



# UK-Adopted International Accounting Standards

## IFRIC Interpretation 16

### Hedges of a Net Investment in a Foreign Operation

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## IFRIC Interpretation 16

### *Hedges of a Net Investment in a Foreign Operation*

#### References

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- IFRS 9 *Financial Instruments*
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 21 The Effects of Changes in Foreign Exchange Rates

#### Background

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- 1 Many reporting entities have investments in foreign operations (as defined in IAS 21 paragraph 8). Such foreign operations may be subsidiaries, associates, joint ventures or branches. IAS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in other comprehensive income until it disposes of the foreign operation.
- 2 Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements.<sup>1</sup> The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.
- 3 IFRS 9 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognised in other comprehensive income and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.
- 4 An entity with many foreign operations may be exposed to a number of foreign currency risks. This Interpretation provides guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation.

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<sup>1</sup> This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint ventures are accounted for using the equity method and financial statements that include a branch or a joint operation as defined in IFRS 11 *Joint Arrangements*.

- 5 IFRS 9 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This Interpretation provides guidance on where, within a group, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting.
- 6 IAS 21 and IFRS 9 require cumulative amounts recognised in other comprehensive income relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be reclassified from equity to profit or loss as a reclassification adjustment when the parent disposes of the foreign operation. This Interpretation provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.

### **Scope**

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- 7 This Interpretation applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with IFRS 9. For convenience this Interpretation refers to such an entity as a parent entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a parent entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.
- 8 This Interpretation applies only to hedges of net investments in foreign operations; it should not be applied by analogy to other types of hedge accounting.

### **Issues**

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- 9 Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. The issues addressed in this Interpretation are:
  - (a) the nature of the hedged risk and the amount of the hedged item for which a hedging relationship may be designated:
    - (i) whether the parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the parent entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation

- currency of the parent entity's consolidated financial statements and the functional currency of the foreign operation;
- (ii) if the parent entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate parent entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate parent entity (ie whether the fact that the net investment in the foreign operation is held through an intermediate parent affects the economic risk to the ultimate parent).
- (b) where in a group the hedging instrument can be held:
- (i) whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity in the group, regardless of its functional currency, can hold the hedging instrument;
  - (ii) whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.
- (c) what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation:
- (i) when a foreign operation that was hedged is disposed of, what amounts from the parent entity's foreign currency translation reserve in respect of the hedging instrument and in respect of that foreign operation should be reclassified from equity to profit or loss in the parent entity's consolidated financial statements;
  - (ii) whether the method of consolidation affects the determination of the amounts to be reclassified from equity to profit or loss.

## Consensus

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### **Nature of the hedged risk and amount of the hedged item for which a hedging relationship may be designated**

- 10 Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency.
- 11 In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or



less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements.

- 12 The hedged risk may be designated as 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. The fact that the net investment is held through an intermediate parent does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate parent entity.
- 13 An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one parent entity within the group (for example, both a direct and an indirect parent entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate parent. A hedging relationship designated by one parent entity in its consolidated financial statements need not be maintained by another higher level parent entity. However, if it is not maintained by the higher level parent entity, the hedge accounting applied by the lower level parent must be reversed before the higher level parent's hedge accounting is recognised.

#### **Where the hedging instrument can be held**

- 14 A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the group, as long as the designation, documentation and effectiveness requirements of IFRS 9 paragraph 6.4.1 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the group should be clearly documented because of the possibility of different designations at different levels of the group.
- 15 For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognised



in profit or loss, in other comprehensive income, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognised in profit or loss or in other comprehensive income. As part of the application of hedge accounting, the total effective portion of the change is included in other comprehensive income. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

#### Disposal of a hedged foreign operation

- 16 When a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the parent in respect of the hedging instrument is the amount that IFRS 9 paragraph 6.5.14 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.
- 17 The amount reclassified to profit or loss from the foreign currency translation reserve in the consolidated financial statements of a parent in respect of the net investment in that foreign operation in accordance with IAS 21 paragraph 48 is the amount included in that parent's foreign currency translation reserve in respect of that foreign operation. In the ultimate parent's consolidated financial statements, the aggregate net amount recognised in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate parent uses the direct or the step-by-step method of consolidation<sup>2</sup> may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation. The use of the step-by-step method of consolidation may result in the reclassification to profit or loss of an amount different from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by IAS 21. However, it is an accounting policy choice that should be followed consistently for all net investments.

#### Effective date

- 18 An entity shall apply this Interpretation for annual periods beginning on or after 1 October 2008. An entity shall apply the amendment to paragraph 14 made by Improvements to IFRSs issued in April 2009 for annual periods beginning on or after 1 July 2009. Earlier application of both is permitted. If an entity applies this Interpretation for a period beginning before 1 October 2008, or the amendment to paragraph 14 before 1 July 2009, it shall disclose that fact.



18A [Deleted]

18B IFRS 9, as issued in July 2014, amended paragraphs 3, 5–7, 14, 16, AG1 and AG8 and deleted paragraph 18A. An entity shall apply those amendments when it applies IFRS 9.

### **Transition**

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19 IAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying the Interpretation. If an entity had designated a hedging instrument as a hedge of a net investment but the hedge does not meet the conditions for hedge accounting in this Interpretation, the entity shall apply IAS 39 to discontinue that hedge accounting prospectively.