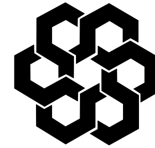

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2008, London**

Project: **D22 *Hedge of a Net Investment in a Foreign Operation* – Net Investment and Recycling (Agenda Paper 2J)**

Introduction

1. At the January 2008 IFRIC meeting, the IFRIC directed the staff to develop a comprehensive example to illustrate the application of the principles it proposed in D22. These proposals were supported by a large majority of the respondents to the draft Interpretation but a number of others disagreed with the fundamental conclusions or expressed concerns about their implications.

2. The examples in the other Agenda Papers in this series illustrate the application of the D22 conclusions in normal situations. However, the IFRIC also asked the staff to consider their effect in particular on the recycling of the accumulated Foreign Currency Translation Reserve (FCTR).

3. In addition, a reviewer suggested that the staff's conclusions with respect to the method of consolidation in the 'normal case' examples appeared to be valid only because the variations in the exchange rates used in the examples were relatively

small. In other situations, in which there was a more significant variation between the functional currencies of the foreign operations that was not reflected in the exchange rate with the parent functional currency, it could be shown that the method of consolidation did affect the effectiveness of the hedging relationships.

4. In the staff's view, these questions are related and the conclusions rest on how the basic principle of IAS 21 is understood. D22 did not explicitly state the IFRIC's conclusion on this question, although the staff believes that it is clear from the consensus reached. However, because this understanding is critical to the application of the Interpretation, the staff recommends that it be discussed explicitly in the final Interpretation. A clear statement would also answer many of the application questions respondents raised in the comment letters.

5. This paper sets out the staff's understanding of the basic principle of IAS 21 and how it affects the conclusion on the two issues identified in paragraphs 2 and 3.

Basic Principle of IAS 21

6. IAS 21 rests on the notion that each entity has a functional currency that is 'the currency of the primary economic environment in which the entity operates.' An entity's exposure to foreign currency risk arises from two sources:

   - Transactions denominated in currencies other than its functional currency
   - Net investments in foreign operations with functional currencies other than its functional currency. In accordance with IAS 21.15, such a net investment includes 'a monetary item that is receivable from or payable to a foreign operation. [if] settlement is neither planned nor likely to occur in the foreseeable future'.

7. IAS 21 requires exchange differences arising from the translation of foreign operations to be recognised initially in a separate component of equity or other comprehensive income (OCI) in accordance with IAS 1 as revised in 2007 (IAS 21.32) and the cumulative amount deferred in OCI to be included in profit or loss when the gain or loss on disposal of the foreign operation is recognised (IAS 21.48). IAS 21.41 notes that 'These exchange differences are not recognised in

profit or loss because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations.'

Which reporting entity? Which risk?

8. Key issues in identifying the amount to be recognised in OCI are to determine the reporting entity and its investment in the foreign operation. The Board sought to clarify what is the reporting entity and what could be considered to be part of the net investment in a foreign operation in its amendment to IAS 21 in 2005.

9. In its Basis for Conclusions to the IAS 21 amendment, the Board noted in particular that constituents had stated that:

> 'It is not clear whether the term 'reporting entity' in paragraph 32 should be interpreted as the single entity or the group comprising a parent and all its subsidiaries. As a result, [they] questioned whether the monetary item must be transacted between the foreign operation and the reporting entity, or whether it could be transacted between the foreign operation and any member of the consolidated group, ie the reporting entity or any of its subsidiaries.' (BC25C)

10. In response, the Board added IAS 21.15A to clarify that, 'The entity that has a monetary item receivable from or payable to a foreign operation described in paragraph 15 may be any subsidiary of the group.' It explained its reasons for the amendment in BC25D of the Basis for Conclusions:

> The Board noted that the nature of the monetary item referred to in paragraph 15 is similar to an equity investment in a foreign operation, ie settlement of the monetary item is neither planned nor likely to occur in the foreseeable future. Therefore, the principle in paragraph 32 to recognise exchange differences arising on a monetary item initially in [OCI] effectively results in *the monetary item being accounted for in the same way as an equity investment* in the foreign operation when consolidated financial statements are prepared. *The Board concluded that the accounting treatment in the consolidated financial statements should not be dependent on the currency in which the monetary item is denominated, nor on which entity within the group conducts the transaction with the foreign operation.* (emphasis added)

11. In the staff's view, two essential points are made in BC25D. First is that the Board explicitly concluded that the relevant reporting entity is the group rather than the individual entity. Implicit in that conclusion is the second point — the net investment must be viewed from the perspective of the group, that is, the accumulated investment by all group entities. This view is supported by the

statement in BC25E that, 'This requirement applies irrespective of the currency of the monetary item and of whether the monetary item results from a transaction with the reporting entity or any of its subsidiaries.' It follows, therefore, that the group's net investment in any foreign operation, and its foreign currency exposure, can be determined only at the group (parent entity consolidated) level. The amounts determined at any sub-group level are relevant only at that sub-group level.

12. This conclusion does not imply that there is a 'correct' method of consolidating subsidiaries in groups with multiple levels. Obviously, some subsidiaries that are themselves parents may have external reporting requirements and it will be necessary for them to prepare their own consolidated financial statements. Those financial statements will reflect the net investments and foreign currency exposures at that level. However, in the staff's view, the group's net investment and foreign currency exposure are those identified by the direct method of consolidation. Differences produced by intermediate consolidations must be adjusted to determine the net investment at the ultimate group level.

13. This view is supported by the Board's conclusions in making the 2005 amendment that the currency in which the monetary item is denominated should not affect the accounting treatment (as noted in paragraph 9). That is, the Board agreed with the constituents who pointed out that:

    An investment in a foreign operation denominated in a currency that is not the functional currency of the reporting entity or the foreign operation does not expose the group to a greater foreign currency exchange difference than arises when the investment is denominated in the functional currency of the reporting entity or the foreign operation. It simply results in exchange differences arising in the foreign operation's individual financial statements and the reporting entity's separate financial statements. (BC25C)

14. In fact, even prior to the 2005 amendment IAS 21.33 was clear that effects from intermediate currencies would be adjusted to OCI in the group financial statements:

    When a monetary item forms part of a reporting entity's net investment in a foreign operation and is denominated in the functional currency of the reporting entity, an exchange difference arises in the foreign operation's individual financial statements in accordance with paragraph 28. If such an item is denominated in the functional currency of the foreign operation, an exchange difference arises in the reporting entity's separate financial

statements in accordance with paragraph 28. *If such an item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, an exchange difference arises in the reporting entity's separate financial statements and in the foreign operation's individual financial statements in accordance with paragraph 28. Such exchange differences are reclassified to the separate component of equity in the financial statements that include the foreign operation and the reporting entity* (ie financial statements in which the foreign operation is consolidated, proportionately consolidated or accounted for using the equity method). (emphasis added)

Application to Method of Consolidation and Recycling

Method of consolidation

15. The conclusion to be drawn from the staff's analysis is that the method of consolidation does not affect either the amount of the reporting entity's net investment or the effectiveness of the hedging instrument no matter what the variation in the exchange rates used in the examples. The staff has provided an additional example (see AP2K) in which there is a significant variation in the $/£ exchange rate but both the £/€and €/$ rates are unaffected.

16. In the staff's view, the parent/group reporting entity's foreign currency exposure to Subsidiary C is €/$. The fact that the net investment is held through Subsidiary B does not affect the economic risk. This is consistent with the IFRIC's conclusion that an entity could not hedge an exposure to changes in the presentation currency. Therefore, the FCTR amounts reported from the step consolidation of BC must be reallocated between the two subsidiaries in the group financial statements (see the €40 entry at the parent consolidation level). Otherwise a positive change in the €/$ exchange rate would be reflected as a loss in the FCTR relating to Subsidiary C.

Recycling and hedge accounting

17. The conclusion to be drawn from the staff's analysis is that the amounts to be recycled on the disposal of a subsidiary are:

    - the cumulative amount reflected in the FCTR (IAS 21.48), and

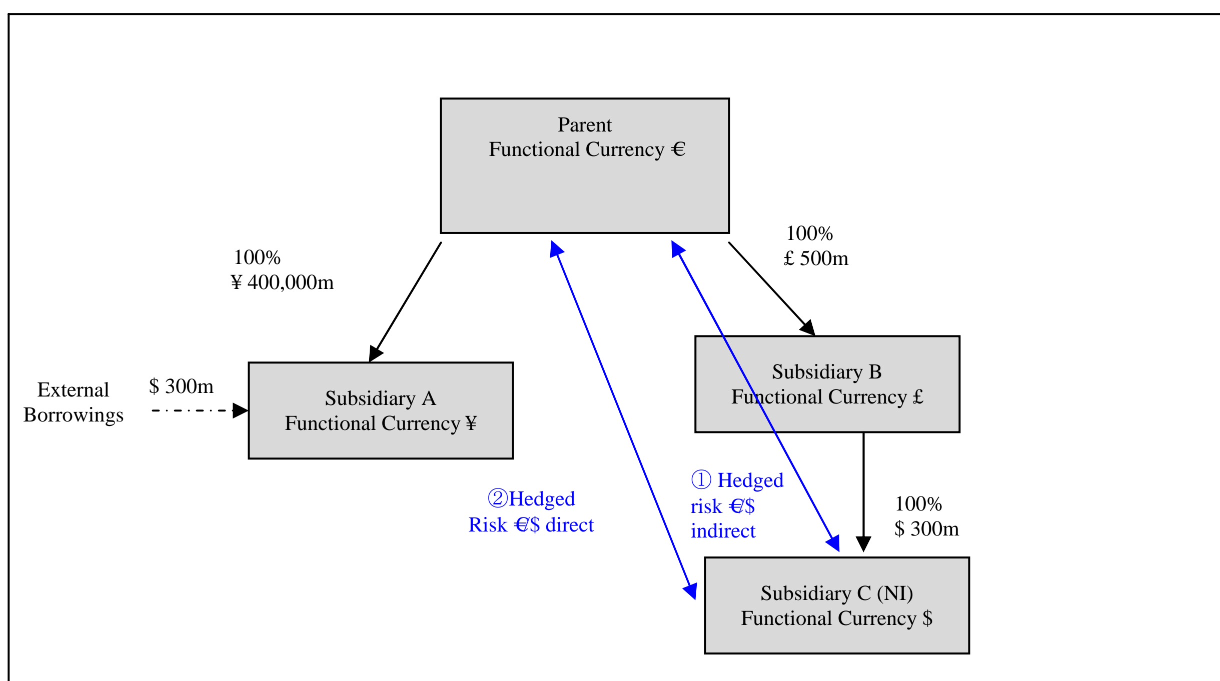
    - the amount of gain or loss on a hedging instrument relating to the effective portion of any hedge that has been reflected in OCI (IAS 39.102)

with respect to that subsidiary *in the group's financial statements*.

18. Some constituents have suggested that the proposals in D22 would result in different amounts being included in profit or loss depending on the order in which subsidiaries were disposed of. The staff does not agree with that view. Constituents expressing this concern believe that the amount that should be reclassified to profit or loss with respect to the hedging instrument is only the amount that would otherwise have been included in group profit or loss.

19. This can be illustrated using the example in AP2B.

Situation 1: Hedging instrument (Borrowing) held by Sub A



20. In that example, the amounts included in the Parent financial statements *before* the application of hedge accounting were:

- €24m loss relating to the net investment in Subsidiary C
- €15m translation gain recognised in profit or loss related to the debt held by Subsidiary A *and* €9m gain recognised in the FCTR related to Subsidiary A related to the retranslation of the part of the net assets related to the debt.

At the very bottom of the spreadsheet in AP2B, the staff have set out the journal entries that recognise the effect of hedge accounting. You will note that in the

parent's consolidated financial statements, no FCTR would appear for either Subsidiary A or Subsidiary C.

21. Assume that Subsidiary C is disposed of on 2 January 2006 following one year of hedge accounting treatment for the year ended 31 December 2005 with gains/losses on the hedging instrument having been included in OCI as the hedge relationship is 100% effective. The amounts that would be reclassified to profit or loss in accordance with paragraph 17 are:
    - *"the cumulative amount of the exchange differences deferred in the separate component of equity*" relating to the foreign operation disposed of, Subsidiary C (IAS 21.48). This is the loss of €24m.
    - *"the gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in equity"* (IAS 39.102). In this case the effective portion of the hedge (based on the method of assessing effectiveness proposed in D22 and used in the examples) will comprise two elements:
        a) the gain of €15m that would, in the absence of hedge accounting treatment, have been recorded in consolidated profit or loss, and
        b) the gain of €9m that would have remained in equity (as FCTR-Entity A) in the absence of hedge accounting treatment.

22. In the staff's view it is necessary to ensure that the amounts reclassified to profit or loss on the disposal of any foreign operation reflect the consolidated net investment *after* taking into account the effects of hedge accounting. To be consistent with the requirements of IAS 39, the hedge effects must include all amounts included in the assessment of hedge effectiveness. In the example, this means that the amount described as the FCTR relating to Subsidiary A prior to the application of hedge accounting must be reclassified to profit or loss on the disposal of Subsidiary C because that amount was included in the determination of the effectiveness of the hedging instrument (debt) held by Subsidiary A. After those amounts are recycled, the consolidated financial statements will reflect the group's FCTR relating to Subsidiary A at the date of disposal of Subsidiary C, which is nil.

23. Similarly, if Subsidiary A is disposed of before Subsidiary C, the €9m gain in relation to retranslation of that part of the net assets that represent the external debt (that forms part of the net assets of Subsidiary A) would not be reclassified to profit or loss but would be reclassified to the group's FCTR relating to Subsidiary C as previously reported in the Parent financial statements. Once

again, the FCTR of Subsidiary C after the disposal of Subsidiary A would be nil, reflecting the hedge relationship in place to that point.

24. The staff' believes that this conclusion is consistent with the Board's view that a net investment can be held anywhere within the group without affecting the group financial statements. It is also consistent with the D22 proposals that the hedging instrument can similarly be held anywhere within the group. If the $300 debt had been held by the Parent instead of Subsidiary A, all of the €24 gain would have been included in profit or loss in the Parent separate financial statements and would have been transferred to OCI as the effective portion of the hedge of the net investment in Subsidiary C. In this case there would be no question that the entire €24 would be recycled when Subsidiary C was disposed of. The staff do not believe that having the debt held by Subsidiary A should produce a different result in the consolidated financial statements.

25. In the staff's view, any other approach to recycling does not reflect *the group reporting entity's* cumulative FCTR and effective hedge amounts with respect each net investment. It also means that where in the group the net investment or hedging instrument is held does matter, contrary to the Board's conclusion in the 2005 amendment to IAS 21 and the IFRIC's conclusion in D22.

Questions for the IFRIC

26. Does the IFRIC agree with the Staff's analysis of the reporting entity and determination of the foreign currency exposure in paragraphs 8 to 14? If not, what alternative to determining the net investment do you propose and why?

27. Does the IFRIC agree with the staff's conclusions on the application of its analysis in paragraphs 8 to 14 to the situations described in paragraphs 15 to 23?

    - If you do not agree with the analysis of the method of consolidation in paragraphs15 and 16, do you agree that that conclusion is not consistent with the Board's conclusion that a net investment could be held anywhere in the group? Should the IFRIC request the Board to amend IAS 21 to support a final Interpretation that reflects this view?

    - If you do not agree with the analysis of the amounts to be included in profit or loss on the disposal of a subsidiary in paragraphs 17 to 23, do you believe

that only the amounts that would otherwise have been included in profit or loss should be recycled on disposal? Does this imply that the IFRIC should reconsider its conclusion on including the entire change in the net investment in assessing the effectiveness of hedge relationships? What is the rationale for excluding some portion of an amount deferred as part of an effective hedge from recycling when the hedged item is disposed of?