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IFRIC issues Interpretation on net investment hedging

On 3 July 2008, the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC 16 **Hedges of a Net Investment in a Foreign Operation**. The Interpretation provides guidance on net investment hedging, including:

- which foreign currency risks qualify for hedge accounting, and what amount can be designated;
- where within the group the hedging instrument can be held; and
- what amount should be reclassified to profit or loss when the hedged foreign operation is disposed of.

The consensus reached by the IFRIC on each of these issues is summarised below.

IFRIC 16 is effective for annual periods beginning on or after 1 October 2008.

Background

IAS 21 **The Effects of Changes in Foreign Exchange Rates** sets out the requirements for accounting for foreign operations. A foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based on or conducted in a country or currency other than those of the reporting entity. Under IAS 21, when translating the financial position and results of a foreign operation, any exchange differences arising from that translation are recognised in other comprehensive income (OCI), and the cumulative differences are presented in a separate component of equity until the foreign operation is disposed of. That separate component of equity is often referred to as the foreign currency translation reserve (FCTR).

An entity may choose to hedge the foreign exchange exposure arising from such foreign operations (referred to as a ‘net investment hedge’) and may apply hedge accounting if the foreign operations are included in the financial statements of the entity using consolidation, proportionate consolidation or by applying the equity method. If the hedging relationship meets the requirements for hedge accounting in IAS 39 **Financial Instruments: Recognition and Measurement**, any exchange gains or losses arising on the portion of the hedging instrument that is determined to be an effective hedge are recognised outside profit or loss in OCI.

Scope

IFRIC 16 applies to entities that hedge the foreign currency risk arising from their net investments in foreign operations and that apply hedge accounting. The Interpretation states explicitly that it does not apply to other types of hedge accounting (i.e. fair value and cash flow hedge accounting), and that the consensus should not be extended by analogy to other types of hedge accounting.

For the remainder of this newsletter, the discussion refers to hedging a foreign operation that is a subsidiary in the consolidated financial statements, as this is the most common hedge relationship. IFRIC 16 applies equally to hedges of net investments in associates and jointly controlled entities that are accounted for by applying equity accounting or, in the latter case, by using proportionate consolidation. Also, the Interpretation applies to financial statements that include branches that qualify as foreign operations.

Consensus

Which foreign currency risks qualify for hedge accounting, and what amount can be designated?

Divergence had emerged in practice as to what risks could be designated as hedged risks for hedge accounting purposes. Specifically, some entities considered that the hedged risk could incorporate the exchange differences arising between the functional currency of the foreign operation and the presentation currency used in the consolidated financial statements of the parent entity.

The IFRIC has disagreed with this viewpoint, and has concluded that the eligible risk is restricted to the exchange differences arising between the functional currency of a parent and the functional currency of the foreign operation.

The IFRIC has also come to the following conclusions.

- For the purpose of identifying the hedged risk, it is irrelevant whether the net investment is held by the parent directly or indirectly. Any foreign currency risk arising between the functional currency of a foreign operation and the functional currency of an immediate, intermediate or the ultimate parent is eligible for hedge accounting.
- The amount that may be designated as a hedged item in a net investment hedge is limited to the carrying amount of the net assets of the foreign operation included in the consolidated financial statements of the parent.
- Any 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 same risk arising from the same net assets of a foreign operation is hedged by more than one parent within the group (e.g. by both a direct and an indirect parent), only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the higher-level parent. In preparing its consolidated financial statements, the higher-level parent can choose to reverse the hedge accounting at the lower parent entity level and start afresh, or it can maintain the hedge accounting at the lower parent entity level and identify whether any incremental foreign currency risk has been hedged at the higher level which qualifies of hedge accounting.

Where within the group can the hedging instrument be held?

A hedging instrument in a net investment hedge may be a derivative or a non-derivative financial instrument, and it may be held by any entity or entities within the group (other than the foreign operation that is itself being hedged). This is the case provided that the designation, documentation and effectiveness requirements of IAS 39.88 are satisfied. In particular, it is important that the hedging strategy of the group is clearly documented because of the possibility of different designations at different levels of the group.

The Interpretation also clarifies that, for the purpose of testing hedge effectiveness for a net investment hedge, the change in the fair value of the hedging instrument 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. All changes in fair value of the hedging instrument are taken into account in testing effectiveness, irrespective of whether (in the absence of hedge accounting) those changes would be recognised in profit or loss, in OCI, or both.

The assessment of effectiveness is not affected by the type of hedging instrument (derivative or non-derivative) nor by the method of consolidation ('direct' or 'indirect' (also known as 'step-by-step') – see IFRIC 16 for a description of these approaches).

What amount should be reclassified to profit or loss when the hedged foreign operation is disposed of?

When an entity disposes of a foreign operation, IAS 21.48 requires that the cumulative exchange gains and losses deferred in the FCTR be reclassified to profit or loss when the gain or loss on disposal is recognised. In the case of a multi-tiered group, the amount held in the FCTR for an individual foreign operation (and, therefore, the amount to be reclassified to profit or loss on disposal of that operation) can be affected by whether the group uses a 'direct' or a 'step-by-step' approach to consolidation.

Where an entity's net investment in a foreign operation has been hedged, and the hedge accounting provisions of IAS 39 have been applied, IAS 39.102 requires that the foreign exchange differences arising on the hedging instrument that have previously been reported in OCI and presented in equity should be reclassified from equity to profit or loss on the disposal or partial disposal of the foreign operation.

Where the step-by-step approach to consolidation is used, there is a potential mismatch between the amount reclassified to profit or loss under IAS 21.48 and amount reclassified under IAS 39.102. In these circumstances, IFRIC 16 allows (but does not require) the entity to adjust the amount deferred in OCI for the hedged item to the amount that would have resulted had the entity applied the direct method of consolidation. The entity should apply this accounting policy consistently for all its net investments.

Effective date and transition

IFRIC 16 is effective for annual periods beginning on or after 1 October 2008. Earlier application is permitted if the entity discloses that fact.

The Interpretation is to be applied prospectively and, therefore, entities are not required to restate the results of prior periods to reflect the effects of the new Interpretation. Instead, entities are required to evaluate all hedging relationships at the date of adoption of IFRIC 16. If an entity determines that a hedge accounting relationship no longer qualifies in accordance with the Interpretation, it should discontinue hedge accounting and any amounts previously recognised in OCI will continue to be deferred until the hedged item affects profit or loss, i.e. when the foreign operation is disposed of.

Application guidance

IFRIC 16 is accompanied by (mandatory) Application Guidance which illustrates the consensus reached by way of examples.

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