19 October 2007

Our ref: ICAEW Rep 101/07

Your ref:

Mr Stig Enevoldsen
Chairman
EFRAG
Avenue des Arts 13-14
1210 Brussels
Belgium

By email: commentletter@efrag.org

Dear Stig

IFRIC D 22 *HEDGES OF A NET INVESTMENT IN A FOREIGN OPERATION*

The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the draft comment letter on IFRIC D 22 *Hedges of a Net Investment in a Foreign Operation,* published by EFRAG in September 2007.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

The Institute generally supports the proposals in IFRIC D 22, and is therefore in agreement with the substance of the draft response from EFRAG.

However, we do have some reservations about the effects of the proposals. In particular, we wonder whether the IFRIC intended that the interpretation should lead to imputing foreign exchange risks that do not exist in a hedging instrument. If the IFRIC believes that imputed risks are permitted that recognise contractual cash flows that do not exist in the hedging instrument, we have recommended that this should be explained in the final interpretation. This and other reservations are set out in in our response, which is attached.

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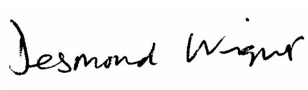
Please contact me if you would like to discuss any issues arising from this response.

Yours sincerely



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ICAEW Representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REP 100/07

IFRIC D 22 - HEDGES OF A NET INVESTMENT IN A FOREIGN OPERATION

Memorandum of comment submitted in October 2007 by The Institute of Chartered Accountants in England and Wales, in response to the International Financial Reporting Interpretations Committee exposure draft D 22 *Hedges of a Net Investment in a Foreign Operation*, published in July 2007.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the International Financial Reporting Interpretations Committee (IFRIC) exposure draft D 22 *Hedges of a Net Investment in a Foreign Operation*, published in July 2007.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures that these skills are constantly developed, recognised and valued.

MAJOR POINTS

Support for the interpretation

4. We welcome the draft interpretation, which has our overall support. The proposals recognise the practical aspects of maintaining a central treasury function, and will grant appropriate flexibility consistent with good practice. However, we have some reservations about the effects of the proposals. In particular, we wonder whether the IFRIC intended that the interpretation should lead to imputing foreign exchange risks that do not exist in a hedging instrument. If the IFRIC believes that imputed risks are permitted that recognise contractual cash flows that do not exist in the hedging instrument, we recommend that this is explained in the final interpretation. We have illustrated this in paragraphs 10 to 12. Our other reservations are set out in paragraphs 8, 9 and 16.

The hedged risk

5. We support the proposal to permit a hedge of the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity.

6. We agree that the selection of a presentation currency should not create a risk for which hedge accounting should be permitted. As set out in paragraph BC13, functional currencies create an economic exposure to changes in cash flows or fair value; as a presentation currency will never create such an exposure there can be no eligibility for hedge accounting.

Location of the hedge

7. We agree that permitting only the ultimate parent entity to hedge its net investments would ignore the exposures arising on net investments in other parts of the group. We therefore support the proposal that hedge accounting can be applied at any level within the group, provided that any exposure to foreign currency risk is hedged only once in the consolidated financial statements.

8. Paragraph 14 refers to the possibility of the same risk being hedged by more than one parent entity within the group, giving the example of a direct and an indirect parent entity. However, there is also the possibility of one parent duplicating a hedge where it hedges both a subsidiary and an indirect subsidiary, and the intermediate functional currency is different. On the facts of paragraph IE2, Entity B could hedge both its direct investment in Entity C and its indirect investment in Entity Z (for an example, see paragraph 9 below). In these circumstances the risk in Entity Z is hedged twice. We suggest that paragraph 14 should make it clear that there are other circumstances that can lead to duplicated hedges and that whatever the circumstances only one hedge is allowed.

9. Taking the group structure as portrayed in paragraph IE2, entity B has a Swiss Franc (CHF), entity C has a euro (EUR) and entity Z has a US dollar (USD) functional currency respectively. Assume B group has a net investment in C of EURO 500, this amount being the net assets of C included in B's consolidated financial statements. B group also has a net investment in Z of USD 200. For simplicity assume that EUR 1 = USD 1.5 = CHF 2. B group hedges the EUR/CHF risk in B's net investment in C. It also hedges the USD/CHF risk in C's net investment in Z. However, C's net assets of EUR 500 (CHF 1000) include its investment in Z of USD 200 (CHF 267). If the B group hedges both net investments in full, then the CHF 267 is double-counted. For the group to be hedged in economic terms, C's net investment in Z needs to be excluded when determining B group's net investment in C.

10. We agree that the hedging instrument(s) may be held by any entity in the group (subject to our reservation below), except in the foreign operation that is being hedged (paragraph 12). However, careful consideration is required as what is meant by 'the group'. We believe that the group structure has a part to play in determining which instrument may be used as the hedging instrument. Without considering the group structure, we consider that it will lead to imputing foreign exchange risks that do not exist within a hedging instrument. That is, recognition of cash flows that do not exist in the contractual terms of the hedging instrument. This would seem to be contrary to the IFRIC's recent Agenda decision "Hedging multiple risks with a single derivative hedging instrument" (IFRIC Update July 2007), which concluded that imputing notional legs is acceptable provided that the split should not result in the recognition of cash flows that do not exist in the contractual terms of a financial instrument. Consider the examples in paragraphs 11 and 12 below.

11. Taking the group structure in paragraph IE2, we have no concerns with the hedging instrument being held within any of the entities, other than that being hedged. However, assume that entity A has another directly held subsidiary, entity D that is a fellow subsidiary of entity B (functional currency Swiss Francs (CHF)). Entity D's functional currency is euro (EUR) and it has some

pounds sterling (GBP) borrowings. What happens when Entity B hedges its net investment in entity C (functional currency GBP) using the GBP borrowings in entity D? Entity B has CHF/GBP exposure relating to its net investment. However, entity D has EUR/GBP exposure relating to its borrowings. The consolidation of entity D into entity A group does not create CHF/GBP exposure. For entity B to apply hedge accounting, it would require an imputed CHF/GBP risk within the borrowings (that is, by imputing EUR/CHF and CHF/GBP exposures). Consequently, A group's consolidated financial statements would recognise a EUR/CHF risk that does not exist within the entity.

12. If the hedging instrument in entity D is a derivative that has CHF/GBP risks such as a CHF/GBP forward foreign exchange contract, the CHF/GBP risk would exist within the hedging instrument and would not need to be imputed.

Effectiveness testing

13. We agree that for the purpose of assessing effectiveness the change in value of the hedging instrument should be computed by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured (paragraph 13). We recommend that it should be clarified that the location of the hedging instrument has no effect on the amount deferred in equity as an effective hedge.

14. It would be helpful if the final Interpretation could include a numerical example of effectiveness testing.

Effectiveness tested as if hedging instrument is held by the parent

15. The draft interpretation contains guidance on which entity within a group can hold the financial instrument designated as hedging a net investment in a foreign operation. Under the proposed interpretation, any entity within the group can hold the hedging instrument and effectiveness is tested as if it was held by the parent. The Basis for Conclusions notes that IAS 39 IG F.2.14 states 'IAS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument'.

16. We believe that the guidance in D22 will be popular with IFRS adopters because it allows additional flexibility. However, we note the following:

- The guidance quoted relates to a cashflow hedge of forecast purchases, not to a net investment hedge. It also does not comment on the effectiveness of the hedge.

- D22 states that it applies to net investment hedging only. However given that the guidance it relies on to allow any entity within a group to hold the hedging instrument relates to cash flow hedging, we have concerns that its scope may be applied more widely.

- The approach taken requires that effectiveness is tested as if the parent holds the hedging instrument. This seems to be contrary to the approach required by IAS 21 for treating the net assets of foreign operations, and to the requirements for recycling of hedging gains and losses in IAS 39. Using example 3B in D22, the hedging instrument held by entity X will be treated as if it is held by entity C. This means that the net assets of X will effectively be split into the hedging instrument, and all its other net assets. If entity Z is sold prior to entity X being sold, should the gains or losses on the hedged item be recycled? To recycle the gains and losses would seem to be consistent with net investment hedging under IAS 39, but contrary to the requirements in IAS 21 which would only allow these gains and losses to be recycled when entity X is sold.

Transition

17. It is possible to interpret paragraphs 38 to 44 of IAS 21 as requiring the remeasurement of foreign operations directly into the group presentation currency for consolidation purposes. On this basis, some entities have hedged against the presentation currency. The transition guidance should state explicitly that it does not intend previously designated hedges to be revisited once the Interpretation is in force.

OTHER POINTS

18. We note that the proposals do not converge with US GAAP (although it does not force a conflict). For example, on the facts set out in paragraph IE2, Entity B would be allowed to hedge the net investment in Entity Z under the proposals, but not under US GAAP. We suggest that the Basis for Conclusions should flag the major differences between the two GAAPs.

19. We suggest that paragraph 9 should explicitly state that the scope of the Interpretation is limited to hedges of a net investment in a foreign operation, and that its principles are not extensible to other situations.

20. The draft Interpretation makes a number of references to the applicability of paragraph 88 of IAS 39 *Financial Instruments: Recognition and Measurement*. In our view, a key requirement of paragraph 88 is the formal designation and documentation of the entity's risk management objective and strategy for undertaking the hedge. We believe it would be worth emphasising in the Interpretation that the hedge must be consistent with the group's risk management policies and procedures.

21. We have noted the following drafting points:

- The reference at the end of the first sentence of paragraph IE5 should be to entity C.

- Paragraph IE17 – we believe the reference to entity X holding an investment in entity Z is incorrect and that this should instead refer to entity X's investment in entity C.

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