

IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*



Background

IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) allows an entity to hedge the foreign currency gains or losses on its net investment in a foreign operation (the 'net investment'). In contrast to the guidance provided on fair value and cash flow hedge accounting, IAS 39 provides minimal guidance on the accounting for a hedge of a net investment. Because of this, the IFRIC has issued IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* (IFRIC 16, or the Interpretation). IFRIC 16 is applicable for annual periods beginning on or after 1 October 2008 and early application is permitted.

IAS 21 *The Effects of Changes in Foreign Exchange Rates* includes the following definitions:

- ▶ 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 or conducted in a country or currency other than those of the reporting entity.
- ▶ The net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation.

IFRIC 16 provides guidance on:

- ▶ Identifying the foreign currency risks that qualify for hedge accounting in the hedge of a net investment;
- ▶ Where within the group the hedging instrument (s) can be held in the hedge of a net investment; and
- ▶ How an entity should determine the amount of foreign currency gain or loss, relating to both the net investment and the hedging instrument, to be recycled on disposal of the net investment.

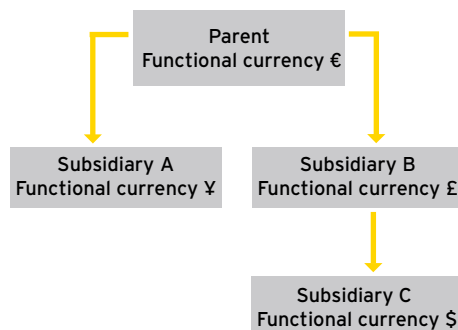


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The Interpretation

IFRIC 16 applies to the hedge of the foreign currency risk arising from a net investment. The Interpretation specifically states that an entity is not allowed to apply IFRIC 16 by analogy to other types of hedge accounting.

The following example is included in the Application Guidance of IFRIC 16 and we use it here to explain the concepts included in the consensus in IFRIC 16:



In this example, the parent entity's investment in subsidiary B is £500m, of which £159m (or US\$300m) relates to subsidiary B's investment in subsidiary C.

The hedged risk

IAS 21 and IAS 39 provide minimal guidance on the foreign currency risk that may be hedged in the hedge of a net investment. An entity can recognise foreign exchange gains and losses on a net investment from differences between the functional currency of the net investment and:

- ▶ the functional currency of its direct parent;
- ▶ the functional currency of any intermediate parent;
- ▶ the functional currency of its ultimate parent; and
- ▶ the presentation currency of the consolidated group (if this is different to the functional currency of the ultimate parent).

However, IFRIC 16 states that an entity can hedge all of the above exposures, except for the exposure arising from translation to a presentation currency. IFRIC 16 notes that the presentation currency does not create an economic risk that can be hedged; functional currencies do.

IFRIC 16 then clarifies that:

- ▶ 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;
- ▶ like other hedge relationships, an exposure cannot be hedged twice; and
- ▶ a hedging relationship designated by a parent entity need not be maintained at the ultimate parent entity.

In the above example, in relation to the \$300m investment in Subsidiary C, Parent could hedge up to \$300m of its \$/€ exposure, up to \$300m of its £/€ exposure or up to \$300m of its \$/£ exposure.

Furthermore, Subsidiary B could hedge its risk arising from Subsidiary C for up to \$300m of its \$/£ exposure. However, if Subsidiary B hedged this investment, Parent will need to ensure that it is not hedging its risk twice at the consolidated level. For example, if Subsidiary B hedged \$300m of its \$/£ exposure, Parent could either hedge \$300m of its £/€ exposure, or reverse Subsidiary B's hedge accounting and hedge the \$300m of its \$/€ risk.



The hedging instrument

IAS 39 indicates that, the entity exposed to the risk being hedged does not need to hold the hedging instrument; ie any entity within the group can hold it as long as the hedge is effective. IFRIC 16 confirms that this also applies to the hedge of a net investment in a foreign operation. There is one exception; the net investment cannot hold the hedging instrument. Thus, the functional currency of the entity holding the hedging instrument is irrelevant (unless it is the parent doing the hedge accounting). The Interpretation further explains that this is true regardless of whether the hedging instrument is a derivative or a non-derivative financial instrument. In the example above, Subsidiary A could hold the hedging instrument if Parent is hedging its net investment in Subsidiary C. However, if Subsidiary B were hedging its net investment in Subsidiary C, an instrument held by Subsidiary A would not qualify for hedge accounting, as it is not held within Subsidiary B's own sub-group.

To assess the effectiveness of the hedging instrument, for the purposes of the consolidated financial statements, the change in value of the hedging instrument is calculated in terms of the functional currency of the parent entity that is hedging its risk. In other words, the functional currency of the entity holding the hedging instrument is ignored when calculating the foreign exchange gains or losses on that instrument for hedging purposes.

Disposal of a hedged foreign operation

The most significant change in IFRIC 16 compared to the Exposure Draft D22, issued in July 2007, is the inclusion of guidance on the disposal and recycling of a net investment. IAS 21 indicates that an entity may complete the consolidation of its subsidiaries using either the direct method or the step-by-step method. The total amount included in other comprehensive income for all foreign operations will be the same regardless of whether the direct or the step-by-step method is used. However, the foreign currency exchange gain or loss allocated to an individual subsidiary will be different depending on the method of consolidation.

On disposal of a foreign operation, IFRIC 16 requires an entity to recycle the amount in other comprehensive income relating to that specific foreign operation. As noted above, this may differ for individual entities depending on the method of consolidation. IFRIC 16 states that an entity has a choice to recycle the amount that arises from either the direct method or the step-by-step method, irrespective of the method that the entity uses for consolidation purposes. The choice of method of recycling is a policy choice and must be followed consistently for all net investments. If this policy choice differs from the actual method used to consolidate subsidiaries, the entity will need to implement systems to separately identify the amounts involved.

Transitional provisions

IFRIC 16 is to be applied prospectively. Therefore, if an entity has designated a hedging instrument as a hedge of a net investment that does not meet the requirements of the Interpretation, it is required to apply IAS 39 to prospectively discontinue hedge accounting.

Business impacts

As the Interpretation shows, there are a number of different ways an entity can hedge the risks arising from its net investment. It is important that entities consider the overall economic risk they are trying to mitigate when determining the hedging strategy for the group. To avoid over-hedging, documentation and communication of these strategies is vital.

An important consideration for entities that hedge their net investments is the accounting policy choice around the recycling of foreign currency gains and losses on disposal of a net investment. IFRIC 16 highlights the link between the consolidation method, the recycling policy and the hedging strategy of a group. It is important that entities revisit their policies in these areas to ensure they are aligned and that the most appropriate accounting policy choice is made.

If entities decide to use a consolidation method that differs from the method of recycling, they will need to consider what systems should be implemented to ensure the appropriate amounts are identified and recycled.

Finally, the effective date of the Interpretation is not far away. Entities should consider *now* the implications and ensure the correct accounting policy choices have been made and documentation is in place before the Interpretation becomes effective.

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