

**30 January 2009****Status: Final****Effective date:****Periods beginning on or after  
1 October 2008****Accounting impact:****Provides guidance on which foreign  
currency risks qualify as a hedged risk  
in the hedge of a net investment in a  
foreign operation**

# International Financial Reporting Bulletin

## IFRIC 16 - 'Hedges of a Net Investment in a Foreign Operation'

### Introduction

The International Financial Reporting Interpretations Committee (IFRIC) has issued IFRIC 16 'Hedges of a Net investment in a Foreign Operation'. The IFRIC was asked for guidance on accounting for the hedge of a net investment in a foreign operation in a parent's consolidated financial statements under IAS 39 'Financial Instruments: Recognition and Measurement', in particular:

- the risks eligible for hedge accounting;
- which entity (or entities) within a group can hold the hedging instrument; and
- how a parent should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item when it disposes of the foreign operation.

### Background

Where an ultimate parent company holds interests in subsidiaries through one or more intermediate parent entities, its consolidated accounts may be prepared in one of two ways. In the step-by-step method, "sub-consolidations" are prepared by each parent in the group, with each sub-consolidation being consolidated by the next intermediate parent higher up the group until eventually the ultimate parent entity has prepared consolidated financial statements. Alternatively, the consolidated financial statements can be prepared using the direct method, which involves consolidating each group entity in a single step (and generally is the most common method when, as is often the case, there is no requirement or need for any intermediate parent to produce consolidated financial statements).

Where entities in a group all have the same functional currency then the ultimate parent's consolidated financial statements should be the same regardless of the method of consolidation. Where entities in a group do not all have the same functional currency, although paragraph BC 18 of IAS 21 'The Effects of Changes in Foreign Exchange Rates' states that the financial statements will result in the same amounts in the presentation currency regardless of the method used, this is not necessarily true if the net assets of any operation are the subject of net investment hedge accounting. Depending on whether the direct or step-by-step method of consolidation is employed and whether the designated hedged risk is functional or presentation currencies, then the split of exchange gains and losses recognised in equity and the income statement will not necessarily be the same.

Given that the method of consolidation should not impact the results and position of an ultimate parent entity's consolidated financial statements, IFRIC decided that an Interpretation was necessary to specify whether the risk that qualifies for hedge accounting in a hedge of a net investment in a foreign operation arises from the exposure to the functional currency of the foreign operation in relation to the presentation currency of the group, or the functional currency of the parent, or both.

Additional issues clarified in IFRIC 16 surrounding net investment hedges and the method used to effect the consolidation are:

- whether the foreign exchange risk arises from the immediate parent entity that holds directly the hedged foreign operation, the ultimate parent that is preparing consolidated financial statements, or the functional currency of any parent (immediate, intermediate or ultimate) in the group;
- the amount of a foreign operation's net assets that may be designated as the hedged item to ensure that the method of consolidation employed does not result in the same risk being hedged more than once in the ultimate parent's consolidated financial statements;
- where in a group structure the hedging instrument may be held in a hedge of a net investment in a foreign operation;
- how the effectiveness of a hedging instrument in a hedge of a net investment should be determined; and
- the amounts of the foreign currency translation reserve in respect of both the hedging instrument and the foreign operation that should be recognised in profit or loss in a parent entity's consolidated financial statements when the hedged foreign operation is disposed of.

**Consensus** The consensus in IFRIC 16 clarifies that:

- hedge accounting may only be applied to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency (i.e. not the presentation currency of the group);
- the hedged risk may be designated as the foreign currency exposure arising between the functional currency of a foreign operation and the functional currency of any of its parents (immediate, intermediate and ultimate);
- 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 of the parent entity;
- if the step-by-step method has been used to effect the consolidation, then:
  - the amount of net assets that can be hedged by the ultimate parent will depend on the extent to which any lower level parent has applied hedge accounting in its consolidated financial statements for the foreign operation;

- if the same net assets are hedged by more than one parent entity within the group in their respective consolidated financial statements for the same foreign currency risk, then only one hedging relationship can qualify for hedge accounting in the consolidated financial statements of the ultimate parent entity;
- where a hedging relationship designated by a parent entity is not maintained by a higher level parent entity, the hedge accounting applied by the lower level parent must be reversed before the higher level parent's hedge accounting is recognised;
- the hedging instrument may be held by any entity included in the consolidation except the entity whose foreign currency net assets are the subject of the hedge (although see postscript below).
- for the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk 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; and
- the amount of the foreign currency translation reserve reclassified (i.e. "recycled") from equity to profit or loss on a disposal of a foreign operation comprises both the cumulative gain or loss on the hedging instrument that was determined to be effective and the cumulative foreign currency gain or loss resulting from the translation of the foreign operation's net assets. The amounts recycled should be the same irrespective of whether the consolidation is effected using the direct or step-by-step methods.

### **Effective Date and EU Adoption**

IFRIC 16 is effective for annual periods beginning on or after 1 October 2008. If an entity had designated a hedging instrument as a hedge of a net investment but the hedge does not meet the conditions for hedge accounting in IFRIC 16, then it should discontinue that hedge accounting prospectively in accordance with the hedge cessation rules in IAS 39. The transitional provisions in IFRIC 16 (i.e. discontinue hedge accounting prospectively) appear to preclude an entity from applying a prior year adjustment to net investment hedges which do not meet IFRIC 16's requirements.

This has interesting implications for entity's which are required to report in accordance with EU endorsed IFRS. As IFRICs are only meant to interpret existing IFRS there should be nothing preventing an entity applying EU adopted IFRS from applying the requirements of an IFRIC prior to endorsement. However, the existence of a transitional provision which runs counter to the general requirement to apply accounting standards retrospectively would, it appear, need to be endorsed before an entity can make use of those transitional provisions. Consequently, entities applying EU endorsed IFRS whose net investment hedges currently conflict with

IFRIC 16's requirements can still apply it before endorsement is obtained, but would need to unwind those non-compliant hedges by means of a prior year adjustment rather than discontinue the hedge accounting prospectively..

### Action required

Entities that hedge account for net investments in foreign operations should review their hedge accounting arrangements to confirm whether they comply with IFRIC 16. In particular, entities should review their net investment hedge accounting to ensure that the designated risk relates to functional currency exposure and not presentation currency exposure. In addition, care is required to ensure that:

- the hedged risk and hedged items in a net investment hedge are appropriately documented;
- the correct amount of exchange gains and losses are reported in the foreign currency translation reserve and income statement on consolidation; and
- an appropriate amount of the foreign currency retranslation reserve is reclassified in profit or loss on disposal of a foreign operation

Entities that apply EU endorsed IFRS whose net investment hedging approach conflicts with IFRIC 16 should consider whether to wait for EU endorsement so as to be able to take advantage of the Interpretation's transitional provisions

### Postscript

IFRIC concluded that the restriction on the hedged entity holding the hedging instrument was appropriate because the foreign exchange differences between the parent's functional currency and the functional currency of the net investment (which includes the hedging instrument) would automatically be included in the group's foreign currency translation reserve as part of the consolidation process and as such there would be a "natural" hedge.

However, it subsequently came to the IASB's attention that this is not necessarily the case. Without hedge accounting, part of the foreign exchange difference arising from the hedging instrument would be included in consolidated profit and loss account. Consequently, on 30 January 2008 an exposure draft was issued proposing that the restriction on the hedged entity holding the hedging instrument be lifted.

The IASB are not proposing to amend the effective date of IFRIC 16 for this proposed post implementation revision to IFRIC 16.

The deadline for responding to the proposed amendment is 2 March 2009. The short deadline has been set as the amendments are urgent and the IASB believes that there is likely to be a broad consensus for them.



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