Deloitte Touche Tohmatsu
180 Strand
London WC2R 1BL
United Kingdom
Tel: National +44 20 7936 3000
Direct Telephone: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
www.deloitte.com
www.iasplus.com

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Robert Garnett, Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London EC4M 6XH

Email: ifric@iasb.org

Dear Bob,

IFRIC Draft Interpretation D22 *Hedges of a Net Investment in a Foreign Operation*

Deloitte Touche Tohmatsu is pleased to respond to the International Financial Reporting Interpretations Committee's (the IFRIC's) draft interpretation D22 *Hedges of Net Investment in a Foreign Operation* (referred to as the 'draft interpretation').

We welcome guidance in the area of hedges of a net investment in a foreign operation (referred to as 'net investment hedging') as IAS 21 (and indirectly IAS 39) require clarification. We also welcome this draft interpretation as it deals with a number of net investment hedging issues as a consolidated package.

We support the objective of the interpretation to remove the ambiguity in IAS 21 regarding whether the hedged risk is the difference between the functional currency of the foreign operation and the functional or presentation currency of the parent. We recognise the arguments both for and against that are included in the draft interpretation and on balance agree with the conclusion that the IFRIC has reached.

We agree with the clarification that any parent entity within a group that has an interest in a foreign operation may apply net investment hedging. We believe the draft interpretation should be clearer as to whether designated net assets are either the net assets of individual foreign operations or net assets of a sub-consolidated foreign operation (ie a foreign operation that itself has investments in foreign operations and therefore converts its investments in foreign operations into its functional currency in determining a sub-consolidation). We believe both approaches are acceptable but we do not believe the draft interpretation is clear.

Our major concern with the draft interpretation is the guidance on which entity within the group can hold the hedging instrument. We believe the guidance in IAS 39.IG.F.2.14 that permits any entity to hold a hedging instrument has been inappropriately extended in this draft

interpretation. We believe that which entity holds the hedging instrument does impact the hedge effectiveness of a net investment hedging relationship. We believe the gains/losses on the hedging instrument derive from recording the hedging instrument in the functional currency of the entity that holds it, and therefore we disagree with the IFRIC that in determining hedge effectiveness the group should 'look-through' the entity that holds the hedging instrument by including part of the foreign currency translation on the net assets of that entity and including that as part of the effective hedging instrument. This approach is contrary to the concepts in IAS 21 that foreign currency translation of foreign operations is different to the foreign currency gains/losses on transactions within an entity. The IFRIC's proposal treats an entity within the group as if it has a functional currency equivalent to the parent's functional currency, when it does not – or put another way, the parent is treated as if it took out the hedging instrument when it did not. In addition to these conceptual conflicts with IAS 21, practically, the approach is contrary with hedge accounting in IAS 39 as the foreign currency gain/loss on net asset retranslation that will be recycled on disposal of the foreign operation (being the hedged risk) will not equal the foreign currency gain/loss on the hedging instrument in the instance where this is held by an entity with a different functional currency to the parent. This anomaly arises because the entity that is holding the hedging instrument has not been sold so the foreign currency translation reserve for that foreign operation cannot yet be recycled.

Our detailed comments on the draft interpretation are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely,

Ken Wild
Global IFRS Leader

cc: Tricia O'Malley, IFRIC Coordinator

Detailed comments on IFRIC D22 *Hedges of a Net Investment in a Foreign Operation*

Scope

The scope should be clarified to make clear that net investment hedging only applies when the translation of the net assets of the foreign operation are being hedged, and not the investment in the foreign operation in the separate financial statements. The reference that is made to consolidated financial statements in the Consensus, paragraph 9, should be reiterated in Scope. In addition, the draft interpretation should include a footnote that states if the entity does not have any subsidiaries, joint ventures, or associates, and therefore does not produce consolidated financial statements, the entity can still apply net investment hedging if it has a branch that is a foreign operation (consistent with paragraph 2 of the draft interpretation).

Paragraph 7 states that the draft interpretation does not apply to other forms of hedge accounting. We appreciate the intention of the IFRIC to limit the scope but we believe the consensus it has reached on where a derivative or non-derivative can reside in the consolidated financial statements for a qualifying hedge will have relevance for other forms of hedge accounting. IAS 39 provides limited guidance in this area and the detailed workings within the draft interpretation will no doubt be analogised by users in determining hedge effectiveness for other foreign currency hedges as the principle is transferable. Although it is not the intention of the IFRIC for the interpretation to be analogised to, we do not believe this is realistic since the IFRIC has analogised with the interpretation guidance on cash flow hedging in reaching its conclusion. We believe that this demonstrates that the draft interpretation is as much an interpretation of IAS 39 hedge effectiveness requirements as it is of IAS 21's foreign currency translation requirements.

Consensus

(i) hedged risk

We support the reference in paragraph 9 to net investment hedging being applied in the consolidated financial statements of the parent entity. As stated in our comments on *Scope* above we believe a cross-reference to a footnote would be helpful, that states in the case of an entity that does not produce consolidated accounts but has a foreign operation that is a branch that net investment hedging of that foreign operation may apply.

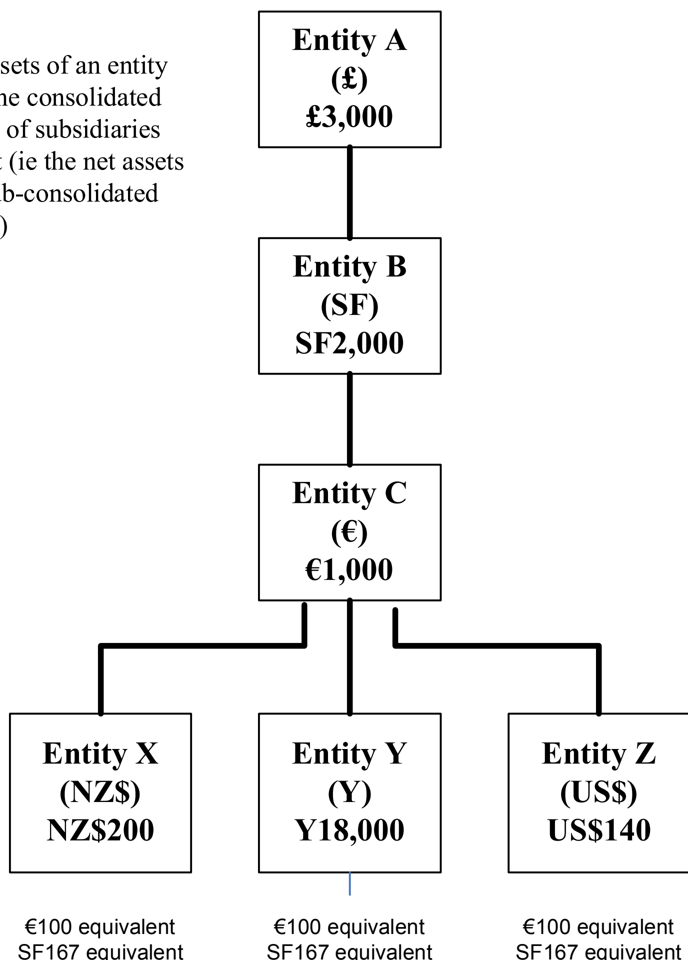
We agree that a parent does not have to be the ultimate parent in order to hedge the foreign currency translation of a foreign operation. We also agree that a parent may be an ultimate, intermediate or immediate parent. We acknowledge that the draft interpretation requires that the requirements in IAS 39.88 must be met, to the extent appropriate, with any net investment hedge. IAS 39.88(a) states that the hedge must be consistent with the "entity's risk management objective and strategy for undertaking the hedge". We believe this point should be reiterated in the draft interpretation in paragraph 11 to highlight that it is not 'open season' for a group to sometimes hedge with the immediate parent, sometimes with the intermediate parent, and sometimes with the ultimate parent, if from a group perspective this is not the way the group manages its foreign currency risk. Without reiteration that hedges need adherence to the risk management policies of the group we fear that groups may use this draft interpretation as an opportunity to defer foreign currency risk on monetary items in equity at all levels within the group even though it is not the basis on which foreign currency exposure is managed.

We believe it is important that there is certainty on whether the hedged risk is the functional currency of the foreign operation versus the functional or presentation currency of the parent. In most instances this issue has no relevance as the presentation and functional currency of the ultimate parent that prepares group accounts are the same, but in some jurisdictions (and some industries, particularly in US$ intensive businesses such as oil) this is an important issue. Various practices have developed reflecting the fact that currently the standard is ambiguous in this respect. We acknowledge the arguments in the draft interpretation in BC5-18 and endorse the view that there are arguments for and against defining the hedged risk as either functional or presentation currency. Specifically, as we state in the preceding paragraph, we are supportive that a net investment hedge can be designated by a parent at different levels within the group and therefore it is more consistent with this proposal to favour the functional currency approach as in reality intermediate and immediate parent's often do not produce sub-consolidated accounts and are therefore unlikely to have an identified group presentation currency. On balance therefore we support the IFRIC's proposed approach of determining the hedged risk as the difference between functional currency of the parent and the foreign operation.

The IFRIC's conclusion that the hedged risk is the difference in the functional currency of the parent and the foreign operation we believe does indirectly imply how an entity should perform its consolidation. Taking the IFRIC's view, when an entity prepares consolidated financial statements it should take the net assets of the foreign operation and convert them into the parent's functional currency first, and then only after that process is complete should the entity take those consolidated results in the functional currency of the parent and then convert them into an alternative presentation currency. This conclusion is reinforced by paragraph BC10 of the draft interpretation that states that if the functional currency of the parent equals the presentation currency of the group that "*no **further*** [emphasis added] *translation adjustment would be required to prepare the consolidated financial statements*". This implies that an entity does not translate its foreign operations directly into a group presentation currency. The draft interpretation should make this clearer as this supports the IFRIC's view that the hedged risk is driven by the functional currency of the parent.

We believe the draft interpretation should be clearer in its illustrative example in paragraphs IE1 to IE7 about what are net assets that can be designated at each level. We recognise that the draft interpretation is clear that any parent in the group structure may in principle try and achieve net investment hedging (but the same foreign operation cannot be hedged twice) but the draft interpretation does not make clear what are the net assets of the foreign operation that can be hedged. The critical issue is whether in determining the amount of net assets that can be hedged, is it permitted for this to be based on the sub-consolidated net assets of a foreign operation or simply the net assets of the individual foreign operations?

We have recreated the diagram in paragraph IE2 below showing the amount of net assets in each individual entity and have also listed the designations in paragraph IE3 showing how the net assets of each designation will vary depending on whether the net assets can be hedged as a sub-consolidated amount of net assets or simply the net assets of each individual foreign operation.



Foreign exchange rates:

£1	=	SF2.5
£1	=	€1.5
SF1	=	€0.6
€1	=	NZ$2
€1	=	Y180
€1	=	US$1.4

Designation	Company only net assets	Sub-consolidated net assets
a) the exposure between Entity A (£) and Entity B (SF)	SF2,000	SF4,167 (ie SF2,000 being Entity B, plus SF1,667 being the net assets of Entity C, plus SF500 being the net assets of X, Y and Z [total €300/0.6]
b) the exposure between Entity A (£) and Entity C (€)	€1,000	€1,300 (ie €1,000 being Entity C plus net assets of X, Y and Z)
(c) the exposure between Entity A (£) and Entity X (NZ$)	NZ$200	n/a as X is not a parent

(d) the exposure between Entity A (£) and Entity Y (¥)	Y18,000	n/a as Y is not a parent
(e) the exposure between Entity A (£) and Entity Z (US$)	US$140	n/a as Z is not a parent
(f) the exposure between Entity B (SF) and Entity C (€)	€1,000	€1,300 (ie €1,000 being Entity C plus net assets of X, Y and Z)
(g) the exposure between Entity B (SF) and Entity X (NZ$)	NZ$200	n/a as X is not a parent
(h) the exposure between Entity B (SF) and Entity Y (¥)	Y18,000	n/a as Y is not a parent
(i) the exposure between Entity B (SF) and Entity Z (US$)	US$140	n/a as Z is not a parent
(j) the exposure between Entity C (€) and Entity X (NZ$)	NZ$200	n/a as X is not a parent
(k) the exposure between Entity C (€) and Entity Y (¥)	Y18,000	n/a as Y is not a parent
(l) the exposure between Entity C (€) and Entity Z (US$)	US$140	n/a as Z is not a parent

We believe either the individual net assets of each foreign operation or the sub-consolidated net assets of a foreign operation may be hedged by a parent and believe the draft interpretation should make this clear. We further believe that the meaning of foreign operation could be clarified in this respect. Additionally, it would be useful to highlight the consequences of designating sub-consolidated net assets of a foreign operation on hedge effectiveness.

In addition, paragraph 14 states that the same risk cannot be hedged twice. We believe this could be misinterpreted to mean that a foreign operation cannot be hedged twice even if two or more parents are hedging different net assets of the same foreign operation. For example, we believe, using our numbers above, that Entity B could hedge the first NZ$100 of net assets of Entity X and Entity C could hedge the next NZ$100 of net assets of Entity X. Paragraph 14 could be read as disallowing this as an exposure to foreign currency risk arising from the net investment in Entity X is being hedged twice (ie the NZ$ of Entity X are being hedged twice). We propose a change to paragraph 14 as follows:

> "An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once. Therefore, if the same ~~**risk is**~~ **net assets of a foreign operation are** hedged by more than one parent entity within the group (for example, a direct and an indirect parent entity) only one hedge relationship will qualify for hedge accounting in the consolidated financial statements."

We also note that paragraphs IE4 and IE5 may contain errors:

IE4 *"…. This hedge would continue to qualify for hedge accounting in Entity B's consolidated financial statements only if Entity B had not also hedged its €/NZ$ foreign currency exposure".*

[We believe '€/NZ$' should read 'SF/NZ$']

IE5 *"… In Entity B's consolidated financial statements, assuming Entity C has hedged the €/NZ$ exposure, Entity B could also apply hedge accounting to the SF/€ foreign exchange exposure arising from the net investment in Entity X."*

[We believe 'Entity X' should read 'Entity C']

(ii) hedging instrument

Our greatest concern with the consensus is the view on where a hedging instrument can be held within the group. The only similar guidance that exists on this issue is in IAS 39.IG.F.2.14 which is an example of a cash flow hedge using a derivative instrument. We believe that the analogy that the IFRIC has made with this Q&A is out of context. The implementation guidance states that in order for a hedge to qualify "IAS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument". The Q&A makes no reference as to whether the hedging instrument is equally effective irrespective of where the hedging instrument sits. The IFRIC has taken this Q&A on cash flow hedging and extended it to net investment hedging as well as arguing that a hedge is always as equally effective regardless of the entity that holds it. We disagree with this for the reasons stated below.

Paragraph 13 of the draft interpretation states that hedge effectiveness takes into account not only the gains/losses on the hedging instrument in the entity holding the hedging instrument but *also* potentially the gains/losses derived from translating the net assets of that entity into the parent's functional currency. This approach is mixing up the gains/losses on the transaction (being the derivative or non-derivative), commonly referred to as *transaction* gains/losses, with the *translation* of the net asset of the entity. Group financial statements preserve this difference and do not try to present group accounts as if it is a single entity with a single functional currency.

Using the example in the draft interpretation the following illustrates our concern:

Paragraph IE21 of the draft illustration states that the gain on the forward contract in Entity X is NZ$80,653 and that this amount will impact consolidated profit or loss when it is translated into € at the average rate, being €39,829. The draft interpretation notes that this amount will not equal the translation of the US$ net assets of Entity Z into € which is €51,325 (71% effective). We believe that this hedge is therefore not highly effective and hedge accounting would not be possible. We believe the inability to apply hedge accounting in this instance is due to hedge effectiveness reasons only. The draft interpretation overcomes this hedge effectiveness problem by arguing that the translation of Entity X's net assets from NZ$ to € should also be part of the hedging instrument. Once added, the hedge becomes fully effective. We disagree with this approach. The gains/losses that would have been recognised in consolidated equity on translating Entity X's net assets are independent of hedge accounting, ie they would be recognised irrespective of hedge accounting, and therefore we do not see that they form part of the hedging instrument.

	Opening fair value of forward in Entity C (Group)	€40,840	NZ$89,847 @ 2.200 [the draft interpretation states that if Entity C had taken out the derivative instead of Entity X that fair value in Entity C would have been €40,655. As Entity X took out the derivative the opening carrying value in the

			group accounts headed by Entity C will be the fair value of the forward in NZ$ in Entity X translated into €] – difference of €185 arises because €40,655 is the fair value derived from using local interest rates which are rounded as opposed to using fair value Entity X and translated at spot rate]
1	Plus translation of above at closing rates less opening rates	€7,726	(NZ$89,847 @ 1.850) - €40,840 above
2	Fair value movement in the period at average rates	€39,828	NZ$80,652 @ 2.025
3	Plus fair value movement in the period at closing rates less average rates	€3,768	NZ$80,652 @ 1.850 - €39,828 above
	Sum	€92,162	

Entity C = € functional *[group that is hedge accounting]*
Entity Z = US$ functional *[foreign operation that is being hedged]*
Entity X = NZ$ functional *[foreign operation that holds hedging instrument]*

The IFRIC proposal strips out the foreign currency risk arising from translating Entity X's net assets into Entity C's group account ['1' and '3' above] and pretends that this is also part of the gain or loss on the hedging instrument as if Entity C had entered into the hedging instrument itself. We believe this approach is mixing up the gain/losses on the underlying instrument (that exist within the entity holding that instrument) and the translation of those underlying instruments for consolidation purposes if those instruments happen to still be outstanding at the period end. We believe the IFRIC approach is contrary to the concepts in:

- IAS 21 as the standard requires the translation of *net* assets (as opposed to splitting out gross assets, such as a the forward contract sitting in Entity X) and
- IAS 39 where an entity must recycle the hedging instrument when the hedged risk impacts P&L. In this case it will not be possible to recycle all the gains/losses on the hedging instrument (as defined by the draft interpretation as '1' '2' and '3') when Entity Z is sold as part of these gains/losses, '1' and '3', will remain in equity until Entity X is sold (if it is ever sold), as Entity X is itself a foreign operation.

We believe IFRIC's approach is flawed in that it results in hedge accounting that does not offset in profit or loss. This illustrates once again that the foreign currency gains/losses arising on the hedging instrument in Entity X are being incorrectly mixed up with the gains/losses arising from translation of that foreign operation. We believe the concepts described above equally apply whether the hedging instrument is a derivative or a non-derivative. This is illustrated in Figure 1 where say Entity X borrowed in US$ as opposed to taking out a derivative.

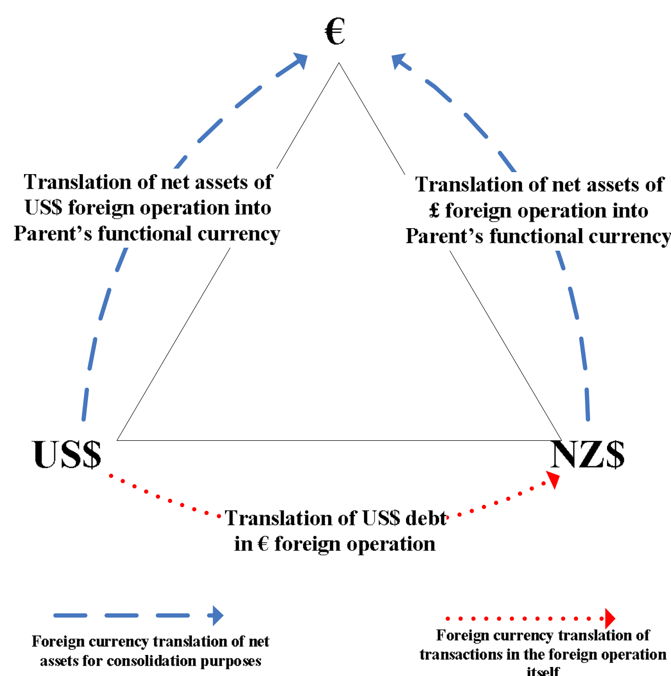


Figure 1

We believe it is ambitious of IFRIC to believe that the conclusions reached in the draft interpretation will not attempt to be applied elsewhere. Using the same entities in your draft interpretation: if Entity Z had a sale in NZ$, is the only eligible cash flow hedge in the group accounts a hedge of the NZ$/US$ risk? We believe it is. The IFRIC proposal raises questions about whether the hedged risk in the group accounts should in fact be the NZ$/€ as the NZ$ sales in the US$ company will impact the € group accounts via translation at average rates. The draft interpretation introduces doubts and potentially divergence as to what is foreign currency risk at the group level and how may it be hedged.

Effective date

We agree that a group should be able to early apply the interpretation if they wish.

Transition

We agree with your proposal for prospective application. As mentioned above, we believe that the ambiguity within IAS 21 has led to different practices being applied and therefore hedge accounting prior to the effective date of the interpretation should remain unchanged. We believe it should be noted in the transition paragraph that any previous hedge accounting that will no longer qualify following the effective date should cease at the effective date. Additionally, we would suggest including guidance on how to treat any amounts previously deferred in equity for net investment hedging relationships that do not qualify for hedge accounting anymore under the draft interpretation. The draft interpretation is silent on this issue although two possible approaches may exist, which could lead to divergence in practice at the time of the adoption of the draft interpretation:

- Recognise immediately in profit or loss at time at point of adoption any amount previously deferred in equity for a net investment hedging relationship that does not qualify for hedge accounting anymore under the draft interpretation at the time of its adoption
- Keep any amount previously deferred in equity for a net investment hedging relationship that does not qualify for hedge accounting anymore under the draft interpretation until the related foreign operation is disposed of at which point the amount will be recognised in profit or loss.

Other comments on the draft interpretation

We believe for completeness it would be preferable to include in the calculation of hedge effectiveness in paragraph IE15 how the forward rates are determined. As hedge effectiveness is determined by reference to the forward rate, not spot rate, it is important that this calculation is performed. As the illustration calculates this by taking the US$ amount and dividing it by the contracted € amount less the fair value of the forward rate, this is a 'short-cut' as it merely imputes the fair value of the forward contract onto the hedged item. A full calculation should be performed that takes the designated net assets and translates them at the then forward rate maturing 1 January 20X3 which is then compared with the fair value of the forward in order to determine hedge effectiveness. To assist you in this regard we have included the calculation below:

Forward rate @ 31/12/X1	=	€/US$ spot rate @ 31/12/X1 x ((1 + US interest) / (1 + € interest))		
	=	1.400 x ((1 + 5.5%) / (1 + 4.5%))		
	=	1.413		
Net assets translated at forward rate at 31/12/X1	=	US$1,000,000 @ 1.413	=	707,714
Net assets translated at forward rate at 31/12/X2	=	US$1,000,000 @ 1.520	=	657,895
				49,819

Therefore, the forward contract is 103 per cent effective (51,450 / 49,819 x 100)

Other related matters

We appreciate that you have only invited comments on aspects of the draft interpretation and therefore are not seeking other comments on IAS 21. We note though that the draft interpretation reiterates the principle that in order to hedge a foreign operation it must have a functional currency different to that of its parent. This is consistent with one aspect of the definition of a foreign operation in IAS 21.8 that states that its functional currency must be different to its parent. However, the definition of a foreign operation also allows an entity to be deemed a foreign operation because it merely operates in a different country to the parent (even though its functional currency may be the same). The reference to the parent or operation's country has no relevance for accounting and we therefore suggest that reference to 'country' is removed from the definition of a foreign operation in the next annual improvements process.