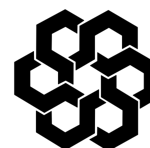

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **19 June 2008, London**

Subject: **Ratification of IFRIC Interpretations**

Cover note for *Hedges of a Net Investment in a Foreign Operation* (Agenda paper 7C)

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1. This paper asks the Board to ratify an Interpretation on hedging net investments in foreign operations.

2. Draft Interpretation D22 was published in July 2007 with a comment deadline of 19 October 2007. The IFRIC received 45 comments letters.

3. In general the comment letters supported the IFRIC's developing an Interpretation on the issues and the conclusions set out in D22. However, commentators asked the IFRIC to clarify some of the matters discussed and explain its rationale more fully. The IFRIC confirmed the consensuses in D22 but has redrafted the Interpretation to improve clarity, added more detailed examples to illustrate their application and added explanations to the Basis for Conclusions. The Basis for Conclusions sets out the changes made to D22 in more detail.

4. After reconfirming its consensuses in January, the IFRIC directed the staff to develop examples to illustrate their application in a variety of circumstances. The IFRIC considered these examples at its meeting in March and was satisfied that the results of its decisions x were appropriate when applied in practice. The models illustrating the application of the consensuses to the structure in the Application Guidance are available from the staff if Board members are interested.

5. The staff would particularly like to thank Jens Berger, Mateusz Lasik and Andrew Spooner of Deloitte for their help in developing the examples. We would also like to thank them and former staff members Lara Pope (E&Y) and Kumar Dasgupta (KPMG) as well as Scott Bandura (PwC) for their assistance in reviewing various drafts of the final Interpretation for clarity and technical accuracy.

Consensuses

6. The IFRIC reached consensuses on the following issues:

    a. the nature of the hedged risk and the amount of the hedged item for which a hedging relationship may be designated:
        * *only functional currencies create hedgeable risks*
        * *an entity may hedge up to the carrying amount of the net assets of the foreign operation in the financial statements of the investor*

    b. where in a group the hedging instrument can be held
        * *the hedging instrument(s) may be held by any entity(ies) within the group as long as the requirements of IAS 39 are satisfied*

    c. what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation
        * *the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge (IAS 39 ¶102)*
        * *the amount included in that parent's foreign currency translation reserve in respect of that foreign operation (IAS 21 ¶48)*

Implications

7. The staff would like to highlight several of the more important implications of the IFRIC's conclusions to assist the Board in reviewing the Interpretation.

Hedging instrument can be held anywhere in the group

8. The IFRIC concluded that any entity within the consolidated group could hold the hedging instrument. This is because the IFRIC concluded that the foreign currency risk should always be viewed from the perspective of the parent entity hedging its net investment. That parent entity may be the immediate, an intermediate or the ultimate parent of the foreign operation.

9. As explained in the Basis for Conclusions (BC26 to BC30), this conclusion is consistent with the Board's conclusion in the amendment it made to IAS 21 in 2006 that a monetary item that is part of the net investment in a foreign operation could be held anywhere in the group. However, it is important to note that in practice, this conclusion permits designations of hedged risks that would not be permitted by IAS 39 for other types of hedges. Consequently, the IFRIC has specifically restricted its conclusions to hedges of net investments and prohibited their application by analogy to other types of hedges (see BC31). The Board similarly limited the use of non-derivatives as hedging instruments to hedges of net investments.

10. The IFRIC has also made it clear that in assessing the effectiveness of a hedge of a net investment the entire change in value of the hedging instrument due to changes in foreign exchange rates is included. Some constituents believed that only the component that IAS 21 requires to be included in profit or loss was permitted to be considered. This would be inconsistent with IFRIC's conclusion that the functional currency of the group entity holding the hedging instrument was not relevant, only the functional currency of the identified parent.

Method of consolidation does not matter

11. In IAS 21 and its Basis for Conclusions the Board made it clear that it would not specify how entities should consolidate their subsidiaries. It chose the method IAS 21 requires for translating financial statements into a presentation currency in large part because either the direct or step-by-step method would produce the same amounts in the consolidated financial statements.

12. Many constituents were of the view that the method of consolidation did matter for hedges of net investments. Some thought that the consolidation method affected the amounts that could be hedged. Some thought that it affected the nature of the hedged risks. As a result of its consideration of the examples presented at its March meeting, the IFRIC concluded that the method of consolidation did not affect hedges of net investments.

13. The IFRIC concluded that the only thing the consolidation method might affect is the amount an entity determines should be reclassified from equity to profit or loss when a foreign operation is disposed of. This issue arises whether or not the net investment is hedged and therefore is actually outside the scope of the Interpretation. However, given the amount of confusion that seems to exist, the IFRIC decided to add two paragraphs to the body of the Interpretation and a brief Illustrative Example to explain the issue. If the Board were to amend IAS 21 for another reason, this material would more appropriately be included there.

14. As part of this discussion, the IFRIC also emphasised that entities were permitted but not required to adjust the foreign currency translation reserves of individual foreign operations to reflect the amounts determined using the direct method of consolidation. The decision to adjust or not is an accounting policy choice.

Consistency with US GAPP

15. The IFRIC's consensuses are not consistent with the requirements of US GAAP for hedges of net investments. However, staff and the IFRIC believe that in many cases the different approaches produce the same results. This discussion is not

included in the Interpretation but the staff thought the Board should be aware that convergence issues had been considered in developing the Interpretation and the results of that consideration.

16. Unlike the consensus, US GAAP requires the hedging instrument to be held by the parent hedging its net investment or by another group entity with the same functional currency as that parent. However, 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. For this reason the IASB considered including similar guidance in IAS 39 during 2003. The IASB concluded at that time that a hedging instrument cannot be an internal contract. The IFRIC could not have adopted a solution consistent with US GAAP without asking the Board to change its conclusion in IAS 39.

17. The IFRIC's consensuses do not impose the restriction on where the hedging instrument may be held or require entities to enter into numerous additional internal contracts. However, they do require an exception to one of the hedging requirements in IAS 39. It seems clear that under both sets of standards it is not possible to achieve results that seem reasonable without making an exception to one requirement or another.

Question for the Board

18. Are you in favour of ratifying the Interpretation?