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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: **March 2008, London**
Project: **D22 Hedges of a Net Investment in a Foreign Operation - Other issues (Agenda Paper 7)**

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1 In the cover note for the last meeting (AP6A), the staff identified a number of issues raised in the comment letters that it intended to deal with once the IFRIC had concluded on the main principles of the Interpretation. The staff believe that a number of those questions, reproduced in the Appendix to this paper, are answered by the comprehensive examples prepared for this meeting (see AP2 series). The remainder of the issues are answered below in Q&A style.

2 **Question (a):** Could a parent entity apply hedge accounting in its separate financial statements? How should the hedged amounts be accounted for?

Answer: Yes but as another type of hedge. D22 Paragraph 2 says that hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of the foreign operation are included in the financial statements (its footnote adds that this will be the case for consolidated financial statements, financial statements in which investments are accounting for using the equity method, financial statements in which venturers' interests in joint ventures are proportionately consolidated and financial statement that include a branch). However, in the parent entity's separate financial statements, the investment must be accounted for as an asset measured at cost or as a financial asset measured at fair value in accordance with IAS 39. Accordingly, from the perspective of the parent's separate financial statements, the reporting entity will not have a net investment hedge but it would be possible to designate the hedging instrument in other type of hedge (eg. a fair value hedge of the foreign currency risk arising from the investment) and account for the hedge relationship in accordance with IAS 39. The staff do not believe that this issue needs to be clarified in the Interpretation.

3 **Question (b):** How should an entity account for the ineffectiveness resulting from a decrease in a net investment value during the term of hedge?

Answer: In accordance with IAS 39, all hedge ineffectiveness is recognised in profit or loss. There is no exception for net investment hedges. Paragraph 2 states "The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation." If the foreign operation suffers losses during the hedge period, the carrying amount of the net assets will decrease. This will create an overhedge that would be recognized as ineffectiveness if not corrected. The other possible cause of a decrease in net assets would be a dividend distribution (even though the parent presumably has some control over this). Therefore, if parent expects its foreign operation to make losses or dividend distributions, it may decide to hedge less than the full carrying amount of the net assets, as otherwise it would not be able to satisfy the hedge accounting requirements in accordance with IAS 39 paragraph 88. The staff do not believe that this issue needs to be clarified in the Interpretation.

4 **Question (c):** Should the transitional requirements be clarified?

Answer: Some commentators thought that the transition guidance in D22 was unclear. D22 paragraph 16 says "IAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying the Interpretation. If an entity uses this exemption, it shall apply this Interpretation *prospectively*" (emphasis added).

The staff believe the IFRIC intended entities adopting the Interpretation prospectively to redesignate hedging relationships on adoption but that previous hedge accounting would not be affected. This would be similar to the transition requirements for hedges in IFRS 1, *First time Adoption*, paragraph 30, which refers to IAS 39 paragraphs 91 and 101. The staff think that in this Interpretation it would be helpful to modify the IFRIC's standard transition wording to be consistent with other transition requirements for IAS 39 and to specify them as follows:

> " … when first applying the Interpretation. If an entity had designated a transaction as a hedge of a net investment but the hedge does not meet the conditions for hedge accounting in this Interpretation, the entity shall apply IAS 39 to discontinue prospectively that hedge accounting."

5 **Question (d):** Is an intra-group loan defined by IAS 21 paragraph 15 in the scope of this interpretation? Could such an intra-group loan be a part of the net investment?

Answer: Yes. IAS 21 paragraph 15 clearly says 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 (emphasis added). Therefore, such an intra-group loan is obviously in scope of the

Interpretation. The staff do not believe that this issue needs to be clarified in the Interpretation.

6 **Question (e):** Does a hedge relationship on a lower group level require hedge documentation also on the higher group levels in order for the lower level hedge to qualify for hedge accounting at any higher level?

Answer: No. The hedge relationship on a lower group level should be effective also on the higher group level without further hedge documentation as long as the hedging relationship on a lower group meets hedging requirements under D22 (eg. the requirement to avoid overhedge etc.) even on the higher group level. The staff do not believe that the issue needs to be clarified in the Interpretation.

7 **Question (f):** Should the interpretation include the reason the hedging instruments may not be held by the foreign operation that is being hedged?

Answer: No. The Interpretation should not include the reason as it is obvious. If a hedging instrument is held by the foreign operation being hedged, the hedging instrument would be a part of net investment (that is, the hedging instrument would be part of the hedged item).

Questions for the IFRIC

8 Do you agree with the staff conclusions on these issues?

9 Do you agree that the other questions raised by respondents that are listed in the Appendix are addressed by the comprehensive example?

Appendix A

Questions raised by respondents that are addressed by the comprehensive example

1 How should an entity account for various fact patterns such as:

▪ a foreign operation is held jointly by two intermediate parents with different currencies

▪ a combination of instruments is held by one or several entities within the group to hedge one exposure

▪ Parent A holds subsidiaries B (100%) and C (70%) AND B holds 30% of C, could B's 30% interest qualify as part of the hedged item in A's consolidated financial statements?

2 Should the interpretation indicate that the location of hedging instrument should have no effect on the amounts actually deferred in equity as an effective hedge?

3 Should the interpretation further clarify possible differences in the amounts of the foreign currency translation reserve caused by the method of the consolidation?