Project **Financial Instruments (Replacement of IAS 39) – Hedge Accounting**

Topic **Eligible hedging instruments – Use of intragroup non-derivative financial instruments as hedging instruments**

Introduction

Background

1. This paper addresses aspects of eligibility for designation as part of a hedging relationship.
2. For the purpose of this paper, the terms 'eligible' and 'eligibility' are used in a broader sense of items that *could* be part of a hedging relationship.

Purpose of the paper

3. The purpose of this paper is to discuss whether in consolidated financial statements *intragroup* monetary items transacted between two group entities with different functional currencies should be eligible hedging instruments when hedging the foreign exchange risk (FX risk).
4. The staff would like to draw the Board's attention to the fact that the widespread of the issue addressed in this paper is limited. However, its occurrence may have a material impact on the financial statements of the entities using the hedging structure outlined in the paper.
5. This paper is structured into the following sections:
   (a) overview of the issue and example;
   (b) overview of the implications for hedge accounting;
   (c) staff recommendation and question to the Board; and

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(d) Appendix A, which provides an outline of the relevant accounting requirements.

The issue and an example

6. Currently, IAS 39 *Financial Instruments: Recognition and Measurement* only allows internal non-derivative financial instruments to be hedging instruments in the individual or separate financial statements. The difference arising from their translation in the consolidated financial statements is *only* an eligible *hedged item* but not an eligible hedging instrument.
7. This assignment of the roles (eligibility as a hedged item but not as a hedging instrument) can have an effect on the accounting treatment for gains and losses arising from the translation of an intragroup monetary item transacted between two group entities with different functional currencies that is inconsistent with the economic substance of the transactions. It is inconsistent because it produces a different outcome from the one that would have arisen had those instruments not been intragroup. The example outlined below illustrates where this issue occurs.
8. Hence, the issue is whether an *intragroup* monetary item transacted between two group entities with different functional currencies can be an eligible hedging instrument in the consolidated financial statements.

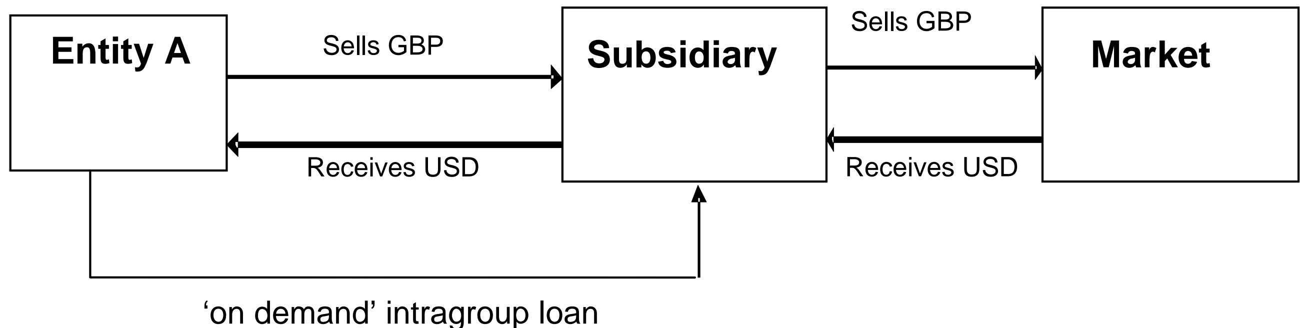
Example

9. Entity A (parent company with GBP functional currency) has a highly-probable forecast transaction to acquire a business (in a business combination) for consideration payable in 12 months' time in a different currency (USD) than its own functional currency. To hedge the foreign exchange risk associated with the future payment, Entity A exchanges £5m of cash funds for $10m at the spot rate of 2$ per £. The proceeds of the transaction are lent to a subsidiary within the group[1], which has USD as its functional currency. The loan will be repaid

[1] The intercompany loan is made within the group to reduce the credit risk and to maximise the return. This is the reason why no FX hedge with a party outside the group is entered into. However, for simplicity, interest earned on the intercompany loan is assumed to be zero.

back to the parent in 12 months or 'on demand' to ensure the settlement of the consideration payable for the acquisition.

10. The aim of this transaction is to hedge the foreign exchange risk between the acquirer's functional currency (GBP) and the currency of the forecast acquisition (USD). A diagram of the transaction is presented below:



11. Because the acquirer and the subsidiary are part of the same group, the intragroup loan will be eliminated on consolidation. However, since the loan granted by entity A is a monetary item denominated in a currency different from its functional currency, it must be translated at the closing rate at each reporting date as required by IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The FX differences are recognised in the income statement, and will not be fully eliminated on consolidation.
12. Although management is hedging the FX risk of the forecast transaction using an intragroup loan, this hedging strategy is only allowable in the individual or separate financial statements of the parent. This is because the hedging instrument (intragroup loan) is eliminated on consolidation, and the foreign exchange differences are only eligible as hedged items but not as hedging instruments.

13. This creates an accounting mismatch because the foreign exchange differences between the functional currency of the parent and the currency of the forecast transaction (which is the same as the functional currency of the subsidiary) are immediately recognised in the income statement, while the transaction being hedged (the forecast acquisition of a business in a business combination) will occur in the future.

14. Hence, the foreign exchange gains or losses will not adjust the calculation of the potential *goodwill* or *bargain purchase* (which carry FX risk) even though they hedge the FX risk. Consequently, the economic substance of the transaction will not be reflected.

15. This accounting outcome suggests that the relationship between the requirements in IAS 21 and the requirements for hedging of foreign exchange risk using intragroup non-derivative financial instruments is inconsistent.

16. The issue outlined above is a scenario where an exception to the general model in IAS 39 would be a sensible outcome with a limited increase in complexity as the scenario above is not widespread. However, such an exception (hedging the foreign exchange risk in a highly probable forecast transaction to acquire a business combination) is a very specific fact pattern that arises in very specific circumstances, particularly when derivative financial instruments are not readily available in the market.

17. The staff believe that this is not primarily a hedge accounting issue but an IAS 21 issue as it arises from the requirement to recognise the gains or losses attributable to the translation of intragroup monetary items in the consolidated profit or loss. Hence, the staff believe that this issue is not within the scope of this project.

18. Nonetheless, the staff believe the Board has at least three alternatives:

    (a) **Alternative 1** – Do not change the current guidance in IAS 39.

    (b) **Alternative 2** – Allow an exception for FX risk in the context in the context of the acquisition of a business (in a business combination).

    (c) **Alternative 3** – Perform a comprehensive review of the requirements of IAS 21 and of their interaction with the hedge accounting requirements.

19. The staff provide an analysis of these three alternatives below.

Alternative 1—Retain the current guidance in IAS 39

20. This alternative allows the Board to keep the *status-quo* in relation to the current requirements. If the Board chooses this alternative, this will be consistent with a

view that considers this issue primarily an issue created by the application of IAS 21. This is also supported by the view that the issue needs to be addressed in a more comprehensive way as part of a future possible project on IAS 21 that includes consideration of the broader issue of the interaction of IAS 21 and hedge accounting (refer to analysis of alternative 3 below)

Alternative 2—Allow an exception limited in scope for hedges of a highly probable forecast transaction to acquire a business combination

21. If the Board chooses this alternative it will create a limited exception for intragroup monetary items to be eligible hedging instruments only in the context of forecast transactions to acquire a business (in a business combination as described in the fact pattern above). This alternative will be limited in scope and will serve a purpose (resolve the issue that some preparers face when using this structure to hedge their exposure to FX risk in this particular scenario).

22. The advantage of allowing an exception that is narrow in scope lies in the fact that the instances where it will occur are limited and easily identifiable. However, there are disadvantages in adopting this approach.

23. Firstly allowing limited exceptions for ring-fenced scenarios is inconsistent with a principles based standard. Secondly, the Board risks not addressing the real issue, which is: can intragroup monetary items denominated in a currency different from the functional currency of the reporting entity be used as hedging instruments for hedging FX risk in the consolidated financial statements irrespective of the nature of hedged item?

24. In addition, allowing exceptions will place increased pressure on the Board to extend the number of ring-fenced scenarios where the use of intragroup monetary items as eligible hedging instruments will be permitted.

Alternative 3—Address the wider issue of the use of non-monetary items as hedging instruments

25. If the Board decides to address the wider issue of eligibility of intragroup monetary items there are additional issues to be considered. These are:

    (a) **Issue 1—**Which *hedged items* are eligible if the hedging instrument is an intragroup monetary item denominated in a currency other than the reporting entity's functional currency?

(b) **Issue 2—**Which *hedging instruments* are eligible if the risk management objective is to hedge FX risk using intragroup monetary items denominated in a currency other than the reporting entity's functional currency?

26. The rationale used in IAS 21[2] to require the gains and losses in intragroup monetary items to be recognised in the consolidated profit or loss is based on the assumption that there is a commitment to settle the FX position within the accounting period or in subsequent periods. If the transaction does not settle within an accounting period the exchange differences are recognised in each period up to the date of settlement at the closing rate.

27. Taking this rationale the staff provides an analysis of the two issues below.

Issue 1

28. This issue relates to the eligibility of the *hedged item*. In addressing this issue the questions is whether hedged items will be limited to forecast transactions to acquire a business in a business combination (as described in the fact pattern above) or alternatively, hedged items will encompass a wider range of transactions carrying FX risk for example forecasted sales and purchases, forecasted purchases of inventory or property, plant and equipment, etc.

29. The staff believe that conceptually there is no reason to limit the eligibility of the hedged items provided that they carry FX risk. This is because FX is a component that is identifiable and reliably measurable both for the hedged item and the hedging instrument.

30. The 'settlement' characteristic described in paragraph 26 is shared both by the intragroup monetary item (hedging instrument) but also by the hedged item. In fact, this characteristic applies to all the hedged items carrying FX risk (for example purchases of property, plant and equipment) and therefore limiting the eligibility of the hedged item depending on the type of hedged item would be inappropriate. This makes the limited exception described in alternative 2 difficult to justify.

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[2] Refer to paragraph 45 of IAS 21.

Issue 2

31. This issue deals with the question of how stringent the qualification criteria for the intragroup monetary items acting as hedging instruments should be.

32. Similarly to issue 1 above, the real question is: should the eligibility criteria for hedging instruments be based on the type of instrument and therefore not all the intragroup monetary items would qualify as eligible hedging instruments?

33. As for the issue above, the staff believe that a qualifying criterion based on the type of instrument will be inappropriate as irrespective of the type of intragroup monetary items these will carry the offsetting element needed for the purpose of the hedging relationship (the FX risk).

34. If the Board decides to address this issue there is a wider range of issues that need to be addressed. These include:

    (a) Whether other intragroup monetary items (for example trade receivables and payables carrying FX risk) shall be eligible hedging instruments in the context of hedging FX risk?

    (b) Whether internal or external derivatives can be combined with intragroup monetary items to obtain the desired synthetic instrument (a monetary item denominated in the currency of the hedged item)?

    (c) Whether monetary items denominated in a currency that is highly correlated with the currency of the transaction being hedged are eligible hedging instruments?

    (d) Whether a combination of b) and c) ie a monetary item denominated in a currency (including the entity's functional currency) and an internal or external derivative (s) can be used to create a synthetic monetary item denominated in a currency that is highly correlated to the currency of the hedged transaction?

    (e) Whether the type of subsidiary generating the monetary item is relevant to eligibility criteria for example: does it have to be a banking subsidiary or can it be any other subsidiary within the group?

35. We believe that all the issues outlined above cannot be addressed without a comprehensive review that involves revisiting IAS 21. As such, while we

acknowledge that this is a significant issue for entities that it applies to, because of the complexity of the interaction between IAS 21 and the eligibility criteria for hedge accounting, the overall issue of eligibility of intragroup monetary items as hedging instruments should be resolved as part of project that involves FX translation (IAS 21).

36. Before coming into a conclusion the staff will weigh the pros and cons of each one of the alternatives available to the Board.

Alternative 1—Retain the current guidance in IAS 39

Pros

37. This alternative will retain the guidance in IAS 39 that is consistent with the current text of IAS 21.

38. It will allow the Board to perform a comprehensive review at a later stage once IAS 21 can be addressed.

Cons

39. It will not address the concerns of some of the constituents, particularly those using intragroup monetary to hedge the FX risk in a highly probable forecast transactions to acquire a business (in a business combination).

Alternative 2—Allow a limited exception in the context of hedging of business combinations

Pros

40. The Board would provide a solution that will serve a narrowly defined purpose. This, despite being limited in terms of its scope of application, will address the concerns of some of the constituents.

Cons

41. In order to provide an exception that is limited in scope, the Board would have to develop a rules based approach that will only work for specific narrowly defined fact patterns.

42. This alternative is inconsistent with a principles based standard and will only provide a 'quick fix' to something that requires a more comprehensive review.

43. This alternative will increase the pressure on the Board to extend the limited exception to other classes of products which will inevitably make the set of requirements rather rules based.

Alternative 3—Perform a comprehensive review of the eligibility criteria for intragroup monetary items

Pros

44. The Board would address the issue of eligibility of intragroup monetary items comprehensively.

Cons

45. Choosing this alternative would significantly expand the scope of the hedge accounting project and also require a comprehensive review of the requirements in IAS 21.

Staff recommendation and question to the Board

46. Based on the pros and cons outlined above, on balance the staff recommend that the guidance in IAS 39 in relation to the use of intragroup monetary items should not be changed as part of this project. Instead, the staff consider that the most appropriate solution is to address the issue in a more comprehensive way as part of a future possible project on IAS 21 that includes consideration of the broader issue of the interaction of IAS 21 and hedge accounting.

47. Hence, the staff recommend alternative 1 but consider that a comprehensive review of FX translation and the related FX hedge accounting is the preferable approach in the medium term.

Question 1 – Exception to the treatment of foreign exchange differences under IAS 21 in the context of hedge accounting
Does the Board agree with the staff recommendation in paragraphs 46 and 47? If the Board disagrees with the staff recommendation, what would the Board prefer instead and why?

Appendix A

Outline of the existing IFRS hedge accounting requirements

A1. Paragraph 80 of IAS 39 states that [emphasis added]:

> 'the foreign exchange risk of a monetary item may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* (IAS 21). In accordance with IAS 21, foreign exchange rate gains and losses on monetary items are not fully eliminated when the monetary item is transacted between two group entities that have different functional currencies'.

A2. Paragraph 45 of IAS 21 states that:

> 'The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of intragroup balances and intragroup transactions of a subsidiary (see IAS 27 and IAS 31 Interests in Joint Ventures). However, an intragroup monetary asset (or liability), whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability (or asset) without showing the results of currency fluctuations in the consolidated financial statements. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting entity, such an exchange difference is recognised in profit or loss or, if it arises from the circumstances described in paragraph 32, it is recognised in other comprehensive income and accumulated in a separate component of equity until the disposal of the foreign operation'.