Hong Kong Institute of Certified Public Accountants 香港會計師公會

MEMBERS' HANDBOOK

Update No. 53

(Issued August 2008)

This Update relates to the issuance of:

- HK(IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate*;
- HK(IFRIC) Interpretation 16 *Hedges of a Net Investment in a Foreign Operation*; and
- Other consequential amendments.

Document Reference and Title	***Instructions***	***Explanations***
VOLUME II		
Contents of Volume II	Discard the existing pages i and iii and replace with the new pages i and iii.	Revised contents pages
HONG KONG (IFRIC) INTERPRETATIONS (HK(IFRIC)-Int)		
HK(IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate*	Insert these pages after HK(IFRIC)–Int 14 *HKAS 19 —The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*	New Interpretation – Note 1
HK(IFRIC) Interpretation 16 Hedges of a Net Investment in a Foreign Operation	Insert these pages after HK(IFRIC)–Int 15 *Agreements for the Construction of Real Estate*	New Interpretation – Note 2
Amendments to other HKFRSs		
HKAS 18 *Revenue*	Insert the revised pages 2 and 15-16. Discard the replaced pages 2 and 15.	Amendments due to HK(IFRIC)–Int 15
HK Interpretation 3 *Revenue – Pre-completion Contracts for the Sale of Development Properties*	Insert the revised page 1. Discard the replaced page 1.	Amendments due to HK(IFRIC)–Int 15

Note:

1. HK(IFRIC)–Int 15 *Agreements for the Construction of Real Estate* is applicable for annual periods beginning on or after 1 January 2009 and supersedes HK Interpretation 3 *Revenue – Pre-completion Contracts for the Sale of Development Properties* issued in 2005.

2. HK(IFRIC)–Int 16 *Hedges of a Net Investment in a Foreign Operation* is applicable for annual periods beginning on or after 1 October 2008.

BACKGROUND ABOUT THE INTERPRETATIONS:

HK(IFRIC)–Int 15 *Agreements for the Construction of Real Estate*

1. HK(IFRIC)–Int 15 *Agreements for the Construction of Real Estate* is effective for annual periods beginning on or after 1 January 2009, the same effective date as IFRIC Interpretation 15 *Agreements for the Construction of Real Estate*. Earlier application is permitted. The Interpretation shall be applied retrospectively. This Interpretation will on 1 January 2009 supersede HK Interpretation 3 *Revenue – Pre-completion Contracts for the Sale of Development Properties* issued in 2005.

2. The Interpretation will standardise accounting practice across jurisdictions for the recognition of revenue among real estate developers for sales of units, such as apartments or houses, 'off plan', that is, before construction is complete.

3. The Interpretation provides guidance on how to determine whether an agreement for the construction of real estate is within the scope of HKAS 11 *Construction Contracts* or HKAS 18 *Revenue* and when revenue from the construction should be recognised.

4. The main expected change in practice is a shift for some entities from recognising revenue using the percentage of completion method (that is, as construction progresses, by reference to the stage of completion of the development) to recognising revenue at a single time (that is, at completion upon or after delivery). Agreements that will be affected will be mainly those currently accounted for in accordance with HKAS 11 that do not meet the definition of a construction contract as interpreted by this Interpretation and do not transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses.

HK(IFRIC)–Int 16 *Hedges of a Net Investment in a Foreign Operation*

1. HK(IFRIC)–Int 16 *Hedges of a Net Investment in a Foreign Operation* is effective for annual periods beginning on or after 1 October 2008, the same effective date as IFRIC Interpretation 16 *Hedges of a Net Investment in a Foreign Operation*. Earlier application is permitted. 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 HKAS 39 *Financial Instruments: Recognition and Measurement* to discontinue that hedge accounting prospectively.

2. Practice has diverged as a result of differing views on which risks are eligible for hedge accounting according to HKFRSs. As a result, HK(IFRIC)–Int 16 is issued to clarify the following three main issues:

   (i) whether risk arises from the foreign currency exposure to the functional currencies of the foreign operation and the parent entity, or from the foreign currency exposure to the functional currency of the foreign operation and the presentation currency of the parent entity's consolidated financial statements.

   (ii) which entity within a group can 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.

   (iii) 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 when the entity disposes of the investment.

3. HK(IFRIC)–Int 16 clarifies these issues, stating that:

   - the presentation currency does not create an exposure to which an entity may apply hedge accounting. Consequently, a parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between its own functional currency and that of its foreign operation.

   - the hedging instrument(s) may be held by any entity or entities within the group.

   - while HKAS 39 *Financial Instruments: Recognition and Measurement* must be applied to determine the amount that needs to be reclassified to profit or loss from the foreign currency translation reserve in respect of the hedging instrument*,* HKAS 21 *The Effects of Changes in Foreign Exchange Rates* must be applied in respect of the hedged item*.*

4. HK(IFRIC)–Int 16 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 HKAS 39. It does not apply to other types of hedge accounting.

5. The main expected change in practice is to eliminate the possibility of an entity applying hedge accounting for a hedge of the foreign exchange differences between the functional currency of a foreign operation and the presentation currency of the parent's consolidated financial statements.

6. It is expected that entities would face difficulty in preparing adequate documentation from the inception of the hedge relationship and therefore this Interpretation requires prospective application.

Main features of HK(IFRIC) Interpretation 15 and HK(IFRIC) Interpretation 16 are summarised at the HKICPA Standard Setting Department Staff Summary http://www.hkicpa.org.hk/professionaltechnical/financial/report_standards.php.

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MEMBERS' HANDBOOK
CONTENTS OF VOLUME II

(Updated to August 2008)

Issue/(Review date)

HONG KONG (IFRIC) INTERPRETATIONS (HK(IFRIC)-Int)

HONG KONG INTERPRETATIONS (HK-Int)*

Note: * *With effect from 24 May 2005, all Interpretations that are developed locally by the Institute are named Hong Kong Interpretations.*

HONG KONG (SIC) INTERPRETATIONS (HK(SIC)-Int)

HK(IFRIC)-Int 15
Issued August 2008

Effective for annual periods
beginning on or after 1 January 2009*

HK(IFRIC) Interpretation 15

Agreements for the Construction of Real Estate

* HK(IFRIC)-Int 15 is applicable for annual periods beginning on or after 1 January 2009. Earlier application is permitted. HK(IFRIC)-Int 15 supersedes HK Interpretation 3 issued in 2005 as revised in 2006.

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CONTENTS

Hong Kong (IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate* (HK(IFRIC)-Int 15) is set out in paragraphs 1–25. HK(IFRIC)-Int 15 is accompanied by an information note, illustrative examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 15
Agreements for the Construction of Real Estate

References

- HKAS 1 *Presentation of Financial Statements* (as revised in 2007)
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 11 *Construction Contracts*
- HKAS 18 *Revenue*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- HK(IFRIC)-Int 12 *Service Concession Arrangements*
- HK(IFRIC)-Int 13 *Customer Loyalty Programmes*

Background

1 In the real estate industry, entities that undertake the construction of real estate, directly or through subcontractors, may enter into agreements with one or more buyers before construction is complete. Such agreements take diverse forms.

2 For example, entities that undertake the construction of residential real estate may start to market individual units (apartments or houses) 'off plan', ie while construction is still in progress, or even before it has begun. Each buyer enters into an agreement with the entity to acquire a specified unit when it is ready for occupation. Typically, the buyer pays a deposit to the entity that is refundable only if the entity fails to deliver the completed unit in accordance with the contracted terms. The balance of the purchase price is generally paid to the entity only on contractual completion, when the buyer obtains possession of the unit.

3 Entities that undertake the construction of commercial or industrial real estate may enter into an agreement with a single buyer. The buyer may be required to make progress payments between the time of the initial agreement and contractual completion. Construction may take place on land the buyer owns or leases before construction begins.

Scope

4 This Interpretation applies to the accounting for revenue and associated expenses by entities that undertake the construction of real estate directly or through subcontractors.

5 Agreements in the scope of this Interpretation are agreements for the construction of real estate. In addition to the construction of real estate, such agreements may include the delivery of other goods or services.

Issues

6 The Interpretation addresses two issues:

(a) Is the agreement within the scope of HKAS 11 or HKAS 18?

(b) When should revenue from the construction of real estate be recognised?

Conclusions

7 The following discussion assumes that the entity has previously analysed the agreement for the construction of real estate and any related agreements and concluded that it will retain neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the constructed real estate to an extent that would preclude recognition of some or all of the consideration as revenue. If recognition of some of the consideration as revenue is precluded, the following discussion applies only to the part of the agreement for which revenue will be recognised.

8 Within a single agreement, an entity may contract to deliver goods or services in addition to the construction of real estate (eg a sale of land or provision of property management services). In accordance with paragraph 13 of HKAS 18, such an agreement may need to be split into separately identifiable components including one for the construction of real estate. The fair value of the total consideration received or receivable for the agreement shall be allocated to each component. If separate components are identified, the entity applies paragraphs 10-12 of this Interpretation to the component for the construction of real estate in order to determine whether that component is within the scope of HKAS 11 or HKAS 18. The segmenting criteria of HKAS 11 then apply to any component of the agreement that is determined to be a construction contract.

9 The following discussion refers to an agreement for the construction of real estate but it also applies to a component for the construction of real estate identified within an agreement that includes other components.

Determining whether the agreement is within the scope of HKAS 11 or HKAS 18

10 Determining whether an agreement for the construction of real estate is within the scope of HKAS 11 or HKAS 18 depends on the terms of the agreement and all the surrounding facts and circumstances. Such a determination requires judgement with respect to each agreement.

11 HKAS 11 applies when the agreement meets the definition of a construction contract set out in paragraph 3 of HKAS 11: 'a contract specifically negotiated for the construction of an asset or a combination of assets …' An agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not it exercises that ability). When HKAS 11 applies, the construction contract also includes any contracts or components for the rendering of services that are directly related to the construction of the real estate in accordance with paragraph 5(a) of HKAS 11 and paragraph 4 of HKAS 18.

12 In contrast, an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate, eg to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods within the scope of HKAS 18.

Accounting for revenue from the construction of real estate

The agreement is a construction contract

13 When the agreement is within the scope of HKAS 11 and its outcome can be estimated reliably, the entity shall recognise revenue by reference to the stage of completion of the contract activity in accordance with HKAS 11.

14 The agreement may not meet the definition of a construction contract and therefore be within the scope of HKAS 18. In this case, the entity shall determine whether the agreement is for the rendering of services or for the sale of goods.

The agreement is an agreement for the rendering of services

15 If the entity is not required to acquire and supply construction materials, the agreement may be only an agreement for the rendering of services in accordance with HKAS 18. In this case, if the criteria in paragraph 20 of HKAS 18 are met, HKAS 18 requires revenue to be recognised by reference to the stage of completion of the transaction using the percentage of completion method. The requirements of HKAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction (HKAS 18 paragraph 21).

The agreement is an agreement for the sale of goods

16 If the entity is required to provide services together with construction materials in order to perform its contractual obligation to deliver the real estate to the buyer, the agreement is an agreement for the sale of goods and the criteria for recognition of revenue set out in paragraph 14 of HKAS 18 apply.

17 The entity may transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. In this case, if all the criteria in paragraph 14 of HKAS 18 are met continuously as construction progresses, the entity shall recognise revenue by reference to the stage of completion using the percentage of completion method. The requirements of HKAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

18 The entity may transfer to the buyer control and the significant risks and rewards of ownership of the real estate in its entirety at a single time (eg at completion, upon or after delivery). In this case, the entity shall recognise revenue only when all the criteria in paragraph 14 of HKAS 18 are satisfied.

19 When the entity is required to perform further work on real estate already delivered to the buyer, it shall recognise a liability and an expense in accordance with paragraph 19 of HKAS 18. The liability shall be measured in accordance with HKAS 37. When the entity is required to deliver further goods or services that are separately identifiable from the real estate already delivered to the buyer, it would have identified the remaining goods or services as a separate component of the sale, in accordance with paragraph 8 of this Interpretation.

Disclosures

20 When an entity recognises revenue using the percentage of completion method for agreements that meet all the criteria in paragraph 14 of HKAS 18 continuously as construction progresses (see paragraph 17 of the Interpretation), it shall disclose:

(a) how it determines which agreements meet all the criteria in paragraph 14 of HKAS 18 continuously as construction progresses;

(b) the amount of revenue arising from such agreements in the period; and

(c) the methods used to determine the stage of completion of agreements in progress.

21 For the agreements described in paragraph 20 that are in progress at the reporting date, the entity shall also disclose:

(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) to date; and

(b) the amount of advances received.

Amendments to the appendix to HKAS 18

22 This Interpretation supersedes the real estate guidance (Example 9) in the appendix to HKAS 18.

23 The appendix to HKAS 18 is amended as described below.

All of the text under the heading '9 *Real estate sales*.' is deleted.

New text is inserted under the heading as follows:

'This example has been superseded by Hong Kong (IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate*.'

Effective date and transition

24 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the Interpretation for a period beginning before 1 January 2009, it shall disclose that fact.

25 Changes in accounting policy shall be accounted for retrospectively in accordance with HKAS 8.

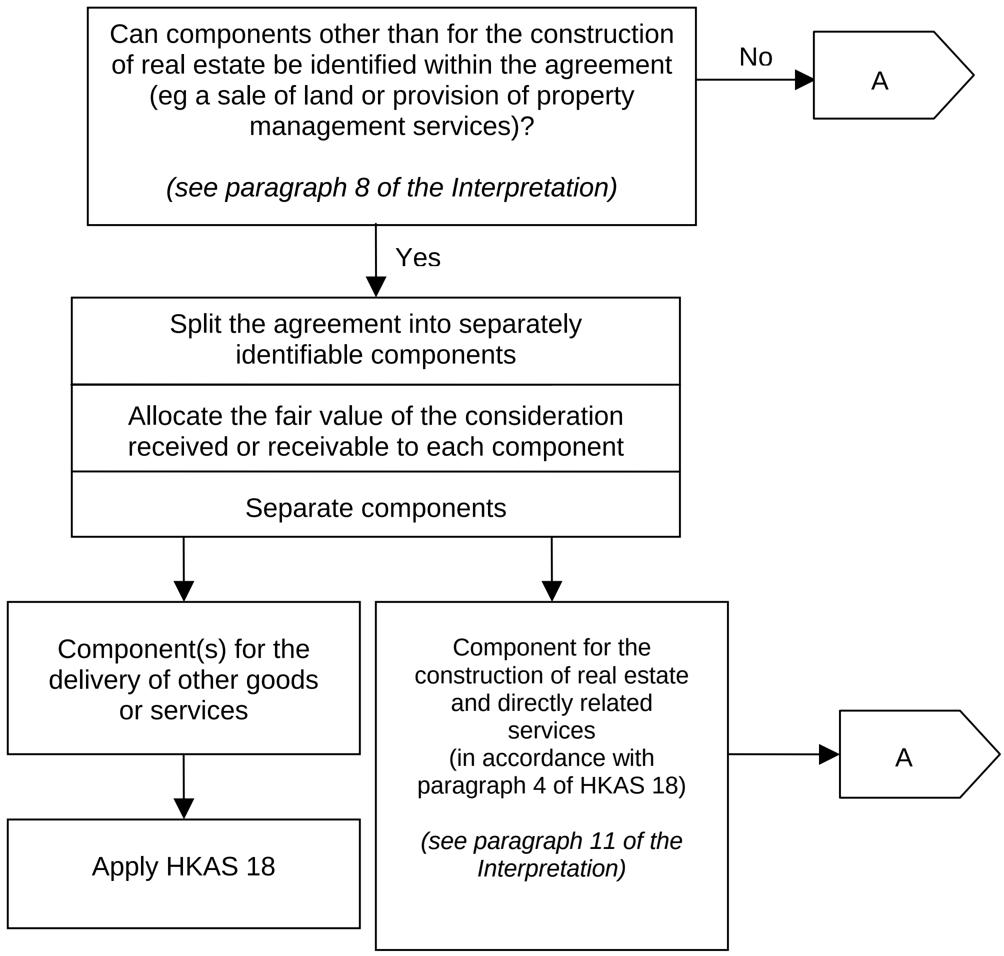
Withdrawal of HK Interpretation 3

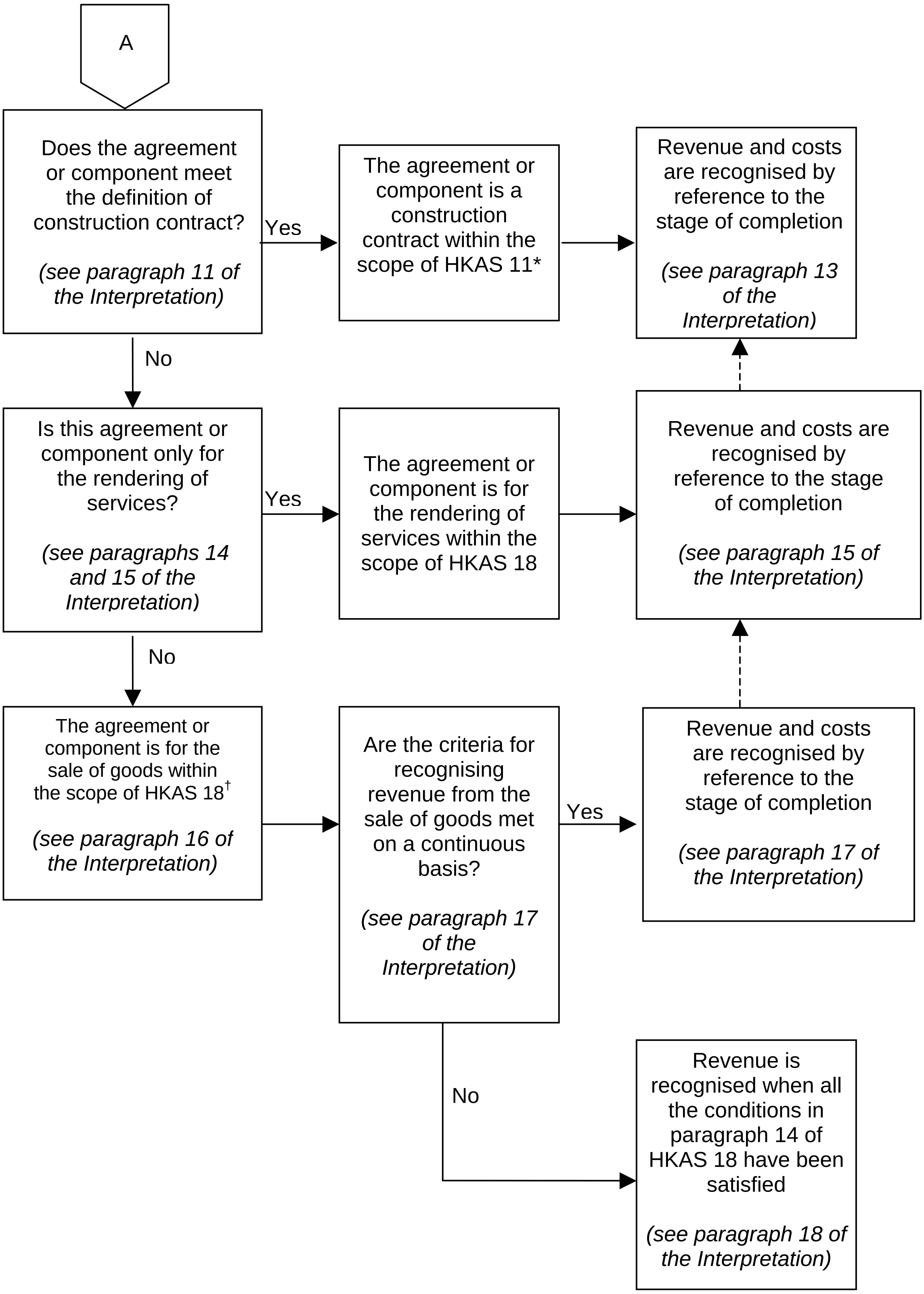
26 This Interpretation supersedes HK Interpretation 3 *Revenue – Pre-completion Contracts for the Sale of Development Properties* issued in 2005 as amended in 2006.

Information note

Analysis of a single agreement for the construction of real estate

This note accompanies, but is not part of, HK(IFRIC)-Int 15.





* The construction contract may need to be segmented in accordance with paragraph 8 of HKAS 11
† Directly related services may need to be separated in accordance with paragraph 13 of HKAS 18

Illustrative examples

These examples accompany, but are not part of, HK(IFRIC)-Int 15.

Example 1

IE1 An entity buys a plot of land for the construction of commercial real estate. It designs an office block to build on the land and submits the designs to planning authorities in order to obtain building permission. The entity markets the office block to potential tenants and signs conditional lease agreements. The entity markets the office block to potential buyers and signs with one of them a conditional agreement for the sale of land and the construction of the office block. The buyer cannot put the land or the incomplete office block back to the entity. The entity receives the building permission and all agreements become unconditional. The entity is given access to the land in order to undertake the construction and then constructs the office block.

IE2 In this illustrative example, the agreement should be separated into two components: a component for the sale of land and a component for the construction of the office block. The component for the sale of land is a sale of goods within the scope of HKAS 18.

IE3 Because all the major structural decisions were made by the entity and were included in the designs submitted to the planning authorities before the buyer signed the conditional agreement, it is assumed that there will be no major change in the designs after the construction has begun. Consequently, the component for the construction of the office block is not a construction contract and is within the scope of HKAS 18. The facts, including that the construction takes place on land the buyer owns before construction begins and that the buyer cannot put the incomplete office block back to the entity, indicate that the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. Therefore, if all the criteria in paragraph 14 of HKAS 18 are met continuously as construction progresses, the entity recognises revenue from the construction of the office block by reference to the stage of completion using the percentage of completion method.

IE4 Alternatively, assume that the construction of the office block started before the entity signed the agreement with the buyer. In that event, the agreement should be separated into three components: a component for the sale of land, a component for the partially constructed office block and a component for the construction of the office block. The entity should apply the recognition criteria separately to each component. Assuming that the other facts remain unchanged, the entity recognises revenue from the component for the construction of the office block by reference to the stage of completion using the percentage of completion method as explained in paragraph IE3.

IE5 In this example, the sale of land is determined to be a separately identifiable component from the component for the construction of real estate. However, depending on facts and circumstances, the entity may conclude that such a component is not separately identifiable. For example, in some jurisdictions, a condominium is legally defined as the absolute ownership of a unit based on a legal description of the airspace the unit actually occupies, plus an undivided interest in the ownership of the common elements (that includes the land and actual building itself, all the driveways, parking, lifts, outside hallways, recreation and landscaped areas) that are owned jointly with the other condominium unit owners. In this case, the undivided interest in the ownership of the common elements does not give the buyer control and the significant risks and rewards of the land itself. Indeed, the right to the unit itself and the interest in the common elements are not separable.

Example 2

IE6 An entity is developing residential real estate and starts marketing individual units (apartments) while construction is still in progress. Buyers enter into a binding sale agreement that gives them the right to acquire a specified unit when it is ready for occupation. They pay a deposit that is refundable only if the entity fails to deliver the completed unit in accordance with the contracted terms. Buyers are also required to make progress payments between the time of the initial agreement and contractual completion. The balance of the purchase price is paid only on contractual completion, when buyers obtain possession of their unit. Buyers are able to specify only minor variations to the basic design but they cannot specify or alter major structural elements of the design of their unit. In the jurisdiction, no rights to the underlying real estate asset transfer to the buyer other than through the agreement. Consequently, the construction takes place regardless of whether sale agreements exist.

IE7 In this illustrative example, the terms of the agreement and all the surrounding facts and circumstances indicate that the agreement is not a construction contract. The agreement is a forward contract that gives the buyer an asset in the form of a right to acquire, use and sell the completed real estate at a later date and an obligation to pay the purchase price in accordance with its terms. Although the buyer might be able to transfer its interest in the forward contract to another party, the entity retains control and the significant risks and rewards of ownership of the work in progress in its current state until the completed real estate is transferred. Therefore, revenue should be recognised only when all the criteria in paragraph 14 of HKAS 18 are met (at completion in this example).

IE8 Alternatively, assume that, in the jurisdiction, the law requires the entity to transfer immediately to the buyer ownership of the real estate in its current state of completion and that any additional construction becomes the property of the buyer as construction progresses. The entity would need to consider all the terms of the agreement to determine whether this change in the timing of the transfer of ownership means that the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. For example, the fact that if the agreement is terminated before construction is complete, the buyer retains the work in progress and the entity has the right to be paid for the work performed, might indicate that control is transferred along with ownership. If it does, and if all the criteria in paragraph 14 of HKAS 18 are met continuously as construction progresses, the entity recognises revenue by reference to the stage of completion using the percentage of completion method taking into account the stage of completion of the whole building and the agreements signed with individual buyers.

Example 3

IE9 Determining whether the entity will retain neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the constructed real estate to an extent that would preclude recognition of some or all of the consideration as revenue depends on the terms of the agreement and all the surrounding facts and circumstances. Such a determination requires judgement. The Interpretation assumes the entity has reached the conclusion that it is appropriate to recognise revenue from the agreement and discusses how to determine the appropriate pattern of revenue recognition.

IE10 Agreements for the construction of real estate may include such a degree of continuing managerial involvement by the entity undertaking the construction that control and the significant risks and rewards of ownership are not transferred even when construction is complete and the buyer obtains possession. Examples are agreements in which the entity guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such circumstances, recognition of revenue may be delayed or precluded altogether.

IE11 Agreements for the construction of real estate may give the buyer a right to take over the work in progress (albeit with a penalty) during construction, eg to engage a different entity to complete the construction. This fact, along with others, may indicate that the entity transfers to the buyer control of the work in progress in its current state as construction progresses. The entity that undertakes the construction of real estate will have access to the land and the work in progress in order to perform its contractual obligation to deliver to the buyer completed real estate. If control of the work in process is transferred continuously, that access does not necessarily imply that the entity undertaking the construction retains continuing managerial involvement with the real estate to the degree usually associated with ownership to an extent that would preclude recognition of some or all of the consideration as revenue. The entity may have control over the activities related to the performance of its contractual obligation but not over the real estate itself.

Basis for Conclusions on HK(IFRIC)-Int 15

This Basis for Conclusions accompanies, but is not part of, HK(IFRIC)-Int 15.

HK(IFRIC)-Int 15 is based on IFRIC Interpretation 15 *Agreements for the Construction of Real Estate*. In approving HK(IFRIC)-Int 15, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 15. Accordingly, there are no significant differences between HK(IFRIC)-Int 15 and IFRIC Interpretation 15. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 15 referred to below generally correspond with those in HK(IFRIC)-Int 15.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

BC2 The IFRIC released draft Interpretation D21 *Real Estate Sales* for public comment in July 2007 and received 51 comment letters in response.

Scope

BC3 Agreements for the construction of real estate are widespread and may relate to residential, commercial or industrial developments. Construction often spans more than one accounting period, may take place on land the buyer owns or leases before construction begins and agreements may require progress payments.

BC4 The main area of divergence in practice concerns the identification of the applicable accounting standard for agreements for the construction of real estate. In some jurisdictions, the prevailing practice is to apply IAS 11 *Construction Contracts* and to recognise revenue as construction progresses. In others, it is to apply the requirements for the sale of goods in IAS 18 *Revenue* and to recognise revenue only when the completed real estate is delivered to the buyer.

BC5 The IFRIC considered whether the scope of the Interpretation should be confined to agreements for the construction of real estate. It concluded in D21 that the scope should be limited to the request received to clarify the requirements of IAS 18 with respect to 'real estate sales' because that was the area identified as having the most diversity in practice. In redeliberating the issue, the IFRIC took the view that the notion of 'real estate sales' in D21 might create confusion and clarified that this Interpretation applies to 'agreements for the construction of real estate'. The primary issue of whether an agreement is within the scope of IAS 11 or IAS 18 arises only when agreements include construction activities. Such agreements may or may not meet the definition of a construction contract. The IFRIC also clarified that the Interpretation might affect entities that undertake the construction of real estate, directly or through subcontractors.

BC6 The IFRIC noted that respondents to D21 were concerned about the implications of the IFRIC's conclusions for agreements that required manufacture of goods to a customer's specifications in industries other than real estate. The IFRIC reconsidered the scope of the Interpretation after it had redeliberated its conclusions with respect to agreements for the construction of real estate. It concluded that the scope of the Interpretation should remain confined to agreements for the construction of real estate. The IFRIC noted that it might be applied by analogy to industries other than real estate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Issue

BC7 The issue is when should revenue from the construction of real estate be recognised? In International Financial Reporting Standards (IFRSs), two standards deal with accounting for revenue: IAS 18 and IAS 11. Because many agreements involve the construction or manufacture of an asset to meet customer's specifications, the IFRIC was asked to clarify how to determine whether an agreement for the construction of real estate is a construction contract within the scope of IAS 11.

Consensus

BC8 The nature and extent of the entity's continuing managerial involvement with the item sold may affect the accounting for the transaction. It may be accounted for as a sale, or as a financing, leasing or some other profit-sharing arrangement. Because the issue addressed in this Interpretation is a revenue recognition issue, the Interpretation assumes that the entity has previously analysed the agreement for the construction of real estate and any related agreements and concluded that it will retain neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the constructed real estate to an extent that would preclude recognition of some or all of the consideration as revenue. This assumption, that the entity would recognise revenue at some point and the issue was one of timing, was implicit in D21 but was not clearly stated. In response to comments received, the IFRIC clarified that an entity must have concluded that the arrangement will result in the recognition of revenue to be within the scope of the Interpretation.

BC9 Some respondents to D21 asked the IFRIC to provide guidance on agreements with multiple components so the Interpretation would cover the more complex transactions that often occur in practice.

BC10 In its redeliberations, the IFRIC noted that, in addition to the construction of real estate, an agreement may include the delivery of other goods or services (eg a sale of land or provision of property management services). In accordance with paragraph 13 of IAS 18, such an agreement may need to be split into separately identifiable components, including one for the construction of real estate. Because IAS 18 is the standard that sets out requirements for revenue recognition in general, the IFRIC decided to consider the issue in the context of IAS 18, ie an entity should first determine whether an agreement that includes the construction of real estate also includes other components that do not need further analysis in this Interpretation.

BC11 The IFRIC noted that IFRIC 12 *Service Concession Arrangements* and IFRIC 13 *Customer Loyalty Programmes* already provide guidance on determining whether a single agreement should be divided into components and, if so, how to allocate the fair value of the total consideration received or receivable for the agreement to each component (see paragraph 13 of IFRIC 12 and paragraphs 5–7 of IFRIC 13). Therefore, the IFRIC concluded that this Interpretation should include only a reminder in paragraph 8 that such identification and allocation are required.

BC12 Regarding the issue of whether and when there is a separately identifiable component for the sale of land, the IFRIC concluded from the existing guidance that the identification of a component for the sale of land should be undertaken when first analysing any potential components. Depending on facts and circumstances, the entity may or may not conclude that such a component is separately identifiable from the component for the construction of real estate.

BC13 The IFRIC noted that respondents were uncertain whether an entity applying D21 would follow the guidance on combining and segmenting contracts in IAS 18 or that in IAS 11. The approach adopted in the Interpretation makes it clear that the specific criteria for contract segmentation in IAS 11 are applied only after the entity has concluded that the agreement is within the scope of that standard.

Determining whether the agreement is within the scope of IAS 11 or IAS 18

BC14 One view is that IAS 11 applies to all agreements for the construction of real estate. In support of this view, it is argued that:

(a) these agreements are in substance construction contracts. The typical features of a construction contract—land development, structural engineering, architectural design and construction—are all present.

(b) IAS 11 requires a percentage of completion method of revenue recognition for construction contracts. Revenue is recognised progressively as work is performed. Because many real estate development projects span more than one accounting period, the rationale for this method—that it 'provides useful information on the extent of contract activity and performance during a period' (IAS 11 paragraph 25)—applies to real estate development as much as it does to other construction contracts. If revenue is recognised only when the IAS 18 conditions for recognising revenue from the sale of goods are met, the financial statements do not reflect the entity's economic value generation in the period and are susceptible to manipulation.

(c) US Statement of Financial Accounting Standards No. 66 *Accounting for Sales of Real Estate* requires a percentage of completion method for recognising profit from sales of units in condominium projects or time-sharing interests (provided specified criteria are met). Thus US generally accepted accounting principles (GAAP) acknowledge that such real estate sales have the same economic substance as construction-type contracts. IFRSs can and should be interpreted in the same way to avoid unnecessary differences.

BC15 A second view is that IAS 11 applies only when the agreement meets the definition of a construction contract. When the agreement does not meet the definition of a construction contract, the agreement is within the scope of IAS 18.

BC16 The consensus reflects the second view. In reaching this consensus, the IFRIC noted that:

(a) the facts that the construction spans more than one accounting period and requires progress payments are not relevant features to consider when determining the applicable standard and the timing of revenue recognition.

(b) determining whether an agreement for the construction of real estate is within the scope of IAS 11 or IAS 18 depends on the terms of the agreement and all the surrounding facts and circumstances. Such a determination requires judgement with respect to each agreement. It is not an accounting policy choice.

(c) IAS 11 lacks specific guidance on the definition of a construction contract and further application guidance is needed to help identify construction contracts.

(d) differences exist between the requirements in IFRSs and US GAAP for revenue recognition in general and for construction contracts in particular. They cannot be eliminated by interpretation. They are being addressed in a general project on revenue recognition conducted jointly by the IASB and the US Financial Accounting Standards Board.

BC17 The IFRIC noted that when IAS 11 applies, for accounting purposes, the construction contract also includes contracts for the rendering of services that are directly related to the construction of the real estate in accordance with paragraph 4 of IAS 18 and paragraph 5(a) of IAS 11.

BC18 In D21 the IFRIC concluded that an agreement for the construction of real estate would be within the scope of IAS 11 in two circumstances—if the agreement met the definition of a construction contract and/or if control and the significant risks and rewards of ownership of the work in progress in its current state transferred to the buyer continuously as construction progresses. Many respondents pointed out that IAS 11 does not require 'continuous transfer' for the use of the percentage of completion method, only that the contract be a 'construction contract'. The IFRIC clarified in the consensus that IAS 11 applies only when the agreement meets the definition of a construction contract and carried forward into the Interpretation the guidance in paragraphs 9(a), 10(a) and BC5(a) of D21.

BC19 In addition, many respondents asked the IFRIC to provide guidance to distinguish between construction contracts that meet the definition included in D21 and other agreements for the manufacture of goods to a customer's specifications. The IFRIC concluded that the most important distinguishing feature is whether the customer is actually specifying the main elements of the structural design. In situations involving the manufacture of goods to a customer's specifications, the customer generally does not have the ability to specify or alter the basic design of the product. Rather, the customer is simply choosing elements from a range of options specified by the seller or specifying only minor variations to the basic design. The IFRIC decided to include guidance to this effect in the Interpretation to help clarify the application of the definition of a construction contract.

Accounting for revenue from the construction of real estate

BC20 When the agreement is within the scope of IAS 11 and its outcome can be estimated reliably, the entity should recognise revenue by reference to the stage of completion in accordance with IAS 11.

BC21 When the agreement does not meet the definition of a construction contract, the agreement is within the scope of IAS 18. The IFRIC identified the following types of agreements for the construction of real estate that are within the scope of IAS 18 and that are distinguishable in substance:

(a) agreements for the rendering of services only;

(b) two types of agreements for the sale of goods:

(i) agreements in which the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses;

(ii) agreements in which the entity transfers to the buyer control and the significant risks and rewards of ownership of the real estate in its entirety at a single time (eg at completion, upon or after delivery).

BC22 The IFRIC noted that a customer may decide to act in essence as its own general contractor and enter into agreements with individual suppliers for specific goods and services. When the entity is responsible only for assembling materials supplied by others (ie it has no inventory risk for the construction materials), the agreement is an agreement for the rendering of services. The IFRIC noted that, if the criteria in paragraph 20 are met, IAS 18 requires revenue to be recognised by reference to the stage of completion using the percentage of completion method. IAS 18 then refers to IAS 11 and states that the requirements of IAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

BC23 The IFRIC also noted that construction activities often require an entity that undertakes the construction of real estate, directly or through subcontractors, to provide services together with construction materials. However, the entity delivers to the buyer a real estate asset, either completed or in its current stage of completion. Therefore, the IFRIC concluded that the criteria in paragraph 14 of IAS 18 for recognition of revenue from the sale of goods should apply to such agreements.

BC24 As noted in paragraph BC18, the IFRIC agreed with respondents to D21 that IAS 11 does not require the entity to transfer to the buyer control and the significant risks and rewards of ownership of the work in process in its current state as construction progresses ('continuous transfer') in order to use the percentage of completion method, only that the contract be a 'construction contract'. In its redeliberations, the IFRIC noted that the criterion it included in paragraph 9(b) of D21 was actually one of the criteria in IAS 18 for recognition of revenue from the sale of goods. Although these agreements may not meet the definition of construction contracts, the IFRIC concluded that they may result in the entity meeting all of the criteria for recognising revenue from the sale of goods in IAS 18 (including the transfer of control and the significant risks and rewards of ownership) continuously as construction progresses, as opposed to at a single time (eg at completion, upon or after delivery).

BC25 The IFRIC concluded that if all these criteria are met continuously, an entity should recognise revenue on the same basis (by reference to the stage of completion). Like paragraph 21 of IAS 18 for the rendering of services, the Interpretation refers entities to IAS 11 for guidance on applying the percentage of completion method. The IFRIC observed that this conclusion was consistent with the basis for using the percentage of completion method in Statement of Position No. 81–1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* issued by the American Institute of Certified Public Accountants, which states:

> …the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses...

BC26 The IFRIC noted that agreements with 'continuous transfer' might not be encountered frequently. However, the IFRIC decided that the Interpretation should address the accounting for such agreements because some respondents to D21 identified agreements with these characteristics.

BC27 The IFRIC also identified agreements for the construction of real estate in which the entity transfers to the buyer control and the significant risks and rewards of ownership of the real estate in its entirety at a single time (eg at completion, upon or after delivery). The IFRIC reaffirmed its conclusion in D21 that these agreements are sales of goods within the scope of IAS 18. Such agreements give the buyer only an asset in the form of a right to acquire, use and sell the completed real estate at a later date. The IFRIC concluded that revenue from such agreements should be recognised only when all the criteria in paragraph 14 of IAS 18 are satisfied.

BC28 The IFRIC noted that this conclusion is consistent with revenue recognition requirements for significant contracts for the delivery of multiple units of goods manufactured to the customer's specifications over more than one accounting period, such as subway cars. In such circumstances, the entity recognises revenue as individual units (or groups of units) are delivered. However, in contrast to the contracts described in paragraph BC24, control and the significant risks and rewards of ownership of the work in process in its current state do not transfer to the buyer as construction/manufacture progresses. This transfer takes place only on delivery of the completed units. In this case, the entity would apply the requirements of paragraph 14 of IAS 18 at that time; use of the percentage of completion method would not be appropriate.

BC29 In some circumstances, an entity has to perform further work on real estate already delivered to the buyer. The IFRIC noted that IFRIC 13 *Customer Loyalty Programmes* already provides guidance on how to apply paragraphs 13 and 19 of IAS 18. Paragraph BC9 of IFRIC 13 states that:

> … IAS 18 does not give explicit guidance. However, the aim of IAS 18 is to recognise revenue when, and to the extent that, goods or services have been delivered to a customer. In the IFRIC's view, paragraph 13 applies if a single transaction requires two or more separate goods or services to be delivered at different times; it ensures that revenue for each item is recognised only when that item is delivered. In contrast, paragraph 19 applies only if the entity has to incur further costs directly related to items already delivered, eg to meet warranty claims. In the IFRIC's view, loyalty awards are not costs that directly relate to the goods and services already delivered—rather, they are separate goods or services delivered at a later date …

BC30 The IFRIC concluded that the Interpretation should provide similar guidance.

Disclosures

BC31 The IFRIC noted that IAS 1 *Presentation of Financial Statements* (as revised in 2007) requires an entity to provide disclosures about its significant accounting policies (paragraph 117), judgements management has made in applying those policies (paragraph 122) and major sources of estimation uncertainty.

BC32 For greater certainty, the IFRIC concluded that, for agreements with 'continuous transfer', the Interpretation should require specific disclosures similar to those of paragraphs 39 and 40 of IAS 11 to satisfy the general requirements of IAS 1.

BC33 The IFRIC noted that this conclusion was generally consistent with D21 because D21 included such agreements in the scope of IAS 11 and therefore implicitly required the full disclosures of that standard.

Changes from draft Interpretation D21

BC34 Most respondents to D21 supported the IFRIC's conclusion that it should develop an interpretation on this issue. However, nearly all respondents expressed concern with some aspects of the proposals or the possible application by analogy to industries other than real estate.

BC35 The most significant changes made from D21 in the light of comments received relate to:

(a) *scope.* D21 referred to 'real estate sales'. The IFRIC clarified that the Interpretation applies to agreements for the construction of real estate.

(b) *applicable standard.* D21 listed typical features, including 'continuous transfer', to help determine whether an agreement for the construction of real estate is within the scope of IAS 11 or IAS 18. The IFRIC concluded that only agreements that meet the definition of a construction contract are within the scope of IAS 11 and carried forward into the Interpretation the guidance in paragraphs 9(a), 10(a) and BC5(a) of D21 on when a contract satisfies that definition.

(c) *continuous transfer.* Many respondents believed that the indicator of 'continuous transfer' (the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses) set out in paragraph 9(b) of D21 was relevant, although not specifically included in IAS 11. The IFRIC took the view that when the criteria for recognising revenue from the sale of goods set out in paragraph 14 of IAS 18 are met continuously, it is appropriate to recognise revenue as the criteria are met. The IFRIC carried forward the criterion set out in paragraph 9(b) of D21 and concluded that the percentage of completion method appropriately recognises revenue in such circumstances. However, the IFRIC did not carry forward the features set out in paragraph 9(b)(i)–(iii) of D21 on the basis that the criterion was sufficiently clear. Overall, the Interpretation and D21 provide similar revenue recognition conclusions for agreements with 'continuous transfer' but for different reasons.

(d) *multiple components.* Some respondents to D21 asked the IFRIC to address the issue of a single agreement with multiple components in order to cover the more complex transactions that often occur in practice. The requirements of IAS 18 in this respect have been included in the consensus and the issue is also addressed in an illustrative example.

(e) *disclosures.* D21 did not specify disclosures because agreements with 'continuous transfer' were included in the scope of IAS 11 and its disclosure requirements would have automatically applied. Paragraphs 20 and 21 of the Interpretation have been added to require specific disclosures for such agreements that now fall within the scope of IAS 18.

(f) *flow chart and illustrative examples.* The IFRIC decided that a flow chart and illustrative examples should accompany, but not be part of, the Interpretation to help entities apply the Interpretation.

HK(IFRIC)-Int 16
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HK(IFRIC) Interpretation 16

Hedges of a Net Investment in a Foreign Operation

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

CONTENTS

Hong Kong (IFRIC) Interpretation 16 *Hedges of a Net Investment in a Foreign Operation* (HK(IFRIC)-Int 16) is set out in paragraphs 1–19 and the Appendix. HK(IFRIC)-Int 16 is accompanied by an illustrative example and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 16
Hedges of a Net Investment in a Foreign Operation

References

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

Background

1 Many reporting entities have investments in foreign operations (as defined in HKAS 21 paragraph 8). Such foreign operations may be subsidiaries, associates, joint ventures or branches. HKAS 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.[*] 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 HKAS 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 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.

5 HKAS 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 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 HKAS 21 and HKAS 39 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.

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[*] 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 (subject to change as proposed in ED 9 *Joint Arrangements* published by the International Accounting Standards Board in September 2007) and financial statements that include a branch.

Scope

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 HKAS 39. 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

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.

Conclusions

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 (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of HKAS 39 paragraph 88 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 HKAS 39 paragraph 102 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 HKAS 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[*] 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 HKAS 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. Earlier application is permitted. If an entity applies this Interpretation for a period beginning before 1 October 2008, it shall disclose that fact.

Transition

19 HKAS 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 HKAS 39 to discontinue that hedge accounting prospectively.

[*] The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate parent. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate parent(s) and then translated into the functional currency of the ultimate parent (or the presentation currency if different).

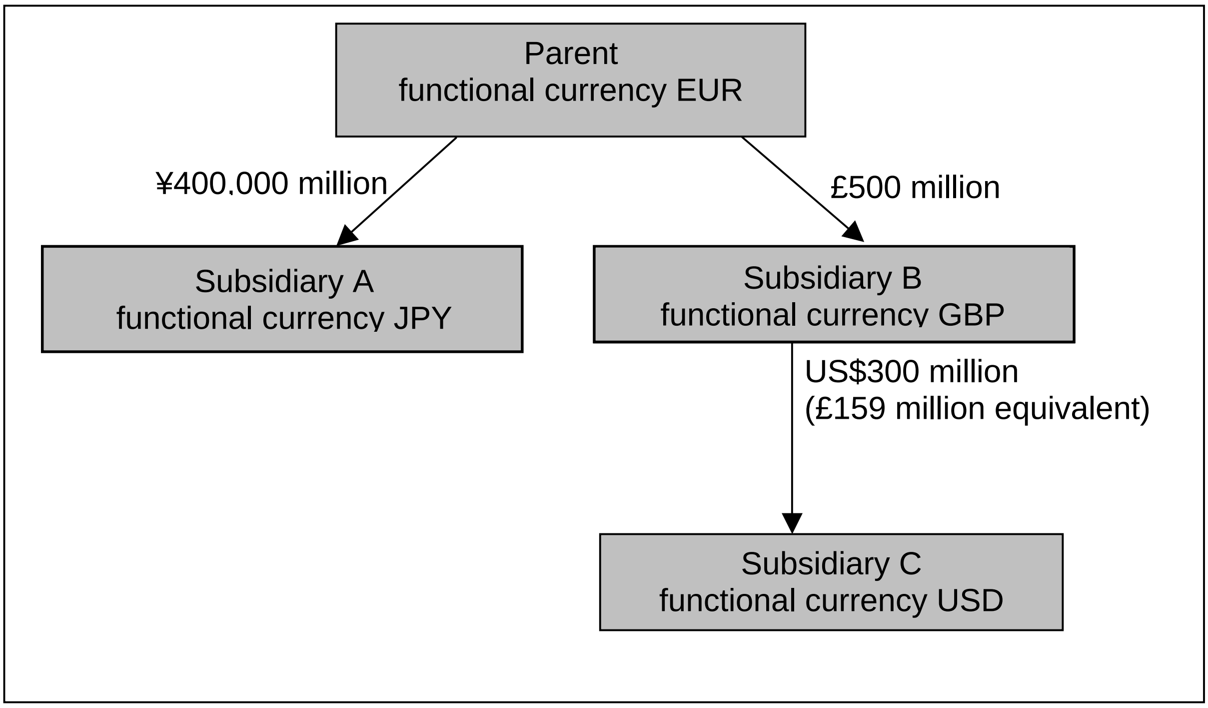
Appendix
Application guidance

This appendix is an integral part of the Interpretation.

AG1 This appendix illustrates the application of the Interpretation using the corporate structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with HKAS 39, although this testing is not discussed in this appendix. Parent, being the ultimate parent entity, presents its consolidated financial statements in its functional currency of euro (EUR). Each of the subsidiaries is wholly owned. Parent's £500 million net investment in Subsidiary B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Subsidiary B's US$300 million net investment in Subsidiary C (functional currency US dollars (USD)). In other words, Subsidiary B's net assets other than its investment in Subsidiary C are £341 million.

Nature of hedged risk for which a hedging relationship may be designated (paragraphs 10–13)

AG2 Parent can hedge its net investment in each of Subsidiaries A, B and C for the foreign exchange risk between their respective functional currencies (Japanese yen (JPY), pounds sterling and US dollars) and euro. In addition, Parent can hedge the USD/GBP foreign exchange risk between the functional currencies of Subsidiary B and Subsidiary C. In its consolidated financial statements, Subsidiary B can hedge its net investment in Subsidiary C for the foreign exchange risk between their functional currencies of US dollars and pounds sterling. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Parent could designate the forward foreign exchange risk.



Amount of hedged item for which a hedging relationship may be designated (paragraphs 10–13)

AG3 Parent wishes to hedge the foreign exchange risk from its net investment in Subsidiary C. Assume that Subsidiary A has an external borrowing of US$300 million. The net assets of Subsidiary A at the start of the reporting period are ¥400,000 million including the proceeds of the external borrowing of US$300 million.

AG4 The hedged item can be an amount of net assets equal to or less than the carrying amount of Parent's net investment in Subsidiary C (US$300 million) in its consolidated financial statements. In its consolidated financial statements Parent can designate the US$300 million external borrowing in Subsidiary A as a hedge of the EUR/USD spot foreign exchange risk associated with its net investment in the US$300 million net assets of Subsidiary C. In this case, both the EUR/USD foreign exchange difference on the US$300 million external borrowing in Subsidiary A and the EUR/USD foreign exchange difference on the US$300 million net investment in Subsidiary C are included in the foreign currency translation reserve in Parent's consolidated financial statements after the application of hedge accounting.

AG5 In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Subsidiary A would be recognised in Parent's consolidated financial statements as follows:

- USD/JPY spot foreign exchange rate change, translated to euro, in profit or loss, and
- JPY/EUR spot foreign exchange rate change in other comprehensive income.

Instead of the designation in paragraph AG4, in its consolidated financial statements Parent can designate the US$300 million external borrowing in Subsidiary A as a hedge of the GBP/USD spot foreign exchange risk between Subsidiary C and Subsidiary B. In this case, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Subsidiary A would instead be recognised in Parent's consolidated financial statements as follows:

- the GBP/USD spot foreign exchange rate change in the foreign currency translation reserve relating to Subsidiary C,
- GBP/JPY spot foreign exchange rate change, translated to euro, in profit or loss, and
- JPY/EUR spot foreign exchange rate change in other comprehensive income.

AG6 Parent cannot designate the US$300 million external borrowing in Subsidiary A as a hedge of both the EUR/USD spot foreign exchange risk and the GBP/USD spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Subsidiary B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the group comprising Subsidiary B and Subsidiary C.

Where in a group can the hedging instrument be held (paragraphs 14 and 15)?

AG7 As noted in paragraph AG5, the total change in value in respect of foreign exchange risk of the US$300 million external borrowing in Subsidiary A would be recorded in both profit or loss (USD/JPY spot risk) and other comprehensive income (EUR/JPY spot risk) in Parent's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in paragraph AG4 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Parent against the US dollar functional currency of Subsidiary C, in accordance with the hedge documentation. The method of consolidation (ie direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts reclassified to profit or loss on disposal of a foreign operation (paragraphs 16 and 17)

AG8 When Subsidiary C is disposed of, the amounts reclassified to profit or loss in Parent's consolidated financial statements from its foreign currency translation reserve (FCTR) are:

(a) in respect of the US$300 million external borrowing of Subsidiary A, the amount that HKAS 39 requires to be identified, ie the total change in value in respect of foreign exchange risk that was recognised in other comprehensive income as the effective portion of the hedge; and

(b) in respect of the US$300 million net investment in Subsidiary C, the amount determined by the entity's consolidation method. If Parent uses the direct method, its FCTR in respect of Subsidiary C will be determined directly by the EUR/USD foreign exchange rate. If Parent uses the step-by-step method, its FCTR in respect of Subsidiary C will be determined by the FCTR recognised by Subsidiary B reflecting the GBP/USD foreign exchange rate, translated to Parent's functional currency using the EUR/GBP foreign exchange rate. Parent's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be reclassified when it disposes of Subsidiary C to be the amount that it would have recognised if it had always used the direct method, depending on its accounting policy.

Hedging more than one foreign operation (paragraphs 11, 13 and 15)

AG9 The following examples illustrate that in the consolidated financial statements of Parent, the risk that can be hedged is always the risk between its functional currency (euro) and the functional currencies of Subsidiaries B and C. No matter how the hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Parent's consolidated financial statements when both foreign operations are hedged are US$300 million for EUR/USD risk and £341 million for EUR/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Parent's consolidated profit or loss. Of course, it would be possible for Parent to designate US$300 million only for changes in the USD/GBP spot foreign exchange rate or £500 million only for changes in the GBP/EUR spot foreign exchange rate.

Parent holds both USD and GBP hedging instruments

AG10 Parent may wish to hedge the foreign exchange risk in relation to its net investment in Subsidiary B as well as that in relation to Subsidiary C. Assume that Parent holds suitable hedging instruments denominated in US dollars and pounds sterling that it could designate as hedges of its net investments in Subsidiary B and Subsidiary C. The designations Parent can make in its consolidated financial statements include, but are not limited to, the following:

(a) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (EUR/USD) between Parent and Subsidiary C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (EUR/GBP) between Parent and Subsidiary B.

(b) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (GBP/USD) between Subsidiary B and Subsidiary C and up to £500 million hedging instrument designated as a hedge of £500 million of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (EUR/GBP) between Parent and Subsidiary B.

AG11 The EUR/USD risk from Parent's net investment in Subsidiary C is a different risk from the EUR/GBP risk from Parent's net investment in Subsidiary B. However, in the case described in paragraph AG10(a), by its designation of the USD hedging instrument it holds, Parent has already fully hedged the EUR/USD risk from its net investment in Subsidiary C. If Parent also designated a GBP instrument it holds as a hedge of its £500 million net investment in Subsidiary B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in Subsidiary C, would be hedged twice for GBP/EUR risk in Parent's consolidated financial statements.

AG12 In the case described in paragraph AG10(b), if Parent designates the hedged risk as the spot foreign exchange exposure (GBP/USD) between Subsidiary B and Subsidiary C, only the GBP/USD part of the change in the value of its US$300 million hedging instrument is included in Parent's foreign currency translation reserve relating to Subsidiary C. The remainder of the change (equivalent to the GBP/EUR change on £159 million) is included in Parent's consolidated profit or loss, as in paragraph AG5. Because the designation of the USD/GBP risk between Subsidiaries B and C does not include the GBP/EUR risk, Parent is also able to designate up to £500 million of its net investment in Subsidiary B with the risk being the spot foreign exchange exposure (GBP/EUR) between Parent and Subsidiary B.

Subsidiary B holds the USD hedging instrument

AG13 Assume that Subsidiary B holds US$300 million of external debt, the proceeds of which were transferred to Parent by an inter-company loan denominated in pounds sterling. Because both its assets and liabilities increased by £159 million, Subsidiary B's net assets are unchanged. Subsidiary B could designate the external debt as a hedge of the GBP/USD risk of its net investment in Subsidiary C in its consolidated financial statements. Parent could maintain Subsidiary B's designation of that hedging instrument as a hedge of its US$300 million net investment in Subsidiary C for the GBP/USD risk (see paragraph 13) and Parent could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in Subsidiary B. The first hedge, designated by Subsidiary B, would be assessed by reference to Subsidiary B's functional currency (pounds sterling) and the second hedge, designated by Parent, would be assessed by reference to Parent's functional currency (euro). In this case, only the GBP/USD risk from Parent's net investment in Subsidiary C has been hedged in Parent's consolidated financial statements by the USD hedging instrument, not the entire EUR/USD risk. Therefore, the entire EUR/GBP risk from Parent's £500 million net investment in Subsidiary B may be hedged in the consolidated financial statements of Parent.

AG14 However, the accounting for Parent's £159 million loan payable to Subsidiary B must also be considered. If Parent's loan payable is not considered part of its net investment in Subsidiary B because it does not satisfy the conditions in HKAS 21 paragraph 15, the GBP/EUR foreign exchange difference arising on translating it would be included in Parent's consolidated profit or loss. If the £159 million loan payable to Subsidiary B is considered part of Parent's net investment, that net investment would be only £341 million and the amount Parent could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.

AG15 If Parent reversed the hedging relationship designated by Subsidiary B, Parent could designate the US$300 million external borrowing held by Subsidiary B as a hedge of its US$300 million net investment in Subsidiary C for the EUR/USD risk and designate the GBP hedging instrument it holds itself as a hedge of only up to £341 million of the net investment in Subsidiary B. In this case the effectiveness of both hedges would be computed by reference to Parent's functional currency (euro). Consequently, both the USD/GBP change in value of the external borrowing held by Subsidiary B and the GBP/EUR change in value of Parent's loan payable to Subsidiary B (equivalent to USD/EUR in total) would be included in the foreign currency translation reserve in Parent's consolidated financial statements. Because Parent has already fully hedged the EUR/USD risk from its net investment in Subsidiary C, it can hedge only up to £341 million for the EUR/GBP risk of its net investment in Subsidiary B.

Illustrative example

This example accompanies, but is not part of, HK(IFRIC)-Int 16.

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, HKAS 39 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.

Basis for Conclusions on HK(IFRIC)-Int 16

This Basis for Conclusions accompanies, but is not part of, HK(IFRIC)-Int 16.

HK(IFRIC)-Int 16 is based on IFRIC Interpretation 16 *Hedges of a Net Investment in a Foreign Operation*. In approving HK(IFRIC)-Int 16, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 16. Accordingly, there are no significant differences between HK(IFRIC)-Int 16 and IFRIC Interpretation 16. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 16 referred to below generally correspond with those in HK(IFRIC)-Int 16.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 The IFRIC was asked for guidance on accounting for the hedge of a net investment in a foreign operation in the consolidated financial statements. Interested parties had different views of the risks eligible 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 parent entity's consolidated financial statements.

BC3 Concern was also raised 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, the IFRIC decided to develop guidance on the accounting for a hedge of the foreign currency risk arising from a net investment in a foreign operation.

BC5 The IFRIC published draft Interpretation D22 *Hedges of a Net Investment in a Foreign Operation* for public comment in July 2007 and received 45 comment letters in response to its proposals.

Consensus

Hedged risk and hedged item

Functional currency versus presentation currency (paragraph 10)

BC6 The IFRIC received a submission suggesting 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. In the direct method of consolidation, each entity within a group is consolidated directly into the ultimate parent entity's presentation currency when preparing the consolidated financial statements. In the step-by-step method, each intermediate parent entity prepares consolidated financial statements, which are then consolidated into its parent entity until the ultimate parent entity has prepared consolidated financial statements.

BC7 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 exposure between 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.

BC8 In response to this, the IFRIC noted that IAS 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 IAS 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. The IFRIC 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.

BC9 However, the IFRIC 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. The IFRIC therefore decided that an Interpretation was needed.

BC10 The IFRIC 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 of the group or the functional currency of the parent entity, or both.

BC11 The answer to this question is important when the presentation currency of the group is different from an intermediate or ultimate parent entity's functional currency. If the presentation currency of the group 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 of the group, a translation adjustment will be included in other comprehensive income to present 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 risk in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* in the hedge of a net investment in a foreign operation.

BC12 The IFRIC noted the following arguments for permitting hedge accounting for a hedge of the presentation currency:

(a) If the presentation currency of the group is different from the ultimate parent entity's functional currency, a difference arises on translation that is recognised in other comprehensive income. It is argued that a reason for allowing hedge accounting for a net investment in a foreign operation is to remove from the financial statements the fluctuations resulting from the translation to a presentation currency. If an entity is not allowed to use hedge accounting for the exposure to the presentation currency of the group when it is different from the functional currency of the parent entity, there is likely to be an amount included in other comprehensive income that cannot be offset by hedge accounting.

(b) IAS 21 requires an entity to reclassify from equity to profit or loss as a reclassification adjustment any foreign currency translation gains and losses included in other comprehensive income on disposal of a foreign operation. An amount in other comprehensive income arising from a different presentation currency is therefore included in the amount reclassified to profit or loss on disposal. The entity should be able to include the amount in a hedging relationship if at some stage it is recognised along with other reclassified translation amounts.

BC13 The IFRIC noted the following arguments for allowing an entity to designate hedging relationships solely on the basis of differences between functional currencies:

(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 effect on 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) IAS 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 economic exchange rate risk arises only from an exposure between two or more functional currencies, not from a presentation currency.

BC14 When comparing the arguments in paragraphs BC12 and BC13, the IFRIC 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 values; a presentation currency never will. No commentators on the draft Interpretation disagreed with the IFRIC's conclusion.

Eligible risk (paragraph 12)

BC15 The IFRIC considered which entity's (or entities') functional currency may be used as a reference point for the hedged risk 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 the inception of the hedge?

BC16 The IFRIC 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.

BC17 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.

BC18 The IFRIC concluded that a group must identify which 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. As a result of comments received on the draft Interpretation, the IFRIC decided to emphasise that this documentation should also include the entity's strategy in undertaking the hedge as required by IAS 39.

Amount of hedged item that may be hedged (paragraphs 11 and 13)

BC19 In the draft Interpretation the IFRIC noted that, in financial statements that include a foreign operation, an entity cannot hedge the same risk more than once. This comment was intended to remind entities that IAS 39 does not permit multiple hedges of the same risk. Some respondents asked the IFRIC to clarify the situations in which the IFRIC considered that the same risk was being hedged more than once. In particular, the IFRIC was asked whether the same risk could be hedged by different entities within a group as long as the amount of risk being hedged was not duplicated.

BC20 In its redeliberations, the IFRIC decided to clarify that the carrying amount of the net assets of a foreign operation that may be hedged in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has hedged all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements. An intermediate parent entity can hedge some or all of the risk of its net investment in a foreign operation in its own consolidated financial statements. However, 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. Alternatively, if the risk has not been hedged by the ultimate parent entity or another intermediate parent entity, the hedge relationship that qualified in the immediate parent entity's consolidated financial statements will also qualify in the ultimate parent entity's consolidated financial statements.

BC21 In its redeliberations, the IFRIC also decided to add guidance to the Interpretation to illustrate the importance of careful designation of the amount of the risk being hedged by each entity in the group.

Hedging instrument

Location of the hedging instrument (paragraph 14) and assessment of hedge effectiveness (paragraph 15)

BC22 The IFRIC 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 IAS 21. This guidance was moved to IAS 39 to ensure that the hedge accounting guidance included in paragraph 88 of IAS 39 would also apply to the hedges of net investments in foreign operations.

BC23 The IFRIC concluded that 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.

BC24 The IFRIC concluded that the foreign operation being hedged could not hold the hedging instrument because that instrument would be part of, and denominated in the same currency as, the net investment it was intended to hedge. In this circumstance, hedge accounting is unnecessary. The foreign exchange differences between the parent's functional currency and both the hedging instrument and the functional currency of the net investment will automatically be included in the group's foreign currency translation reserve as part of the consolidation process. The balance of the discussion in this Basis for Conclusions does not repeat this restriction.

BC25 The IFRIC also concluded that to apply the conclusion in paragraph BC23 when determining the effectiveness of a hedging instrument in the hedge of a net investment, 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 hedging 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. In other words, the fact that some of the change in the hedging instrument is recognised in profit or loss by one entity within the group and some is recognised in other comprehensive income by another does not affect the assessment of hedge effectiveness.

BC26 In the draft Interpretation the IFRIC noted Question F.2.14 in the guidance on implementing IAS 39, 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:

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

This was the only basis for the IFRIC's conclusion regarding which entity could hold the hedging instrument provided in the draft Interpretation. Some respondents argued that the Interpretation should not refer to implementation guidance as the sole basis for an important conclusion.

BC27 In its redeliberations, the IFRIC considered both the International Accounting Standards Board's amendment to IAS 21 in 2005 and the objective of hedging a net investment described in IAS 39 in addition to the guidance on implementing IAS 39.

BC28 In 2005 the Board was asked to clarify which entity is the reporting entity in IAS 21 and therefore what instruments could be considered part of a reporting entity's net investment in a foreign operation. In particular, constituents questioned whether a monetary item must be transacted between the foreign operation and the reporting entity to be considered part of the net investment in accordance with IAS 21 paragraph 15, or whether it could be transacted between the foreign operation and any member of the consolidated group.

BC29 In response the Board added IAS 21 paragraph 15A to clarify that, 'The entity that has a monetary item receivable from or payable to a foreign operation described in paragraph 15 may be any subsidiary of the group.' The Board explained its reasons for the amendment in paragraph BC25D of the Basis for Conclusions:

> The Board concluded that the accounting treatment in the consolidated financial statements should not be dependent on the currency in which the monetary item is denominated, nor on which entity within the group conducts the transaction with the foreign operation.

In other words, the Board concluded that the relevant reporting entity is the group rather than the individual entity and that the net investment must be viewed from the perspective of the group. It follows, therefore, that the group's net investment in any foreign operation, and its foreign currency exposure, can be determined only at the relevant parent entity level. The IFRIC similarly concluded that the fact that the net investment is held through an intermediate entity does not affect the economic risk.

BC30 Consistently with the Board's conclusion with respect to monetary items that are part of *the net investment*, the IFRIC concluded that monetary items (or derivatives) that are *hedging instruments* in a hedge of a net investment may be held by any entity within the group and the functional currency of the entity holding the monetary items can be different from those of either the parent or the foreign operation. The IFRIC, like the Board, agreed with constituents who noted that a hedging item denominated in a currency that is not the functional currency of the entity holding it does not expose the group to a greater foreign currency exchange difference than arises when the instrument is denominated in that functional currency.

BC31 The IFRIC noted that its conclusions that the hedging instrument can be held by any entity in the group and that the foreign currency is determined at the relevant parent entity level have implications for the designation of hedged risks. As illustrated in paragraph AG5 of the application guidance, these conclusions make it possible for an entity to designate a hedged risk that is not apparent in the currencies of the hedged item or the foreign operation. This possibility is unique to hedges of net investments. Consequently, the IFRIC specified that the conclusions in the Interpretation should not be applied by analogy to other types of hedge accounting.

BC32 The IFRIC also noted that the objective of hedge accounting as set out in IAS 39 is to achieve offsetting changes in the values of the *hedging instrument* and of the *net investment* attributable to the hedged risk. Changes in foreign currency rates affect the value of the entire *net investment* in a foreign operation, not only the portion IAS 21 requires to be recognised in profit or loss in the absence of hedge accounting but also the portion recognised in other comprehensive income in the parent's consolidated financial statements. As noted in paragraph BC25, it is the total change in the hedging instrument as result of a change in the foreign currency rate with respect to the parent entity against whose functional currency the hedged risk is measured that is relevant, not the component of comprehensive income in which it is recognised.

Reclassification from other comprehensive income to profit or loss (paragraphs 16 and 17)

BC33 In response to requests from some respondents for clarification, the IFRIC discussed what amounts from the parent entity's foreign currency translation reserve in respect of both the hedging instrument and the foreign operation should be recognised in profit or loss in the parent entity's consolidated financial statements when the parent disposes of a foreign operation that was hedged. The IFRIC noted that the amounts to be reclassified from equity to profit or loss as reclassification adjustments on the disposition are:

(a) the cumulative amount of gain or loss on a hedging instrument determined to be an effective hedge that has been reflected in other comprehensive income (IAS 39 paragraph 102), and

(b) the cumulative amount reflected in the foreign currency translation reserve in respect of that foreign operation (IAS 21 paragraph 48).

BC34 The IFRIC noted that when an entity hedges a net investment in a foreign operation, IAS 39 requires it to identify the cumulative amount included in the group's foreign currency translation reserve as a result of applying hedge accounting, ie the amount determined to be an effective hedge. Therefore, the IFRIC concluded that when a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss from the foreign currency translation reserve in respect of the hedging instrument in the consolidated financial statements of the parent should be the amount that IAS 39 requires to be identified.

Effect of consolidation method

BC35 Some respondents to the draft Interpretation argued that the method of consolidation creates a difference in the amounts included in the ultimate parent entity's foreign currency translation reserve for individual foreign operations that are held through intermediate parents. These respondents noted that this difference may become evident only when the ultimate parent entity disposes of a second tier subsidiary (ie an indirect subsidiary).

BC36 The difference becomes apparent in the determination of the amount of the foreign currency translation reserve that is subsequently reclassified to profit or loss. An ultimate parent entity using the direct method of consolidation would reclassify the cumulative foreign currency translation reserve that arose between its functional currency and that of the foreign operation. An ultimate parent entity using the step-by-step method of consolidation might reclassify the cumulative foreign currency translation reserve reflected in the financial statements of the intermediate parent, ie the amount that arose between the functional currency of the foreign operation and that of the intermediate parent, translated into the functional currency of the ultimate parent.

BC37 In its redeliberations, the IFRIC noted that the use of the step-by-step method of consolidation does create such a difference for an *individual* foreign operation although the aggregate net amount of foreign currency translation reserve for all the foreign operations is the same under either method of consolidation. At the same time, the IFRIC noted that the method of consolidation *should not* create such a difference for an individual foreign operation, on the basis of its conclusion that the economic risk is determined in relation to the ultimate parent's functional currency.

BC38 The IFRIC noted that the amount of foreign currency translation reserve for an individual foreign operation determined by the direct method of consolidation reflects the economic risk between the functional currency of the foreign operation and that of the ultimate parent (if the parent's functional and presentation currencies are the same). However, the IFRIC noted that IAS 21 does not require an entity to use this method or to make adjustments to produce the same result. The IFRIC also noted that a parent entity is not precluded from determining the amount of the foreign currency translation reserve in respect of a foreign operation it has disposed of as if the direct method of consolidation had been used in order to reclassify the appropriate amount to profit or loss. However, it also noted that making such an adjustment on the disposal of a foreign operation is an accounting policy choice and should be followed consistently for the disposal of all net investments.

BC39 The IFRIC noted that this issue arises when the net investment disposed of was not hedged and therefore is not strictly within the scope of the Interpretation. However, because it was a topic of considerable confusion and debate, the IFRIC decided to include a brief example illustrating its conclusions.

Transition (paragraph 19)

BC40 In response to respondents' comments, the IFRIC clarified the Interpretation's transitional requirements. The IFRIC decided that entities should apply the conclusions in this Interpretation to existing hedging relationships on adoption and cease hedge accounting for those that no longer qualify. However, previous hedge accounting is not affected. This is similar to the transition requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* paragraph 30, for relationships accounted for as hedges under previous GAAP.

Summary of main changes from the draft Interpretation

BC41 The main changes from the IFRIC's proposals are as follows:

(a) Paragraph 11 clarifies that the carrying amount of the net assets of a foreign operation that may be hedged in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has hedged all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements.

(b) Paragraph 15 clarifies that 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.

(c) Paragraphs 16 and 17 and the illustrative example clarify what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation.

(d) Paragraph 19 clarifies transitional requirements.

(e) The appendix of application guidance was added to the Interpretation. Illustrative examples accompanying the draft Interpretation were removed.

(f) The Basis for Conclusions was changed to set out more clearly the reasons for the IFRIC's conclusions.

Contents

Hong Kong Accounting Standard 18 *Revenue* (HKAS 18) is set out in paragraphs 1-37. All the paragraphs have equal authority. HKAS 18 shall be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Appendix A

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at October 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 18.

The International Accounting Standard comparable with HKAS 18 is IAS 18 *Revenue*.

There are no major textual differences between HKAS 18 and IAS 18.

Appendix B

Amendments resulting from other HKFRSs

The following sets out amendments required for this Standard resulting from other newly issued HKFRSs that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted.

HK(IFRIC)-Int 15 *Agreements for the Construction of Real Estate* (issued in August 2008) - effective for annual periods beginning on or after 1 January 2009

The appendix to HKAS 18 is amended as described below.

> All of the text under the heading '9 *Real estate sales*.' is deleted.
>
> New text is inserted under the heading as follows:
>
> 'This example has been superseded by Hong Kong (IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate*'.

HK Interpretation 3
Revised June 2006

Effective for pre-completion contracts for the sale of development properties entered into on or after 1 January 2005*

HK Interpretation 3

Revenue – Pre-completion Contracts for the Sale of Development Properties

* This Interpretation is applicable for pre-completion contracts for the sale of development properties entered into on or after 1 January 2005. HK(IFRIC)-Int 15 *Agreements for the Construction of Real Estate* issued in August 2008 is applicable for annual periods beginning on or after 1 January 2009 and supersedes this Interpretation.

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