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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 (Agenda Paper 6)**

INTRODUCTION

1. At the March 2007 IFRIC meeting, the IFRIC reached a consensus on the accounting for a hedge of a net investment in a foreign operation (net investment). The consensus indicated that, in the hedge of a net investment:

   (a) the hedged risk is the foreign currency exposure arising between the functional currency of the net investment and the functional currency of any parent entity (the immediate, intermediate or ultimate parent), and not the group presentation currency; and

   (b) the functional currency of the entity holding the hedging instrument will be relevant when the foreign currency exposure arising from that hedging instrument is measured by reference to the functional currency of the entity holding it.

2. Draft text of the staff's proposed [draft] Interpretation is provided in Agenda Paper 6(i) (marked-up) and Agenda Paper 6(ii) (clean). [Draft Interpretation not provided to Observers]

3. This paper outlines the following sweep issues for a hedge of a net investment:

   (a) reconsideration of the decision made by IFRIC at the March meeting regarding where the hedging instrument can be held;

   (b) whether, when a hedging instrument is borrowings undertaken by an entity with a different functional currency to the parent entity hedging its risk, the borrowings can be on lent through an intra-group loan to the parent entity, to obtain an eligible hedging instrument;

   (c) whether an entity should look through its directly held net investment to establish its foreign currency exposure at a lower level; and

   (d) consideration of the effective date and transitional provisions.

STAFF RECOMMENDATIONS

4. The staff recommend:

   (a) **the functional currency of the entity holding the hedging instrument will be relevant when the foreign currency exposure arising from that hedging instrument and recognised in consolidated profit or loss is measured by reference to the functional currency of the entity holding it. That is, confirming the decision made at the March 2007 IFRIC meeting;**

   (b) the [draft] Interpretation allows an entity to use an internally generated loan as a hedging instrument;

   (c) the [draft] Interpretation does not restrict an entity from hedging the full carrying amount of its net investment if that net investment has other lower level net investments; and

   (d) the [draft] Interpretation be applied prospectively.

5. The staff also recommend that the IFRIC approve the [draft] Interpretation, subject to drafting and the decisions made in this meeting.

DISCUSSION – TRANSLATION TO A PRESENTATION CURRENCY

6. During the review of the [draft] Interpretation, a question was raised on the accuracy of the IFRIC Update issued in March 2007. IFRIC Update stated:

> 'In the IFRIC's example a foreign currency swap contract is held as a hedge of a net investment by another group entity; the two currencies in the swap are the same as the functional currencies of the investing entity and its net investment. The IFRIC concluded that in such a case *the functional currency of the entity holding the hedging instrument has no relevance to the effectiveness of the hedging instrument*, which would have the same value at current exchange rates no matter what the functional currency of the entity holding it.' [Emphasis added]

Fur further information on this decision please refer to paragraphs 15 to 18.

7. If an entity holds a derivative instrument with a non zero fair value at the beginning and the end of the period, there will be a foreign currency translation gain or loss recorded in equity in the consolidated financial statements on translation of that derivative instrument to the presentation currency of the group. This is because the opening carrying amount of the derivative instrument has been translated at a closing rate that differs from the previous year's closing rate, creating a foreign exchange gain or loss that is recorded in equity.[1] The foreign exchange translation gain or loss recorded in equity is calculated based on the exchange rate movement between the functional currency of the entity holding the instrument and the presentation currency of the group. Accordingly, the foreign currency translation gain or loss recorded in equity when creating consolidated financial statements is dependent on the functional currency of the entity holding the instrument.

8. Paragraph 7 discusses the translation gain or loss recognised when translating the opening fair value of the derivative asset or liability at different closing rates. There is also a difference created when an entity recognises a derivative asset or liability at closing rates but recognises the income or expense arising on

[1] IAS 21 paragraph 41(b).

that derivative at the exchange rate at the date of the transaction (or average rates).[2] An amount is recorded in equity that is determined based on the exchange rate movements between the functional currency of the entity holding the instrument and the group presentation currency.

9. The question raised is whether the statement in IFRIC Update, that the functional currency of the entity holding the derivative instrument has no relevance to the effectiveness of the hedging instrument, was correct.

10. The staff believe that IFRIC Update is correct. The gain or loss recorded in profit and loss determines whether an instrument qualifies for hedge accounting. The foreign exchange gain or loss recorded in profit or loss from the derivative instrument (in the example, a foreign currency swap contract) is not affected by the functional currency of the entity holding it. It is determined by the currencies identified in the contract. Only the amount recorded in equity on consolidation is affected by the functional currency of the entity. The same exchange gain or loss would be included in consolidated profit or loss regardless of the functional currency of the entity holding that instrument.

11. In contrast to the derivative instrument, the amount recorded in profit or loss on a non-derivative instrument (such as borrowings) is determined by reference to the functional currency of the entity holding it. Accordingly, the functional currency of the entity holding the non-derivative instrument is relevant when determining whether an instrument qualifies for hedge accounting. In a similar manner to the borrowings, the amount that is recorded in equity on translation to the consolidated financial statements should not be considered when determining whether an instrument qualifies as a hedging instrument.

12. The derivative and the non-derivative instrument will qualify for hedge accounting based on the foreign currencies that determine the amount that is recorded in profit or loss in consolidated financial statements.

13. **The staff believe the decision made at the March meeting is correct and the guidance included in the [draft] Interpretation regarding where a hedging instrument can be held should not be changed. Does the IFRIC agree?**

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[2] IAS 21 paragraph 41(a).

DISCUSSION – PASSING ON THE INSTRUMENT

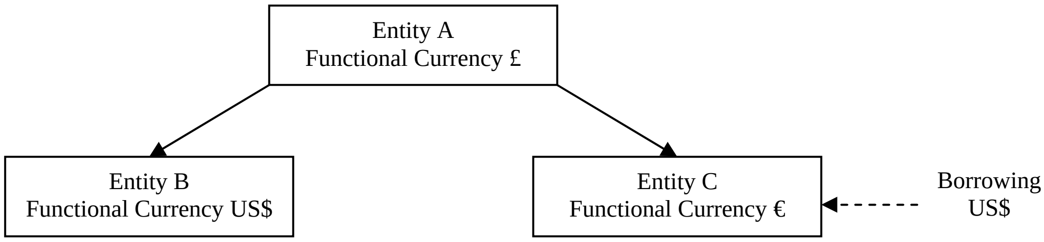
14. At the March 2007 meeting, the IFRIC decided that Question F2.14 in the Implementation Guidance of IAS 39 *Financial Instruments: Recognition and Measurement* applies to the hedge of a net investment. In a hedge of a NI, the parent entity exposed to the risk being hedged does not need to hold the hedging instrument for it to qualify for hedge accounting. However, the IFRIC qualified this guidance by stating that in situations where the hedging instrument was a non-derivative instrument held by an entity with a different functional currency to the parent entity hedging its risk, that non-derivative instrument would not qualify for hedge accounting in the consolidated financial statements.

15. The IFRIC discussed two different hedging instruments – one a forward contract and the other borrowings. The IFRIC agreed the following points regarding each instrument:

    (a) The foreign exchange gain or loss on a forward contract is measured based on the two currencies identified in the contract. The functional currency of the entity holding the forward contract does not impact the measurement of the foreign currency exposure from that instrument. The same amount is recorded in consolidated profit or loss regardless of the functional currency of the entity holding the forward contract. If the two currencies in the forward contract are the same as the functional currency of the net investment and the functional currency of the parent hedging its net investment, it is expected that the instrument will qualify for hedge accounting, all other things being equal.

    (b) The foreign currency gain or loss on a non-derivative instrument (such as borrowings) arises when the borrowing is denominated in a currency that is different to the functional currency of the entity undertaking them. The functional currency of the entity holding the instrument determines the amount recorded in profit or loss. Borrowings denominated in the same currency as the functional currency of the net investment will only qualify for hedge accounting when they are held by an entity with the same functional currency as the parent, all other things being equal.

16. The following example explains this. Entity A has a functional currency of Pound Sterling (£) and holds two investments – Entity B (functional currency of United States Dollars (US$)) and Entity C (functional currency of Euro (€)). Entity A wishes to hedge its net investment in Entity B (the £ / US$ exposure).



17. If Entity C undertakes a US$ borrowing, a foreign currency exposure is recorded in profit or loss (assuming no hedge accounting) which is measured based on the US$ / € exchange rate (ie the denomination of the borrowings and the functional currency of the entity holding the borrowings). The exposure on the net investment arises from the £ / US$ exchange rate (ie the functional currencies of the parent and the net investment). Therefore, the IFRIC concluded that the borrowing when held by Entity C will not qualify as a hedging instrument because it is not creating a foreign currency exposure that will offset the foreign currency exposure on the net investment.

18. Now consider the same example, however, Entity C on lends the borrowing to Entity A through an intra-group loan. Entity A now has an exposure to US$ arising from the intra-group loan that will affect profit or loss and is measured based on the functional currency of Entity A (a £ / US$ exposure). Entity C has an exposure from the external borrowing and an equal but opposite exposure from the intra-group loan to Entity A (assuming the borrowing and the loan are the same notional value). The foreign exchange risk from the intra-group loan held by Entity A would (all other things being equal) be expected to offset the foreign currency risk from the net investment in Entity B.

19. Some staff believe that such an intra-group loan can be used as a hedging instrument because the foreign currency gain or loss on the intra-group loan is

not eliminated on consolidation but is included in consolidated profit or loss[3]. Even though the intra-group loan itself is eliminated, because the two entities transacting have different functional currencies the foreign currency gain or loss on the intra-group loan is not eliminated. Accordingly, if the intra-group loan is designated as a hedging instrument along with the external borrowings, the gain or loss that would normally survive in consolidated profit or loss is removed and recorded in equity against the foreign currency translation reserve arising from the net investment.

20. Further to this, in many group structures with a number of different entities, existing corporate practice is that one entity within a group will complete all of the group's cash borrowings. Thus allowing an entity to use an intra-group loan to hedge its net investment would ensure that current business practice can be preserved.

21. However, other staff argue that IAS 39 is clear in stating that a hedging instrument is not allowed to be an internal contract. Paragraph 73 of IAS 39 states 'only instruments that involve a party external to the reporting entity … can be designated as hedging instruments'. In the example in paragraphs 16 and 17, the intra-group loan held by Entity A is an internal contract.

22. Any guidance included in the [draft] Interpretation that allows an entity to use an intra-group loan as a hedging instrument would require an amendment to IAS 39. It is correct to state that there is an amount that is not eliminated on consolidation, however this amount is not derived from an external transaction. The staff note that an amendment was made to IAS 39 that allowed the foreign exchange gain or loss on an intra-group transaction to be a hedged item, however it did not discuss whether such an amount can be a hedging instrument. To provide such guidance would in some staff's view require a similar amendment to IAS 39. Further, some staff believe that if such an amendment was made, it would be difficult to argue that the guidance should only apply to a hedge of a net investment; it would have to apply to all hedge relationships.

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[3] This is assuming the intra-group loan is not considered to be a monetary item for which settlement is neither planned nor likely to occur in the foreseeable future (refer paragraph 15 and 15A of IAS 21). If the intra-group loan is not expected to be settled in the foreseeable future, the foreign currency gains or losses on that intra-group loan can be included in equity as it is considered to be part of the net investment.

23. FAS 138 *Accounting for Certain Derivative Instruments and Certain Hedging Activities* allows an entity to use an internal contract as a hedging instrument when hedging foreign currency, and for this reason the IASB considered including similar guidance in IAS 39 during 2003. The IASB concluded that a hedging instrument cannot be an internal contract. Paragraphs BC 169 and 170 of IAS 39 identify the reasons behind the IASB decision. One of the main reasons was that it is conceptually wrong to permit an entity to recognise internally generated gains and losses through internal transactions. Further, the fundamental principle of consolidation is that intra-group balances are eliminated in full. Accordingly, the Board decided that there should be no exception to allow internal contracts as hedging instruments. Therefore, some staff believe it would be difficult to argue that the guidance in IAS 39 should be reconsidered and amended for hedges of a net investment.

24. The staff present two views:

View 1 An entity can use an intra-group borrowing as a hedging instrument to hedge the foreign currency risk arising from a net investment subject to the requirements of IAS 39 and the [draft] Interpretation.

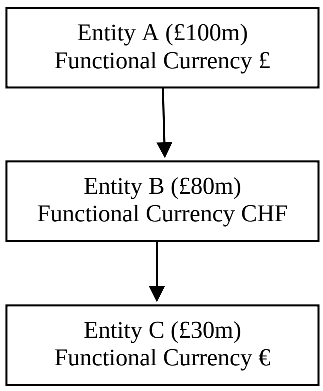
View 2 An entity cannot use intra-group borrowings to hedge the foreign currency risk arising from its net investments because IAS 39 does not permit an internal contract to be used as a hedging instrument.

The staff have included View 1 in the current draft wording of the Interpretation. Does the IFRIC prefer View 1 or View 2?

Discussion – What exposure arises from the net investment?

25. This section looks specifically at whether an entity should look through its directly held net investment to consider the full extent of its foreign currency exposure at the lowest possible level of net investment. Consider the following example where Entity A holds a 100 percent investment in Entity B and Entity B holds a 100 per cent investment in Entity C:

- Entity A – functional currency of pound sterling (£) with a carrying amount of £100m, including (where relevant) any net investments it holds;
- Entity B – functional currency of Swiss Francs (CHF) and a carrying amount of £80m, including (where relevant) any net investments it holds; and
- Entity C – functional currency of Euro (€) with a carrying amount of £30m including, (where relevant) any net investments it holds.



26. Entity A wants to hedge the risk arising from its net investment in Entity B. What is the amount of the hedged risk to changes in the £ / CHF exchange rate that Entity A is exposed to? Is Entity A's exposure the £80m equivalent of CHF? Or should Entity A look through its investment in Entity B to its investment in Entity C and assess its exposure to be £50m of CHF exposure and £30m of € exposure in Entity C?

27. The amount of Entity A's risk in Entity B is affected by exchange rate movements between the functional currency of Entity B and the functional currency of Entity C. Some staff believe the exchange rate movements between Entity B and Entity C should not be included as part of the hedge of exchange rate movement between Entity A and Entity B. Accordingly, some staff conclude that when hedging a net investment, an entity should be required to assess the full extent of its exposure by looking through the net investment it is

hedging to assess whether there are lower level net investments that give rise to exposures in other functional currencies.

28. Other staff argue that IAS 39 does not require an entity to reduce its risk when using hedge accounting. Any [draft] Interpretation should not impose restrictions by forcing an entity to reduce its risk. For example in a cash flow hedge in which an entity is hedging the foreign exchange risk arising from a future cash payment, that entity is not required to assess if it has any receivables in the same foreign currency before determining the extent of its exposure to that currency, and thus the amount it can hedge. IAS 39 does not prohibit an entity from choosing to hedge an amount that is greater than the net amount of its exposure. Accordingly, some staff argue that an entity should not be prohibited from hedging the full extent of the carrying amount of the net investment, as long as they are not hedging the same risk twice in the same consolidated financial statements.

29. The staff provide two alternative views:

View 1 When an entity holds a net investment, that itself holds other net investments, the entity should determine the functional currency exposures from all lower level net investments before determining the amount of the net investment it can hedge;

View 2 An entity can hedge up to the full extent of its carrying amount in a net investment regardless of whether that net investment has investments in other foreign operations because IAS 39 does not require a risk reduction notion when using hedge accounting.

The staff have included View 2 in the current draft wording of the Interpretation. Does the IFRIC prefer View 1 or View 2?

EFFECTIVE DATE AND TRANSITIONAL PROVISIONS

30. During the review of the [draft] Interpretation, a question was raised about the possible implications of the proposed effective date and transitional provisions. The [draft] Interpretation stated:

> **Effective Date**
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> An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date to be set at three months after the Interpretation is finalised]. Earlier application is permitted. If an entity applies this [draft] Interpretation for a period beginning before [above date], it shall disclose that fact.
>
> **Transition**
>
> IAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an [draft] Interpretation. An entity is not required to comply with those requirements when first applying the [draft] Interpretation. If an entity uses this exemption, it shall apply this [draft] Interpretation to arrangements existing at the start of *the earliest period for which comparative information under IFRSs is presented* on the basis of facts and circumstances existing at the start of that period.1 [Emphasis added]

31. Some commentators believe that the transitional provisions do not provide sufficient relief. IAS 39 requires contemporaneous designation of the hedging instrument to obtain hedge accounting. This could lead to a gap between when the [draft] Interpretation becomes effective and when an entity can actually begin applying it. For example, an entity preparing 31 December 2008 year end financial statements would need to have all hedging designation and documentation in place by 1 Jan 2007. So if the [draft] Interpretation became effective during the 2008 year, entities may not be able to apply it until the following year. For those entities that have to present an additional comparative period, such as SEC registrants, this could present even further delays.

32. The staff believe the IFRIC could:

View 1 retain the current wording and provide a question in the Invitation to Comment on whether the IFRIC should maintain its preferred transitional provisions (application from the earliest period for which comparative information is presented); or

View 2 allow entities to prospectively apply the [draft] Interpretation

The staff have included View 2 in the current draft wording of the Interpretation. Does the IFRIC prefer View 1 or View 2?