

[DRAFT] INTERPRETATION D22

Hedges of a Net Investment in a Foreign Operation

Comments to be received by 19 September 2007

INVITATION TO COMMENT

The Council on Corporate Disclosure and Governance (CCDG) invites comments on any aspect of this draft interpretation *Hedges of a Net Investment in a Foreign Operation*. Comments are most helpful if they indicate the specific paragraph to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing, so as to be received by 19 September 2007, preferably by email to: accounting_std@acra.gov.sg or addressed to:

Council on Corporate Disclosure and Governance
c/o Accounting and Corporate Regulatory Authority
10 Anson Road #05-01/15
International Plaza
Fax: 6225 1676

DRAFT INTERPRETATION D22

Hedges of a Net Investment in a Foreign Operation

[Draft] Interpretation X *Hedges of a Net Investment in a Foreign Operation* ([draft] INT FRS X) is set out in paragraphs 1–16. [Draft] INT FRS X is accompanied by Illustrative Examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in paragraphs 2 and 7–17 of the *Preface to Financial Reporting Standards*.

References

- FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- FRS 21 *The Effects of Changes in Foreign Exchange Rates*
- FRS 39 *Financial Instruments: Recognition and Measurement*

Background

- 1 Many reporting entities have investments in foreign operations (as defined in FRS 21 paragraph 8). Such foreign operations may be subsidiaries, associates, joint ventures or branches. FRS 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 financial statements of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in equity until it disposes of the foreign operation.
- 2 In individual or consolidated financial statements, an entity may apply hedge accounting to the foreign currency risk arising from its net investment in a foreign operation. Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of the foreign operation are included in the financial statements.* 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 FRS 39 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 portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity and is offset against the foreign exchange differences arising on translation of the financial statements of the foreign operation into the presentation currency. When the entity disposes of the foreign operation, both the cumulative foreign exchange differences arising from translation of the financial statements of the foreign operation and the offsetting cumulative gain or loss on the hedging instruments are recognised in profit or loss.
- 4 In an entity with many foreign operations, the entity may be exposed to a number of foreign currency exposures. This [draft] Interpretation provides guidance on identifying

* This will be the case for consolidated financial statements, financial statements in which investments are accounted for using the equity method, financial statements in which venturers' interests in joint ventures are proportionately consolidated and financial statements that include a branch.

the foreign currency risks that qualify as a hedged item in the hedge of a net investment in a foreign operation.

- 5 FRS 39 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 [draft] 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.

Scope

- 6 This [draft] Interpretation applies to an entity with net investments in a foreign operation that hedges the foreign currency risk arising from those net investments in foreign operations and wishes to qualify for hedge accounting in accordance with FRS 39. For convenience this [draft] Interpretation refers to such an entity as a parent entity. All references to a parent entity apply equally to an entity that has a net investment in foreign operation that is a joint venture, an associate or a branch.
- 7 This [draft] Interpretation does not apply to other forms of hedge accounting.

Issues

- 8 Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. The issues addressed in this [draft] Interpretation are:

(a) *the nature of the hedged risk 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 financial statements and the functional currency of the foreign operation; and
- (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 item may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate parent entity.

(b) *where in a group the hedging instrument can be held:*

whether a qualifying hedging relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity within the group, regardless of its functional currency, can hold the hedging instrument.

Consensus

- 9 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 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).
- 10 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.
 - 11 The requirements of FRS 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.
 - 12 A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be used as a hedging instrument in a hedge of a net investment in a foreign operation. If so, the hedging instrument(s) may be held by any entity within the group (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of FRS 39 paragraph 88 are satisfied, in so far as that paragraph relates to a net investment hedge.
 - 13 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, the total change in value may be recorded in profit or loss, or equity, or both.
 - 14 An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once. Therefore, if the same risk is hedged by more than one parent entity within the group (for example, a direct and an indirect parent entity) only one hedge relationship will qualify for hedge accounting in the consolidated financial statements.

Effective date

- 15 An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date to be set at three months after the Interpretation is finalised]. Earlier application is permitted. If an entity applies this [draft] Interpretation for a period beginning before [above date], it shall disclose that fact.

Transition

- 16 FRS 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 [draft] Interpretation. If an entity uses this exemption, it shall apply this [draft] Interpretation prospectively.

Illustrative Examples

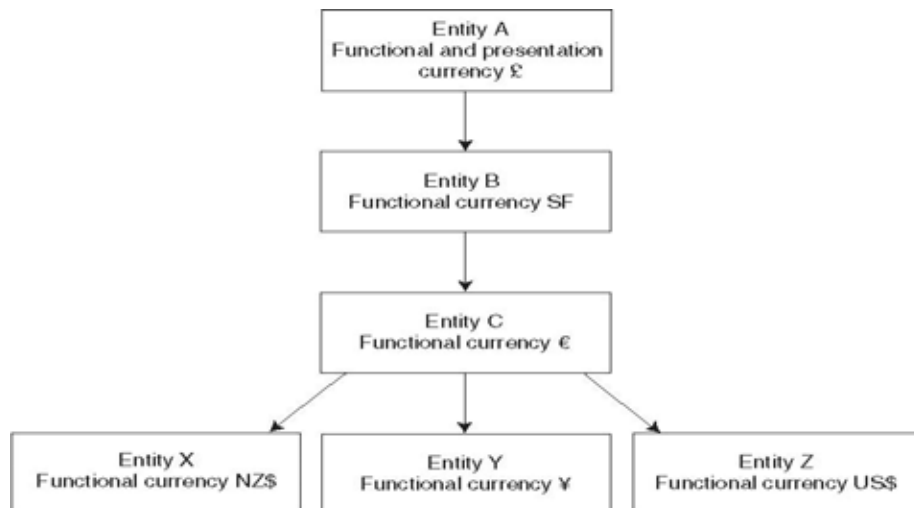
These [draft] examples accompany, but are not part of, [draft] INT FRS X.

Facts

IE1 Entity A has a functional and presentation currency of sterling (£). Entity A holds a 100 per cent interest in Entity B, whose functional currency is Swiss francs (SF). Entity B has a 100 per cent interest in Entity C, whose functional currency is euro (€). Entity C has a 100 per cent interest in the following investments:

- Entity X, whose functional currency is New Zealand dollars (NZ\$);
- Entity Y, whose functional currency is Japanese yen (¥); and
- Entity Z, whose functional currency is United States dollars (US\$).

IE2 The following diagram depicts the group structure:



Example 1—Entity A’s consolidated financial statements

IE3 This example identifies the eligible hedged risk in Entity A’s consolidated financial statements. The exposures arising between any parent entity (ie Entity A, B or C) and its net investment in a foreign operation may be designated as the hedged risk. Therefore, the following exposures can be designated:

- (a) the exposure between Entity A (£) and Entity B (SF);
- (b) the exposure between Entity A (£) and Entity C (€);
- (c) the exposure between Entity A (£) and Entity X (NZ\$);
- (d) the exposure between Entity A (£) and Entity Y (¥);
- (e) the exposure between Entity A (£) and Entity Z (US\$);

- (f) the exposure between Entity B (SF) and Entity C (€);
 - (g) the exposure between Entity B (SF) and Entity X (NZ\$);
 - (h) the exposure between Entity B (SF) and Entity Y (¥);
 - (i) the exposure between Entity B (SF) and Entity Z (US\$);
 - (j) the exposure between Entity C (€) and Entity X (NZ\$);
 - (k) the exposure between Entity C (€) and Entity Y (¥); or
 - (l) the exposure between Entity C (€) and Entity Z (US\$).
- IE4 However, not all of the exposures listed in paragraph IE3 can qualify for hedge accounting at the same time. An entity may apply hedge accounting to a risk only once. For example, if Entity C prepared consolidated financial statements it can apply hedge accounting to the foreign exchange exposure from Entity X (€/NZ\$). This hedge would continue to qualify for hedge accounting in Entity B's consolidated financial statements only if Entity B had not also hedged its €/NZ\$ foreign currency exposure.
- IE5 In Entity B's consolidated financial statements, assuming Entity C has hedged the €/NZ\$ exposure, Entity B could apply hedge accounting to the SF/€ foreign exchange exposure arising from the net investment in Entity X. However, if Entity B prepared consolidated financial statements and wanted to obtain hedge accounting for its SF/NZ\$ foreign currency exposure arising from the group's net investment in Entity X, the hedge of the exposure to €/NZ\$ that qualified in Entity C's consolidated financial statements would not qualify in Entity B's consolidated financial statements and would need to be reversed in Entity B's consolidated financial statements.
- IE6 The exchange rate movements between the functional currencies of Entities X, Y and Z cannot be a hedge of a net investment in a foreign operation because there is no parent entity–foreign operation relationship between those entities.
- IE7 The documentation and designation process must identify those items required by FRS 39 paragraph 88 including the foreign exchange exposure that is being hedged (ie the foreign currency exposure between the functional currencies of the foreign operation and the parent entity) and the hedging instrument being used.

Example 2—Presentation currency different from the functional currency

- IE8 Using the same facts as in paragraphs IE1 and IE2, also assume that Entity A presents its consolidated financial statements in Australian dollars rather than sterling.
- IE9 The exposures arising between the functional currency of the parent entity and the functional currency of its net investment in a foreign operation may qualify for hedge accounting—ie those discussed in Example 1. However, the existence of a presentation currency that is different from the functional currency of Entity A does not create any new exposure to which hedge accounting may be applied.

Example 3—Where a hedging instrument is held

- IE10 Using the same facts as in paragraphs IE1 and IE2, consider Entity C's consolidated financial statements. At 31 December 20X1 Entity C is hedging 100 per cent of the risk

arising from its net investment in Entity Z—ie the foreign currency exposure to €/US\$. Entity C's carrying amount of net assets in Entity Z is US\$1,000,000 at 31 December 20X1 and 31 December 20X2.

Spot exchange rates are as follows:

| | 31 December 20X1 | 31 December 20X2 | Average 20X2 |
|-----------|------------------|------------------|--------------|
| €/US\$ | 1.400 | 1.520 | 1.460 |
| €/NZ\$ | 2.200 | 1.850 | 2.025 |
| US\$/NZ\$ | 1.571 | 1.217 | 1.394 |

At 31 December 20X1 one-year interest rates are as follows:

| | |
|------|------|
| € | 4.5% |
| US\$ | 5.5% |
| NZ\$ | 8.0% |

The hedging instrument used in Examples 3A and 3B is a buy €750,000 sell US\$1,000,000 forward contract maturing on 1 January 20X3. The fair value of the forward contract measured in euro, United States dollars and New Zealand dollars is:

| | 31 December 20X1 | Calculations | 31 December 20X2 | Calculations |
|------|------------------|-----------------------------------------------------------------------------------------|------------------|-----------------------------------------------------|
| € | €40,655 | $[750,000 / (1 + 0.045)] - \{[1,000,000 / (1 + 0.055)] / 1.400\}$ | €92,105 | $750,000 - (1,000,000 / 1.520)$ |
| US\$ | US\$56,917 | $\{[750,000 / (1 + 0.045)] \times 1.400\} - [1,000,000 / (1 + 0.055)]$ | US\$140,000 | $(750,000 \times 1.520) - 1,000,000$ |
| NZ\$ | NZ\$89,847 | $\{[750,000 / (1 + 0.045)] \times 2.200\} - \{[1,000,000 / (1 + 0.055)] \times 1.571\}$ | NZ\$170,500 | $(750,000 \times 1.850) - (1,000,000 \times 1.217)$ |

IE11 Each example assumes that the designation and documentation requirements have been met.

Example 3A—Hedging instrument held by Entity C

IE12 To hedge its risk arising from the net investment in Entity Z, Entity C will hold the forward contract detailed in paragraph IE10.

Would the hedging instrument qualify for hedge accounting in Entity C's consolidated financial statements?

IE13 Yes. At inception of the hedge, the notional amount of the forward contract designated as the hedging instrument does not exceed the hedged portion of the carrying amount of the net investment in the foreign operation. In this example the carrying amount of net assets in Entity Z designated as the hedged item is US\$1,000,000 and the notional amount of the forward contract is US\$1,000,000. The hedged risk is the exposure arising from the difference between Entity C's functional currency (euro) and Entity Z's functional

currency (US dollars).

- IE14 The following accounting entries arise from the forward contract prior to recording the hedge accounting entry in Entity C's financial statements:

Opening balance of forward contract held by Entity A at 31 December 20X1
 Forward contract €40,655

Journal entries for the year to 31 December 20X2 without hedge accounting
 Dr Forward contract €51,450
 Cr Profit or loss €51,450

- being the profit arising from the forward contract (€92,105 – €40,655).

Closing balance of forward contract held by Entity A at 31 December 20X2
 Forward contract €92,105

- IE15 For the purpose of assessing actual effectiveness for the forward contract, any gain or loss is measured by computing the change in the fair value of the forward contract in one of its two reference currencies (the euro or US dollar) and, if necessary, translating that amount at the relevant spot exchange rate into the functional currency of the parent entity hedging its foreign operation, in accordance with the hedge documentation. In this example the fair value of the forward contract is measured in euro. The functional currency of the parent entity hedging its foreign operation is also euro.

Hedge effectiveness:

In this example, the whole of the forward contract is used as the hedging instrument and effectiveness is assessed by comparing the changes in the value of the forward contract to changes in the value of US\$1,000,000 attributable to forward exchange rates:

| | 31 December 20X1 | 31 December 20X2 |
|----------------------------------------------------|-------------------------------------------|-------------------------------------------|
| Forward € / US\$ rates to 1 January 20X3 | 1.410 [1,000,000 / (750,000 – 40,655)] | 1.520 [1,000,000 / (750,000 – 92,105)] |
| € value of Entity Z's net assets at forward rates | €709,220 (1,000,000 / 1.410) | €657,895 (1,000,000 / 1.520) |
| Change in value of Entity Z in X2 at forward rates | | €51,325 (709,220 – 657,895) |
| Change in value of the forward contract | | €51,450 |

Therefore, the forward contract is 100 per cent effective (51,450 / 51,325 × 100).*

Journal entries for the year to 31 December 20X2 to record hedge accounting
 Dr Profit or loss €51,450
 Cr Equity €51,450

- being the hedge accounting entry for the net investment in Entity Z.

* Because of rounding the two amounts are not exactly equal; when unrounded numbers are used the two amounts are fully offset, which is why the total profit or loss amount is removed and recorded in equity.

Would the hedge relationship discussed in paragraph IE12 qualify for hedge accounting in Entity A's consolidated financial statements?

- IE16 Yes, as long as Entity Z is not hedged by a parent above Entity C. For the purpose of assessing effectiveness, the gain or loss on the hedging instrument will be calculated by reference to the functional currency of Entity C.

Example 3B—Hedging instrument held by Entity X

- IE17 To hedge its risk arising from the net investment in Entity Z, Entity X will hold the forward contract detailed in paragraph IE10.

Would the hedging instrument qualify for hedge accounting in Entity C's consolidated financial statements?

- IE18 Yes. At the inception of the hedge, the notional amount of the forward contract or borrowing designated as the hedging instrument does not exceed the hedged portion of the carrying amount of the net investment in the foreign operation. In this example the carrying amount of net assets of Entity Z designated as the hedging instrument is US\$1,000,000 and the notional amount of the forward contract is US\$1,000,000. The hedged risk is the exposure arising from the difference between Entity C's functional currency (euro) and Entity Z's functional currency (US dollars).

- IE19 The following accounting entries would be recorded for the forward contract in Entity X's financial statements:

Opening balance of forward contract held by Entity X at 31 December 20X1
 Forward contract NZ\$89,847

Journal entries for the year to 31 December 20X2 without hedge accounting
 Dr Forward contract NZ\$80,653
 Cr Profit or loss NZ\$80,653

– being the profit arising from the forward contract (170,500 – 89,847).

Closing balance of forward contract held by Entity X at 31 December 20X2
 Forward contract NZ\$170,500

Translation journal entries in Entity C's consolidated accounts to translate Entity X's financial statements
 Dr Forward contract €39,829
 Cr Profit or loss €39,829

– being the retranslation of Entity X's NZ\$ profits into euro at the average rate (80,653 / 2.025).

Dr Forward contract €3,761
 Cr Equity €3,761

– being the retranslation of Entity X's NZ\$ profits at the closing rate [(80,653 / 1.850) – (80,653 / 2.025)].

Dr Forward contract €7,725
 Cr Equity €7,725

...continued

...continued

– being the retranslation of Entity X’s opening NZ\$ balance sheet into euro at the closing rate $[(89,847 / 1.850) - (89,847 / 2.200)]$.

Entity C’s closing consolidated balance sheet shows
Forward contract €92,162
(170,500 / 1.85)

IE20 For the purpose of assessing actual effectiveness for the forward contract, any gain or loss is measured by computing the change in the fair value of the forward contract in one of its two reference currencies (the euro or US dollar) and, if necessary, translating that amount at the relevant spot exchange rate into the functional currency of the parent entity hedging its foreign operation in accordance with the hedge documentation. In this example the fair value of the forward contract is measured in euro. The functional currency of the entity hedging its risk is also euro.

IE21 It is important to note that the functional currency of the entity holding the instrument (Entity X with a functional currency of NZ\$) is irrelevant in determining effectiveness. The change in fair value recorded in profit or loss in Entity X’s financial statements is NZ\$80,653. Translated at average rates in Entity C’s financial statements, the amount recorded in profit or loss was only €39,829. This would not be effective in offsetting the risk arising from the net investment in Entity Z.* Therefore, the [draft] Interpretation requires hedge effectiveness to be computed by reference to the functional currency of the parent entity hedging its risk— ie Entity C’s functional currency of euro. Therefore, both the amount recorded in profit or loss and the amount recorded in equity on translation to the parent entity’s functional currency arising from the forward contract should be considered when assessing effectiveness.

Hedge effectiveness:

The same hedge effectiveness test that was performed in Example 3A would be completed when Entity X holds the hedging instrument. However, the amount removed from profit or loss will be only €39,829 because the remainder of the change in value of the forward contract is already recorded in equity (ie the €3,761 and the €7,725).*

Journal entries for the year to 31 December 20X2 to record hedge accounting

| | | | |
|----|----------------|---------|---------|
| Dr | Profit or loss | €39,829 | |
| | Cr | Equity | €39,829 |

– being the hedge accounting entry for the net investment in Entity Z.

Would the hedge relationship discussed in paragraph IE17 qualify for hedge accounting in Entity A’s consolidated financial statements?

IE22 Yes, for the same reasons as are discussed in paragraph IE16 assuming Entity Z is not hedged by a parent above Entity C.

* Change in value of Entity Z is €1,325 compared with €39,829—creating 77.6% effectiveness.

* Because of rounding the two amounts are not exactly equal; when unrounded numbers are used the two amounts are fully offset.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, draft INT FRS X.

- BC1 This Basis for Conclusions summarises the considerations in reaching its consensus.
- BC2 It was asked for guidance on the accounting for the hedge of a net investment in a foreign operation in the consolidated financial statements. Interested parties had different views of the eligible risks for hedge accounting purposes. One issue is whether the risk arises from the foreign currency exposure to the functional currencies of the foreign operation and the parent entity, or whether it arises from the foreign currency exposure to the functional currency of the foreign operation and the presentation currency of the group.
- BC3 Concern was also raised by constituents about which entity, within a group, could hold a hedging instrument in a hedge of a net investment in a foreign operation and in particular whether the parent entity holding the net investment in a foreign operation must also hold the hedging instrument.
- BC4 Accordingly, it decided to develop guidance on the accounting for a hedge of the foreign currency risk arising from a net investment in a foreign operation.

Basis for consensus

Hedged risk

- BC5 It received a submission pointing out that the method of consolidation can affect the determination of the hedged risk in a hedge of a net investment in a foreign operation. The submission noted that consolidation can be completed by either the direct method or the step-by-step method. The direct method of consolidation indicates that each entity within a group is consolidated directly into the ultimate parent entity's presentation currency when preparing the consolidated financial statements. The step-by-step method indicates that each intermediate parent entity would prepare consolidated financial statements, which would then be consolidated into its parent entity until the ultimate parent entity has prepared consolidated financial statements.
- BC6 The submission stated that if the direct method was required, the risk that qualifies for hedge accounting in a hedge of a net investment in a foreign operation would arise only from the functional currency of the foreign operation and the presentation currency of the group. This is because each foreign operation is translated only once into the presentation currency. In contrast, the submission stated that if the step-by-step method was required, the hedged risk that qualifies for hedge accounting is the risk between the functional currencies of the foreign operation and the immediate parent entity into which the entity was consolidated. This is because each foreign operation is consolidated directly into its immediate parent entity.
- BC7 In response to this, it was noted that FRS 21 *The Effects of Changes in Foreign Exchange Rates* does not specify a method of consolidation for foreign operations. Furthermore, paragraph BC18 of the Basis for Conclusions on FRS 21 states that the method of translating financial statements will result in the same amounts in the presentation currency regardless of whether the direct method or the step-by-step method is used. It was therefore concluded that the consolidation mechanism should not determine what risk qualifies for hedge accounting in the hedge of a net investment in a foreign operation.

- BC8 However, it was noted that its conclusion would not resolve the divergence of views on the foreign currency risk that may be designated as a hedge relationship in the hedge of a net investment in a foreign operation. It therefore decided that an Interpretation was needed.
- BC9 It was considered whether the risk that qualifies for hedge accounting in a hedge of a net investment in a foreign operation arises from the exposure to the functional currency of the foreign operation in relation to the presentation currency, or in relation to the functional currency, of the parent entity, or both.
- BC10 The answer to this question is important when the presentation currency of the parent entity is different from an intermediate or ultimate parent entity's functional currency. If the presentation currency and the functional currency of the parent entity are the same, the exchange rate being hedged would be identified as that between the parent entity's functional currency and the foreign operation's functional currency. No further translation adjustment would be required to prepare the consolidated financial statements. However, when the functional currency of the parent entity is different from the presentation currency, a translation adjustment will be included in equity to express the consolidated financial statements in a different presentation currency. The issue, therefore, is how to determine which foreign currency risk may be designated as the hedged item in accordance with FRS 39 *Financial Instruments: Recognition and Measurement* in the hedge of a net investment in a foreign operation.
- BC11 It was noted the following arguments for permitting hedge accounting for a hedge of the presentation currency:
- (a) If the presentation currency is different from the ultimate parent entity's functional currency, a difference arises on translation that is included in equity. It is argued that a reason for allowing hedge accounting for a net investment in a foreign operation is to remove from the balance sheet the fluctuations resulting from the translation to a presentation currency. If an entity is not allowed to use hedge accounting for the exposure to its presentation currency when it is different from the functional currency of the parent entity, there is likely to be an amount included in equity that cannot be offset by hedge accounting.
 - (b) FRS 21 requires an entity to recycle in profit or loss any foreign currency translation gains and losses included in equity on disposal of a foreign operation. An amount in equity arising from a different presentation currency is therefore included in the amount recycled on disposal (ie it is recognised in profit or loss). The entity should be able to include the amount in a hedging relationship if at some stage it is recognised along with other recycled translation amounts.
- BC12 It was noted the following arguments for allowing an entity to designate hedging relationships solely on the basis of differences between functional currency:
- (a) The functional currency of an entity is determined on the basis of the primary economic environment in which that entity operates (ie the environment in which it generates and expends cash). However, the presentation currency is an elective currency that can be changed at any time. To present amounts in a presentation currency is merely a numerical convention necessary for the preparation of financial statements that include a foreign operation. The presentation currency will have no economic impact on the financial statements of the parent entity. Indeed, a parent entity may choose to present financial statements in more than one presentation currency, but can have only one

functional currency.

- (b) The functional currency of a foreign operation when compared with the functional currency of the parent entity holding the foreign operation will fluctuate over time. Everything else being equal, the value of a foreign operation will increase or decrease in the parent's own functional currency, according to those fluctuations. A parent entity's net investment in a foreign operation will not change in value when expressed in that parent's presentation currency.
 - (c) FRS 39 requires a hedging relationship to be effective in offsetting changes in fair values or cash flows attributable to the hedged risk. A net investment in a foreign operation gives rise to an exposure to changes in exchange rate risk for a parent entity. An exchange rate risk arises only from an exposure between two or more functional currencies, not from a presentation currency.
- BC13 When comparing the arguments in paragraphs BC11 and BC12, it was concluded that the presentation currency does not create an exposure to which an entity may apply hedge accounting. The functional currency is determined on the basis of the primary economic environment in which the entity operates. Accordingly, functional currencies create an economic exposure to changes in cash flows or fair value; a presentation currency never will.
- BC14 It was then considered which entity's (or entities') functional currency may be used as a reference point for the hedged item in a net investment hedge. Does the risk arise from the functional currency of:
- (a) the immediate parent entity that holds directly the foreign operation;
 - (b) the ultimate parent entity that is preparing its financial statements; or
 - (c) the immediate, an intermediate or the ultimate parent entity, depending on what risk that entity decides to hedge, as designated at inception?
- BC15 It was concluded that the risk from the exposure to a different functional currency arises for any parent entity whose functional currency is different from that of the identified foreign operation. The immediate parent entity is exposed to changes in the exchange rate of its directly held foreign operation's functional currency. However, indirectly every entity up the chain of entities to the ultimate parent entity is also exposed to changes in the exchange rate of the foreign operation's functional currency.
- BC16 Permitting only the ultimate parent entity to hedge its net investments would ignore the exposures arising on net investments in other parts of the entity. Conversely, permitting only the immediate parent entity to undertake a net investment hedge would imply that an indirect investment does not create a foreign currency exposure for that indirect parent entity.
- BC17 It was concluded that a group must identify which hedged risk (ie the functional currency of which parent entity and of which net investment in a foreign operation) is being hedged. The specified parent entity, the hedged risk and hedging instrument should all be designated and documented at the inception of the hedge relationship.
- BC18 In reaching this conclusion, it was noted that, in financial statements that include a foreign operation, an entity cannot hedge the same risk more than once. An intermediate parent entity can hedge the risk in its own consolidated financial statements but such hedges will not qualify for hedge accounting at the ultimate parent entity level if the ultimate parent entity has also hedged the same risk. However, if the risk has not been

hedged already by the ultimate parent entity or an intermediate parent entity, the hedge relationship that qualified in the immediate parent entity's consolidated financial statements will also qualify in the group's consolidated financial statements.

Hedging instrument

BC19 It was discussed where in a group structure a hedging instrument may be held in a hedge of a net investment in a foreign operation. Guidance on the hedge of a net investment in a foreign operation was originally included in FRS 21. This guidance was moved to FRS 39 to ensure that the hedge accounting guidance included in paragraph 88 of FRS 39 would also apply to the hedges of net investments in foreign operations.

BC20 It was noted the Implementation Guidance in FRS 39 Question F.2.14, on the location of the hedging instrument, and considered whether that guidance could be applied by analogy to a net investment hedge. The answer to Question F.2.14 concludes:

'FRS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.'

BC21 Accordingly, any entity within the group, other than the foreign operation being hedged, may hold 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. The functional currency of the entity holding the instrument is irrelevant in determining effectiveness.

BC22 When determining the effectiveness of a hedging instrument in the hedge of a net investment, to apply the conclusions in paragraphs BC20 and BC21, an entity computes the gain or loss on the hedging instrument by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge documentation. This is the same regardless of the type of hedging instrument used. This ensures that the effectiveness of the instrument is determined on the basis of changes in fair value or cash flows of the hedged instrument, compared with the changes in the net investment as documented. Thus, any effectiveness test is not dependent on the functional currency of the entity holding the instrument.