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

26 November 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 accounts 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 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 support the IFRIC's conclusion that hedging instruments can be held by any entity within the group. This conclusion will be especially helpful for groups managing their risks on a centralised basis through treasury centres that enter into hedging instruments on behalf of other entities within the group. The conclusion is therefore an important step in aligning hedge accounting provisions with risk management practice. However, we think aspects of the statement need clarifying. (Further details are set out in the appendix.) We also note that, in order to apply this conclusion to a situation where a hedging instrument is held by an entity other than a parent hedging its net investment, entities need to understand how to interpret the requirements in IAS 21 on treatment of translation gains and losses in the context of IAS 39's requirements on the treatment of gains and losses on the hedging instrument. In our view neither the existing material nor the draft Interpretation is clear enough in this respect and we encourage IFRIC to provide further explanations.

We also believe that D22 can be further improved by clarifying 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 10

1 This paragraph states: “Hedge accounting may 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.” We understand that this requirement would only be relevant if the presentation currency of the parent entity were different from its functional currency. Therefore, we think it would be clearer if the paragraph reads “Hedge accounting may not be applied to the foreign exchange differences arising between the functional currency of the foreign operation and the presentation currency (if different from the parent’s entity functional currency) of the parent entity.”

Paragraph 11

2 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

3 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)…” Although we in principle welcome this statement, we think it would be much more useful if material could be added clarifying the following matters:

(a) Although a foreign currency swap or forward creates the same currency exposure regardless of the functional currency of the entity holding the instrument, the same is not true of a loan or other cash instrument. Judging from our own discussions and from some of the letters we have received, it is clear that there are differing views as to how this can be reconciled with the statement in paragraph 12, with some believing that the statement assumes the imputation of foreign currency risks that do not exist in practice. We think it would be helpful if IFRIC could clarify how it envisages the requirements of existing standards will be met when the hedging instrument is a loan and is held by an entity that has a different functional currency risk to that of the entity that has the foreign operation investment.

(b) In line with the conclusion in paragraph 12, 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.

(c) The draft IFRIC Interpretation allows the hedging instruments to be held by any entity within the group "except the foreign operation that itself is being hedged". Presumably the reason why a hedging instrument cannot be held by the foreign operation that itself is being hedged is that the gains and losses on the hedging instrument would be included in the amount of the net investment, i.e. they will be part of the hedged item. However, there seems to be some uncertainty about the rationale here so we think it would be helpful if IFRIC clarified things further by explaining its reasoning in the basis for conclusions.

Paragraph 13

4 D22 states in paragraph 13 that "depending on where the hedging instrument is held, the total change in value may be recorded in profit or loss, or equity, or both". The draft Interpretation also includes implementation guidance which explains how to measure effectiveness of the hedge if the hedging instrument is held by an entity within the group whose functional currency is different from the functional currency of the parent entity applying net investment hedge accounting. However, we think more guidance is needed on how to interpret the requirements in IAS 21 on treatment of translation gains and losses in the context of IAS 39's requirements on the treatment of gains and losses on the hedging instrument, particularly where the hedging instrument is held by an entity within the group whose functional currency is different from the functional currency of the parent entity applying net investment hedge accounting. In our view neither the existing material nor the material in D22 is sufficiently clear in this respect.

In particular we believe that the IFRIC should further analyse and explain the following areas of interaction between IAS 21 and IAS 39 requirements:

(a) IAS 21 requires entities to recognise translation gains and losses in equity while IAS 39 requires them to record gains and losses of the effective portion in equity and the ineffective portion in profit or loss. Therefore, the question is which standard, IAS 21 or IAS 39, should take precedence in recording gains and losses on the hedging instrument to which hedge accounting is applied; or can the requirements be reconciled in some way?

(b) IAS 39 requires recycling of gains and loses on the hedging instruments that have been recognised directly in equity under the net investment hedge accounting provisions into profit or loss when the hedged net assets in the foreign operation are disposed of. The question is how to apply these requirements when the hedging instrument is held by an entity other than the parent hedging its net investment and IAS 21 would require that translation gains and losses on the hedging instruments being recorded in the profit or loss only when the entity holding the hedging instrument is liquidated.

One way of doing this might be to develop an example that illustrates more fully than the existing examples the principles that should be applied here.

Paragraph 14

5 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 16

6 We agree with the IFRIC's proposal to apply IFRIC D22 prospectively. However, we think it would be helpful if the IFRIC could include further explanations as to how exactly this should be done; in particular how D22 should be applied prospectively to hedge relationships to which entities applied hedge accounting prior to the effective date of this Interpretation but which would no longer qualify for hedge accounting under the provisions of IFRIC D22.

Paragraph IE4

7 The last sentence refers to Entity B having a €/NZ$ foreign currency exposure. 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.

8 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

9 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

10 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."