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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:** **May 2007, London**

**Project:** **Hedging of a Net Investment in a Foreign Operation – Sweep Issues (Addendum to Agenda Paper 6)**

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*This addendum supplements Agenda Paper 6 paragraphs 6 – 13*

## DISCUSSION – TRANSLATION TO A PRESENTATION CURRENCY

1. The staff have reconsidered the analysis and recommendation included in paragraphs 6 – 13 of Agenda Paper 6. The recommendation had indicated:

> When the two currencies of a derivative instrument are the same as the functional currency of the parent hedging its risk and the functional currency of the net investment in a foreign operation (net investment), the functional currency of the entity holding the derivative instrument has no relevance to the effectiveness of the hedging instrument.

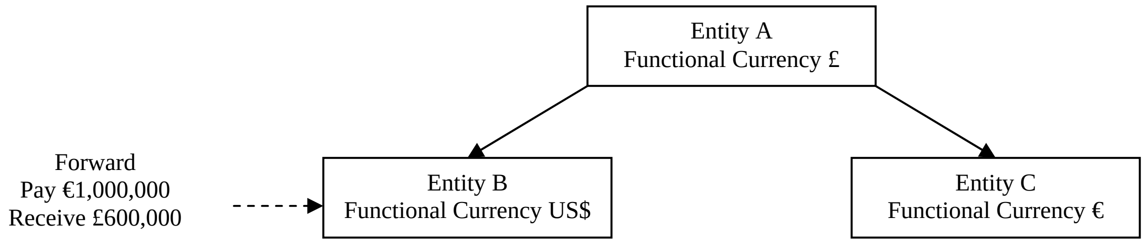
2. The staff now believe that this is incorrect. The value of the derivative instrument is measured based on the two currencies in the contract. However, the derivative must then be recognised in the financial statements of the entity holding (ie it must be measured in the functional currency of that entity). At each subsequent period end, the derivative must be remeasured to fair value based on the two currencies in the contract and recognised at the closing rate in the functional

currency of the entity holding it. Opening period and closing period foreign exchange rates can fluctuate considerably. This can create a significant difference between the amount that is recorded in consolidated profit or loss when the instrument is held by the parent hedging its risk, compared to the amount recorded in consolidated profit or loss when the instrument is held by an entity with a functional currency that is different from the parent entity.

3. The following example highlights this. The example has a derivative instrument that has a fair value at the beginning of the period and at the end of the period. The example highlights the fact that the functional currency of the entity holding the hedging instrument affects the amount recorded in consolidated profit or loss.

**Example of a Hedge of a Net Investment Using a Forward Contract**

4. Entity A has a functional currency of Pound Sterling (£) and holds two investments – Entity B (functional currency of United States Dollars (US$)) and Entity C (functional currency of Euro (€)). At 31 December 20X1 Entity A is hedging its net investment in Entity C (the £ / € exposure) using a forward contract held by Entity B. The forward contract is pay €1,000,000 receive £600,000 and it matures on 1 January 20X3.




5. Below are the detailed calculations of the value of the forward.

Spot exchange rates are as follows:

| | 31/12/X1 | 31/12/X2 | Average X2 |
|---|---|---|---|
| £ / € | 2.000 | 2.300 | 2.150 |
| £ / US$ | 2.200 | 1.800 | 2.000 |
| US$ / € | 0.909 | 1.278 | 1.093 |

At 31/12/X1 one year interest rates are as follows:

| | |
|---|---|
| £ | 5.00% |
| US$ | 5.50% |
| € | 4.50% |

The fair value of the forward contract is as follows:

| | 31/12/X1 | *Calculations* | 31/12/X2 | *Calculations* |
|---|---|---|---|---|
| £ | 92,960 | *(600,000 / (1 + 0.05)) – (((1000,000 / (1 + 0.045)) / 2.000)* | 165,217 | *600,000 – (1,000,000 / 2.300)* |
| US$ | 204,511 | *((600,000 / (1 + 0.05)) * 2.20) – ((1000,000 / (1 + 0.045)) / 0.909)* | 297,391 | *(600,000 * 1.800) – (1,000,000 / 1.278)* |
| € | 185,919 | *((600,000 / (1 + 0.05)) * 2.000) – (1000,000 / (1 + 0.045)* | 380,000 | *(600,000 * 2.300) – 1,000,000* |

## Scenario 1 - Forward contract held by Entity A

The forward contract is held by Entity A. Entity A's opening consolidated balance sheet shows:

| | £ | | |
|---|---|---|---|
| Forward contract | 92,960 | | |

Entity A's closing consolidated balance sheet shows:

| | £ | | |
|---|---|---|---|
| Forward contract | 165,217 | | *(92,960 + 72,257)* |

The journal entries in Entity A's own and consolidated accounts for y/e 31/12/X2 are as follows:

| | £ | £ | *Calculations* |
|---|---|---|---|
| Dr Forward contract | 72,257 | | *(165,217 – 92,960)* |
| Cr Profit and Loss | | 72,257 | |

*-being the profit arising from remeasuring the forward contract in GBP*

## Scenario 2 – Forward contract held by Entity B

The forward contract is held by Entity B. Entity B's opening balance sheet shows:

| | US$ | *Calculations* |
|---|---|---|
| Forward contract | 204,511 | *(92,960 * 2.200)* |

Entity B's closing balance sheet shows:

| | US$ | *Calculations* |
|---|---|---|
| Forward contract | 279,391 | *(165,217 * 1.800)* |

The journal entries in Entity B's own accounts for y/e 31/12/X2 are as follows:

| | US$ | US$ | *Calculations* |
|---|---|---|---|
| Dr Forward contract | 92,880 | | *(297,391 - 204,511)* |
| Cr Profit and Loss | | 92,880 | |

*-being the profit arising from remeasuring the forward contract in US$*

Entity A's closing consolidated balance sheet shows:

| | £ | £ | *Calculations* |
|---|---|---|---|
| Forward contract | £165,217 | | *(297,391 / 1.800)* |

Translation journal entries in Entity A's consolidated accounts to translate Entity B's financial statements:

| | | | |
|---|---|---|---|
| Dr Forward | 46,440 | | *(92,880 / 2.000)* |
| Cr Profit and Loss | | 46,440 | |

*-being the translation of B's USD profits into GBP at the average rate*

| | | | |
|---|---|---|---|
| Dr Forward | 5,160 | | *(92,880 / 1.800) – (92,880 / 2.000)* |
| Cr Equity | | 5,160 | |

*-being the retranslation of Entity B's USD profits into GBP at the closing rate*

| | | | |
|---|---|---|---|
| Dr Forward | 20,657 | | *(204,511 / 1.80) – (204,511 / 2.200)* |
| Cr Equity | | 20,657 | |

*-being the retranslation of Entity B's opening USD balance sheet into GBP at the closing rate*

**Hedge Effectiveness**

Assuming €1,000,000 of Entity C's net assets are subject to the hedge, the whole of the forward contract is used as the hedging instrument and effectiveness is assessed by comparing the changes in the value of the forward contract to changes in the value of €1,000,000 attributable to forward exchange rates.

| | 31/12/X1 | *Calculations* | 31/12/X2 | *Calculations* |
|---|---|---|---|---|
| Forward £ / € rates to 1/1/X3 | 1.972 | *1,000,000 / (600,000 – 92,960)* | 2.30 | *1,000,000 / (600,000 – 165,217)* |
| £ value of €1,000,000 at forward rate | £507,040 | *(1,000,000 / 1.972)* | £434,783 | *(1,000,000 / 2.30)* |
| Change in value of net investment | | | (£72,258) | *(434,783 – 507,040)* |
| Profit or loss – Scenario 1 | | | £72,258 | 100% effective |
| Profit or loss – Scenario 2 | | | £46,440 | 64% effective |

6. When a forward contract is held by a parent entity hedging its net investment risk (Scenario 1 in the example), the amount recorded in profit or loss would be expected to offset the foreign currency risk arising on the net investment. In the example, Scenario 1 is 100% effective. However, when the forward contract is held by an entity with a different functional currency (Scenario 2), the change in value of the forward contract is based on the currencies in the contract, but is then translated at average rates into the functional currency of the entity holding it. The amount recorded in consolidated profit or loss on the derivative instrument is affected by the functional currency of the entity holding it. Accordingly, the derivative instrument in Scenario Two is not effective.

7. In Scenario 2 of the example, the amount recorded in profit or loss (£46,440), when combined with the amounts in foreign currency translation reserve relating to that derivative (£5,160 and £20,657), will give rise to the same amount that would be recorded in profit or loss had the derivative instrument been held by Entity A (£72,257). This raises the same question that IFRIC discussed regarding situations in which the hedging instrument is borrowings. IFRIC concluded that only the amount recorded in profit or loss should be considered when determining the eligibility of a hedging instrument that is a non-derivative instrument. Should this guidance also apply to a derivative instrument? The staff believe it should.

8. Thus, the staff conclude that the functional currency of the entity holding the instrument is relevant for both a derivative instrument and a non-derivative instrument. Further, the staff believe that the discussion in paragraphs 1 – 7 does

not change the tentative decision made by IFRIC on the non-derivative instrument. Moreover, it highlights that the functional currency of the entity holding the instrument is important, regardless of the type of instrument, in assessing whether a hedging instrument is eligible for hedge accounting. This raises the question whether guidance in the IAS 39 *Financial Instruments: Recognition and Measurement* Implementation Guidance Question F2.14 (F2.14) is correct in stating the hedging instrument can be held anywhere within the group.

## ALTERNATIVES

9. The staff have identified a number of options the IFRIC could take when dealing with the hedging instrument in a hedge of a net investment. Appendix A provides possible wording changes to the [draft] Interpretation based on each option. [Appendix A has not been provided to Observers]

### Option One – F2.14 does apply to net investment hedging but internal instruments or intra-group loans must pass the risk on to the parent hedging its risk

10. The IFRIC concluded at the March 2007 IFRIC meeting that when a non-derivative instrument is held by an entity with a different functional currency from the parent hedging its risk, the instrument will not be eligible for hedge accounting. Paragraphs 14 to 24 of Agenda Paper 6 discuss whether an entity can transfer the risk from the entity with the external instrument to the entity with the exposure to ensure the instrument will qualify for hedge accounting. The staff recommended in Agenda Paper 6 that an intra-group loan and the external borrowings, together, can qualify for hedge accounting.

11. Based on the discussions in paragraph 1 – 8 above and following on from the recommendation in Agenda Paper 6, the staff believe that when an entity with a different functional currency from the parent hedging its net investment risk holds a derivative instrument, that instrument can be passed on to the parent through internal contracts, creating an eligible hedging instrument. This would result in the same requirements for both derivative and non-derivative hedging instruments. The arguments for and against using internal contracts are laid out in paragraphs 14 – 24 of Agenda Paper 6. Requiring internal contracts would ensure that the guidance in F2.14 survives, however, only when internal contracts are in

place that transfer the risk from the external instrument on to the parent entity would an eligible hedging instrument (ie the external and the internal instruments) be achieved.

**Option Two – F2.14 does apply to net investment hedging, but an amendment should be made highlighting that the functional currency of the entity holding the instrument could affect the effectiveness of the hedging instrument.**

12. The amount recorded in consolidated profit or loss on a derivative or a non-derivative instrument is affected by the functional currency of the entity holding it. F2.14 states that as long as the other hedge accounting criteria are met, then it will not matter where the hedging instrument is held. However, some staff believe that this guidance could be enhanced by indicating how the functional currency of the entity holding the instrument can affect the amount that is included in consolidated profit or loss, and thus the eligibility of the hedging instrument.

13. The IFRIC could propose guidance in a [draft] Interpretation that overrides the guidance in F2.14, or the IFRIC could suggest an amendment to F2.14 though the annual improvements process. Either option would clarify the statement in F2.14 that that the functional currency of the entity holding the instrument could affect the eligibility of the hedging instrument.

**Option Three – Complete both Options One and Two**

14. As an extension of Options One and Two, the IFRIC could propose guidance that the functional currency of the entity holding the instrument does matter (ie either in the [draft] Interpretation or through the annual improvements project). At the same time the [draft] Interpretation could also allow entities to pass the foreign currency risk arising on the external contract, through internal contracts, to the parent entity hedging its net investment risk.

**Option Four – F2.14 applies to the hedge of a net investment and there is no requirement to use internal instruments – ie the translation gain or loss can be used as part of the hedging instrument.**

15. This option would allow an entity to hold a hedging instrument anywhere within the group. However to obtain a qualifying instrument that would be effective

both prospectively and retrospectively, the amounts included in the foreign currency translation reserve (ie the £5,160 and the £20,657) must be considered when testing effectiveness.  If the foreign currency translation reserve is not included in the effectiveness tests the instrument may not be deemed eligible. Scenario 2 of the example in paragraph 5 identifies situations in which the average exchange rate has fluctuated greatly from the closing exchange rate which result in the hedging instrument being ineffective.

16. This option would ensure that F2.14 still applies to the hedge of a net investment, but it would also allow translation gains and losses, recognised in equity, to be used as part of the hedging instrument.

**Option Five – Include no guidance in the [draft] Interpretation on where the hedging instrument can be held**

17. Some staff believe that the [draft] Interpretation should not include any guidance on the hedging instrument.  The request for consideration received by IFRIC did not consider the hedging instrument.  Further, IAS 39 provides guidance on the hedging instrument.  Thus, these staff believe that F2.14 is sufficient because it states that the other hedge accounting criteria in IAS 39 must be met.

**Staff conclusions**

18. The staff believe that the work completed during this project on the hedging instrument has been beneficial and should be included in any interpretation issued by IFRIC.  F2.14 discusses the amount recorded in consolidated profit or loss, it does not mention that such an amount is dependent on the functional currency of the entity holding the instrument.  F2.14 does not appear provide sufficient guidance.  Accordingly, the staff recommend either Option One or Three.

**19. The staff ask IFRIC which option they prefer?**

**[Appendix A has not been provided to Observers]**