EFRAG

European Financial Reporting Advisory Group

The costs and benefits of implementing IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*

Introduction

1 Following discussions in 2007 between the various parties involved in the EU endorsement process, it was decided that more extensive information than hitherto should to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*.

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of IFRIC 16, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing IFRIC 16 in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments and information received.

EFRAG's endorsement advice

3 EFRAG already carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

Summary of IFRIC 16

4 One way in which an entity may carry on foreign activities is to set up a foreign operation. That foreign operation might be a company or other legal entity (or a collection of legal entities) or it might be just a branch. (For simplicity, the language used in this Invitation to Comment assumes that a subsidiary company has been set up.) 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.

5 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.

6 IAS 21 requires each entity (including each foreign operation) to determine its functional currency; in other words the currency of the primary economic environment in which the entity operates. IAS 21 then requires each entity to translate its foreign currency items into that functional currency and to account for the effects of such translation in accordance with the detailed requirements of the standard; that means some effects will be presented in the income statement ('profit or loss'), and some outside of the income statement ('other comprehensive income' or 'OCI') and subsequently recycled ('reclassified') to profit or loss.

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 IAS 21 permits an entity to present its financial statements in a currency other than its functional currency. (This is known as the presentation currency.) When an entity has a presentation currency that is different from its functional currency, IAS 21 requires:

(a) the entity's assets and liabilities to be translated from the functional currency into the presentation currency at the balance sheet exchange rate;

(b) the entity's income and expenses to be translated from the functional currency into the presentation currency at the exchange rates prevailing at the dates of the transactions. For practical reasons, an average rate for the period is usually used; and

(c) all resulting exchange differences to be presented initially in OCI, and reclassified in profit or loss in a subsequent period in accordance with the detailed requirements of the standard.

8 As such, the choice of presentation currency will have an effect on return-on-capital ratios (because the same exchange rate is not used for the income statement as for the balance sheet) and on the net income reported (when the differences recognised in OCI are reclassified in profit or loss). Bearing that in mind, clarification has been sought from the IFRIC as to whether a hedge of the functional currency/presentation currency exchange rate would be eligible for hedge accounting.

9 IFRIC 16 makes it clear that such hedges would not be eligible for hedge accounting.

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

10 In a very simple group there might be only one parent company and one subsidiary. In that structure it is easy to see that, if the parent wishes to hedge its net investment in the subsidiary, the hedgeable risk is the foreign currency exposure arising between the functional currency of the subsidiary and the functional currency of the parent. However, the IASB has been asked to clarify which exchange rates are hedgeable risks under IAS 39 when intermediate parent entities

are involved. For example, assume that the ultimate parent in a group has a functional currency of Euros, its subsidiary has a functional currency of UK£, and that subsidiary (the foreign operation) has a functional currency of US$. The IFRIC was asked to clarify whether, if the ultimate parent wished to hedge the net investment in the foreign operation and get hedge accounting treatment for that hedge in its consolidated financial statements, is the only hedgeable foreign currency risk the €/$ exchange rate or could, for example, the £/$ rate risk also be hedged?

11 IFRIC 16 makes it clear that 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. In other words, in our example the ultimate parent could hedge the €/$ exchange rate; but it could also hedge the £/$ exchange rate, which is the exchange risk to which the intermediate parent entity is exposed.

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?

12 It is common for international groups to have a central treasury function that is responsible for managing the currency risks that arise throughout the group. Such functions are often placed within separate legal entities. Although such central treasury function companies typically do not have investments in foreign operations, they often hold the hedging instruments that are used to hedge the group's net investments in such operations. IFRIC has been asked whether such hedges are eligible for hedge accounting. Or, put more generally, whether it matters, for hedge accounting purposes, which entity is holding the hedging instrument being used to hedge a net investment in a foreign operation?

13 IFRIC 16 makes it clear 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.

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

14 As already explained, IAS 21 requires certain exchange differences to be presented initially in OCI. Similarly, IAS 39 requires the exchange differences arising on the hedging instrument used to hedge a net investment in a foreign operation and on the net investment itself to be presented initially in OCI (in the so-called 'foreign currency reserve'). IAS 21 requires that, on disposal of a foreign operation, the cumulative amount of the exchange differences presented in the foreign currency reserve for that foreign operation to be reclassified (ie recycled) to profit or loss.

15 There are broadly speaking two different ways of preparing the consolidated financial statements of a group that has intermediate parent entities and subgroups. One way is to prepare first the consolidated financial statements for the lowest level of sub-group, then consolidate those financial statements into the consolidated financial statements at the next level up until consolidated financial statements for the ultimate parent entity are prepared. This is known as the step-by-step method. Under the alternative method (the direct method), no sub-consolidations are prepared and instead all the assets and liabilities of the group are recognised

directly in the ultimate parent's consolidated balance sheet. The aggregate net amount of the foreign currency reserve would be the same under either of the consolidation methods. However, the amount included in the foreign currency translation reserve in respect of an individual foreign operation may be affected by the method of consolidation.

16 IFRIC 16 clarifies that:

(a) under existing IFRS, both methods of consolidation are acceptable and that, on disposal of a foreign currency, the exchange differences taken to the foreign currency reserve for that particular foreign operation under the method adopted should be reclassified to profit or loss; and

(b) existing IFRS permits a parent that has used the step-by-step method to determine 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 in order to reclassify the appropriate amount to profit or loss. However, making such an adjustment to the amount that would otherwise be reclassified is not required. It is an accounting policy choice that should be followed consistently for disposal of all net investments.

EFRAG's initial analysis of the costs and benefits of IFRIC 16

17 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing IFRIC 16, both in year one and in subsequent years. The results of the initial assessment can be summarised as follows.

(a) EFRAG's assessment of the additional costs that would arise was that IFRIC 16 was:

(i) likely to involve some preparers in some incremental year one costs, but those costs are likely to be very insignificant;

(ii) likely to involve preparers in no incremental ongoing costs; and

(iii) likely to involve users in no year one or ongoing incremental costs.

(b) EFRAG's initial assessment of the benefits that would arise from IFRIC 16 was that IFRIC 16 will reduce uncertainty and therefore diversity in practice, and this is likely to result in improvements in the quality of the information provided.

(c) EFRAG's assessment was that the benefits to be derived from implementing IFRIC 16 in the EU are likely to exceed the costs involved in its implementation.

18 EFRAG published its initial assessment of the costs and benefits of implementing IFRIC 16 in the EU and supporting analysis on 18 September 2008 and invited comment on it until 20 October 2008. In response, EFRAG received 11 comment letters. Two of those letters did not comment on EFRAG's initial assessment. The other nine all agreed with EFRAG's initial assessment and had no additional comments, although one stated it had not carried out a detailed examination of the effects involved.

19 In addition, EFRAG consulted its User Panel in October 2008 on EFRAG's initial assessment and Panel members were content with the assessment.

EFRAG's final analysis of the costs and benefits of IFRIC 16

20 Based on its initial analysis, comment letters received in response to that analysis and input from EFRAG's User Panel members, EFRAG's final analysis of the costs and benefits of IFRIC 16 is presented in the paragraphs below.

Costs for preparers

21 EFRAG's assessment is that:

(a) clarification 1 will not involve preparers in any incremental year one or ongoing costs, except that those needing to change their existing practice will probably need to incur some year one costs to amend their procedures. However, ERFRAG's assessment is that these costs will be insignificant;

(b) clarifications 2 and 3 will bring financial reporting closer to the hedging practices of a number of multinational groups. EFRAG believes that in most cases entities will already have systems in place—or those systems will require insignificant changes—to enable entities to apply the requirements of the Interpretation. It follows that it will involve preparers in insignificant incremental year one costs and no ongoing costs; and

(c) EFRAG's assessment is that clarification 4 will not involve preparers in any incremental year one or ongoing costs, except that—as with clarification 1—those needing to change their existing practice will probably need to incur what EFRAG believes will be an insignificant amount of year one costs to amend their procedures.

22 As IFRIC 16 is to be applied prospectively, there will be no year one transitioning costs.

Costs for users

23 EFRAG is not aware of any aspect of IFRIC 16 that will increase the costs users incur in analysing the financial statements. Its assessment is therefore that it will not involve users in any incremental year one or ongoing costs.

Benefits for preparers and users

24 In EFRAG's view, IFRIC 16 will enhance the comparability of the information provided by eliminating some of the uncertainty that currently exists about the application of existing IFRS. This will result in a reduction in the diversity of current practice.

Overall assessment

25 EFRAG's assessment is that, although this will not result in major benefits, the benefits that will arise are likely to exceed the very insignificant costs that are likely to result from its implementation in the EU.

EFRAG
3 November 2008