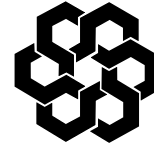

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International Accounting Standards Board

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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: **March 2008, London**

Project: **D22 Hedges of a Net Investment in a Foreign Operation - Illustrative Examples - Cover Note (Agenda Paper 2A)**

Purpose of this paper

1 In the January meeting, the IFRIC directed the staff to develop comprehensive examples that illustrate and test the main D22 conclusions such as:

a) The same risk can be hedged only once in the group.

b) The amount of net investment to be hedged cannot be duplicated.

c) A parent entity can hedge a net investment it holds indirectly.

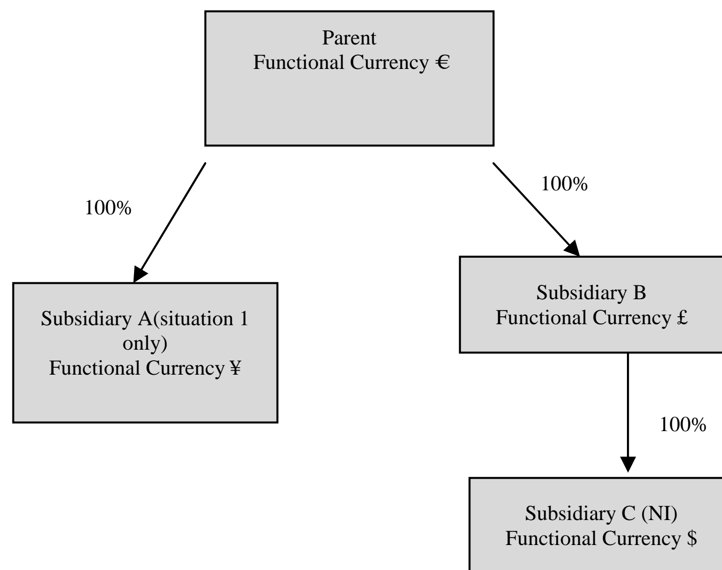
d) Where the hedging instrument is held does not matter to the hedge effectiveness.

e) The consolidation method does not matter to the hedge effectiveness.

f) The nature of the hedging instrument (cash instrument or derivative) does not matter to the hedge effectiveness.

Organisation of the documents

2 The consolidated group used in the examples has a three layer group structure (ultimate parent, intermediate parent and subsidiary). Each group entity has a different functional currency, as illustrated below:



3 We have included four situations that vary where within the group the hedging instrument is held while holding the designated hedged risk constant. Each situation is analysed with both a borrowing and a forward contract as the hedging instrument, and for each type of hedging instrument we illustrate the results for both the direct and step-by-step method of consolidation.

Situation 1 — Hedging instrument held by Subsidiary A

Situation 2 — Hedging instrument held by Subsidiary B (intermediate parent)

Situation 3A — Hedging instrument held by Parent

Situation 3B — Hedging instruments held by Parent (two hedging instruments in two currencies).

4 Differences in the amounts between the examples arise based on whether the rate being hedged is the spot or forward rate (hedging instrument is a borrowing or a forward). There are also some minor differences due to rounding.

5 Each situation has one word file and one spreadsheet file for each type of hedging instrument. Each spreadsheet file has two sheets (see the tabs at the bottom of the screen) – one for the step-by-step method of consolidation and another for the direct method. The files illustrating the forward contract have additional sheets illustrating the calculation of the forward rate amounts. The word file:

- describes the case scenario, both in words and with a diagram, and
- sets out the results of the hedge effectiveness test for each consolidation method and for both the ultimate parent's consolidated financial statements and the intermediate parent's consolidated financial statements, if applicable.

The spreadsheet file has the consolidation worksheets for the opening and closing balance sheets/profit or loss on the top, hedge effectiveness calculation on the left below the worksheets and the journal entries (on separate financial statements and on parent's consolidated financial statements) on the right below.

Assumptions and translation mechanism

6 It should be noted that the examples assume that the amounts received from issuing the debt were immediately exchanged by the borrower into its functional currency on 1 January 2005 (included in "other assets"). Therefore they are not translated at the closing rate in its separate financial statements at the end of the year.

7 The examples use the following translation mechanism:
the opening equity in each foreign operation is translated at the opening rate,
the closing equity is translated at the closing rate,
the income amount is translated at the average rate and

the exchange difference is included in FCTR (foreign currency translation reserve – a component of other comprehensive income. FCTR is equivalent to CTA, cumulative translation reserve, in US GAAP terminology).

8 Therefore, FCTR is sum of

i) the exchange difference on opening equity (opening assets less opening liabilities) between the opening rate and at the closing rate, and

ii) the exchange difference on the income amount between the average rate and the closing rate. (We should note that in some cases there is no difference between translation at the average rate and the year and rate due to the exchange rates being used, but the journal entry is included to indicate what would happen if the amounts were different.)

FCTR arises from each entity during the translation process in the consolidation. In the spreadsheets, we have identified which entity FCTR has arisen from (eg. FCTR (Entity A)). FCTR will be recycled to profit or loss when the parent disposes of its investment (eg. FCTR (Entity A) will be included in profit or loss on Entity A's disposition), therefore FCTR should be tracked by each subsidiary at each level.

Acknowledgements

9 The staff wants to thank Mateusz Lasik and Jens Berger of Deloitte for their valuable help in reviewing the examples of hedging with a cash instrument that we developed and preparing the comparable illustrations of a forward contract hedge. Their comments and those of Lara Pope of Ernst & Young improved the package substantially.

Outcome from the test

10 The staff believes that the attached examples illustrate and confirm the main D22 conclusions in paragraph 1 in this paper as the IFRIC requested. The detailed result for each situation is summarised in the related paper.

11 In particular, Example 3B clarifies the interaction of two principles. By the first principle, Parent can hedge both €/$ risk and €/£ risk because they are not the same risks. However, Parent cannot hedge all of the €/£ risk from Subsidiary B. Hedging the remaining £159m of net assets in Subsidiary B, which represent the net investment in Subsidiary C, would amount to hedging the same net assets, those of Subsidiary C, twice for the same risk, ie retranslation into € It would result in an overhedge of the net investment of Subsidiary B in Parent's consolidated financial statements, because Parent has already hedged the entire €/$ risk from its net investment in Subsidiary C.

12 The examples also illustrate a number of matters of practical application that should be clarified in the final Interpretation. For example, the Interpretation will need to discuss how the amount to be recycled on disposal of a subsidiary should be determined.

Questions for the IFRIC

13 Do you agree with the staff's conclusions in paragraphs 9 to 11? Should the staff begin drafting the final Interpretation reflecting these conclusions? Which of the situations/examples we have illustrated should be included in the Interpretation?