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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2009, London**

Project: **Annual Improvements Project**

Subject: **Comment Letter Analysis on Proposed Amendment to IFRIC 16 - Comment letter analysis (Agenda Paper 10B)**

Background

1. The Board released the Exposure Draft *Post-implementation Revisions to IFRIC Interpretation*s in January 2009. The Board proposes to amend paragraph 14 of IFRIC 16 to remove the restriction on the entity that can hold the hedging instruments. IFRIC 16 is effective for annual periods beginning on or after 1 October 2008 with prospective application. The Board concluded that this

amendment should apply in the same way. The extract from the Exposure Draft is attached to this paper (Appendix A).

2. The Board invited comments on the amendment to IFRIC 16 by 2 March 2009. The Board received 25 comment letters as of 4 March 2009.

3. This paper summarises comments on the proposed amendments to IFRIC 16. This paper has the following Appendices:
Appendix A Original proposal in the ED
Appendix B Other comments (the staff does not intend to discuss these comments unless requested by the Board)

4. The staff recommendation is to finalise the amendment as proposed and to revise the effective date as noted in paragraph 15.

Question 1 – Removal of the restriction on the entity that can hold hedging instruments

Comments received

5. A majority of commentators agreed with the proposal. For example:

   "EFRAG supports the proposed amendment. We understand that the IFRIC proposes that entities should be able to designate a financial instrument as a hedging instrument of the net investment in a foreign operation that holds this instrument and report gains and losses on the instrument in equity in the consolidated financial statements to the extent the hedge is effective. Indeed, if entities are able to designate such a financial instrument as a hedging instrument following all the hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measure*ment and IFRIC 16, there is no reason to prohibit hedge accounting for such a hedge"

6. Some commentators[1] agree that a parent entity should be able to use a derivative held by the foreign operation being hedged as a hedge of the net investment in that foreign operation. The amendment as currently drafted applies to both derivative and non-derivative instruments. These commentators recommend that the amendment should apply only to derivative instruments held by the foreign operation being hedged. A non-derivative financial instrument would only be an effective hedge of the net investment if it were issued by the foreign operation in its own functional currency and this would have no foreign currency impact on the profit and loss of the consolidated group. Consequently, the rationale described in BC2 to support the amendment does not apply to non-derivative instruments.

[1] CL13, 14

Staff analysis and recommendation

7. The staff does not agree that the amendment should be restricted to derivative instruments. The staff notes that paragraphs AG13 to AG15 of IFRIC 16 illustrate that a non-derivative instrument held by the foreign operation does not need to be considered to be part of the parent's net investment. As a result, even if it is denominated in the foreign operation's functional currency a non-derivative instrument could still affect the profit and loss of the consolidated group. Consequently, it could be argued that the amendment is not required to permit non-derivative instruments to be designated as hedges. However, in the staff's view, restricting the amendment only to derivatives in the Interpretation is likely to cause confusion without explicit reference to the AG paragraphs and additional explanation in the Interpretation itself.

8. Therefore, the staff recommends that the proposal not be changed.

Question 2 – Effective date

9. IFRIC 16 is effective for annual periods beginning on or after 1 October 2008 with prospective application. The Board concluded that this amendment should apply in the same way.

10. A majority of commentators agreed with the proposal. Although in general they do not support amendments that take effect for periods beginning prior to the date of publication, they consider the backdating to be a tolerable exception in the special case of rectifying an incorrect conclusion of IFRIC 16.

11. However, some[2] are concerned that in order to apply the amendment entities would have had to have designation documents in place for the hedges on 1 October 2008, while entities would not have been aware of the amendment until

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[2] CL2, 6, 10, 17, 19, 22

January 2009 when the Board discussed it. Therefore, they recommend that either the effective date of the amendment to IFRIC 16 be changed or that the final amendment exempt entities, on initial implementation of the interpretation, from the requirement to have had the hedge designation documents in place until a certain date when they implement this amendment.

12. Another commentator[3] does not support backdating the effective date of standards. The requirement to document the hedge at inception is important. This commentator believes that it should be clarified that IFRIC 16 does not involve any exceptions from complying with the requirements in IAS 39 as regards the necessity of having the designation documentation in place before applying hedge accounting.

13. Another commentator[4]believes that the Board should clarify whether a parent entity would be permitted to apply hedge accounting in an annual period beginning on or after 1 October 2008 for a hedge of a net investment in a foreign operation from the date that the hedge was designated appropriately and documented if that date were prior to the final amendment to IFRIC 16 being published.

14. Another commentator[5] recommends amending IFRIC 16 effective 90 days after issue of the finalised amendments (90 days is the usual period between publication of an Interpretation and its effective date) to allow jurisdictions with an endorsement process to incorporate the changes into their local law. Earlier application should be permitted to allow entities in jurisdictions without endorsement processes to adopt the amendments instantaneously.

Staff analysis and recommendation

[3] CL12

[4] CL13

[5] CL23

15. The Board's proposal intended that entities could apply the amended version of IFRIC 16 from the original effective date (ie. 1 October 2008). The staff notes that commentators question whether entities would have had proper hedge designation in place on 1 October 2008 because the Board did not discuss this amendment until its January meeting. The staff also notes that commentators are concerned about making an exception to IAS 39 regarding retrospective designation of hedging relationships. In addition, entities with calendar years affected by the original restriction are unlikely to have adopted IFRIC 16 early. Therefore, it will first be applied for their fiscal years commencing on 1 January 2009. Entities with fiscal years commencing after that date will only ever have to apply the amended version of IFRIC 16.

16. Therefore, the staff recommends that the amendment be effective for annual periods beginning on or after 1 January 2009 to remove any implication that hedge accounting could be applied before the hedge was designated appropriately and documented. The additional wording of paragraph 18is proposed as follows:

Effective date

18 An entity shall apply this Interpretation for annual periods beginning on or after 1 October 2008. An entity shall apply the amendment to paragraph 14 made in [month] 2009 for annual periods beginning on or after 1 January 2009. Earlier application of both is permitted. If an entity applies this Interpretation for a period beginning before 1 October 2008, or the amendment to paragraph 14 before 1 January 2009, it shall disclose that fact.

Question to the Board

17. ***Do you agree with the staff's recommendations in paragraphs 8 and 15?***

18. If the Board agrees with the staff recommendation to change the effective date of the amendment, the Basis for Conclusions will be updated to reflect that decision.

Appendix A– Extract from ED

Proposed amendment to IFRIC Interpretation 16 *Hedges of a Net Investment in a Foreign Operation*

Paragraphs 14 and 18 are amended (deleted text is struck through and new text is underlined).

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 or entities 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.

Effective date

18 An entity shall apply this Interpretation <u>(including the amendment to paragraph 14 made in [month] 2009)</u> for annual periods beginning on or after 1 October 2008. Earlier application is permitted. If an entity applies this Interpretation for a period beginning before 1 October 2008, it shall disclose that fact.

Proposed amendment to Basis for Conclusions on

IFRIC Interpretation 16

Paragraph 24 is deleted and a footnote added (new text is underlined and deleted text is struck through).

Hedging instrument

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

BC24 [Deleted] ~~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 group'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.~~ *

* The Board deleted paragraph BC24 to reflect its decision in [month 2009] to amend paragraph 14.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the proposed amendment to IFRIC 16.

BC1 Paragraph 14 of IFRIC 16 states that the hedging instrument cannot be held by the foreign operation whose net investment is being hedged. The restriction was included in draft Interpretation D22 (from which IFRIC 16 was developed) and attracted little comment from respondents. The IFRIC concluded, as part of its redeliberations, that the restriction was appropriate because 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 group's foreign currency translation reserve as part of the consolidation process (paragraph BC24 of the Basis for Conclusions on IFRIC 16).

BC2 It has been brought to the attention of the International Accounting Standards Board that this conclusion is not correct. Without hedge accounting, part of the foreign exchange difference arising from the hedging instrument would be included in consolidated profit or loss. Therefore, the Board proposes to amend paragraph 14 of IFRIC 16 to remove the restriction on the entity that can hold hedging instruments.

BC3 IFRIC 16 is effective for annual periods beginning on or after 1 October 2008 with prospective application. The Board concluded that this amendment should apply in the same way.

Appendix B– Other comments (the staff does not intend to discuss unless requested by the Board)

1. Comment on hedging effectiveness[6]: A hedging instrument held by the hedged operation is part of the hedged net assets, a decline in the fair value of the hedging instrument may lead to a decline in the foreign operation's net assets to an amount below the amount previously designated as the hedged item, thereby triggering hedge ineffectiveness and a potential de-designation of the hedging relationship. This may, however, be avoided if the foreign operation enters into a 'back-to-back' derivative with the parent entity that replicates the terms of the derivative hedging instrument entered into between the foreign operation and a party external to the reporting entity as changes in the fair values of the external derivative hedging instrument and the intra-group derivative usually would have no significant net impact on the net assets of the foreign operation. The Board may wish to consider whether it would be helpful to discuss these potential issues in the final amendment.

   [Staff response]

   Although the proposal removes the restriction on the entity that can hold hedging instruments, the staff notes that entities should meet the necessary hedging requirements in IAS 39, including hedge effectiveness test, to apply hedge accounting. IFRIC 16 emphasises this point. The staff believes that no further guidance is needed in the Interpretation.

2. A commentator[7] requests further research on this issue. It suggests that the Board should consider 'all other possible fact patterns involving hedging instruments held by the foreign operation being hedged' and make the results of that research public.

   [Staff response]

[6] CL13

[7] CL23

The staff note the urgency of the amendment in practice. Therefore, the staff believe that IASB should proceed with the amendment on a timely basis. The staff also notes that the entire issue of net investment hedging with various instruments was thoroughly considered by the IFRIC in developing the Interpretation and the amendment simply corrects an unfortunate slip. We do not think that additional research would change the Board's conclusion

3. One commentator[8] supports efforts by the IASB to clarify implementation issues on a timely basis and considers that it is reasonable for issues of this nature to be addressed with a shortened due process. Another commentator [9] believes that this issue is a relatively minor amendment and therefore should be dealt with as part of annual improvements process.

[Staff response]
The staff noted the comments. However, because IFRIC 16 is already effective and this issue is significant to some entities, the staff continues to believe that the final amendment should be incorporated in Annual Improvements to be issued in April 2009.

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[8] CL16

[9] CL11