

STAFF PAPER

November 2015

IFRS Interpretations Committee Meeting

| Project | New items for initial consideration | | |
|-------------|--|-----------------|---------------------|
| Paper topic | IFRS 9 <i>Financial Instruments</i> —Net investment hedges | | |
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The IFRS Interpretations Committee (‘the Interpretations Committee’) received a request regarding IFRS 9 *Financial Instruments*. The request asks the Interpretations Committee to clarify how to determine hedge effectiveness for hedges of a net investment in a foreign operation (‘net investment hedges’).
2. The objective of this Agenda Paper is to provide the Interpretations Committee with a summary of the issue and the staff’s analysis and recommendation.

Structure of the paper

3. This paper is organised as follows:
 - (a) Background;
 - (b) Summary of outreach conducted;
 - (c) Staff analysis;
 - (d) Assessment against the Interpretations Committee’s agenda criteria;
 - (e) Staff recommendation;
 - (f) Questions for the Interpretations Committee;
 - (g) Appendix A—Proposed wording for tentative agenda decision; and
 - (h) Appendix B—Submission.

Background

The issue

4. The submitter has asked the Interpretations Committee to clarify how hedge effectiveness should be determined when accounting for net investment hedges. The submitter states that IFRS 9 does not provide specific guidance as to how hedge effectiveness for net investment hedges should be determined. The paragraphs in IFRS 9 dealing with the accounting for net investment hedges are reproduced below:

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.**

6.5.14 The cumulative gain or loss on the hedging instrument of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustments (see IAS 1) in accordance with paragraphs 48-49 of IAS 21 on the disposal or partial disposal of the foreign operation.

5. The submitter states that even though the paragraphs above are not explicit as to how to determine the effective portion to be recognised in other comprehensive income (OCI), 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**’ (**emphasis added**) and, in addition, paragraph 6.5.13(a) has a cross-reference to **paragraph 6.5.11** of IFRS 9.

Paragraph 6.5.11 of IFRS 9 deals with the accounting for cash flow hedges including the ‘lower of’ test that describes the mechanics that determine the effective portion of the gain or loss on the hedging instruments that is recognised in OCI.

6. The submitter states that this cross-reference to the accounting for cash flow hedges was not in the corresponding paragraph of IAS 39 *Financial Instruments: Recognition and Measurement* dealing with the accounting for

net investment hedges (ie paragraph 102 of IAS 39). Because the submitter understands that there is currently diversity in practice when entities apply the requirements in IAS 39 and that the IASB's objective, as stated in paragraphs BC6.383–5 of IFRS 9, was not to change the requirements in IAS 39 for net investment hedges, it requests clarification, because diversity in application is believed to be continuing.¹

7. The submitter has identified two views relating to the appropriate accounting treatment.

View 1—the 'lower of' test required for cash flow hedges does not apply to the accounting for net investment hedges

8. Net investment hedges should be accounted for 'similarly' to cash flow hedges, but this similarity is limited to the recognition of the effective portion of the gains or losses on the hedging instruments in OCI, without applying a 'lower of' test as required for cash flow hedges. Consequently, proponents of this view think that the hedge ineffectiveness for net investment hedges should be measured in profit or loss as the difference between the period-to-period gain or loss on the designated net assets of the foreign operation and the period-to-period gain or loss on the hedging instrument.
9. For the purpose of illustrating the treatment described above, the submitter considered the case of an entity that entered into a net investment hedge at the start of Year 1. It is assumed that the net investment hedge meets the hedge effectiveness requirements in paragraph 6.4.1 (c) of IFRS 9. The details of the net investment hedge are as follows:²

¹ In particular, paragraph BC6.384 of IFRS 9 states: 'Consequently, the IASB proposed retaining the requirements of IAS 39 for a hedge of a net investment in a foreign operation.'

² In this Agenda Paper, currency amounts are denominated in 'currency units' (CU).

| | Year 1 | Year 2 |
|---|--------|--------|
| Foreign Exchange (FX) translation on the net assets | 20 | 30 |
| Cumulative FX translation on the net assets | 20 | 50 |
| Gain/Loss derivative | -18 | -35 |
| Cumulative Gain/Loss derivative | -18 | -53 |

10. Supporters of View 1 would determine and recognise effectiveness as follows:

| View 1 | Year 1 | | Year 2 | | Year 2 Cumulative | |
|-------------------------------|--------|----|--------|----|-------------------|-----|
| | Dr | Cr | Dr | Cr | Dr | Cr |
| Net assets | 20 | | 30 | | 50 | |
| OCI Net assets | | 18 | | 30 | | 48 |
| Derivative Gain or Loss (OCI) | 18 | | 30 | | 48 | |
| Derivative | | 18 | | 35 | | 53 |
| Hedge ineffectiveness | | 2 | | 5 | | 3 |
| | 38 | 38 | 65 | 65 | 101 | 101 |

Under-hedging is a gain
Over-hedging is a loss

11. Proponents of this view think that unlike a cash flow hedge, for a net investment hedge the hedged item is recognised in the statement of financial position whereas cash flow hedges of forecast transactions are not. According to these proponents, the main purpose of the ‘lower of’ test is to avoid recognition in profit or loss of amounts relating to forecast transactions when those transactions have not occurred. In the case of net investment hedges, such a test with such a purpose is not necessary. Because of this, net investment hedges is seen as being more akin to a fair value hedge, because in both cases the hedge item is an existing item and is recognised in the statement of financial position; and in both cases hedge ineffectiveness arises when the gains and losses of the recognised hedged item and recognised hedging instrument do not offset perfectly.

12. Proponents of this view note that this accounting would result in recognition of translation gains and losses in profit or loss prior to disposal of the related foreign operation, but argue that paragraph 5 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* is explicit in excluding net investment hedges from its scope:

5 This Standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. IFRS 9 applies to hedge accounting.

13. As a result, proponents of this view think that IAS 21 does not prohibit gains and losses on the translation of the net assets of the foreign operation that are hedged

from being recognised in profit or loss prior to the foreign operation being disposed of.

14. These proponents also note that this approach is consistent with US GAAP. In particular, requirements ASC 815-35-35-23 and 35.24 state:

35-23

Ineffectiveness in a net investment hedge shall be recognized in earnings for both overhedges and underhedges—specifically:

- a. If the change in the fair value of the actual derivative instrument designated as the hedging instrument exceeds the change in fair value of the hypothetical derivative instrument, the difference represents an overhedge that shall be recognized in earnings.
- b. If the change in fair value of the actual derivative instrument designated as the hedging instrument is smaller than the change in fair value of the hypothetical derivative instrument, the difference represents an underhedge that shall be recognized in earnings.

35-24

The recognition of hedge ineffectiveness for an underhedge of an entity’s net investment in a foreign operation deliberately differs from the accounting for cash flow hedges in Subtopic 815-30.

View 2—the ‘lower of’ test required for cash flow hedges applies to the accounting for net investment hedges

15. Proponents of this view think that net investment hedges should also be accounted for ‘similarly’ to cash flow hedges, but this similarity is not limited to the recognition of the effective portion of the gains or losses on the hedging instruments in OCI. Instead, it extends to applying the ‘lower of’ test as required for cash flow hedges. As mentioned in paragraph 5, paragraph 6.5.11 of IFRS 9 deals with the accounting of cash flow hedges and in particular with the ‘lower of’ test:

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.**
- (b) **the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.**
- (c) **any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss.**
- (d) **the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:**
 - (i) **if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see IAS 1) and hence it does not affect other comprehensive income.**
 - (ii) **for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).**
 - (iii) **however, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is**

not expected to be recovered into profit or loss as a reclassification adjustment (see IAS 1).

16. Proponents of this view think that the ‘lower of’ test should apply, because the accounting for net investment hedges in paragraph 102 of IAS 39 was carried over to IFRS 9 (paragraph 6.5.13 (a)). In paragraph 102 of IAS 39 there was a reference to paragraph 88 of IAS 39, which, when the requirements in IFRS 9 were being drafted, was replaced by the cross-reference to paragraph 6.5.11 of IFRS 9. Paragraph 88 of IAS 39 dealt with the conditions for application of hedge accounting, but, paragraph 6.5.11 of IFRS 9 deals with the mechanics of cash flow hedge accounting.

17. According to this view, the net investment hedge example in paragraphs 9–10 would be as follows:

| View 2 | Year 1 | | Year 2 | | Year 2 Cumulative | |
|-------------------------------|--------|----|--------|----|-------------------|-----|
| | Dr | Cr | Dr | Cr | Dr | Cr |
| Net assets | 20 | | 30 | | 50 | |
| OCI Net assets | | 20 | | 30 | | 50 |
| Derivative Gain or Loss (OCI) | 18 | | 32 | | 50 | |
| Derivative | | 18 | | 35 | | 53 |
| Hedge ineffectiveness | | | 3 | | 3 | |
| | 38 | 38 | 65 | 65 | 103 | 103 |

Under-hedging has no PL effect

Cumulative gain of CU50 on net assets is lower than cumulative losses of CU53 on hedging derivative

18. In addition, proponents of this view disagree with the notion that cash flow hedges are limited to forecast transactions (ie off-balance sheet items) and therefore that the ‘lower of’ test exists only for those types of exposures. For example, a cash flow hedge of variable interest rate payments arising from a recognised financial liability can be the hedged item in a cash flow hedge.

19. In addition, this view prevents any foreign currency gains or losses from the net investment in the foreign operation being recognised in profit or loss prior to its disposal. This would be consistent with the requirements in paragraph 48 of IAS 21 to reclassify foreign currency gains and losses on foreign operations only on disposal of the foreign operation.

Summary of outreach conducted

20. In order to gather information about the issue described in the submission, we sent requests to securities regulators, members of the International Forum of Accounting Standard-Setters (IFASS) and the global IFRS technical teams of the international networks of the large accounting firms (hereafter, ‘accounting firms’). Specifically, we asked:
- (a) the most commonly observed method that entities use to determine hedge effectiveness for net investment hedges; and
 - (b) the extent to which there is diversity in practice in respect of the issue submitted.

Responses received

21. We received 17 responses from the following respondents:
- (a) 2 groups of regulators;
 - (b) 10 national standard-setters; and
 - (c) 5 accounting firms.
22. The views received represent informal opinions and do not reflect the formal views of those organisations.
23. The geographical breakdown for the responses received from national standard-setters is as follows:

| Geographical region | Number of respondents |
|----------------------------|------------------------------|
| Asia | 3 |
| Europe | 1 |
| Americas | 2 |
| Oceania | 2 |
| Africa | 2 |
| Total respondents | 10 |

24. We summarise the results of the outreach in the following paragraphs (see paragraphs 25–34).

Summary of outreach responses

25. 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 should be understood as representing the current practice observed by the respondents of entities applying IAS 39.
26. The majority of the responses stated that View 2 is the approach most commonly observed. The responses to the outreach do not reveal significant divergence in practice, although a couple of respondents observed approaches that were different from either view identified by the submitter (see paragraphs 8–19) and two respondents noted that clarification is needed in both IAS 39 and IFRS 9.
27. The feedback received by type of respondent is summarised below.

Regulators

28. One of the regulators commented that it has not observed the issue submitted. A possible reason provided for this is that because IAS 39 is silent on the mechanics that an entity must follow when accounting for net investment hedges, foreign private issuers would be more likely to follow US GAAP, which has clear guidance on the matter (see paragraph 14).
29. The second regulator received responses from six different jurisdictions. Of the responses received, one enforcer noted that in its jurisdiction View 2 would be the most commonly used approach. Another enforcer noted that the observed method differs from both View 1 and View 2 outlined in the submission. According to this enforcer, only when the exchange rate differences on the hedging instrument exceed the translation differences on the hedging item, would then that excess be recognised in profit or loss. Considering the example submitted, the approach followed in the jurisdiction of this enforcer would be represented by the following entries:

| One European jurisdiction | Year 1 | | Year 2 | | Year 2 Cumulative | |
|-------------------------------|-----------------------|-----------|-----------------------|-----------|-------------------|------------|
| | Dr | Cr | Dr | Cr | Dr | Cr |
| Net assets | 20 | | 30 | | 50 | |
| OCI Net assets | | 20 | | 30 | | 50 |
| Derivative Gain or Loss (OCI) | 18 | | 30 | | 48 | |
| Derivative | | 18 | | 35 | | 53 |
| Hedge ineffectiveness | | | 5 | | 5 | |
| | <u>38</u> | <u>38</u> | <u>65</u> | <u>65</u> | <u>103</u> | <u>103</u> |
| | <i>Same as View 2</i> | | <i>Same as View 1</i> | | | |

Accounting firms

30. The feedback received from all five accounting firms can be summarised as follows:

- (a) One accounting firm stated that they have received feedback from one of their network members confirming that View 2 is being applied in practice for net investment hedges in that jurisdiction.
- (b) One accounting firm stated that net investment hedges are not very widely used by its global client base, but when they see net investment hedging, the approach typically observed mirrors View 2. As a result, they do not see very much diversity in practice.
- (c) One accounting firm stated that net investment hedges in IAS 39 are quite common and that the most commonly used approach observed is the ‘lower of’ test (ie View 2). This accounting firm noted that they observe little diversity in practice in respect of the issue submitted, with comments aligned to those of the accounting firm in paragraph 30(d)(i).
- (d) Two accounting firms have stated that net investment hedges typically involve designation of foreign currency-denominated non-derivative financial liabilities, such as borrowings, as the hedging instruments:
 - (i) One accounting firm stated that the gain or loss on the hedging instrument and the change in fair value of the hedged item are often equal, because both changes are measured in terms of spot-to-spot movement, thereby not resulting in any ineffectiveness. This accounting firm has not observed diversity in practice. They also stated that

when a derivative instrument is used as the hedging instrument (for example, a forward contract), the hedges of net investment are usually highly effective and, consequently, this accounting firm does not see this as a significant issue in practice. They also stated that when ineffectiveness does exist, the predominant method observed to determine such ineffectiveness has been the ‘lower of’ test (ie View 2).

- (ii) The other accounting firm stated that net investment hedges are not widely used by its global client base, but that when they see net investment hedges they typically involve borrowings as the hedging instruments. The approach that they have typically observed when entities use IAS 39 is that entities compare (a) the periodic foreign currency gain or loss on the foreign currency denominated borrowing with (b) the translation gain or loss on the net assets to determine hedge effectiveness. Any excess of (a) over (b) is recognised as ineffectiveness. This approach has some similarities to applying the ‘lower of’ test, in that ineffectiveness is recognised in profit or loss only if the entity is ‘over-hedged’. This accounting firm has not observed significant diversity in practice.

National standard-setters

- 31. Three national standard-setters stated that View 2 is the most commonly observed approach in their jurisdictions. View 2 was also supported by a member of the staff at another national standard-setter who did not think that diversity in practice would develop.
- 32. Two national standard-setters stated that in their jurisdictions both views are common and accepted when entities use IAS 39. Although the Advisory Committee on Financial Instruments of one of these national standard-setters support View 2 (ie the ‘lower of’ test), both of these standard-setters think the issue warrants clarification in both Standards, IAS 39 and IFRS 9. Another national standard-setter stated that there are divergent views in their jurisdiction

and that allowing a choice would perpetuate inconsistent application of the requirements. This national standard-setter was more inclined to follow an approach that aligns the IFRS requirements further with US GAAP (ie View 1).

33. Another national standard-setter received responses from a preparer and two local accounting firms. The preparer stated that while the ‘lower of’ test is applied, the hedges it uses are typically highly effective, because the currency pairs between the hedged item and the hedging instrument match and are measured on a consistent basis. One of the local accounting firms stated that net investment hedges have not been widely used, with that firm having seen only two cases that involved a one-year hedging tenor in which the hedge relationship terminated at the end of each financial year. In that case, it did not matter which approach the entity applied. The second local accounting firm’s published position states that they would accept both methods.
34. Another national standard-setter mentioned that no issues had been raised in its jurisdiction and that no diversity was expected either.

Staff analysis

35. The submitter is requesting clarification on the requirement in paragraph 6.5.13 of IFRS 9 for the accounting of net investment hedges (paragraph 6.5.13 has been reproduced in paragraph 4 of this Agenda Paper). The staff think that the request is focussed on the clarification of the following points of the requirements:
- (a) Paragraph 6.5.13 states that ‘hedges of a net investment in a foreign operation [...] shall be accounted for **similarly** to cash flow hedges [...]’ (**emphasis added**). In relation to this requirement, how should ‘similarly’ be understood? 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 OCI, or 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?

- (b) Paragraph 6.5.13 (a) of IFRS 9 includes a direct reference to paragraph 6.5.11 of IFRS 9, which was not in the corresponding paragraph of IAS 39 (ie paragraph 102). This direct reference to paragraph 6.5.11 is not understood, because it is perceived as being inconsistent with the IASB's objective of not changing the accounting for net investment hedging in IAS 39, as stated in paragraphs BC6.383–5 of IFRS 9.

36. For the purpose of analysing the extent to which the term 'similarly' should be understood to apply, we have considered:

- (a) the underlying reasons that explain why investments in foreign operations are eligible hedged items in IFRS and the 'dual character' of foreign currency risk, ie the risk being hedged (see paragraphs 38–44 of this Agenda Paper);
- (b) the requirements in IAS 21 *The Effects of Changes in Foreign Exchange Rates* (see paragraphs 45–52 of this Agenda Paper); and
- (c) the basis underlying the 'lower of' test for the accounting for cash flow hedges (see paragraphs 53–56 of this Agenda Paper).

37. The inclusion of the direct reference to paragraph 6.5.11 of IFRS 9 is analysed in paragraphs 57–58 of this Agenda Paper.

Investments in foreign operations as hedged items

38. As stated in IFRS 9, 'hedge accounting is an exception to the normal recognition and measurement requirements in IFRS' that allows the matching, in the same accounting period, of the financial effect of a change in the fair value or cash flows of a hedged item arising from changes in the hedged risk with the financial effect of a change in the fair value or cash flows of a related (and specifically designated) hedging instrument. The reason was that 'in many situations the

information that resulted from applying those normal requirements without using hedge accounting either did not provide useful information or omitted important information’.

39. Paragraph 78 in IAS 39 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics. Net investments in foreign operations, however, are portfolios of assets and liabilities with dissimilar risk characteristics and, consequently, would not qualify as eligible hedged items under the requirements.
40. However, the International Accounting Standards Committee (IASC) at that time concluded that with respect to foreign currency risk (and only that risk), a hedge of a net investment in a foreign operation is essentially a hedge of foreign currency exposure in the investment as a whole, not a fair value hedge of the change in the value of the investment (see paragraph AG99 of IAS 39 below) and created a third model for such hedges that was different from both the fair value and cash flow hedge accounting models in the Standard.

AG99 An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognises in profit or loss the investor’s share of the associate’s profit or loss, rather than changes in the investment’s fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in profit or loss the subsidiary’s profit or loss, rather than changes in the investment’s fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

41. IFRS 9 has maintained hedges of a net investment in a foreign operation as the third type of hedging relationship.
42. When considering foreign currency risk as the hedgeable risk in IFRS 9, the IASB concluded in paragraph BC6.275 that ‘foreign currency risk affects both the cash flows and the fair value of the hedged item and hence has a **dual character**’ (**emphasis added**).

43. The submission presented two possible approaches for determining hedge effectiveness in the case of a net investment hedge. When considering the mechanics in those approaches, the mechanics of View 1 would be more closely aligned to fair value hedge accounting (with the main departure being that the hedged item in View 1 is being revalued through OCI instead of profit or loss). View 2 represents the mechanics of cash flow hedge accounting.
44. The consideration of the risk being hedged (ie foreign currency risk) and its ‘dual character’ (ie foreign currency risk affects both the fair value and the cash flows of the net investment) would not make either of the views included in the submission (see paragraph 43) more relevant than the other. Consequently, consideration of the features of the risk being hedged does not help us in concluding on the extent to which the term ‘similarly’ in paragraph 6.5.13 of IFRS 9 should be understood.

The requirements in IAS 21

45. Paragraph 32 of IAS 21 requires translation of foreign operations to be recognised initially in OCI and reclassified from equity to profit or loss on disposal of the net investment in accordance with paragraph 48 of IAS 21. In addition, paragraph 41 of IAS 21 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’. Paragraph 48 of IAS 21 is reproduced below:
- 48 On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognised in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised (see IAS 1 *Presentation of Financial Statements* (as revised in 2007)).**
46. As mentioned in paragraph 45, IAS 21 requires the translation of foreign operations to be recognised in OCI. Consequently, only a model similar to cash flow hedge accounting would contribute to offset or partially offset the recognition of the exchange differences arising from net investments in a foreign

operation in OCI with the portion of the gain or loss on the hedging instrument that is determined to be effective because that gain or loss is also recognised in OCI. The question is whether this is the only reason why the accounting for net investment hedges should be carried out ‘similarly’ to cash flow hedges (ie to solve an ‘accounting mismatch’) or whether there is any other (more substantial) underlying reason.

47. Considering the same methodology as was followed in the previous section of this paper, we think that it is key to compare the mechanics of the views included in the submission (ie View 1 and View 2) to, in the case of this section, the requirements and principles of IAS 21 (see paragraphs 45–46).
48. When analysing the mechanics of both views, the staff has noted that in a situation of under-hedging³, View 1 would challenge the requirements and principles of IAS 21. This is because in such a situation, View 1 would result in recycling part of the exchange differences *arising from the hedged item* recognised in OCI to profit or loss for an amount equal to the difference between the period-to-period change in fair value (present value) of the hedged item and the period-to-period gain or loss on the hedging instrument. View 2 would, however, result in no ineffectiveness being recognised in profit or loss.
49. In addition, the recycling of part of the exchange differences arising from the hedged item in View 1 would cause the cumulative OCI balances relating to the hedged item in both views to differ by an amount equal to the cumulative ineffectiveness being recognised in profit or loss by View 1.
50. In an over-hedged situation⁴, both views would result in the recognition of ineffectiveness in profit or loss. The staff note that, in this situation, the recognition of ineffectiveness in both views is **not** triggered by the recycling of exchange differences arising from the hedged item previously recognised in OCI

³ When considering only one period of analysis, an under-hedged situation would in this case take place when the gain or loss on the hedging instrument is lower (in absolute amounts) than the change in fair value of the hedged item.

⁴ To be consistent with footnote 3, an over-hedged situation would take place when the gain or loss on the hedging instrument is higher (in absolute amounts) than the change in fair value of the hedged item.

but by the excess of the gains or losses on the hedging instrument over the fair value changes of the hedged item. Having said that, because View 2 would determine any ineffectiveness on the basis of cumulative changes and View 1 would determine any ineffectiveness on the basis of period-to-period changes, the staff note that, for a given period, the ending balance of the OCI account relating to the effective portion of the gains or losses arising from the hedging instrument may differ between the two views.

51. When considering the requirements and principles in IAS 21 and the mechanics of both views in both situations, the staff think that the ‘lower of’ test (ie View 2) would be the approach that is more closely aligned to the requirements and principles of IAS 21. This is because View 2 does not result in the recycling of foreign exchange differences arising from the hedged item that were previously recognised in OCI. When ineffectiveness arises, in the case of the ‘lower of’ test, this is always the result of an over-hedged situation in which a portion of the cumulative gains or losses on the hedging instrument is not considered to be effective and, consequently, it is recognised in profit or loss.
52. Consequently, on the basis of the analysis of this section, only when ‘similarly’ is understood as applying the ‘lower of’ test to the accounting for net investment hedges will the requirements and principles in IAS 21 also be respected.

The basis underlying the ‘lower of’ test

53. The rationale behind the ‘lower of’ test is described in paragraphs BC6.372–4 of IFRS 9 (**emphasis added**):

BC6.372 For cash flow hedges, recognising in profit or loss gains and losses arising on the hedged item in excess of the gains and losses on the hedging instrument is problematic because many hedged items of cash flow hedges are highly probable forecast transactions. Those hedged items do not yet exist although they are expected to occur in the future. Hence, recognising gains and losses on those items in excess of the gains and losses on the hedging instrument is tantamount to **recognising gains and losses on items that do not yet exist** (instead of deferral of the gain or loss on the hedging instrument). The IASB noted that this

would be conceptually questionable as well as counter-intuitive outcome.

BC6.373 IAS 39 required a ‘lower of’ test for determining the amounts that were recognised for cash flow hedges in other comprehensive income (the effective part) and profit or loss (the ineffective part). The ‘lower of’ test ensured that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not recognised. In contrast, the ‘lower of’ test did not apply to fair value hedges because, for that type of hedge, the hedged item exists. For example, while a firm commitment might not be recognised in accordance with IFRSs, the transaction already exists. Conversely, a forecast transaction does not yet exist but will occur only in the future.

BC6.374 In its deliberations leading to the Exposure Draft, the IASB discussed whether the requirements for measuring the hedge ineffectiveness that is recognised in profit or loss should be aligned for fair value hedges and cash flow hedges. The IASB noted that the requirements could be aligned by also applying the ‘lower of’ test to fair value hedges or by eliminating it for cash flow hedges. In the IASB’s view, aligning the requirements would reduce complexity. However, the IASB considered that, for conceptual reasons, **recognising gains and losses on items that do not yet exist instead of only deferring the gain or loss on the hedging instrument was not appropriate**. On the other hand, the IASB considered that the nature of fair value hedges is different from that of cash flow hedges. Also applying the ‘lower of’ test to fair value hedges, even though that test was designed to address only the specific characteristics of cash flow hedges, was not justified. Consequently, the IASB decided to retain the ‘lower of’ test for cash flow hedges and not to introduce it for fair value hedges.

54. ‘Foreign operation’ is defined in IAS 21 as ‘a subsidiary, associate, joint arrangement 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’. In addition, paragraph 2 of IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* states that ‘Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements’. Footnote 1 to paragraph 2 in IFRIC 16 adds that ‘This will be the case for consolidated financial

statements, financial statements in which investments such as associates or joint ventures are accounted for using the equity method and financial statements that include a branch or a joint operation as defined in IFRS 11 *Joint Arrangements*. Consequently, the staff note that in the case of net investments in foreign operations, the assets and liabilities comprising the subsidiary, or the branch or the investment in the case of an associate or a joint venture, represent recognised items in the consolidated financial statements.

55. When considering the rationale underlying the requirement of the ‘lower of’ test, the staff note that net investments in foreign operations either consist of assets and liabilities or are an equity-accounted investment that ‘exist’ in contrast with highly probable forecast transactions, as referred to in paragraphs BC6.372–4 of IFRS 9, which are items that do not yet exist. Having said that, the staff think that:
- (a) cash flow hedge accounting can be also applied to hedged items that already exist (for example, a cash flow hedge of variable interest rate payments arising from a recognised financial liability); and
 - (b) the fact that these requirements were thought to primarily apply to specific transactions (ie highly probable forecast transactions) does not mean that they are not suitable for other transactions or scenarios when the goal is shared. For example, in the case of highly probable forecast transactions, the non-recognition of gains and losses arising on the hedged items in excess of the gains and losses on the hedging instruments is backed up by the fact that those items do not exist yet. In the case of net investment hedges, the reason for the non-recognition of ineffectiveness when the cumulative gains and losses of the hedging instrument are lower than the cumulative change in fair value (present value) of the hedged item can be reinforced by the fact that not recognising ineffectiveness by recycling foreign exchange differences arising from the hedged item from OCI to profit or loss would be more aligned to the requirements and principles in IAS 21.

56. The staff think that not only the mechanics (see paragraphs 47–52) but also the rationale underlying the ‘lower of’ test is closely aligned to the requirements and principles of IAS 21. Consequently, the analysis in this section also indicates understanding the term ‘similarly’ as meaning that the requirements of the ‘lower of test’ should be applied to the accounting for net investment hedges.

The direct reference to paragraph 6.5.11 in paragraph 6.5.13 (a) of IFRS 9

57. The staff think that the inclusion of a direct reference to the requirements relating to the ‘lower of’ test in the requirements dealing with the accounting for net investment hedges (ie paragraph 6.5.13(a)) is a clear indication that the latter should consider the mechanics required for cash flow hedges when determining the effective portion of the gains or losses arising from the hedging instruments.
58. The fact that that reference had not been included in the corresponding paragraph relating to the accounting for net investment hedges in IAS 39 (paragraph 102) does not mean that the intention of that Standard was different. Having said that, this does not mean that the requirements in IAS 39 could not be clearer. The responses received from the outreach request have, however, shown that in the majority of instances observed, the ‘lower of’ test is applied by entities accounting for net investment hedges in accordance with IAS 39.

Conclusion

59. The staff has analysed how should the term ‘similarly’ should be understood by:
- (a) analysing the nature of the risk being hedged in the case of net investment hedges (ie foreign currency risk) with the views included in the submission;
 - (b) analysing the mechanics of the views submitted and comparing them with the requirements and principles of IAS 21 to understand which view’s mechanics are more closely aligned to that Standard; and
 - (c) analysing the rationale underlying the ‘lower of’ test and noting that rationale is closely aligned to requirements and principles in IAS 21.

60. On the basis of the analysis undertaken the staff think that the term ‘similarly’ in paragraph 6.5.13 of IFRS 9 should not be understood to be limited to the recognition of the gain or loss on the hedging instrument that is determined to be an effective hedge in OCI only for the purposes of solving an ‘accounting mismatch’. The term ‘similarly’ should be understood to also extend to the application of the requirements of the ‘lower of’ test when accounting for net investment hedges, because the mechanics and underlying rationale of those requirements are closely aligned to the requirements and principles of IAS 21.

Agenda criteria assessment

61. The staff's assessment of the Interpretations Committee's agenda criteria is as follows:⁵

| | |
|--|--|
| Paragraph 5.16 states that the Interpretations Committee should address issues: | Agenda criteria satisfied? |
| that have widespread effect and have, or are expected to have, a material effect on those affected; | No. On the basis of our analysis of the outreach results received, we do not think the issue can be considered to be widespread. |
| where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and | No. The diversity in practice when entities use IAS 39 that was identified in the outreach performed is not significant. The requirements for net investment hedges in IFRS 9 are clearer and should lead to a lower degree of diversity in practice. |
| that can be resolved efficiently within the confines of existing IFRSs and the <i>Conceptual Framework for Financial Reporting</i> . | Not applicable. |
| In addition: | |
| Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)? | Not applicable. |
| The solution developed should be effective for a reasonable time period. (paragraph 5.21) | Not applicable. |

⁵ These criteria can be found in the [IFRS Foundation Due Process Handbook](#).

Staff recommendation

62. The staff think that paragraph 6.5.13(a) of IFRS 9 clearly indicates that the ‘lower of’ test applies when accounting for net investment hedges. The analysis performed in this Agenda Paper provides further corroboration of the adequacy of that direct reference in paragraph 6.5.13 (a) to the ‘lower of’ test. In addition, the majority of the responses received from the outreach request revealed that the ‘lower of’ test is the approach that is most commonly used by entities using IAS 39.
63. On the basis of the analysis performed, the outreach results and our assessment of the Interpretations Committee’s agenda criteria, we recommend that the Interpretations Committee should not take this issue onto its agenda.
64. We have set out proposed wording for the tentative agenda decision in **Appendix A** of this paper.

Questions for the Interpretations Committee

Questions to the Interpretations Committee

1. Does the Interpretations Committee agree with the staff analysis and recommendation set out in paragraphs 35–64?
2. In the case the Interpretations Committee agrees with the staff analysis and recommendation, does the Interpretations Committee have any comments on the drafting of the tentative agenda decision set out in Appendix A?

Appendix A—Tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

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

The Interpretations Committee received a request to clarify how hedge effectiveness should be determined when accounting for net investment hedges. Specifically, the submitter asked whether the ‘lower of’ test required for cash flow hedges should also be applied for 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:

- paragraph 6.5.13(a) of IFRS 9 has a direct reference to paragraph 6.5.11, indicating that the requirements for cash flow hedges should be applied to the accounting for net investment hedges; and
- the application of the ‘lower of’ test for determining the effective portion of the gains or losses arising from the hedging instruments when accounting for net investment hedges would avoid the recycling of exchange differences arising from the hedged items recognised in other comprehensive income (OCI) prior to the foreign operation being disposed of. The Interpretations Committee notes that such an outcome would be more closely aligned to the requirements and principles of IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

In addition, the Interpretations Committee noted the following:

- it received no evidence of significant diversity by entities using IAS 39 when determining the effective portion of the gains or losses arising from the hedging instruments by applying the ‘lower of’ test when accounting for net investment hedges; and
- few entities have yet adopted the hedging requirements in IFRS 9; consequently, it is too early to assess whether the issue is widespread.

In the light of the existing IFRS requirements the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore [decided] not to add this issue to its agenda.

Appendix B—Submission received

B1. We reproduce below the submission that we received. We have deleted details that would identify the submitter of this request.

Wayne Upton Chairman
 IFRS Interpretations Committee
 30 Cannon Street
 London
 United Kingdom EC4M 6XH

19 August 2015

Dear Mr Upton

Suggested agenda item: Hedge effectiveness measurement for hedges of a net investment in a foreign operation under IFRS 9 *Financial Instruments*

It has come to our attention that there are divergent views on the appropriate methodology for recognition of hedge effectiveness measurement in hedges of a net investment in a foreign operation ('net investment hedges') under IFRS 9 *Financial Instruments*. We are seeking clarification from the Committee on the issue detailed below.

IFRS 9:6.5.11 requires that when measuring hedge ineffectiveness for cash flow hedges an entity recognises in the cash flow hedge reserve an amount that is:

(...)

adjusted to the lower of [emphasis added] **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.

The above approach does not apply to fair value hedges as IFRS 9:6.5.8 makes it clear that the gain or loss on the hedging instrument shall be recognised in profit or loss and the gain or loss on the hedged item shall also be recognised in profit or loss⁶. In this case there is no 'lower of test as with cash flow hedges.

IFRS 9 has no specific guidance as to how hedge effectiveness is measured with respect to net investment hedges. However, IFRS 9:6.5.13 does state that net investment hedges should be accounted for "similarly" to cash flow hedges. This paragraph explains that:

- the portion of the gain or loss on the hedging instrument that is effective should be recognised in OCI (see paragraph 6.5.11); and
- the ineffective portion shall be recognised in profit or loss.

As discussed below, the cross-reference to paragraph 6.5.11 differs from its equivalent in paragraph 102 of IAS 39 *Financial Instruments: Recognition and Measurement*.

⁶ Unless the hedged item is an equity instrument at fair value through other comprehensive income in which case all gains and losses are recognised in other comprehensive income.

IFRS 9:6.5.14 then explains when the amounts recognised in OCI should be reclassified to profit or loss.

These paragraphs are not, however, explicit as to how to determine the effective portion to be recognised in OCI.

For the purpose of illustration, an entity enters into a net investment hedge at the start of Period 1. The net investment hedge meets the hedge effectiveness requirements of IFRS 9:6.4.1 (c).

| | Period 1 CU | Period 2 CU |
|--|----------------|----------------|
| Period to period foreign currency translation of the designated net assets | 20 gain | 30 gain |
| Cumulative foreign currency translation of the designated net assets | 20 gain | 50 gain |
| Period to period gain/loss on the hedging instrument | 18 loss | 35 loss |
| Cumulative gain/loss on the hedging instrument | 18 loss | 53 loss |

Alternative views

View 1 - hedge ineffectiveness is measured in profit or loss as the difference between the period- to-period gain/loss on the designated net assets of the foreign operation and the gain/loss on the hedging instrument without application of a 'lower of test

This methodology would result in the following entries in the example described above.

| | Period 1 CU | Period 2 CU |
|--|----------------|----------------|
| Period to period foreign currency translation of the designated net assets (in OCI) | 18 gain | 30 gain |
| Period to period gain/loss on the hedging instrument (in OCI) | 18 loss | 30 loss |
| Hedge ineffectiveness (in profit or loss) (Difference between gain on designated net assets and loss on hedging instrument) | 2 gain | 5 loss |

Proponents of this view note that IFRS 9:6.5.13 requires that net investment hedges be accounted for "similarly" to cash flow hedges but believe that this similarity is limited to recognition of the effective part of the gains or losses on the hedging instrument in OCI. In other respects the two types of hedge are different.

A net investment hedge is *unlike* a cash flow hedge in that for a net investment hedge the hedged item is recognised in the statement of financial position whereas for cash flow hedges of forecast transactions they are not. As such, the 'lower of test (which, for a cash flow hedge, serves the purpose of avoiding recognition in profit or loss of amounts relating to forecast transactions when those transactions have not occurred) is not necessary. In this respect, a net investment hedge is seen as being more akin to a fair value hedge as in both cases the hedged item is an existing item and is recognised in the statement of financial position; and in both cases hedge ineffectiveness arises when the gains and losses of the recognised hedged item and recognised hedging instrument do not offset perfectly.

Proponents of View 1 note that this accounting results in recognition of translation gains and losses in profit or loss prior to disposal of the related foreign operation but argue that IAS 21:5 is explicit in scoping out net investment hedges:

"This standard does not apply to the hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. IFRS 9 applies to hedge accounting."

Consequently, IAS 21 does not prohibit gains and losses on the translation of the net assets of the foreign operation that are hedged from being recognised in profit or loss prior to the foreign operation being disposed of.

It is also of note that this approach applied in View 1 is consistent with US GAAP⁷.

View 2 - hedge ineffectiveness is measured in profit or loss as the difference between the cumulative gain or loss on the designated net assets of the foreign operation and the cumulative gain or loss on the hedging instrument only when the cumulative gain or loss on the hedging instrument is larger than that of the hedged item

This methodology would result in the following entries in the example described above.

| | Period 1 CU | Period 2 CU |
|--|----------------|--|
| Period to period foreign currency translation of the designated net assets (in OCI) | 20 gain | 30 gain |
| Period to period gain/loss on the hedging instrument (in OCI) | 18 loss | 32 loss |
| Hedge ineffectiveness (in profit or loss) (Reflecting the 'lower of' test. In Period one, no ineffectiveness is recognised as the loss on the hedging instrument is lower than the gain on the hedged item) | Nil | 3 loss (cumulative loss of CU53 on hedging instrument minus cumulative gain of CU50 on hedged item) |

IFRS 9:6.5.13 states net investment hedges shall be accounted for similarly to cash flow hedges, with IFRS 9:6.5.13(a) stating:

"(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*)"
[emphasis added]

⁷

This originates from Derivative Interpretations Group H8. DIG H8 notes that net investment hedge ineffectiveness arises from both over-hedges and under-hedges and should be recognised in earnings (ASC 815-35-35-23 and 35-24)

When IFRS 9(2013) was published, the wording previously included in IAS 39:102 was carried over to IFRS 9 plus the words highlighted in bold above in parenthesis were added in place of a reference to paragraph 88 of IAS 39. The addition of these words is relevant as paragraph 6.5.11 is the paragraph on cash flow hedges that specifically includes the 'lower of test whereas paragraph 88 of IAS 39 refers only to the conditions for application of hedge accounting and not to the mechanics of that accounting.

Furthermore, proponents of this view disagree with the notion that cash flow hedges are limited to forecast transactions (i.e. off-balance sheet items) and therefore that the 'lower of test' exists only for those types of exposures. For example, a cash flow hedge of variable interest rate payments on debt is a hedge of an item that is recognised in the statement of financial position. Also the approach described as View 2 prevents any foreign currency gains or losses from the net assets of the foreign operation being recognised in profit or loss prior to its disposal. This would be consistent with the requirements in IAS 21:48 to reclassify foreign currency gains and losses on foreign operations only on disposal of the foreign operation.

Reasons for the Committee to address the issue

Net investment hedging is a very common hedge accounting approach that will continue to apply when entities adopt IFRS 9. We understand both of the approaches described above are currently applied under IAS 39 but given the additional wording was added to IFRS 9:6.5.13 which was not in IAS 39:102 and the IASB's objective (as stated in IFRS 9:BC.383-5) was not to change net investment hedging we believe clarity is needed. Without clarity we expect diversity in application to continue.

The issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.