INTERPRETATION OF STATUTORY BOARD FINANCIAL REPORTING STANDARD

INT SB-FRS 116

Hedges of a Net Investment in a Foreign Operation

Illustrative Example

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This example accompanies, but is not part of, INT SB-FRS 116.

Disposal of a foreign operation (paragraphs 16 and 17)

IE1 This example illustrates the application of paragraphs 16 and 17 in connection with the reclassification adjustment on the disposal of a foreign operation.

Background

IE2 This example assumes the group structure set out in the application guidance and that Parent used a USD borrowing in Subsidiary A to hedge the EUR/USD risk of the net investment in Subsidiary C in Parent's consolidated financial statements. Parent uses the step-by-step method of consolidation. Assume the hedge was fully effective and the full USD/EUR accumulated change in the value of the hedging instrument before disposal of Subsidiary C is €24 million (gain). This is matched exactly by the fall in value of the net investment in Subsidiary C, when measured against the functional currency of Parent (euro).

IE3 If the direct method of consolidation is used, the fall in the value of Parent's net investment in Subsidiary C of €24 million would be reflected totally in the foreign currency translation reserve relating to Subsidiary C in Parent's consolidated financial statements. However, because Parent uses the step-by-step method, this fall in the net investment value in Subsidiary C of €24 million would be reflected both in Subsidiary B's foreign currency translation reserve relating to Subsidiary C and in Parent's foreign currency translation reserve relating to Subsidiary B.

IE4 The aggregate amount recognised in the foreign currency translation reserve in respect of Subsidiaries B and C is not affected by the consolidation method. Assume that using the direct method of consolidation, the foreign currency translation reserves for Subsidiaries B and C in Parent's consolidated financial statements are €62 million gain and €24 million loss respectively; using the step-by-step method of consolidation those amounts are €49 million gain and €11 million loss respectively.

Reclassification

IE5 When the investment in Subsidiary C is disposed of, SB-FRS 109 requires the full €24 million gain on the hedging instrument to be reclassified to profit or loss. Using the step-by-step method, the amount to be reclassified to profit or loss in respect of the net investment in Subsidiary C would be only €11 million loss. Parent could adjust the foreign currency translation reserves of both Subsidiaries B and C by €13 million in order to match the amounts reclassified in respect of the hedging instrument and the net investment as would have been the case if the direct method of consolidation had been used, if that was its accounting policy. An entity that had not hedged its net investment could make the same reclassification.