STAFF PAPER

March 2016

IFRS Interpretations Committee Meeting

Project	**IFRS 9 *Financial Instruments*—Net investment hedges**
Paper topic	Comment Letter Analysis and Finalisation of Agenda Decision

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Introduction

1. In November 2015, the IFRS Interpretations Committee ('the Interpretations Committee') discussed how hedge effectiveness should be determined when accounting for hedges of a net investment in a foreign operation ('net investment hedges') in accordance with IFRS 9 *Financial Instruments*. More specifically, the Interpretations Committee discussed whether the 'lower of test' that is required for cash flow hedges should also be applied in determining the effective portion of the gains or losses arising from the hedging instrument when accounting for net investment hedges.

2. The Interpretations Committee considered the analysis prepared by the staff together with the feedback received from the outreach. The majority of the responses received stated that few entities have yet adopted the hedging requirements in IFRS 9. As a result, the answers received represented the current practice observed by the respondents of entities applying IAS 39 *Financial Instruments: Recognition and Measurement*, which did not indicate that the issue was widespread or that diversity in practice was significant. In addition, the Interpretations Committee did not expect significant diversity to arise when IFRS 9 is adopted more widely.

3. On the basis of the existing requirements and in the light of the outreach results received, the Interpretations Committee determined that neither an Interpretation nor

an amendment to the Standard was necessary. Consequently, the Interpretations Committee decided to issue a tentative agenda decision not to add this issue onto its agenda.[1]

Purpose of the paper

4. The purpose of this paper is to:

   (a) provide a summary of the comments received on the tentative agenda decision;

   (b) set out our analysis of the comments received; and

   (c) propose a recommendation for a final agenda decision.

Summary of comment letters

5. The comment period for the tentative agenda decision ended on 21 January 2016. We received four comment letters, which are reproduced in Appendix B to this paper.

6. All of the comment letters received agreed with the Interpretations Committee's tentative decision not to add this issue to its agenda. One of the comment letters received disagreed, however, with particular aspects of the wording of the tentative agenda decision. In particular, the respondent's disagreement relates to the wording of the sentence marked in bold in the following paragraph of the tentative agenda decision:

   […] The Interpretations Committee observed that:

   a. paragraph 6.5.13 of IFRS 9 states that 'Hedges of a net investment in a foreign operation … shall be accounted for similarly to cash flow hedges …'. Paragraph 6.5.13 (a), which focusses on net investment hedges, also has a reference to paragraph 6.5.11, which deals with the accounting for cash flow hedges; this includes the 'lower of' test. **This indicates that the 'lower of' test should be applied when determining the effective portion of the gains or losses arising from the hedging instruments when accounting for net investment hedges.**

[1] The tentative agenda decision can be found at: http://media.ifrs.org/2015/IFRIC/November/IFRIC-Update-November-2015.html

7. According to the respondent, the guidance relating to the 'lower of' test in paragraph 6.5.11 (a) (ii) of IFRS 9 cannot be *literally* applied when accounting for net investment hedges because 'it is a hedge of foreign exchange differences arising under IAS 21 *The Effects of Changes in Foreign Exchange Rates* on a net investment that is not measured at fair (or present) value and there are no hedged cash flows.' Paragraph 6.5.11(a)(ii) is reproduced below [**emphasis added**]:

> 6.5.11 As long as a cash flow hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship shall be accounted for as follows:
>
> (a) the separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):
>
> (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
>
> **(ii) the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.**

8. This respondent suggests that the Interpretations Committee should clarify that:

(a) the effective portion of the gains and losses on the hedging instrument should be based on an approach *similar to* that set out in paragraph 6.5.11(a) for cash flow hedges; and

(b) the amount calculated with respect with paragraph 6.5.11(a)(ii) may be determined in accordance with IAS 21 (ie the recognised translation differences on the hedged item rather than changes in fair value (present value)).

Staff analysis of comment letters

9. The matter that the respondent has requested to be clarified in the agenda decision relates to the fact that, in the case of net investment hedges, the cumulative changes of the hedged item will not be on the basis of fair value or present value but will, instead, be on the basis of translation differences. Consequently, an entity will not be able to apply the 'lower of' test *literally* as it is drafted in paragraph 6.5.11(a)(ii) of IFRS 9 but only *similarly* to the approach described in that paragraph of the Standard.

10. We note that, in the case of net investment hedges, the changes in the hedged item arising from the translation differences will also be required to be present valued in accordance with paragraph B6.5.4 of IFRS 9 which states that [**emphasis added**]:

> B6.5.4 When measuring hedge ineffectiveness, an entity shall consider the time value of money. Consequently, the entity determines the value of the hedged item **on a present value basis** and therefore the change in the value of the hedged item also includes the effect of the time value of money.

11. The objective of these requirements is that time value of money is considered when measuring the ineffectiveness of a hedging relationship. In addition, the same is also required under paragraph 6.5.11(a)(ii) reproduced above. Consequently, we think that the alignment between the requirements in paragraphs B6.5.4 and 6.5.11(a)(ii) would contribute to decrease the concerns expressed by this respondent.

12. In addition, we note that the submission received requested clarification on the requirement in paragraph 6.5.13 of IFRS 9, which states 'hedges of a net investment in a foreign operation […] shall be accounted for **similarly** to cash flow hedges […]' (**emphasis added**).[2] Specifically, the Interpretations Committee was asked to provide clarity on how 'similarly' should be understood (ie should 'similarly' be limited to the recognition of the gain or loss on the hedging instrument that is determined to be an effective hedge in other comprehensive income (OCI)? Alternatively, should 'similarly' also be understood to extend to the mechanics that are used for cash flow hedges (ie the 'lower of' test) for determining the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge?). Paragraph 6.5.13 is reproduced in footnote 2 of this agenda paper.

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[2] Paragraph 6.5.13 of IFRS 9 states:

6.5.13 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IAS 21), shall be accounted for similarly to cash flow hedges:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income (see paragraph 6.5.11); and

(b) the ineffective portion shall be recognised in profit or loss.

13. On the basis of the comment letters received, it appears that the tentative agenda decision satisfactorily clarified this question. In addition, none of the comments received in the outreach request noted that the application of the 'lower of' test for the accounting of net investment hedges raised questions about the measurement of the cumulative changes of the hedged items (ie the net investments).

Staff recommendation

14. We think that the requirements in paragraph 6.5.13 of IFRS 9 together with the Interpretation Committee's tentative agenda decision provide clarity on the submission received.

15. Consequently, we think the tentative agenda decision does not need to be modified to incorporate the respondent's concern about its drafting as described in paragraphs 6–8 of this paper. The tentative agenda decision in Appendix A has only been amended to include some proposed editorial changes.

Question for the Interpretations Committee

Question for the Interpretations Committee
Does the Interpretations Committee agree with the staff recommendation to finalise the agenda decision?

Appendix A—Agenda decision

A1. We propose the following wording for the final agenda decision, which is marked from the tentative agenda decision. The proposed changes are strictly editorial. New text is underlined and deleted text if struck through.

IFRS 9 *Financial Instruments*—Determining hedge effectiveness for net investment hedges

The Interpretations Committee received a request to clarify how <u>an entity should determine</u> hedge effectiveness ~~should be determined~~ when accounting for net investment hedges in accordance with IFRS 9 *Financial Instruments*. Specifically, the submitter asked whether<u>, when accounting for net investment hedges, an entity should apply</u> the 'lower of' test that is required for cash flow hedges ~~should also be applied for~~ <u>in</u> determining the effective portion of the gains or losses arising from the hedging instrument ~~when accounting for net investment hedges~~.

The Interpretations Committee observed that:

a. paragraph 6.5.13 of IFRS 9 states that 'Hedges of a net investment in a foreign operation … shall be accounted for similarly to cash flow hedges …'. Paragraph 6.5.13 (a), which focusses on net investment hedges, also has a reference to paragraph 6.5.11, which deals with the accounting for cash flow hedges; this includes the 'lower of' test. This indicates that<u>, when accounting for net investment hedges, an entity should apply</u> the 'lower of' test ~~should be applied when~~ <u>in</u> determining the effective portion of the gains or losses arising from the hedging instrument~~s when accounting for net investment hedges~~.

b. ~~the application of the 'lower of' test for~~ <u>in</u> determining the effective portion of the gains or losses arising from the hedging instrument~~s~~ when accounting for net investment hedges<u>, the application of the 'lower of' test</u> avoids the recycling of exchange differences arising from the hedged item~~s~~ that have been recognised in other comprehensive income ~~prior to the~~ <u>before the disposal of the</u> foreign operation ~~being disposed of~~. The Interpretations Committee noted that such an outcome would be aligned ~~to~~ <u>with</u> the requirements ~~and principles~~ of IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

In addition, the Interpretations Committee noted the following:

a. it <u>did not</u> receive~~d no~~ <u>any</u> evidence of significant diversity ~~by~~ <u>between</u> entities ~~using~~ <u>applying</u> IAS 39 *Financial Instruments: Recognition and Measurement* ~~when~~ <u>in</u> determining the effective portion of the gains or losses arising from the hedging instrument~~s~~ by applying the 'lower of' test when accounting for net investment hedges.

b. few entities have yet adopted the hedging requirements in IFRS 9; consequently, it is too early to assess whether the issue is widespread. However, the Interpretations Committee did not expect significant diversity to arise when IFRS 9 is adopted more widely.

In the light of the existing ~~IFRS~~ requirements <u>in IFRS Standards,</u> the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary<u>. Consequently, the Interpretations Committee</u> ~~and therefore~~ ~~[~~decided~~]~~ not to add this issue to its agenda.

A2. We propose the following wording for the final agenda decision.

IFRS 9 *Financial Instruments*—Determining hedge effectiveness for net investment hedges

The Interpretations Committee received a request to clarify how an entity should determine hedge effectiveness when accounting for net investment hedges in accordance with IFRS 9 *Financial Instruments*. Specifically, the submitter asked whether, when accounting for net investment hedges, an entity should apply the 'lower of' test that is required for cash flow hedges in determining the effective portion of the gains or losses arising from the hedging instrument.

The Interpretations Committee observed that:

a. paragraph 6.5.13 of IFRS 9 states that 'Hedges of a net investment in a foreign operation … shall be accounted for similarly to cash flow hedges …'. Paragraph 6.5.13 (a), which focusses on net investment hedges, also has a reference to paragraph 6.5.11, which deals with the accounting for cash flow hedges; this includes the 'lower of' test. This indicates that, when accounting for net investment hedges, an entity should apply the 'lower of' test in determining the effective portion of the gains or losses arising from the hedging instrument.
b. in determining the effective portion of the gains or losses arising from the hedging instrument when accounting for net investment hedges, the application of the 'lower of' test avoids the recycling of exchange differences arising from the hedged item that have been recognised in other comprehensive income before the disposal of the foreign operation. The Interpretations Committee noted that such an outcome would be aligned with the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

In addition, the Interpretations Committee noted the following:

a. it did not receive any evidence of significant diversity between entities applying IAS 39 *Financial Instruments: Recognition and Measurement* in determining the effective portion of the gains or losses arising from the hedging instrument by applying the 'lower of' test when accounting for net investment hedges.

b. few entities have yet adopted the hedging requirements in IFRS 9; consequently, it is too early to assess whether the issue is widespread. However, the Interpretations Committee did not expect significant diversity to arise when IFRS 9 is adopted more widely.

In the light of the existing requirements in IFRS Standards, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee decided not to add this issue to its agenda.

Appendix B—Comment letters received

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Mr Wayne Upton
Chairman, IFRS Interpretations Committee
IFRS Foundation
30 Cannon Street
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United Kingdom

Our ref MV/288
Contact Mark Vaessen

20 January 2016

Dear Mr Upton

Tentative agenda decision: *IFRS 9 Financial Instruments—Determining hedge effectiveness for net investment hedges*

We appreciate the opportunity to comment on the above IFRS Interpretations Committee (the Committee) tentative agenda decision included in the November 2015 IFRIC Update. We have consulted with, and this letter represents the views of, the KPMG network.

We agree with the Committee's tentative decision that this issue need not be added to the Committee's agenda. However, we disagree with certain aspects of the wording of the tentative agenda decision.

As the Committee observes, paragraph 6.5.13 of IFRS 9 states that 'Hedges of a net investment in a foreign operation ... shall be accounted for *similarly to* [italics added] cash flow hedges ...' and paragraph 6.5.13(a) refers to paragraph 6.5.11, which deals with the accounting for cash flow hedges, and includes what the Committee describes as the 'lower of' test.

The tentative agenda decision then states: "This indicates that the 'lower of' test should be applied when determining the effective portion of the gains or losses arising from the hedging instruments when accounting for net investment hedges."

However, in describing the 'lower of' test, IFRS 9.6.5.11(a)(ii) refers to the "cumulative change in fair value (present value) of the hedged item (i.e. the present value of the cumulative change in the hedged expected future cash flows)." This guidance is not capable of literal application to a net investment hedge because it is a hedge of foreign exchange differences arising under IAS 21 *The Effects of Changes in Foreign Exchange Rates* on a net investment that is not measured at fair (or present) value and there are no hedged cash flows.

Therefore, we think that the Committee should clarify that:

- the effective portion of the gains and losses on the hedging instrument should be based on an approach *similar to* that set out in IFRS 9.6.5.11(a) for cash flow hedges; and

- given the different nature of a net investment hedge and the guidance in IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*, and depending on how the hedge is designated, the amount calculated with respect to 6.5.11(a)(ii) may be determined in accordance with IAS 21 – i.e. the recognised IAS 21 translation differences on the hedged item rather than changes in fair/present value.

Please contact Mark Vaessen or Chris Spall on +44 (0) 20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited

cc: Reinhard Dotzlaw, KPMG LLP (Canada)

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Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
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18 January 2016

Dear Mr Upton

Tentative agenda decision – IFRS 9 *Financial Instruments*: Determining hedge effectiveness for net investment hedges

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the November IFRIC Update of the tentative decision not to take onto the Committee's agenda a request for clarification on how hedge effectiveness should be determined when accounting for net investment hedges in accordance with IFRS 9.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

MAZARS

Mr. Wayne Upton

IFRS Interpretation Committee
30 Cannon Street
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Paris, January 29, 2016

RE: IFRS Interpretations Committee tentative agenda decisions, November 2015

Dear Wayne,

MAZARS is pleased to comment on the various IFRS Interpretations Committee tentative agenda decisions published in the September IFRIC Update.

We have gathered all our comments as appendices to this letter. Should you prefer us to prepare separate comment letter for each tentative agenda decision, please let us know.

Should you have any questions regarding our comments, please do not hesitate to contact Michel Barbet-Massin (+33 1 49 97 62 27) or Edouard Fossat (+33 1 49 97 65 92).

Best regards,

Michel Barbet-Massin
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MAZARS

Appendix 2

IFRS 9 Financial Instruments—Determining hedge effectiveness for net investment hedges (Agenda Paper 11)

We agree with the IFRS Interpretations Committee's decision not to add this issue onto its agenda, and with the rationale expressed in the tentative agenda decision.

Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

DRSC

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Berlin, 19 January 2016

Dear Wayne,

IFRS IC's tentative agenda decisions in its November 2015 meeting

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on several tentative agenda decisions taken by the IFRS IC, as published in the November 2015 *IFRIC Update*. Please find our detailed comments in the appendix to this letter.

If you would like to discuss our views further, please do not hesitate to contact Jan-Velten Große or me.

Yours sincerely,

Andreas Barckow
President

Appendix A – Comments on tentative agenda decisions

IAS 39/IFRS 9 – Derecognition of modified financial assets

We consider the decision being inappropriate given that there is an issue in practice. While the IFRS IC take the view that it is not appropriate to progress with the issue "at this time" and that it cannot be resolved "through an interpretation", we point to the fact that there are other means to address an issue, even in case it is a broad one. We suggest the IASB take action and deliberate a clarification as to how and when to derecognise modified financial assets and potentially charge the IFRS IC in developing respective proposals. Otherwise, we clearly see the danger that other parties, esp. out of the regulatory domain, will take the lack of clarity as a reason to develop second level GAAP.

IAS 39/IFRS 9 – Determining hedge effectiveness for net investment hedges

We agree with the decision.

IAS 20 – Accounting for recoverable cash payments

Generally, we are not convinced that the rationale for clarifying whether and how IAS 20 applies, i.e. whether there is a government grant (thus P/L recognition) or a forgivable loan (thus liability recognition), is appropriate. As per the IFRIC Update, many Committee members thought that the definition of a forgivable loan might be fulfilled, while the (full) Interpretations Committee clearly observed that there is a financial liability, which is contradictory in itself. Rather, fulfilling the definition of a forgivable loan is a necessary (but not sufficient) condition for recognising a financial liability.

In particular, we object to the finding that the arrangement described is a financial liability. Taking into account the (few) details given we would have concluded that fulfilling the conditions for a repayment is at the very discretion of the entity having received the cash payment; hence, there is clearly no financial liability.