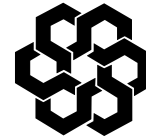

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

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: **January 2007, London**

Project: **Hedging of a Net Investment in a Foreign Operation (Agenda Paper 11)**

INTRODUCTION

1. In November 2006, the IFRIC decided to add to its agenda, a project 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 asked staff to analyse further:

    (a) the scope of the project;

    (b) identification of a NI and the hedgeable risk attaching to it;

    (c) what instruments could be used for hedging a NI, whether their location within the group was relevant and how to assess hedge effectiveness; and

    (d) the implications of the project for convergence with US GAAP.

2. The IFRIC also asked the staff to consider whether providing guidance, clarifying that IAS 21 *The Effects of Changes in Foreign Exchange Rates* does not dictate a method of consolidation, would resolve the majority of issues raised by the project.

3. This paper provides:

   (A) the staff recommendation;

   (B) consideration of whether clarification, that IAS 21 does not indicate the mechanics of consolidation, would resolve the majority of issues raised in section B of this project;

   (C) discussion and analysis of the scope of the project;

   (D) an analysis of US GAAP and its relevance to this project; and

   (E) a summary of the discussion and recommendations.

   Appendix A includes an example of a hedge of a NI in group financial statements and has been included for discussion purposes.

A STAFF RECOMMENDATION

4. The staff conclude that the requirements of IAS 21 and IAS 39 *Financial Instruments: Recognition and Measurement* are unclear about what the hedged risk is, and where a hedging instrument can be held, when accounting for the hedge of a NI.

5. The staff conclude that IAS 21 does not specify the mechanics of consolidation, however, the staff also concluded that providing guidance to this effect would not substantially resolve the issues raised in paragraph 3.

6. Therefore the staff recommend that the project should not focus on providing guidance about the mechanics of consolidation. Rather, it should address what the hedged risk is in a hedge of a NI in consolidated financial statements, what types of hedging instruments can be used and where the hedging instrument can be held within the group.

B CLARIFICATION THAT IAS 21 DOES NOT INDICATE A METHOD OF CONSOLIDATION

7. At the November IFRIC meeting, an IFRIC member indicated that some constituents believed IAS 21 paragraph 18 stipulated that, consolidation of a group consisting of entities with multiple functional currencies, must be completed using the direct method of consolidation. This meant translating individual entities directly into the presentation currency (the direct mechanism) and not firstly into the functional currency of the immediate, intermediate or ultimate parent entity before translating into the presentation currency of the group (the step by step mechanism). The following sentence from paragraph 18 of IAS 21 was highlighted as giving that indication:

> '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.'

8. At the time, IFRIC members indicated that this sentence was merely noting that consolidated financial statements necessarily had to be presented in a common currency. Translating the results and financial position of each individual entity into a presentation currency allows this. Of the consolidation and translation method, IAS 21 paragraph BC 18 states:

> '[the translation method included in IAS 21] 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.'

9. Thus, both the direct method and the step by step method will result in the same amount shown in the presentation currency on consolidation of the financial statements. As a corollary to this, the staff conclude that in accounting for a hedge of a NI, the mechanics of consolidation should not have any impact on deciding what the exposure is, or when hedge accounting can be achieved.

10. An IFRIC member asked whether providing guidance on the mechanics of consolidation would resolve the majority of issues raised in this project. Such guidance would allow entities to use both consolidation mechanisms. This

will result in the same profit or loss and financial position, whichever method is chosen, as stated in paragraph BC 18 of IAS 21.

11. However, such guidance will not resolve the question of what the hedged risk is in the hedge of a NI. Diversity will still exist over whether the risk arises merely as an accounting exposure, on the consolidation to a presentation currency or whether it arises from an economic exposure, between different functional currencies within a group.

12. Further, guidance that indicated only that IAS 21 allows any consolidation method would not answer questions raised regarding where a hedging instrument can be held within a group. Initially, a hedging instrument is measured based on the functional currency of the entity holding it. Thus where in the group the instrument can be held should be considered further.

13. Therefore, in the staff's view, guidance focused more specifically on what the risk is and where the hedging instrument can be held will provide more relevant information for entities.

14. **Does the IFRIC agree that stating only that IAS 21 does not stipulate the mechanics of consolidation, would not provide sufficient guidance for the hedge of a NI?**

C DETERMINATION OF THE SCOPE OF THE PROJECT

15. Section C discusses a range of issues to analyse and identify the scope of the project.

November Meeting – Summary and Proposals

16. At the November 2006 IFRIC meeting, the staff noted that answering the following questions would be fundamental to providing guidance on how to account for a hedge of a NI:

    What is the hedged risk?

    Is it the difference between two entities with different functional currencies' within a group, or is it the translation to a group presentation currency? The two options identify the hedged risk as either an *economic exposure* between two functional currencies, or an *accounting exposure* arising from consolidation into the presentation currency.

    One consideration is – why do entities hedge a NI? Is it to fix expected receipts from future dividends – ie a type of cash flow hedge? Is it to reduce balance sheet volatility – ie a type of fair value hedge? Or it is for some other reason such as sheltering of gains and losses on derivatives held for other purposes? The reasons for hedging could help to answer the question of what the hedged risk is in a hedge of a NI.

    Where in the group can the hedging instrument be held?

    Different entities within the group could hold the hedging instrument. How does this affect the ability to achieve hedge accounting in consolidated financial statements? Further, if 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?

17. As noted at the November 2006 IFRIC meeting the staff recommend a conceptual basis for removing diversity and providing guidance on the accounting for a hedge of a NI. The staff believe the way forward for

determining what the hedged risk is and where the exposure arises should be along the following lines:

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

(b) the presentation currency as such does not give rise to an economic exposure, though it may coincide with the parent's functional currency which does;

(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 parent doing the hedging; and

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

The following sections analyse further the scope of the project.

What is the NI?

18. An IFRIC member raised the point that, some entities are actually hedging a future dividend payment they expect to receive from the NI and not the NI itself. This is in some ways analogous to a cash flow hedge. Some entities can determine with some certainty, the timing and amount of a future dividend (received in a foreign currency). They then look to fix the amount of cash to be received in their own functional currency. However, entities are not allowed to hedge foreign currency fluctuations on a future dividend payment under IAS 39, until the dividend has been declared and become an intra-group monetary item[1]. As a substitute, an entity might hedge a portion of the

[1] Refer to paragraph 80 of IAS 39.

carrying value of its NI, equal or similar to, the amount of the expected future dividend, achieving the desired result.

19. Other constituents believe that IAS 39 is allowing the entity to hedge its interest in the net assets of that operation. In some respects, this could be analogous to a fair value hedge. Assuming an entity has recognised any impairment of its NI that has arisen under IAS 36 *Impairment of Assets*, the fair value of the NI will be at least as much as the entity's interest in the net assets of the operation. Thus, any hedge of the NI would be equal to at least a portion of the fair value of the investment. However, because the NI is not carried at fair value, the hedge is not a fair value hedge.

20. The IFRIC asked the staff to consider further what is being hedged in the hedge of a NI. IAS 21 paragraph 8 includes the following definition:

> '*Net investment in a foreign operation* is the amount of the reporting entity's interest in the net assets of that operation.'[2]

21. In a cash flow hedge IAS 39 indicates that specified cash flows are usually a limited set of highly probably future cash flows that are not yet represented by an asset. This is not the case in a hedge of a NI, because there is a recognised [net] asset. A fair value hedge however, is hedging a recognised asset in a similar manner to a NI hedge.

22. Further to this, when the Board initially allowed a NI hedge, one of the reasons was to decrease volatility of the financial position. Hedging accounting under a fair value model achieves this by offsetting two balance sheet items against each other. However, a cash flow hedge actually creates volatility on the balance sheet because only one side of the transaction, the hedging instrument, is recognised on the balance sheet, with movements on the hedging instrument recognised in equity. The hedged item (the cash flow) is not yet recognised.

[2] IAS 21 paragraph 15 states that a monetary item for which settlement is neither planned nor likely to occur in the foreseeable future, is in substance, a part of the entity's net investment in that foreign operation. This paper does not consider the monetary items that form part of a NI.

23. Thus, the staff believe that the hedge of a NI under IAS 21 and IAS 39 is attempting to hedge an asset in a similar manner to a fair value hedge, and not a future dividend payment.

24. Does the IFRIC believe that the hedge of a NI is similar to a cash flow or a fair value hedge?

What is the hedged risk?

25. As noted in November 2006, there are currently two views of what the risk is in a hedge of a NI. The functional currency view identifies the hedged risk as being the exchange rate fluctuations between the functional currency of the NI and the functional currency of a parent entity holding the NI. The functional currency approach relies on the notion that the value of the parent's NI will change when exchange rates move – thus giving rise to a real economic risk for the parent. However, because the NI is not recorded at fair value, this hedge is not a fair value hedge.

26. IAS 39 (and FAS 52 *Foreign Currency Translation)* indicate that a hedging relationship only qualifies for hedge accounting if it is expected to be highly effective in offsetting fair values or future cash flows (FAS 52 states 'as an economic hedge')[3]. To achieve this, an entity must be hedging an economic exposure. The functional currency approach is more in line with this as it identifies as the hedged risk an economic exposure between two functional currencies.

27. A consequence of the functional currency approach is that it allows an entity to hedge either an intermediate exposure or the whole exposure (from the NI's functional currency up to the ultimate parent's functional currency). Thus, on consolidation, an entity can hedge the exposure between two intermediate entities. Under this model, an entity must not be able to hedge the same risk twice at two different levels in consolidated accounts. Consider the example in Appendix A. The group would not be able to hedge the risk between Subsidiary B and Subsidiary C (£ / $) as well as hedging the risk between Parent and Subsidiary C (€ / $). The group could however hedge the risk

[3] IAS 39 paragraph 88 (b) and FAS 52 paragraph 20 (a).

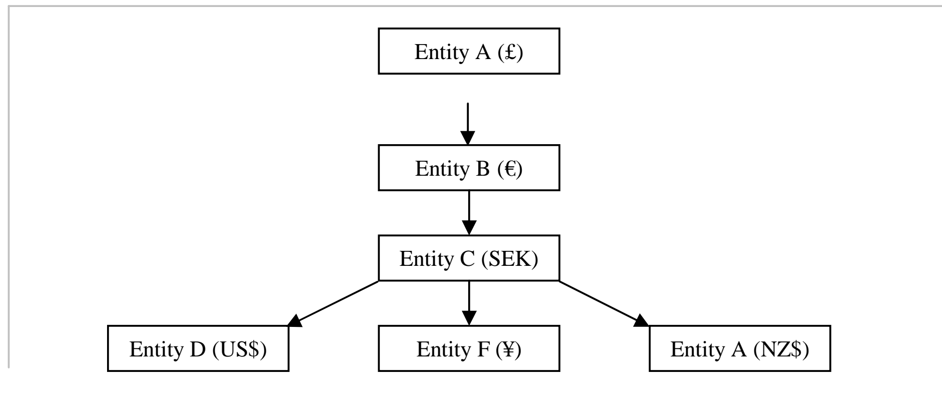
between Subsidiary B and Subsidiary C, (£ / $) and then hedge the risk between Subsidiary B and Parent (€ / £). Documentation and designation at inception of the hedge will identify the hedged risk.

28. The second approach is the presentation currency view. This view indicates that the exposure being hedged is the exchange rate movements between the presentation currency of the group and the functional currency of the NI. This focuses on the total exposure between the NI and the presentation currency of the group. It measures the exposure affecting the reader of the consolidated financial statements – ie the risk the entity is exposed to is measured based on the currency in which the financial statements of the group are presented. Any functional currencies in between the NI and the group presentation currency do not give rise to an exposure that can be hedged.

29. The consequence of the presentation currency view is that a hedge must be measured based on a presentation currency. To achieve an effective hedge, the presentation currency has to be viewed in effect as being the functional currency of the group, which IAS 21 specifically states it is not. Under IAS 21, the presentation currency is merely a standard numerical unit chosen by the entity to present its financial statements. As such, it does not give rise to an economic exposure.

30. If the presentation currency approach is taken, an anomaly arises for a group consisting of two entities (a parent and a subsidiary), both with the same functional currencies, but for consolidation purposes the group has a different presentation currency. The exchange rate fluctuations arising on consolidation to the presentation currency could be hedged under the presentation currency approach. The presentation currency does not create any cash flow effect for the group, but the hedging instrument will create a cash flow effect.

31. In summary to compare the two views, the staff include an example of a group with 100% ownership between each of the entities. The presentation currency of the group is the same as the functional currency of Entity A (ie £).



32. The presentation currency approach would allow the group to hedge any exposure between the presentation currency (£) and the functional currency of any subsidiary in the group – ie £ / €, £ / SEK, £ / ¥, £ / US$ and £ / NZ $. These are the only exposures that could be hedged in this example, under the presentation currency approach.

33. The functional currency approach would allow the same exposures as listed in paragraph 32 (this is because the functional currency of the ultimate parent and presentation currency of the group are the same). The functional currency approach also allows any combination of exposures (as long as there is a parent type relationship) for example – € / SEK, € / ¥, € / US$, € / NZ $, SEK / ¥, SEK / US $, SEK / NZ $. This is because this is where the exposure exists based on the functional currency of each entity. It is important to note, however that if the entity hedged the € / ¥ exposure, they could not also hedge the SEK / ¥ exposure in the same set of financial statements.

34. The staff believe that the functional currency approach creates a better conceptual basis for the hedge of a NI.

35. What does the IFRIC believe a hedge of a NI is hedging:

(a) the risk between the functional currency of a NI and the functional currency of a parent entity; or

(b) the risk between the functional currency of the NI and the presentation currency of the group?

Hedging Instruments – What, where and how are they effective?

36. The next section focuses on the hedging instrument. Namely, what type of instrument can be used, where can the instrument be held and is it effective? This will be considered under both the functional currency and the presentation currency views.

37. The functional currency view states that the hedged risk in a hedge of a NI arises from movements between different functional currencies within a group. The first type of hedging instrument considered is a cash loan or borrowings. The borrowings must be held by the parent hedging the NI so that any gains or losses (that would normally go to profit or loss) on the hedging instrument will be effective against any movements in the functional currency of the NI against the parent's functional currency. The staff believe that any other entity within the group could hold the borrowings from an external entity, provided they were then passed to the parent entity. This would ensure that the exchange risk on the instrument is transferred to the entity with the exposure from the NI.

38. The staff believe there is a need to transfer the borrowings to the parent entity because a hedge of a NI is hedging a translation exposure, not a transaction exposure as is the case for a fair value or cash flow hedge. Because of this the staff believe a link stronger, than merely that the exposures are measured at the same amount (ie if the instrument was held by a different entity with the same functional currency as the parent), should be required. To create a stronger link the hedging instrument should be transferred to the parent with the hedged item so that the parent is exposed to both risks. Creating this stronger link will act to limit possible sheltering of risks from hedging instruments.

39. Now consider a one legged derivative (such as a forward contract) under the functional currency approach. As a minimum, the entity holding the derivative must have the same functional currency as the parent that is hedging the NI. Movements in the value of the derivative will be measured based on the functional currency of the entity holding it. Thus, the movements will be

valued in the same way as the movements in the NI against the functional currency of the parent entity hedging it, and the hedge will be effective.

40. However, as with the external borrowings, the staff believe that the exposure should be received by the parent entity with the hedged item by way of intra-group transactions to ensure that the link between the hedging instrument and the NI is stronger than just being measured at the same value. Further to this when the effect of the derivative is passed on to the parent entity through intra-group transactions, all gains and losses on the intra-group transactions should be reflected in profit or loss. This ensures the exposure, external to the group, is transmitted to the parent holding the NI.

41. Finally, in a two legged derivative (such as a swap), the functional currency of the entity holding the hedging instrument does not matter. This is because the value of a swap is not measured based on the functional currency of the entity holding it. Thus any entity with in the group could in theory hold the external derivative. However, again the staff believe that the risk must be transferred to the parent wishing to hedge its NI, in a similar manner as discussed for the borrowings and the one legged instrument.

42. Under the presentation currency view, an entity is hedging the risk of movements in the exchange rates between the functional currency of the NI and the presentation currency of the group. The staff believe that this implies that only the ultimate parent should be able to hedge the NI, even if the functional currency of the ultimate parent is different from the presentation currency. Any hedging instrument can be used, as discussed under the functional currency approach. The staff do not believe that the external hedging instrument must be held by the ultimate parent, but the risk must be transferred up to the ultimate parent entity through intra-group transactions as discussed under the functional currency approach in paragraphs 38–41.

43. The staff have argued that the risk should be transferred to the entity with the hedge risk. It is noted that IAS 39 paragraph IG F2.14 does not require the operating unit exposed to the risk to be a party to the hedging instrument for a cash flow hedge. As stated above in paragraphs 38–41 the staff believe that a hedge of a NI requires a stronger link between the hedging instrument and the

hedge risk. This ensures that the exposure, external to the group, arising from the hedging instrument is transferred to the parent entity hedging the NI.

44. The concern with allowing any transaction exposure to offset a translation exposure, simply because they are measured at the same amount, is that the hedge of a NI 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 NI.

45. **Does the IFRIC agree that the risk arising from the hedging instrument must be held by the parent seeking to hedge its NI? If not what would be suggested instead?**

D RELEVANCE OF US GAAP TO THIS PROJECT

46. US GAAP discusses, in more detail than IFRSs, the accounting for a hedge of a NI. As noted in November 2006, FAS 52 and IAS 21 are based on the same underlying principles. However, some notions in both IAS 39 and FAS 133 are very different; thus the staff does not believe that adopting US GAAP outright is the best way forward. Below is a comparison of the differences between the staff proposals and US GAAP and whether the staff believe it is worth creating divergence to achieve a better standard.

47. Paragraph 94 of the basis for conclusions of FAS 52 *Foreign Currency Translation* states the following:

> '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 specifically indicates that the entity that holds a NI is exposed to foreign currency fluctuations which are measured based on the entity's functional currency. This gives weight to the functional currency argument. US GAAP specifically states the hedged risk is the movements between the functional currency of the NI and the functional currency of the *immediate* parent. This gives rise to the first difference compared to the staff's proposals because the staff would allow any parent entity to hedge the

exposure between its functional currency and the NI. Thus US GAAP is more restrictive on what the hedged risk is.

48. US GAAP allows any entity within the group 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, or to which the exposure on the external hedging instrument is passed, 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.

49. Further, US GAAP under FAS 133 allows an entity to use internally generated derivative contracts as hedging instruments in group financial statements. IAS 39 does not allow this in group financial statements.

50. This raises the question of whether these differences create a sufficiently improved standard compared to FAS 52 and FAS 133. The staff believe it is necessary to consider the accounting for the hedge of a NI conceptually first before defaulting to US GAAP without exploring what the best outcome should be.

51. The staff notes that even if convergence with US GAAP is not achieved on this point, compliance with an IFRS reflecting the staff's views would not prevent entities from simultaneously complying with US GAAP. 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.

D SUMMARY

52. The paper highlights the following issues:

    (a) Consolidation guidance: whether guidance, stating that IAS 21 does not stipulate a specific method of consolidation, would sufficiently solve the issues raised in this paper?

        The staff do not believe it would because there will be the unanswered question of what the risk is in a hedge of a NI.

(b) The NI in a hedge of a NI: whether a hedge of a NI is similar to a cash flow hedge by which the entity is hedging a future dividend payment, or whether the entity is hedging the assets recognised in the financial position, similar to a fair value hedge?

The staff believe it is more in line with a fair value hedge.

(c) The hedged risk: is it the difference between the functional currency of a parent and that of its (direct or indirect) NI or is it the difference between the presentation currency of the group and the functional currency of the NI?

The staff believe the hedged risk is the economic risk arising from the functional currency of a parent and that of its (direct or indirect) NI.

(d) The hedging instrument: what type of instrument? Where can it be held? And is it effective?

The staff believe that any normal hedging instrument can be used but it must be held by the entity with the exposure to the NI, or passed to that entity through one or more intragroup transactions that generate foreign currency gains or losses in profit or loss.

APPENDIX A – EXAMPLE OF A HEDGE OF A NI

A1. 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 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)