying notion of hedging the functional currency exposure, and both views give an entity some flexibility in how to hedge the risk arising. In light of this, the staff considered whether the option of

adopting the guidance in US GAAP without amendments would be more sensible. Stated differently, would adopting requirements reflecting View C provide sufficient benefits to outweigh the cost of continuing to diverge in some respects from the corresponding US requirements?

71. Adopting the US GAAP guidance would ensure convergence between two standards (IAS 21 and FAS 52) that are considered to be, for the most part, already converged. This would naturally reduce compliance costs to entities. This is the main benefit the staff see arising from adopting US GAAP. However, there are consequences of accepting View B over View C.

72. The staff believe that some restriction should be put in place to mandate when a transaction risk can be recognised directly in equity. It is important that there is a link between the hedging instrument (taken out with a third party) and the NI. Requiring the hedging instrument to be held by an entity that has passed the exposures through to a specified parent entity will ensure that there is some economic relationship between the net investment and its hedging instrument. Further, requiring both the intra-group hedges set up to link the hedge instrument and the NI, to be reflected in profit or loss, will ensure that the external exposures are indeed transferred to the specified parent.

73. The staff notes that even if convergence with US GAAP is not achieved on this point, compliance with an IFRS reflecting View C would not prevent entities from simultaneously complying with US GAAP reflecting View B. The only effect of complying with both standards would be to restrict the choice of which parent's functional currency would be used to assess the exposure.

74. The staff believe that the issues raised in this paper are sufficiently important that they need to be debated in full on their merits. That debate should not be short cut by a reluctance to adopt restrictions on hedging a net investment that are not already present in US GAAP.

APPENDIX A – EXAMPLES

EXAMPLE 1

1. Example 1 shows the journal entries that would be completed for the Complex Example A in paragraph 10 where Subsidiary A is holding the borrowings[15].

Sub A holds borrowings to hedge exposure in Sub C			
Sub A Accounts		**¥m**	**€**
01-Jan-05	Borrowings of $300m	(35,400)	
31-Dec-05	Borrowings of $300m	(37,500)	
P&L loss		2,100	15
Parent Accounts		**€**	
01-Jan-05	Invest in C of $300m	240	
31-Dec-05	Invest in C of $300m	264	
FCTR loss		(24)	

Exchange Rates		
	Year 0 - 1 USD	**Year 1 - 1 USD**
JPY	118	125
EUR	0.80	0.88
GBP	0.53	0.58

01-Jan-05	**A ¥**	**A €**	**B £**	**B €**	**C $**	**C €**	**Parent €**	**Consol Adjs A**	**Consol Adjs B**	**Consol Adjs C**	**TOTAL GROUP €**
Assets	400,000	2,712	500	755	300	240					3,707
Investments							3,467	(2,472)	(755)	(240)	0
Total	400,000	2,712	500	755	300	240	3,467	(2,472)	(755)	(240)	3,707
Liabilities	(35,400)	(240)									(240)
	(35,400)	(240)	0	0	0	0	0	0	0	0	(240)
Equity	(364,600)	(2,472)	(500)	(755)	(300)	(240)	(3,467)	2,472	755	240	(3,467)
P&L reserve											0
FCTR											0
	(364,600)	(2,472)	(500)	(755)	(300)	(240)	(3,467)	2,472	755	240	(3,467)

31-Dec-05	**A ¥**	**A €**	**B £**	**B €**	**C $**	**C €**	**Parent €**	**Consol Adjs A**	**Consol Adjs B**	**Consol Adjs C**	**TOTAL GROUP €**
Assets	400,000	2,816	500	759	300	264					3,839
Investments							3,467	(2,472)	(755)	(240)	0
Total	400,000	2,816	500	759	300	264	3,467	(2,472)	(755)	(240)	3,839
Liabilities	(37,500)	(264)									(264)
	(37,500)	(264)	0	0	0	0	0	0	0	0	(264)
Equity	(364,600)	(2,472)	(500)	(755)	(300)	(240)	(3,467)	2,472	755	240	(3,467)
P&L reserve	2,100	15									15
FCTR		(95)		(4)		(24)					(123)
	(362,500)	(2,552)	(500)	(759)	(300)	(264)	(3,467)	2,472	755	240	(3,575)

[15] Examples 1 and 2 in Appendix A assume that Subsidiary B does not hold borrowings of $300m.

EXAMPLE 2

2. Example 2 shows the journal entries that would be completed for the complex Example A in paragraph 10 except that the funds are on-lent to Parent through an inter-company loan. The exchange rates are the same as Example 1.

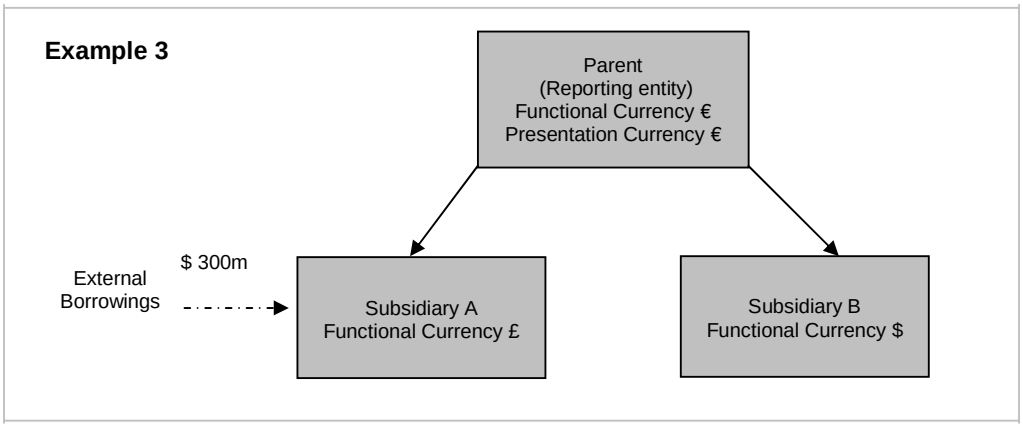
Sub A transfers borrowings to Parent to hedge exposure in Sub C

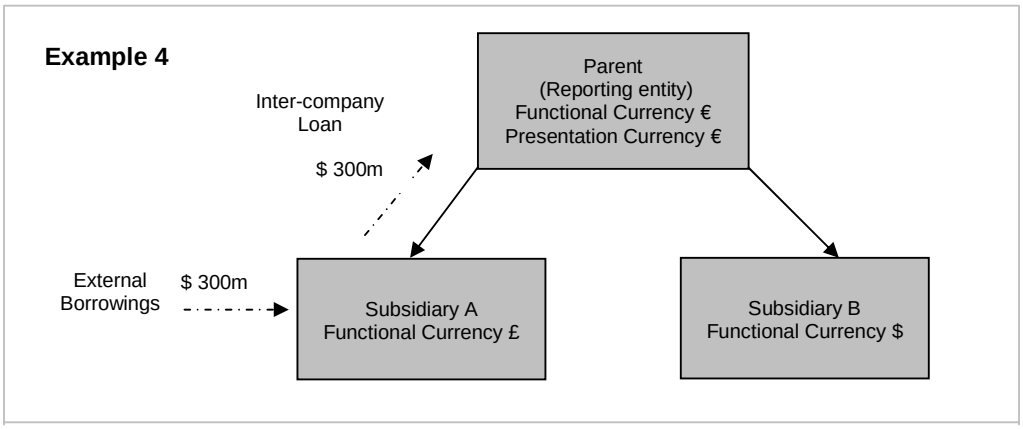
Sub A Accounts		¥
01-Jan-05	Borrowings of $300m	(35,400)
31-Dec-05	Borrowings of $300m	(37,500)
P&L loss		2,100
01-Jan-05	Loan to P of $300m	35,400
31-Dec-05	Loan to P of $300m	37,500
P&L loss		(2,100)
Parent Accounts		€
01-Jan-05	Loan from A of $300	(240)
31-Dec-05	Loan from A of $300	(264)
P&L loss		24
01-Jan-05	Invest in C of $300m	240
31-Dec-05	Invest in C of $300m	264
FCTR loss		(24)

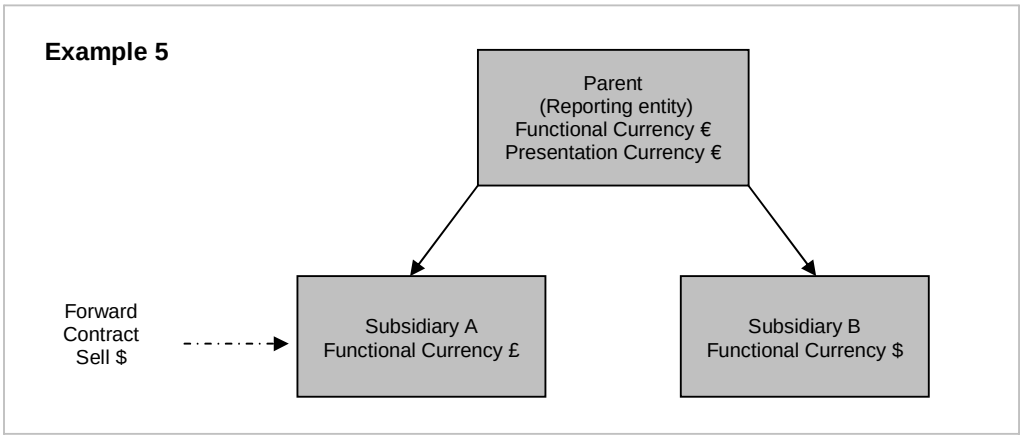
01-Jan-05	A ¥	A €	B £	B €	C $	C €	Parent €	Consol Adjs A	Consol Adjs B	Consol Adjs C	Inter-company	TOTAL GROUP €
Assets	364,600	2,472	500	755	300	240	240					3,707
Intercomp Rec	35,400	240									(240)	0
Investments							3,467	(2,472)	(755)	(240)		0
Total	400,000	2,712	500	755	300	240	3,707	(2,472)	(755)	(240)		3,707
Intercomp Pay							(240)				240	0
Liabilities	(35,400)	(240)										(240)
	(35,400)	(240)	0	0	0	0	(240)	0	0	0		(240)
Equity	(364,600)	(2,472)	(500)	(755)	(300)	(240)	(3,467)	2,472	755	240		(3,467)
P&L reserve												0
FCTR												0
	(364,600)	(2,472)	(500)	(755)	(300)	(240)	(3,467)	2,472	755	240		(3,467)

31-Dec-05	A ¥	A €	B £	B €	C $	C €	Parent €	Consol Adjs A	Consol Adjs B	Consol Adjs C	Inter-company	TOTAL GROUP €
Assets	364,600	2,567	500	759	300	264	240					3,829
Intercomp Rec	37,500	264									(264)	0
Investments							3,467	(2,472)	(755)	(240)		0
Total	402,100	2,831	500	759	300	264	3,707	(2,472)	(755)	(240)		3,829
Intercomp Pay							(264)				264	0
Liabilities	(37,500)	(264)										(264)
	(37,500)	(264)	0	0	0	0	(264)	0	0	0		(264)
Equity	(364,600)	(2,472)	(500)	(755)	(300)	(240)	(3,467)	2,472	755	240		(3,467)
P&L reserve							24					24
FCTR		(95)		(4)		(24)						(123)
	(364,600)	(2,567)	(500)	(759)	(300)	(264)	(3,443)	2,472	755	240	0	(3,566)

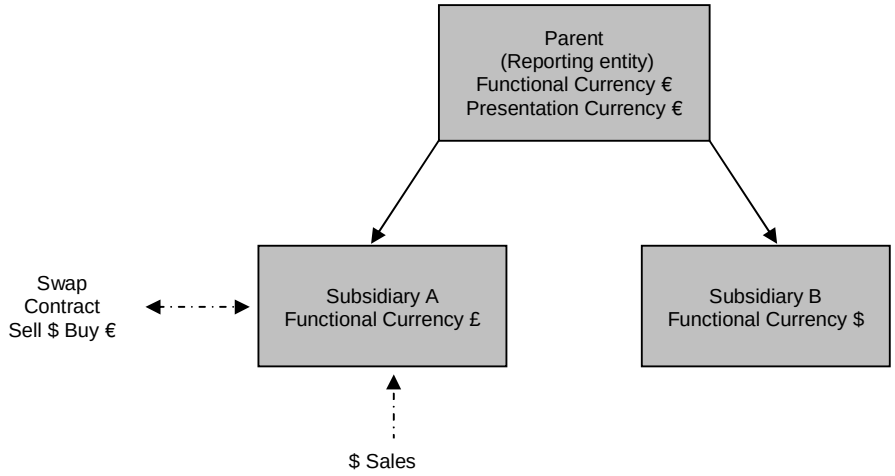
3. Examples 3 to 6 show different scenarios for the hedging instrument. Example 3 shows Subsidiary A holding external borrowings, Example 4 on lends the borrowing to Parent, Example 5 uses a forward contract and Example 6 uses a swap.







Example 6


Parent
(Reporting entity)
Functional Currency €
Presentation Currency €
Swap
Contract
Sell $ Buy €
Subsidiary A
Functional Currency £
Subsidiary B
Functional Currency $
$ Sales