EFRAG
European Financial Reporting Advisory Group

D22 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

xx October 2007

DRAFT COMMENT LETTER
Comments should be sent to Commentletter@efrag.org by 19 October 2007

Dear Sir/Madam,

Re: IFRIC D22 *Hedges of a Net Investment in a Foreign Operation*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IFRIC Draft Interpretation D22 *Hedges of a Net Investment in a Foreign Operation*. This letter is submitted in EFRAG's capacity as a contributor to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive Interpretation when it is issued.

IFRIC D22 addresses the following issues arising in accounting for hedges of net investment in consolidated account of entities:

(a) whether hedge accounting may be applied to the foreign exchange differences arising between the functional currency of the foreign operation and the presentation currency of the parent entity;

(b) whether hedge accounting may be applied to 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 entity of that foreign operation), and

(c) whether hedging instrument(s) may be held by any entity within the group.

We agree that these issues may cause a divergent interpretation in practice. IAS 39 *Financial Instruments: Recognition and Measurement* has limited guidance on net investment hedges. Further complications are caused by a lack of clarity on certain interactions between the requirements in IAS 39 and IAS *21 The Effects of Changes in Foreign Exchange Rates*. EFRAG therefore welcomes the IFRIC's decision to develop an Interpretation on the issue.

EFRAG furthermore supports the consensus set out in IFRIC D22 and considers the solutions that the IFRIC proposes to the above issues to be appropriate and a step forward in aligning hedge accounting with risk management practice. In particular:

(a) We agree that hedge accounting shall not be applied to the foreign exchange differences arising between the functional currency of the foreign operation and the presentation currency of the parent entity. The foreign currency risk that exposes an entity to unpredictable cash in- or outflows arises when an entity operates under different economic environments with their own currencies. Translating financial statements into a presentation currency may also have an unpredictable effect on equity, but this is a result of an accounting exercise that does not lead to real cash in- or outflows; and we agree that hedge accounting should not be applicable to this type of exposure.

(b) The IFRIC has concluded that hedge accounting may be applied to 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 entity of that foreign operation). We support this conclusion and we note that it recognises the fact that an entity faces direct and indirect exposures when it operates in several different economic environments and may decide to organise its risk management accordingly.

(c) We furthermore agree with the IFRIC's conclusion that hedging instruments can be held by any entity within the group.

While we support with the Interpretation we believe that it can be further improved if IFRIC clarifies the wording of certain parts of the Interpretation. The Appendix to this letter points out the parts of the Interpretation that we find unclear.

If you would like further clarification of the points raised in this letter, either Svetlana Boysen or I would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX

EFRAG supports the consensus in D22, but has some comments about the clarity of some parts of the text. Those comments are set out below.

Paragraph 11:

1 We think the highlighted part in the following sentence is not correct: "The requirements of IAS 39 paragraph 88 apply to the hedge of a net investment in a foreign operation *in a manner similar to that in which they apply to fair value or cash flow hedges.*" Paragraph 88 in IAS 39 clearly states that its requirements relate to net investment hedges directly, i.e. not by analogy to fair value or cash flow hedges. Moreover, paragraph 12 of the draft Interpretation also makes the reference to paragraph 88 in IAS 39. There the reference is appropriate and it is sufficient. Therefore, we suggest that the entire above quoted sentence should be deleted.

Paragraph 12

2 This paragraph states that "…the hedging instrument(s) may be held by any entity within the group (except the foreign operation that itself is being hedged)…". In line with this conclusion we understand that it should be equally acceptable if more than one entity within a group hold hedging instruments. For example, one entity may hold a derivative hedging instrument while another entity holds a non-derivative instrument. The group would like to designate the two instruments as a combined hedging instrument to hedge its exposure in a net investment in a foreign operation. To avoid any divergence of views, IFRIC should make clear in the interpretation that this is allowed as long as hedge accounting requirements in IAS 39 and in this Interpretation are satisfied.

3 We find confusing the following sentence in this paragraph: "Depending on where the hedging instrument is held, the total change in value may be recorded in profit or loss, or equity, or both". If hedge accounting is applied, in the consolidated financial statements the change in value of the hedging instrument will be accounted for under IAS 39, i.e. the effective portion will be included in equity and the ineffective will be reported in profit or loss. If the sentence is intended to illustrate this point, we think a simple cross-reference to IAS 39 would be much more useful. However, it might be that the purpose of the sentence is to explain that if in consolidated financial statements the change in value of the hedging instrument is partially recorded in profit or loss and partially recorded in equity before journal entries to record hedge accounting are made, the entity should consider the total change in value of the hedging instrument in measuring hedge effectiveness. If this is indeed the intention of the above quoted sentence, a more precise explanation is needed.

Paragraph 14:

4 We understand and agree with the intention of the following sentence: "An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once". However, we are concerned that it might be interpreted to imply that, if the entity applied hedge accounting but then ceased to apply hedge accounting, it cannot make a new designation to the same exposure later. We think this potential source of confusion can be eliminated by deleting the sentence we have quoted; the rest of the paragraph explains the point sufficiently clearly.

Paragraph IE4:

5 The last sentence refers to Entity B having a €/NZ$ foreign currency exposure. We think this is confusing because, according to the preceding paragraph IE3, Entity B does not have a €/NZ$ exposure that can be designated for hedge accounting because its functional currency is neither NZ$ nor €. It may be a typo and the example in paragraph IE4 should have stated "if Entity B had not also hedged … its SF/NZ$ foreign currency exposure". Alternatively the example may be suggesting that Entity B is permitted to look through its directly held net investment to assess the portion of its exposure that arises from the functional currencies of any lower level net investments. We think it would be helpful to clarify this example.

6 We think that the example should state "if Entity B had not also hedged *and applied hedge accounting to*…". We think that the distinction between "hedging" and "applying hedge accounting" is an important one and the wording used in D22 sometimes confuses the two. (Paragraph BC18 seems to be another example of this.)

Paragraph IE5

7 We think the purpose of the example is to illustrate why the €/NZ$ hedge entered by Entity C would qualify for hedge accounting in the situation described in the first sentence and would not qualify in the situation described in the second sentence. However, whether that is the intention or not, we think the example should be rewritten to make its intention clearer.

Paragraph IE6:

8 We think the wording of this example is a little unclear and would be improved if it were changed to "The exchange rate movements between the functional currencies of Entities X, Y and Z are not hedgeable risks in a net investment hedge (rather than "cannot be a hedge of a net investment) because there is no parent entity–foreign operation relationship between those entities."