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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: **May 2008, London**

Project: **D22 Hedges of a Net Investment in a Foreign Operation – Draft Interpretation (Agenda Paper 3B)**

IFRIC *International Financial Reporting Interpretations Committee*

IFRIC Interpretation XX

Hedges of a Net Investment in a Foreign Operation

IFRIC Interpretation X *Hedges of a Net Investment in a Foreign Operation* (IFRIC X) is set out in paragraphs 1–XX. IFRIC X is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in paragraphs 2 and 7–17 of the *Preface to International Financial Reporting Standards.*

References

- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 21 *The Effects of Changes in Foreign Exchange Rates*
- IAS 39 *Financial Instruments: Recognition and Measurement*

Background

1 Many reporting entities have investments in foreign operations (as defined in IAS 21 paragraph 8). Such foreign operations may be subsidiaries, associates, joint ventures or branches. IAS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in other comprehensive income until it disposes of the foreign operation.

2 Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements.[1] 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.

3 IAS 39 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognised in other comprehensive income and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.

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1 This will be the case for consolidated financial statements, financial statements in which investments are accounted for using the equity method, financial statements in which venturers' interests in joint ventures are proportionately consolidated (subject to change by Exposure Draft ED9 Joint Arrangements issued by the Board in September 2007) and financial statements that include a branch.

4 An entity with many foreign operations may be exposed to a number of foreign currency risks. This Interpretation provides guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation.

5 IAS 39 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This Interpretation provides guidance on where, within a group, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting.

6 IAS 21 and IAS 39 require cumulative amounts recognised in other comprehensive income relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be reclassified from equity to profit or loss as a reclassification adjustment when the parent disposes of the foreign operation. This Interpretation provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.

Scope

7 This Interpretation applies to an entity with net investments in foreign operations that hedges the foreign currency risk arising from those net investments and wishes to qualify for hedge accounting in accordance with IAS 39. For convenience this Interpretation refers to such an entity as a parent entity. All references to a parent entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.

8 This Interpretation does not apply to other types of hedge accounting; it should not be applied by analogy.

Issues

9 Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. The issues addressed in this Interpretation are:

(a) *the nature of the hedged risk and the amount of the hedged item for which a hedging relationship may be designated:*

(i) whether the parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the parent entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the parent entity's financial statements and the functional currency of the foreign operation;

(ii) if the parent entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate parent entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate parent entity (that is, whether the fact that the net investment in the foreign operation is held through an intermediate parent affects the economic risk to the ultimate parent).

(b) *where in a group the hedging instrument can be held:*

(i) whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity in the group, regardless of its functional currency, can hold the hedging instrument;

(ii) whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.

(c) *what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation:*

(i) when a foreign operation that was hedged is disposed of, what amounts from the parent entity's foreign currency translation reserve in respect of the hedging instrument and in respect of that foreign operation should be reclassified from equity to profit or loss in the parent entity's consolidated financial statements;

(ii) whether the method of consolidation affects the determination of the amounts to be reclassified from equity to profit or loss.

Consensus

Nature of the hedged risk and amount of the hedged item for which a hedging relationship may be designated

10 Hedge accounting may not be applied to the foreign exchange differences arising between the functional currency of the foreign operation and the presentation currency of the parent entity's consolidated financial statements.

11 In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been preserved in the parent's consolidated financial statements.

12 The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional

currency of any parent entity (the immediate, intermediate or ultimate parent entity) of that foreign operation. The fact that the net investment is held through an intermediate parent does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate parent entity. However, different methods of consolidation may affect the foreign currency risk that can be hedged merely due to the mechanics of the consolidation methods (see Appendix AG4).

13 An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the net assets of a foreign operation are hedged by more than one parent entity within the group (for example, both a direct and an indirect parent entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate parent. A hedging relationship designated by one parent entity need not be maintained by another higher level parent entity. However, if it is not, the hedge accounting applied by the lower level parent must be reversed before the higher level parent's hedge accounting is recognised.

Where the hedging instrument can be held

14 A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity(ies) within the group (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of IAS 39 paragraph 88 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the group should be clearly documented because of the possibility of different designations at different levels of the group.

15 For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the

functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, the total change in value may be recognised in profit or loss, in other comprehensive income, or both. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

Disposal of a foreign operation

16 When a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the parent in respect of the hedging instrument is the amount paragraph 102 of IAS 39 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.

17 The amount reclassified to profit or loss from the foreign currency translation reserve in the consolidated financial statements of the parent in respect of the net investment in that foreign operation is the amount included in the parent's foreign currency translation reserve in respect of that foreign operation. In the ultimate parent's consolidated financial statements, the aggregate net amount recognised in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the parent uses the direct or step-by-step method of consolidation[2] may affect the amount included in the foreign currency translation reserve in respect of an individual foreign operation. When the hedging instrument is not held by the parent entity hedging its net investment, the use of the step-by-step method of consolidation may result in the reclassification to profit or loss of an amount different from that used to determine hedge effectiveness. This difference may be eliminated by retrospectively determining the amount relating to that foreign operation using the direct method of consolidation. Although this adjustment is not required by the Standard, the amounts of reclassification upon disposal (ie whether this adjustment will be made) should be stated in the hedge documentation at the inception of the hedge and should be followed consistently for all net investment hedges.

[2] The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate parent. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate parent(s) and then translated into the functional currency of the ultimate parent.

Effective date

18 An entity shall apply this 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 Interpretation for a period beginning before [above date], it shall disclose that fact.

Transition

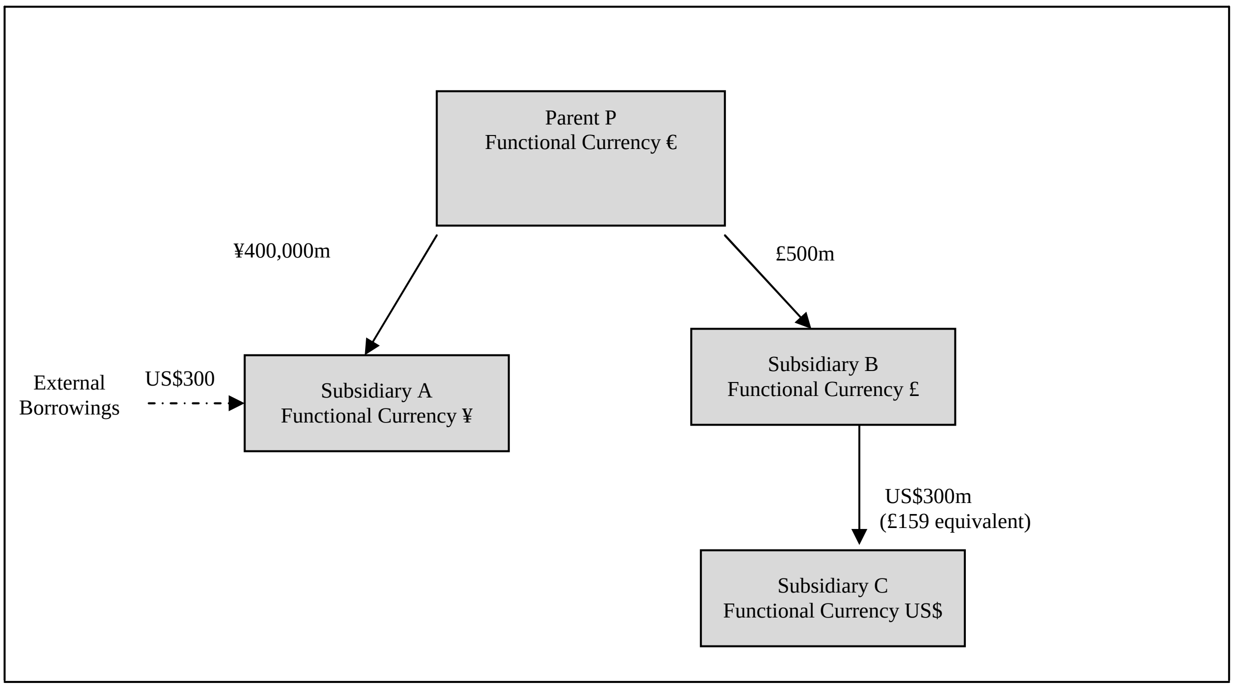
19 IAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying the Interpretation. If an entity had designated a hedging instrument as a hedge of a net 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.

Appendix

Application guidance

This appendix is an integral part of the Interpretation.

AG1 This Appendix illustrates the application of the consensuses in the Interpretation using the corporate structure illustrated below. Parent, being the ultimate parent entity, presents its consolidated financial statements in its functional currency of €. Each of the subsidiaries is wholly owned. Parent's £500m net investment in Subsidiary B includes the £159m equivalent of Subsidiary B's US$300m net investment in Subsidiary C. That is, Subsidiary B's net assets other than its investment in Subsidiary C are £341m.



Nature of hedged risk for which a hedging relationship may be designated (paragraphs 10-13)

AG2 Parent can hedge its net investment in each of Subsidiaries A, B and C for the foreign exchange risk between their respective functional currencies (¥, £ and US$) and €. In addition, Subsidiary B can hedge its net investment in Subsidiary C for the foreign exchange risk between their functional currencies of US$ and £. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Parent could designate the forward foreign exchange risk.

Amount of hedged item for which a hedging relationship may be designated (paragraphs 10-13)

AG3 Parent wishes to hedge the foreign exchange risk from its net investment in Subsidiary C. Subsidiary A has an external borrowing of US$300m. The net assets of Subsidiary A at the start of the reporting period are ¥400,000m including the proceeds of the external borrowing of US$300m.

AG4 The hedged item can be an amount of net assets equal to or less than the carrying amount of Parent's net investment in Subsidiary C (US$300m) in the consolidated financial statements of Parent. In its consolidated financial statements Parent can designate the US$300m external borrowing in Subsidiary A as a hedge of the €/US$ spot foreign exchange risk associated with its net investment in the US$300m net assets of Subsidiary C. Alternatively, in its consolidated financial statements Parent can designate the US$300m external borrowing in Subsidiary A as a hedge of the £/US$ spot foreign exchange risk between Subsidiary C and Subsidiary B if the step-by-step method of consolidation is used. (If the direct method of consolidation is used all foreign exchange risks are computed by reference to Parent's functional currency of € therefore a designation of the £/US$ risk is not possible because of the mechanics of the consolidation method.) However, Parent cannot designate both the €/US$ spot foreign exchange risk and the £/US$ spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge only one designated risk. Subsidiary B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the group comprising Subsidiary B and Subsidiary C.

Where in a group can the hedging instrument be held (paragraphs 14-15):

AG5 The total change in value in respect of foreign exchange risk of the US$300m external borrowing in Subsidiary A would be recorded in both profit or loss ($/¥ spot risk) and other comprehensive income (€/¥ spot risk) in Parent's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing hedge effectiveness because the change in value of both the hedging instrument and the hedged item are computed by reference to the € functional currency of Parent against the US$ functional currency of Subsidiary C, in accordance with the hedge documentation. The method of consolidation (ie direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge but as noted in AG4 may affect the designation of the hedged risk.

Amounts reclassified to profit or loss on disposal of a foreign operation (paragraphs 16-17):

AG6 When Subsidiary C is disposed of, the amounts reclassified to profit or loss in Parent's consolidated financial statements from its foreign currency translation reserve (FCTR) are:

a) in respect of the US$300m external borrowing of Subsidiary A, the amount IAS 39 requires to be identified, that is, the total change in value in respect of foreign exchange risk that was recognized in other comprehensive income as the effective portion of the hedge; and

b) in respect of the US$300m net investment in Subsidiary C, the amount determined by the entity's consolidation method. If Parent uses the direct method, its FCTR in respect of Subsidiary C will be determined directly by the €/US$ foreign exchange rate. If Parent uses the step-by-step method, its FCTR in respect of Subsidiary C will be determined by the FCTR recognized by Subsidiary B reflecting the £/US$ foreign exchange rate, translated to Parent's functional currency using the €/£ foreign exchange rate. Parent's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be reclassified using the direct method when it disposes of Subsidiary C.

Hedging more than one foreign operation (paragraph 11 and 13)

AG7 Parent may wish to hedge the foreign exchange risk in relation its net investment in Subsidiary B as well as that in relation to Subsidiary C. Assume Parent holds suitable hedging instruments denominated in US$ and £ that it could designate as hedges of its net investments in Subsidiary B and Subsidiary C. Parent can make one of the following designations in its consolidated financial statements:

- US$300m hedging instrument designated as a hedge of the US$300m of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (€/$) between Parent and Subsidiary C *and no other designation*.

- US$300m hedging instrument designated as a hedge of the US$300m of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (€/$) between Parent and Subsidiary C *and* £341m hedging instrument designated as a hedge of £341m of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (€/£) between Parent and Subsidiary B.

- US$300m hedging instrument designated as a hedge of the US$300m of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (£/$) between Subsidiary B and Subsidiary C (if the step-by-step method of consolidation is used) *and* £341m hedging instrument designated as a hedge of £341m of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (€/£) between Parent and Subsidiary B

- £500m hedging instrument designated as a hedge of the £500m of net investment in Subsidiary B with the risk being the spot foreign exchange exposure (€/£) between Parent and Subsidiary B *and no other designation*

AG8 The €/US$ risk from Parent's net investment in Subsidiary C is a different risk from the €/£ risk from Parent's net investment in Subsidiary B. However, in the second case identified in AG7, by its designation of the US$ hedging instrument it holds, Parent has already fully hedged its €/US$ risk. Designating a hedge of the remaining £159m of Parent's net investment in Subsidiary B (the £ equivalent of its net investment in Subsidiary C) would result in hedging the net investment in Subsidiary C twice for £/€ risk in Parent's consolidated financial statements.

AG9 If the US$ hedging instrument were held by Subsidiary B, Parent could designate that hedging instrument as a hedge of its US$300m net investment in Subsidiary C for the £/US$ risk *and* the £ hedging instrument it holds as a hedge of its entire £500m net investment in Subsidiary B.

Basis for Conclusions
IFRIC Interpretation X

This Basis for Conclusions accompanies, but is not part of, IFRIC X.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 The IFRIC was asked for guidance on accounting for the hedge of a net investment in a foreign operation in the consolidated financial statements. Interested parties had different views of the risks eligible for hedge accounting purposes. One issue is whether the risk arises from the foreign currency exposure to the functional currencies of the foreign operation and the parent entity, or whether it arises from the foreign currency exposure to the functional currency of the foreign operation and the presentation currency of the parent entity's financial statements.

BC3 Concern was also raised by constituents about which entity within a group could hold a hedging instrument in a hedge of a net investment in a foreign operation and in particular whether the parent entity holding the net investment in a foreign operation must also hold the hedging instrument.

BC4 Accordingly, the IFRIC decided to develop guidance on the accounting for a hedge of the foreign currency risk arising from a net investment in a foreign operation.

BC5 The IFRIC published draft Interpretation D22 *Hedges of a Net Investment in a Foreign Operation* for public comment in July 2007 and received 45 comment letters in response to its proposals.

Hedged risk and hedged item

Functional currency versus presentation currency (paragraph 10)

BC6 The IFRIC received a submission suggesting that the method of consolidation can affect the determination of the hedged risk in a hedge of a net investment in a foreign operation. The submission noted that consolidation can be completed by either the direct method or the step-by-step method. In the direct method of consolidation, each entity within a group is consolidated directly into the ultimate parent entity's presentation currency when preparing the consolidated financial statements. In the step-by-step method, each intermediate parent entity prepares consolidated financial statements, which are then consolidated into its parent entity until the ultimate parent entity has prepared consolidated financial statements.

BC7 The submission stated that if the direct method was required, the risk that qualifies for hedge accounting in a hedge of a net investment in a foreign operation would arise only from exposure between the functional currency of the foreign operation and the presentation currency of the group. This is because each foreign operation is translated only once into the presentation currency. In contrast, the submission stated that if the step-by-step method was required, the hedged risk that qualifies for hedge accounting is the risk between the functional currencies of the foreign operation and the immediate parent entity into which the entity was consolidated. This is because each foreign operation is consolidated directly into its immediate parent entity.

BC8 In response to this, the IFRIC noted that IAS 21 *The Effects of Changes in Foreign Exchange Rates* does not specify a method of consolidation for foreign operations. Furthermore, paragraph BC18 of the Basis for Conclusions on IAS 21 states that the method of translating financial statements will result in the same amounts in the presentation currency regardless of whether the direct method or the step-by-step method is used. The IFRIC therefore concluded that the consolidation mechanism should not determine what risk qualifies for hedge accounting in the hedge of a net investment in a foreign operation.

BC9 However, the IFRIC noted that its conclusion would not resolve the divergence of views on the foreign currency risk that may be designated as a hedge relationship in the hedge of a net investment in a foreign operation. The IFRIC therefore decided that an Interpretation was needed.

BC10 The IFRIC considered whether the risk that qualifies for hedge accounting in a hedge of a net investment in a foreign operation arises from the exposure to the functional currency of the foreign operation in relation to the presentation currency or the functional currency of the parent entity, or both.

BC11 The answer to this question is important when the presentation currency of the parent entity is different from an intermediate or ultimate parent entity's functional currency. If the presentation currency and the functional currency of the parent entity are the same, the exchange rate being hedged would be identified as that between the parent entity's functional currency and the foreign operation's functional currency. No further translation adjustment would be required to prepare the consolidated financial statements. However, when the functional currency of the parent entity is different from the presentation currency, a translation adjustment will be included in other comprehensive income to present the consolidated financial statements in a different presentation currency. The issue, therefore, is how to determine which foreign currency risk may be designated as the hedged risk in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* in the hedge of a net investment in a foreign operation.

BC12 The IFRIC noted the following arguments for permitting hedge accounting for a hedge of the presentation currency:

(a) If the presentation currency is different from the ultimate parent entity's functional currency, a difference arises on translation that is recognised in other comprehensive income. It is argued that a reason for allowing hedge accounting for a net investment in a foreign operation is to remove from the financial statements the fluctuations resulting from the translation to a presentation currency. If an entity is not allowed to use hedge accounting for the exposure to its presentation currency when it is different from the functional currency of the parent entity, there is likely to be an amount included in other comprehensive income that cannot be offset by hedge accounting.

(b) IAS 21 requires an entity to reclassify from equity to profit or loss as a reclassification adjustment any foreign currency translation gains and losses included in other comprehensive income on disposal of a foreign operation. An amount in OCI arising from a different presentation currency is therefore included in the amount reclassified to profit or loss on disposal. The entity should be able to include the amount in a hedging relationship if at some stage it is recognised along with other reclassified translation amounts.

BC13 The IFRIC noted the following arguments for allowing an entity to designate hedging relationships solely on the basis of differences between functional currencies:

(a) The functional currency of an entity is determined on the basis of the primary economic environment in which that entity operates (ie the environment in which it generates and expends cash). However, the presentation currency is an elective currency that can be changed at any time. To present amounts in a presentation currency is merely a numerical convention necessary for the preparation of financial statements that include a foreign operation. The presentation currency will have no economic impact on the financial statements of the parent entity. Indeed, a parent entity may choose to present financial statements in more than one presentation currency, but can have only one functional currency.

(b) IAS 39 requires a hedging relationship to be effective in offsetting changes in fair values or cash flows attributable to the hedged risk. A net investment in a foreign operation gives rise to an exposure to changes in exchange rate risk for a parent entity. An economic exchange rate risk arises only from an exposure between two or more functional currencies, not from a presentation currency.

BC14 When comparing the arguments in paragraphs BC12 and BC13, the IFRIC concluded that the presentation currency does not create an exposure to which an entity may apply hedge accounting. The functional currency is determined on the basis of the primary economic environment in which the entity operates. Accordingly, functional currencies create an economic exposure to changes in cash flows or fair values; a presentation currency never will. No commentators on the draft Interpretation disagreed with the IFRIC's conclusion.

Eligible risk (paragraph 12)

BC15 The IFRIC considered which entity's (or entities') functional currency may be used as a reference point for the hedged risk in a net investment hedge. Does the risk arise from the functional currency of:

(a) the immediate parent entity that holds directly the foreign operation;

(b) the ultimate parent entity that is preparing its financial statements; or

(c) the immediate, an intermediate or the ultimate parent entity, depending on what risk that entity decides to hedge, as designated at inception of the hedge?

BC16 The IFRIC concluded that the risk from the exposure to a different functional currency arises for any parent entity whose functional currency is different from that of the identified foreign operation. The immediate parent entity is exposed to changes in the exchange rate of its directly held foreign operation's functional currency. However, indirectly every entity up the chain of entities to the ultimate parent entity is also exposed to changes in the exchange rate of the foreign operation's functional currency.

BC17 Permitting only the ultimate parent entity to hedge its net investments would ignore the exposures arising on net investments in other parts of the entity. Conversely, permitting only the immediate parent entity to undertake a net investment hedge would imply that an indirect investment does not create a foreign currency exposure for that indirect parent entity.

BC18 The IFRIC concluded that a group must identify which hedged risk (ie the functional currency of which parent entity and of which net investment in a foreign operation) is being hedged. The specified parent entity, the hedged risk and hedging instrument should all be designated and documented at the inception of the hedge relationship. As a result of comments received on the draft Interpretation, the IFRIC decided to emphasise that this documentation should also include the entity's strategy in undertaking the hedge as required by IAS 39.

Amount of hedged item that may be hedged (paragraphs 11 and 13)

BC19 In the draft Interpretation the IFRIC noted that, in financial statements that include a foreign operation, an entity cannot hedge the same risk more than once. This comment was intended to remind entities that IAS 39 does not permit multiple hedges of the same risk. Some respondents asked the IFRIC to clarify the situations in which the IFRIC considered that the same risk was being hedged more than once. In particular, the IFRIC was asked whether the same risk could be hedged by different entities within a group as long as the amount of risk being hedged was not duplicated.

BC20 In its redeliberations, the IFRIC decided to clarify that the carrying amount of the net assets of a foreign operation that may be hedged in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has hedged all or part of the net assets of that foreign operation. An intermediate parent entity can hedge some or all of the risk of its net investment in a foreign operation in its own consolidated financial statements. However, such hedges will not qualify for hedge accounting at the ultimate parent entity level if the ultimate parent entity has also hedged the same risk. Alternatively, if the risk has not been hedged by the ultimate parent entity or another intermediate parent entity, the hedge relationship that qualified in the immediate parent entity's consolidated financial statements will also qualify in the ultimate parent entity's consolidated financial statements.

BC21 In its redeliberations, the IFRIC also decided to add guidance to the Interpretation to illustrate the importance of careful designation of the amount of the risk being hedged by each entity in the group.

Hedging instrument

Location of the hedging instrument (paragraph 14) and assessment of hedge effectiveness (paragraph 15)

BC22 The IFRIC discussed where in a group structure a hedging instrument may be held in a hedge of a net investment in a foreign operation. Guidance on the hedge of a net investment in a foreign operation was originally included in IAS 21. This guidance was moved to IAS 39 to ensure that the hedge accounting guidance included in paragraph 88 of IAS 39 would also apply to the hedges of net investments in foreign operations.

BC23 The IFRIC concluded that any entity within the group, other than the foreign operation being hedged, may hold the hedging instrument, as long as the hedging instrument is effective in offsetting the risk arising from the exposure to the functional currency of the foreign operation and the functional currency of the specified parent entity. The functional currency of the entity holding the instrument is irrelevant in determining effectiveness.

BC24 The IFRIC concluded that the foreign operation being hedged could not hold the hedging instrument because that instrument would be part of, and denominated in the same currency as, the net investment it was intended to hedge. In this circumstance, hedge accounting is unnecessary. The foreign exchange differences between the parent's functional currency and both the hedging instrument and the functional currency of the net investment will automatically be included in the parent's foreign currency translation reserve as part of the consolidation process. The balance of the discussion in this Basis for Conclusions does not repeat this restriction.

BC25 The IFRIC also concluded that to apply the conclusion in paragraph BC23 when determining the effectiveness of a hedging instrument in the hedge of a net investment, an entity computes the gain or loss on the hedging instrument by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge documentation. This is the same regardless of the type of hedging instrument used. This ensures that the effectiveness of the instrument is determined on the basis of changes in fair value or cash flows of the hedging instrument, compared with the changes in the net investment as documented. Thus, any effectiveness test is not dependent on the functional currency of the entity holding the instrument. In other words, the fact that some of the change in the net investment is recognized in profit or loss by one entity within the group and some is recognized in other comprehensive income by another does not affect the assessment of hedge effectiveness.

BC26 In the draft Interpretation the IFRIC noted the Implementation Guidance in IAS 39 Question F.2.14, on the location of the hedging instrument, and considered whether that guidance could be applied by analogy to a net investment hedge. The answer to Question F.2.14 concludes:

> 'IAS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.'

This was the only basis for the IFRIC's conclusion regarding which entity could hold the hedging instrument provided in the draft Interpretation. Although this is still an important part of the conclusion, some respondents argued that the Interpretation should not refer to implementation guidance as the sole basis for an important conclusion.

BC27 In its redeliberations, the IFRIC considered both the Board's amendment to IAS 21 in 2005 and the objective of hedging a net investment described in IAS 39.

BC28 In 2005, the Board was asked to clarify which entity is the reporting entity in IAS 21 and therefore what instruments could be considered to be part of a reporting entity's net investment in a foreign operation. In particular, constituents questioned whether a monetary item must be transacted between the foreign operation and the reporting entity to be considered part of the net investment in accordance with IAS 21 paragraph 15, or whether it could be transacted between the foreign operation and any member of the consolidated group.

BC29 In response the Board added IAS 21 paragraph 15A to clarify that, 'The entity that has a monetary item receivable from or payable to a foreign operation described in paragraph 15 may be any subsidiary of the group.' The Board explained its reasons for the amendment in BC25D of the Basis for Conclusions:

> The Board concluded that the accounting treatment in the consolidated financial statements should not be dependent on the currency in which the monetary item is denominated, nor on which entity within the group conducts the transaction with the foreign operation.

That is, the Board concluded that the relevant reporting entity is the group rather than the individual entity and that the net investment must be viewed from the perspective of the group. It follows, therefore, that the group's net investment in any foreign operation, and its foreign currency exposure, can be determined only at the relevant parent entity level. The IFRIC similarly concluded that the fact that the net investment is held through an intermediate entity does not affect the economic risk.

BC30 Consistent with the Board's conclusion with respect to monetary items that are part of the net investment, the IFRIC concluded that monetary items (or derivatives) that are a hedge of a net investment may be held by any entity within the group. The IFRIC, like the Board, agreed with constituents who noted that an item denominated in a currency that is not the functional currency of either the entity or the foreign operation does not expose the group to a greater foreign currency exchange difference than arises when the instrument is denominated in the functional currency of one of those entities. It simply results in exchange differences arising in the financial statements of both entities.

BC31 The IFRIC also noted that the objective of hedge accounting as set out in IAS 39 is to achieve offsetting changes in the fair values of the hedging instrument and of the net investment attributable to the hedged risk. Changes in foreign currency rates affect the fair value of the entire net investment in a foreign operation, not only that portion IAS 21 requires to be recognised in profit or loss. As noted in paragraph BC25, it is the total change in the net investment as result of a change in the foreign currency rate with respect to the parent entity against whose functional currency the hedged risk is measured that is relevant, not the component of comprehensive income in which it is recognised.

Reclassification from OCI to profit or loss (paragraphs 16 and 17)

BC32 In response to requests from some respondents for clarification, the IFRIC discussed what amounts from the parent entity's foreign currency translation reserve in respect of both the hedging instrument and the foreign operation should be recognised in profit or loss in the parent entity's consolidated financial statements when the parent disposes of a foreign operation that was hedged. The IFRIC noted that the amounts to be reclassified from equity to profit or loss as reclassification adjustments on the disposition are:

(a) The cumulative amount of gain or loss on a hedging instrument determined to be an effective hedge that has been reflected in other comprehensive income (IAS 39 paragraph 102), and

(b) The cumulative amount reflected in the foreign currency translation reserve in respect of that foreign operation (IAS 21 paragraph 48)

BC33 The IFRIC noted that when an entity hedges a net investment in a foreign operation, IAS 39 requires it to identify the cumulative amount included in the group's foreign currency translation reserve as a result of applying hedge accounting, that is, the amount determined to be an effective hedge. Therefore, the IFRIC concluded that when a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss from the foreign currency translation reserve in respect of the hedging instrument in the consolidated financial statements of the parent should be the amount IAS 39 requires to be identified.

Effect of consolidation method

BC34 Some respondents to the draft Interpretation argued that the method of consolidation creates a difference in the amounts included in the parent's foreign currency translation reserve for individual foreign operations that are held through intermediate parents. These respondents noted that this difference may only become evident when the ultimate parent entity disposes of a second tier subsidiary (ie an indirect subsidiary).

BC35 The difference becomes apparent in the determination of the amount of the foreign currency translation reserve that is subsequently reclassified to profit or loss. An ultimate parent entity using the direct method of consolidation would reclassify the cumulative foreign currency translation reserve that arose between its functional currency and that of the foreign operation. An ultimate parent entity using the step-by-step method of consolidation might reclassify the cumulative foreign currency translation reserve reflected in the financial statements of the intermediate parent, that is the amount that arose between the functional currency of the foreign operation and that of the intermediate parent, translated into the functional currency of the ultimate parent.

BC36 In its redeliberations, the IFRIC noted that the use of the step-by-step method of consolidation does create such a difference for an individual foreign operation although the aggregate net amount of foreign currency translation reserve for all the foreign operations is the same under either method of consolidation. At the same time, the IFRIC noted that the method of consolidation *should not* create such a difference for an individual foreign operation based on its conclusion that the economic risk is determined in relation to the ultimate parent's functional currency.

BC37 Therefore, the IFRIC concluded that the amount determined by the direct method of consolidation is the conceptually correct amount of foreign currency translation reserve for an individual foreign operation. However, the IFRIC noted that IAS 21 does not require an entity to use this method or to make adjustments to produce the same result. The IFRIC also noted that a parent entity is not precluded from retrospectively determining the amount of the foreign currency translation reserve in respect of a foreign operation it has disposed of using the direct method of consolidation in order to reclassify the appropriate amount to profit or loss.

Transition (paragraph 19)

BC38 In response to respondents' comments, the IFRIC clarified the Interpretation's transitional requirements. The IFRIC decided that entities should apply the conclusions in this Interpretation to existing hedging relationships on adoption and cease hedge accounting for those that no longer qualify. However, previous hedge accounting is not affected. This is similar to the transition requirements in IFRS 1 *First time Adoption of International Financial Reporting Standards* paragraph 30, for relationships accounted for as hedges under previous GAAP.

Summary of main changes from the Draft Interpretation

BC39 The main changes from the IFRIC's proposals are as follows:

(a) The Interpretation paragraph 11 clarifies that the carrying amount of the net assets of a foreign operation that may be hedged in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has hedged all or part of the net assets of that foreign operation.

(b) The Interpretation paragraph 15 clarifies that the assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

(c) The Interpretation paragraphs 16 and 17 clarify what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation.

(d) The Interpretation paragraph 18 clarifies transitional requirements.

(e) Appendix - Application Guidance was added to the Interpretation. Illustrative Examples in the Draft Interpretation were removed.

(f) The Basis for Conclusions was changed to more clearly set out the reasons for IFRIC’s conclusions.