

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

3 November 2008

Dear Mr Holmquist

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

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRIC Interpretation 16 *Hedges of a Net Investment in a Foreign Operation* (IFRIC 16), which was issued by the IFRIC on 3 July 2008. It was issued as an Exposure Draft in July 2007 and EFRAG commented on that draft.

One way in which an entity may carry on foreign activities is to set up a foreign operation. IAS 21 *The Effects of Changes in Foreign Exchange Rates* sets out how an entity should account for foreign currency transactions and for transactions by its foreign operations. When an entity sets up a foreign operation, it usually makes some sort of investment in it. Some parent entities choose to hedge the foreign currency exposure arising on that net investment. IAS 39 *Financial Instruments: Recognition and Measurement* sets out how an entity should account for its hedges of net investments in foreign operations. IFRIC 16 clarifies how to apply the requirements of IASs 21 and 39 to certain accounting issues that arise when hedging those net investments.

IFRIC 16 became effective for annual periods beginning on or after 1 October 2008, with earlier application permitted.

EFRAG has carried out an evaluation of IFRIC 16. As part of that process, EFRAG issued an initial evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports IFRIC 16 and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

EFRAG's Endorsement Advice Letter on IFRIC 16

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IFRIC 16 and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IFRIC Interpretation 16 Hedges of a Net Investment in a Foreign Operation.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

- 1 When evaluating IFRIC 16, EFRAG asked itself four questions:
 - (a) Is there an issue that needs to be addressed?
 - (b) If there is an issue that needs to be addressed, is an Interpretation an appropriate way of addressing it?
 - (c) Is IFRIC 16 a correct interpretation of existing IFRS?
 - (d) Does the accounting that results from the application of the IFRIC meet the criteria for EU endorsement?
- 2 Having formed tentative views on the issues and prepared a draft assessment, EFRAG issued that draft assessment on 18 September 2008 and asked for comments on it by 20 October 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

Is there an issue that needs to be addressed?

- 3 EFRAG understands from its discussions and consultations that there are some aspects of the existing hedge accounting requirements for hedges of net investments in foreign operations that are not clear and that there is consequently uncertainty as to the accounting required. Those areas include the issues addressed in IFRIC 16. As a result, EFRAG believes IFRIC 16 is addressing issues that need to be addressed.

Is an Interpretation an appropriate way of addressing it?

- 4 EFRAG believes that an interpretation is an appropriate way of addressing issues that arise from a lack of clarity as long as that lack of clarity is not caused by inconsistencies between standards, in which case amendments to one or more standards are required.

- 5 In this case it has been suggested by some that one of the reasons for the existing lack of clarity is that there are inconsistencies between IAS 21 *Effects of Changes in Foreign Exchange Rates* and IAS 39 *Financial Instruments: Recognition and Measurement*. EFRAG does not believe that such inconsistencies exist; there are merely areas that lack clarity. It therefore believes that an interpretation is appropriate way of addressing the issues raised in IFRIC 16.

Is IFRIC 16 a correct interpretation of existing IFRS?

- 6 IFRIC 16 focuses broadly speaking on four issues.

Clarification 1—When an entity has a presentation currency that is different from its functional currency, do the foreign exchange differences that arise represent a hedgeable risk?

- 7 Under IAS 21 an entity has a free choice as to the currency in which it presents its financial statements (the presentation currency) even though the currency chosen will have an effect on return on capital ratios and on the actual result reported. However, there is some uncertainty as to whether, if an entity hedged the exchange rate 'risk' arising from having a presentation currency that is different from its functional currency, those hedges are eligible for hedge accounting.
- 8 IFRIC 16 states that such hedges are not eligible for hedge accounting. The IFRIC's reasoning is that hedge accounting is available only for hedges of risks that have a real economic effect on the reporting; presenting amounts in a presentation currency is merely a numerical convention necessary for the preparation of financial statements that include a foreign operation and will have no economic effect on the parent entity.
- 9 EFRAG believes this is a correct interpretation of existing IAS 39. That is because IAS 39 requires that, for a hedge to be eligible for hedge accounting, it must, inter alia, be a hedge of an exposure to changes in fair value or to variability in cash flows; and a hedge of the exchange rate 'risk' arising from having a presentation currency that is different from the functional currency is neither.

Clarification 2—When there are immediate, intermediate and ultimate parent entities, which exchange rates represent hedgeable risks?

- 10 In some groups a particular subsidiary might have an immediate parent, an intermediate parent and an ultimate parent. There is some uncertainty as to which exchange rate exposures are hedgeable risks in such circumstances. In particular, existing IFRS is not clear whether the only hedgeable risk from the ultimate parent's perspective is the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of the immediate parent, or whether exposures arising from the functional currencies of the other parents (including the ultimate parent) are relevant.
- 11 IFRIC 16 clarifies that the fact that the net investment is held through an intermediate parent does not affect the nature of the exchange rate risk arising for an intermediate or ultimate parent entity. Hedge accounting is available for any hedge of the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity (the immediate, intermediate or ultimate parent), as long as in any set of financial statements, the net investment in the foreign operation is hedged only once.

- 12 The IFRIC's reasoning is that, when the foreign currency exposure of a net investment in a foreign operation is different from the functional currency of the holder of that net investment (whether it be an immediate parent, an intermediate parent or an ultimate parent), there is a hedgeable risk. The immediate parent entity is exposed to changes in the exchange rate of its directly held foreign operation's functional currency. However, indirectly every entity up the chain of entities to the ultimate parent entity is also exposed to changes in the exchange rate of the foreign operation's functional currency.
- 13 EFRAG believes that this is a reasonable interpretation of existing IFRS. It also notes, as the Basis for Conclusions to IFRIC 16 itself explains, that, if existing IFRS permitted the ultimate parent entity to hedge only the exchange rate differences that arise between the ultimate parent's functional currency and the foreign operation's functional currency, it would mean that a hedge taken out by an intermediate parent entity to hedge its net investment in the foreign operation would have to be ignored in the ultimate parent entity's consolidated financial statements. Conversely, permitting only the immediate parent entity to undertake a net investment hedge would imply that an indirect investment does not create a foreign currency exposure for that indirect parent entity. Under IFRIC 16, hedging activity undertaken at the different parent levels is reflected in the ultimate parent entity's consolidated financial statements.

Clarification 3—Does it matter, for hedge accounting purposes, which entity is holding the hedging instrument being used to hedge a net investment in a foreign operation?

- 14 In a number of international groups it is common for the hedging instruments used to hedge net investments in foreign operations to be held by an entity that does not itself have the net investment being hedged. There is a difference of view as to how existing IFRS are to be applied in such circumstances.
- 15 IFRIC 16 clarifies that it does not matter which entity within the group holds the hedging instrument as long as the hedging instrument is effective in offsetting the risk arising from the exposure to the functional currency of the foreign operation and the functional currency of the specified parent entity, except that the hedging instrument cannot be held by the foreign operation that is being hedged. 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. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognised in profit or loss, in other comprehensive income, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognised in profit or loss or in other comprehensive income. As part of the application of hedge accounting, the total effective portion of the change is included in other comprehensive income. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation and the functional currency of the entity holding the instrument is irrelevant in determining effectiveness.
- 16 In summary, the IFRIC's reasoning is as follows:
- (a) The foreign operation being hedged could not hold the hedging instrument because that instrument would be part of, and denominated in the same currency as, the net investment it was intended to hedge.

- (b) There is some existing implementation guidance (Question F.2.14 in the guidance on implementing IAS 39) that states that "IAS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument."
 - (c) The IASB concluded, when revising IAS 21 in 2005, that the reporting entity in a set of consolidated financial statements is the group rather than the individual entity and that the net investment must be viewed from the perspective of the group. It follows, therefore, that the group's net investment in any foreign operation, and its foreign currency exposure, can be determined only at the relevant parent entity level. The IFRIC has similarly concluded that the fact that the net investment is held through an intermediate entity does not affect the economic risk. Consistent with this, monetary items (or derivatives) that are hedging instruments in a hedge of a net investment may be held by any entity within the group and the functional currency of the entity holding the monetary items can be different from those of either the parent or the foreign operation. A hedging item denominated in a currency that is not the functional currency of the entity holding it does not expose the group to a greater foreign currency exchange difference than arises when the instrument is denominated in that functional currency.
 - (d) When determining the effectiveness of a hedging instrument in the hedge of a net investment, an entity computes the gain or loss on the hedging instrument by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge documentation. This ensures that the effectiveness of the instrument is determined on the basis of changes in fair value or cash flows of the hedging instrument, compared with the changes in the net investment as documented. Thus, any effectiveness test is not dependent on the functional currency of the entity holding the instrument. In other words, the fact that some of the change in the hedging instrument is recognised in profit or loss by one entity within the group and some is recognised in other comprehensive income by another does not affect the assessment of hedge effectiveness.
- 17 EFRAG believes this is a reasonable interpretation of existing IFRS. IFRIC 16's conclusions that the hedging instrument can be held by any entity in the group and that the foreign currency is determined at the relevant parent entity level have implications for the designation of hedged risks and make it possible for an entity to designate a hedged risk that is not apparent in the currencies of the hedged item or the foreign operation. In effect, IFRIC 16 allows currency exposures arising on a net investment in a foreign operation to be 'passed up' through the group, which enables entities to apply hedge accounting in those circumstances where the group has offsetting foreign currency exposures. EFRAG notes that this approach to designating risks is considered acceptable only for hedges of net investments, and IFRIC 16 states that it should not be applied by analogy to other types of hedge accounting.

Clarification 4—What amounts should be reclassified from OCI to profit or loss as reclassification adjustments on disposal of the foreign operation?

- 18 Existing IFRS requires certain exchange differences arising in respect of a net investment in a foreign operation to be presented initially in the OCI and, if and when that foreign operation is disposed of, the cumulative amount of those exchange differences should then be reclassified to profit or loss. However, the amount of exchange differences initially presented in OCI for a particular foreign operation (but not for the reporting entity's foreign operations in total) will differ

depending on whether the step-by-step method of consolidation or the direct method of consolidation has been used. As a result, there is some uncertainty as to what amount should be reclassified when a foreign operation is disposed of.

- 19 IFRIC 16 acknowledges that the two methods of consolidation will have the effect described in the preceding paragraph, and it confirms that both methods are nevertheless acceptable under existing IFRS. That means that the amount reclassified from the OCI or foreign currency reserve to profit or loss on the disposal of a foreign operation could vary depending on the consolidation method used. However, IFRIC 16 also makes it clear that existing IFRS does not preclude a parent entity from determining the amount of the foreign currency reserve in respect of a foreign operation it has disposed of as if the direct method of consolidation had been used (even though the step-by-step method has been used until then) for the purpose of reclassifying amounts to profit or loss. Making such an adjustment to the amount that would otherwise be reclassified is not though required. Whether such an adjustment is made is an accounting policy choice that should be followed consistently for disposal of all net investments, irrespective of whether hedge accounting is applied or not.
- 20 EFRAG believes this clarification is a correct interpretation of existing IFRS.

Overall conclusion

- 21 Therefore, for the reasons set out above, EFRAG believes that IFRIC 16 is a reasonable interpretation of existing IFRS.

Does the accounting that results from the application of IFRIC 16 meet the criteria for EU endorsement?

- 22 Finally, EFRAG asked itself whether it believed that the information resulting from the application of IFRIC 16 would meet the criteria for EU endorsement; in other words, that:
- (a) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
 - (b) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the Interpretation.

- 23 A key issue for EFRAG in considering whether IFRIC 16 meets the above criteria was that it has previously concluded that IAS 21 and IAS 39 (as amended for adoption in the EU)¹ meet the criteria. As discussed in the previous section, EFRAG believes that IFRIC 16 is a reasonable interpretation of that existing IFRS.

Relevance

- 24 According to the IFRS Framework, information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past,

¹ The fact that material in IAS 39 was omitted from the text that was endorsed for use in the EU is of no relevance to our discussion of IFRIC 16.

present or future events or confirming, or correcting, their past evaluations. EFRAG has therefore considered whether IFRIC 16 would result in the provision of relevant information; in other words, information that has predictive value, confirmatory value or both.

- 25 EFRAG is not aware of any reason to believe that some or all of the information that results from the application of IFRIC 16 is not relevant, or that IFRIC 16 results in relevant information being omitted. In EFRAG's view, IFRIC 16 merely seeks to clarify the application of existing requirements that have been judged to meet the relevance criteria.

Reliability

- 26 The Framework explains that information has the quality of reliability when it is free from material error and bias, can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG has therefore considered whether information resulting from the application of IFRIC 16 exhibits those qualities.
- 27 EFRAG believes that it does, in that IFRIC 16 merely seeks to clarify the application of existing requirements that have been judged to meet the reliability criteria and, as far as EFRAG can judge, does not raise any additional reliability concerns of its own.

Comparability

- 28 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 29 In EFRAG's view, IFRIC 16 enhances the comparability of the information provided by eliminating some of the uncertainty that currently exists about the application of existing IFRS, which will result in a reduction in the diversity of current practice.
- 30 The one area where this is not the case is in the transitional provisions, which require the clarifications to be applied prospectively. (The effective date is annual periods beginning on or after 1 October 2008.) EFRAG believes that, as a matter of principle, it is usually preferable to apply changes in standards and clarifications retrospectively—because retrospective application does not raise comparability issues. However, when changes or clarifications concern hedge accounting requirements, it could be very burdensome to apply the change or clarification retrospectively, and the fact that the hedge accounting requirements preclude entities from redesignating hedge relationships in the past periods can have other implications for the quality of the information provided. Therefore, EFRAG concluded that it is acceptable in this case for the changes and clarifications in IFRIC 16 to be applied prospectively.

Understandability

- 31 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

- 32 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most aspects are covered by the discussion above about relevance, reliability and comparability because information that, for example, represents something as similar when it is in fact dissimilar is not understandable. The one aspect of understandability that EFRAG believes is not covered involves the complexity of the information provided and of the methodologies underlying the information. EFRAG's initial assessment is that the clarifications in IFRIC 16 do not add to the complexities that already exist.

True and Fair

- 33 Having concluded that the information that results from the application of IFRIC 16 will meet the criteria of relevance, reliability, comparability and understandability and being unaware of any other reason to be concerned about the accounting effect of the Interpretation, EFRAG sees no reason to believe that it is inconsistent with the true and fair view requirement.

European Interest

- 34 EFRAG has considered whether the benefits of implementing IFRIC 16 in the EU exceed the costs of doing so. Its assessment is that, although implementation of IFRIC 16 would involve some costs, they are likely to be insignificant and to be outweighed by the benefits.

Conclusion

- 35 EFRAG's overall conclusion is that IFRIC 16 satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.