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Technical Accounting Alert

Interpretation 16 Hedges of a Net Investment in a Foreign Operation

Introduction

On 3 July 2008 the International Financial Reporting Interpretations Committee published IFRIC 16 Hedges of a Net Investment in a Foreign Operation (IFRIC 16).

The AASB then released Interpretation 16 which is identical to IFRIC 16 in August 2008.

Foreign operations are operations (subsidiaries, associates, joint ventures or branches) whose activities are conducted in a currency other than the functional currency of the reporting entity. Investments in foreign operations create currency risk because exchange rate movements affect the reporting entity's functional currency equivalent of the foreign operation's net assets and results. The reporting entity might decide to hedge this currency risk by borrowing money in the foreign operation's functional currency or entering into foreign exchange contracts (for example).

AASB 121 *The Effects of Changes in Foreign Exchange Rates* requires the reporting entity to translate the results and net assets of its foreign operations into its presentation currency (which need not be the same as its functional currency). Exchange differences arising are reported in other comprehensive income until the foreign operation is disposed of.

AASB 139 *Financial Instruments: Recognition and Measurement* ("AASB 139") permits (but does not require) the reporting entity to apply a form of hedge accounting (referred to as net investment hedge accounting) to its investments in foreign operations, provided certain strict conditions are met. Net investment hedge accounting operates in a similar way to cash flow hedge accounting. Interpretation 16 addresses various issues that have led to inconsistency in applying net investment hedge accounting in practice.

Issues addressed

The main issues addressed by Interpretation 16 are:

- the nature of the hedged risk;
- the amount of the hedged item;
- where in the group the hedging instrument may be held; and
- reclassifications from equity to profit or loss on disposal of the foreign operation.

Consensus

The following paragraphs summarise the main conclusions expressed in Interpretation 16's Consensus.

Nature of the hedged risk

Interpretation 16 clarifies that currency risk eligible for net investment hedge accounting relates to exposure arising between the foreign operation's functional currency and the functional currency of the immediate, intermediate or ultimate parent entity. A higher level or ultimate parent may also designate a hedge based on exposures arising between the functional currencies of a foreign operation and an intermediate parent.

Translation risks (relating to exchange differences between foreign operation's functional currency and the reporting entity's presentation currency) are not eligible for hedge accounting.

Functional and presentation currency

Parent entity P has a functional currency of USD but presents its consolidated financial statements in AUD. P has two subsidiaries E (AUD functional currency) and J (Japanese Yen functional currency).

P may designate the following currency risks in a net investment hedge based on functional currencies:

- USD to AUD currency exposure relating to E
- USD to Yen currency exposure relating to J

Because P uses AUD as its presentation currency, currency translation risks also arise on:

- AUD to USD exchange differences on translation of P's financial statements
- AUD to Yen exchange differences on translation of J's financial statements

Neither of these risks is eligible for hedge accounting. However, P can still designate based on the functional currency exposures relating to E and J, even though in E's case there will be no translation differences on consolidation.

The amount of the hedged item

The amount of the foreign operation's net assets eligible for designation as the hedged item cannot exceed the carrying value of those net assets in the parent entity's consolidated financial statements. If a lower-level (intermediate) parent applies hedge accounting for a net investment in a foreign operation, the amount of the foreign operation's net assets eligible for hedge accounting by a higher or ultimate parent entity is reduced accordingly. In other words, an exposure to currency risk on a net investment in a foreign operation cannot qualify for hedge accounting more than once.

Where in the group the hedging instrument may be held

Interpretation 16 clarifies that the availability of hedge accounting in the consolidated financial statements is not affected by which group entity holds the hedging instrument. The designated hedging instrument (a derivative or non-derivative financial instrument) in a net investment hedge could therefore be held either by the parent itself or by another group entity.

Reclassifications from equity to profit or loss on disposal of the foreign operation

If the reporting entity disposes of its investment in the foreign operation, reclassifications from equity to profit and loss are required of:

- the cumulative foreign currency translation reserve (“FCTR”) recorded on consolidation of the foreign operation in accordance with AASB 121; and

- if net investment hedge accounting has been applied, the cumulative change in the fair value of the hedging instrument to the extent the hedge was an effective one. In accordance with AASB 139, this effective portion is recorded in other comprehensive income (equity). Any ineffective portion of the hedge is recognised immediately in profit and loss.

Interpretation 16 notes that the amount of the cumulative FCTR may differ depending on whether the reporting entity applies the 'direct' or 'step-by-step' method of consolidation. If the 'step-by-step' method is used, the FCTR relating to the foreign operation in question will be determined at the level of that foreign operation's immediate parent, rather than the ultimate parent. However, Interpretation 16 permits (as an accounting policy choice) the reporting entity to reclassify from equity the amount that would have been included in the FCTR if the direct method had been applied.

Application guidance

Interpretation 16 includes an Application Guidance section, setting out detailed examples of how to apply its requirements. These examples and the full text of Interpretation 16 should be studied carefully if net investment hedging is applied.

Effective date and transition

Interpretation 16 must be applied for annual periods commencing on or after 1 October 2008. Earlier application is permitted.

On first adopting Interpretation 16, retrospective application is not required. If entities have designated a hedge accounting relationship that is no longer permissible, hedge accounting is discontinued prospectively (in accordance with AASB 139's requirements on discontinuing hedge accounting).

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia representative or a member of the National Audit Support team at NAS@grantthornton.com.au