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**International
Accounting Standards
Board**

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

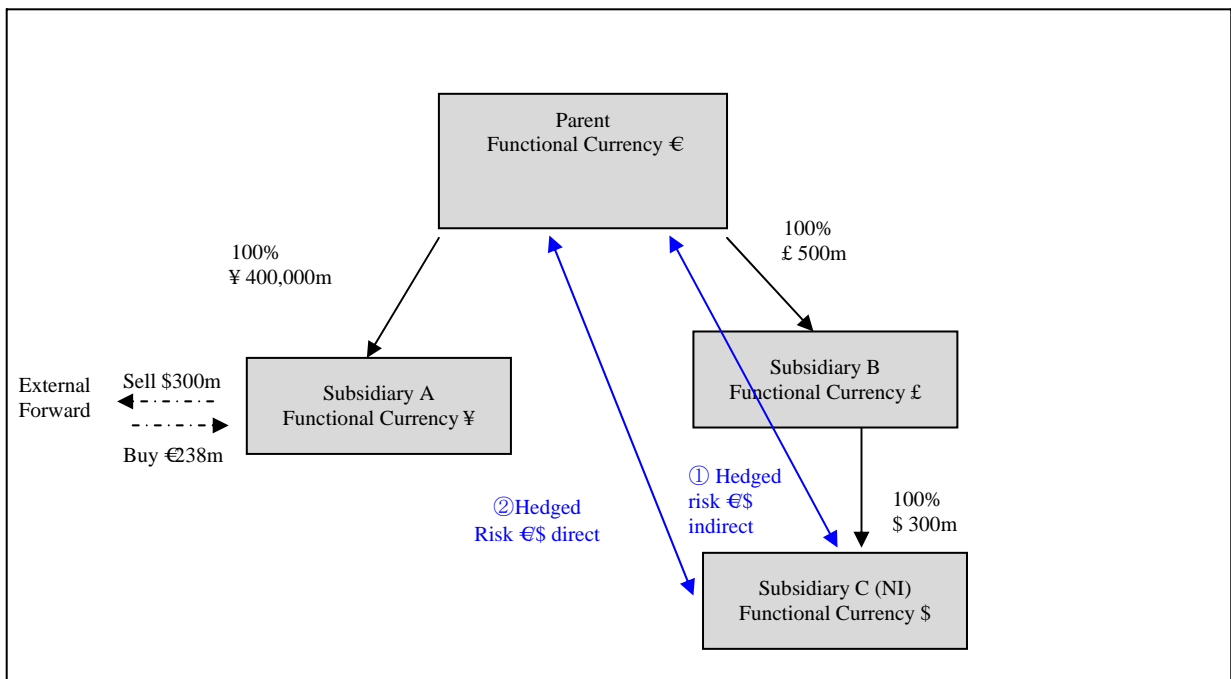
INFORMATION FOR OBSERVERS

IFRIC meeting: March 2008, London

**Project: Situation 1: Hedging instrument held by Sub A — Forward
(Agenda Paper 2C)**

- On 1 January 2005, Parent entity, which presents consolidated financial statements in € holds a 100% investment in Subsidiary A (¥400,000m) and a 100% investment in Subsidiary B (£500m). Subsidiary B also holds a 100% investment in Subsidiary C (\$300m). Parent entity has a functional currency of €, Subsidiary A has a functional currency of Japanese Yen (¥), Subsidiary B has a functional currency of Pound Sterling (£) and Subsidiary C has a functional currency of \$. Parent entity wishes to hedge its foreign exchange exposure from its net investment in Subsidiary C. On 1 January 2005 Subsidiary A enters into an external forward contract to sell \$300m for €238m in one year's time. The net assets of Subsidiary A on 1 January 2005 are ¥400,000m. The net assets of Subsidiary B on 1 January 2005 are £500m including an amount in respect of the net assets of Subsidiary C which are equal to \$300m

on this date. The Parent has no assets other than the investments in Subsidiary A and Subsidiary B. The Parent designates the forward as a hedge of the forward foreign exchange risk associated with its net investment in the first \$300m net assets of Subsidiary C in its consolidated financial statements.



Results of hedge effectiveness

Step-by-step method of consolidation

Hedged risk	In which financial statements?	
	In Parent's consolidated F/S	In Sub B's consolidated F/S
① Euro/\$ exposure from a net investment in Subsidiary C between Parent and Subsidiary C	Spreadsheet Forward No. 1-1 100% effective	N/A forward held by Subsidiary A cannot be used as hedging instrument because it is held outside Subsidiary B's group

Direct method of consolidation

Hedged risk	In which financial statements?	
	In Parent's consolidated F/S	In Sub B's consolidated F/S
② Euro/\$ exposure from a net investment in Subsidiary C between Parent and Subsidiary C	No. 1-2 100% effective	N/A In addition to the explanation above, under the direct method, it is mechanically impossible to apply hedge accounting in subsidiary B's consolidated F/S

SITUATION 1-1 FORWARD (step by step method): designate \$/Euro exposure from Entity C as hedged risk on Parent's consolidated F/S

Year 0											
USD	1										
JPY	118										
EUR	0.8										
GBP	0.53										
	P (EUR)	A(JPY)	A(EUR)	C(USD)	C(GBP)	B(GBP)	consol adj	BC(GBP)	BC(EUR)	consol adj	PABC(EUR)
Investment in A	2712									-2712	0
Investment in B	755									-755	0
Investment in C						159	-159				0
Other assets		400000	2712	300	159	341		500	755		3467
	<u>3467</u>	<u>400000</u>	<u>2712</u>	<u>300</u>	<u>159</u>	<u>500</u>		<u>500</u>	<u>755</u>		<u>3467</u>
Opening	-3467	-400000	-2712	-300	-159	-500	159	-500	-755	3467	-3467
FCTR											
Income											
Closing	<u>-3467</u>	<u>-400000</u>	<u>-2712</u>	<u>-300</u>	<u>-159</u>	<u>-500</u>		<u>-500</u>	<u>-755</u>		<u>-3467</u>
Forward	0	0	0	0	0	0	0	0	0	0	0
Check	0	0	0	0	0	0	0	0	0	0	0

Year 1											
USD	1										
JPY	125										
EUR	0.88										
GBP	0.58										
	P (EUR)	A(JPY)	A(EUR)	C(USD)	C(GBP)	B(GBP)	consol adj	BC(GBP)	BC(EUR)	consol adj	PABC(EUR)
Investment in A	2712									-2712	0
Investment in B	755									-755	0
Investment in C						159	-159				0
Other assets		400000	2816	300	174	341		515	781		3597
	<u>3467</u>	<u>400000</u>	<u>2816</u>	<u>300</u>	<u>174</u>	<u>500</u>		<u>515</u>	<u>781</u>		<u>3597</u>
Opening	-3467	-400000	-2712	-300	-159	-500	159	-500	-755	3467	-3467
FCTR (Entity A) from assets*3			-104								-104
FCTR (Entity A) from forward*3			0								0
FCTR (Entity B)*5									-4		-4
FCTR (EntityC)*6					-15			-15	-23		-23
Income (Forward)		3732	26								26
Closing	<u>-3467</u>	<u>-396268</u>	<u>-2790</u>	<u>-300</u>	<u>-174</u>	<u>-500</u>		<u>-515</u>	<u>-781</u>		<u>-3572</u>
Equity											
Forward	0	-3732	-26	0	0	0	0	0	0	0	-26
Check	0	0	0	0	0	0	0	0	0	0	0

A accounts		JPY	
Forward	Year 0		0
Forward	Year 1		-3732
P/L from translation of Forward			-3732

SITUATION 1-1 FORWARD (step by step method): designate \$/Euro exposure from Entity C as hedged risk on Parent's consolidated F/S

Hedged item (net assets in amounts)	USD 300m
change in value of net assets at forward rates (as per IE 15 of D22)	-26 Euro
Hedging instrument	Forward to sell \$300m and buy EUR
Change in P/L from forward	26 Euro
Change in FCTR*1	0 Euro
	26
Hedge effectiveness	-100%

*1 Hedging instrument (FCTR)	
retranslation of income from forward at closing rate (=JPY3732/125*0.88 - Euro26)	0
retranslation of opening balance of forward at closing rate	0
	0

*3 Formula	
FCTR (Entity A) from assets	EUR2712-JPY400000/125*0.88=EUR-104
FCTR (Entity A) from forward	(JPY3732/125*0.88-Euro26)=EUR0

*5 EUR755-GBP515/0.58*0.88- (EUR-23)=EUR-4
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*6 GBP159-USD300*0.58=GBP-15
GBP-15/0.58*0.88=EUR-23

The following entries would be recorded for hedging instrument (USD forward)

(A's separate F/S)

Dr) Profit and loss (forward)	JPY 3732	Cr) Forward	JPY 3732
being the profit/loss arising from the forward			
(P's consolidated F/S - before hedging)			
Dr) Profit and loss (forward)	EUR 26	Cr) Forward	EUR 26
being translation of Entity A's JPY profit/loss into EUR at the average rate			
Dr) Equity (FCTR-Entity A)	EUR 0	Cr) Forward	EUR 0
being retranslation of Entity A's JPY profit/loss into EUR at the closing rate			
Dr) Equity (FCTR-Entity A)	EUR 0	Cr) Forward	EUR 0
being translation of Entity A's opening balance of forward into EUR at the closing rate			
Dr) Other assets	EUR 104	Cr) Equity (FCTR-Entity A)	EUR 104
being translation of Entity A's opening balance of other assets into EUR at the closing rate			
(P's consolidated F/S - hedging entry)			
Dr) Equity (FCTR-Entity C)	EUR 26	Cr) Profit and loss (forward)	EUR 26
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR-Entity C)	EUR 0	Cr) Equity (FCTR-Entity A)	EUR 0
being reclassification entry within Equity (FCTR) for hedging (ie. eliminating FCTR- Entity C)			

The following entries would be recorded for hedged item

(P's consolidated F/S)

Dr) Other assets	EUR 23	Cr) Equity(FCTR-Entity C)	EUR 23
being translation of Entity C's USD financial statements (after elimination) into EUR			

Check: Equity (FCTR) EUR 4

<After hedge entry>

	Before hedge PABC(EUR)	hedge entr	After hedge PABC(EUR)
Investment in A	0		0
Investment in B	0		0
Investment in C	0		0
Other assets*4	3597		3597
	3597		3597
Opening	-3467		-3467
FCTR (Entity A)from assets*	-104		-104
FCTR (Entity A)from forward	0	0	0
FCTR (Entity B)	-4		-4
FCTR (EntityC)	-23	26	4
Income (Forward)	26	-26	0
Closing			
Equity	-3572	0	-3572
Forward	-26		-26
Check	0		0

SITUATION 1-2 FORWARD(direct method):designate \$/Euro exposure from Entity C as hedged risk on Parent's consolidated F/S

Hedged item (net assets in amounts) change in value of net assets at forward rates (as per IE 15 of D22)	USD 300m -26 Euro
Hedging instrument Change in P/L from forward Change in FCTR*1	Forward to sell \$300m and buy EUR 26 Euro 0 Euro 26
Hedge effectiveness	-100%
*1 Change in FCTR retranslation of income (forward) at closing rate (=JPY3732/125*0.88 - Euro26)	0
retranslation of opening balance of forward at closing rate	0
	0

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*3 Formula FCTR (Entity A) from assets EUR2712-JPY400000/125*0.88=EUR-104 FCTR (Entity A) from forward (JPY3732/125*0.88-Euro26)=EUR0

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*5 EUR515-GBP341/0.58*0.88=EUR-3

*6 EUR240-USD300*0.88=EUR-24

The following entries would be recorded for hedging instrument (USD forward)			
(A's separate F/S)			
Dr) Profit and loss (forward)	JPY 3732	Cr) forward	JPY 3732
being the profit/loss arising from the forward			
(P's consolidated F/S)			
Dr) Profit and loss (forward)	EUR 26	Cr) forward	EUR 26
being translation of Entity A's JPY profit/loss into EUR at the average rate			
Dr) Equity (FCTR-Entity A)	EUR 0	Cr)forward	EUR 0
being retranslation of Entity A's JPY profit/loss into EUR at the closing rate			
Dr) Equity (FCTR-Entity A)	EUR 0	Cr)forward	EUR 0
being translation of Entity A's opening balance of forward into EUR at the closing rate			
Dr) Other assets	EUR 104	Cr) Equity (FCTR-Entity A)	EUR 104
being translation of Entity A's opening balance of other assets into EUR at the closing rate			
(P's consolidated F/S - hedging entry)			
Dr) Equity (FCTR-Entity C)	EUR 26	Cr) Profit and loss (forward)	EUR 26
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR- Entity C)	EUR 0	Cr) Equity (FCTR-Entity A)	EUR 0
being reclassification entry within Equity (FCTR) for hedging (ie. eliminating FCTR- Entity C)			

The following entries would be recorded for hedged item			
(P's consolidated F/S)			
Dr) Other assets	EUR 264	Cr) Equity(Opening)	EUR 240
		Equity(FCTR-Entity C)	EUR 24
being translation of Entity C's USD financial statements into EUR			

Check: Equity (FCTR) EUR 2

	Before hedge	After hedge
	PABC(EUR) hedge entry	PABC(EUR)
Investment in A	0	0
Investment in B	0	0
Investment in C	0	0
Other assets*4	3597	3597
	<u>3597</u>	<u>3597</u>
Opening	-3467	-3467
FCTR (Entity A)from assets**	-104	-104
FCTR (Entity A)from forward	0	0
FCTR (Entity B)	-3	-3
FCTR (EntityC)	-24	26
Income (forward)	26	-26
Closing	0	0
Equity	-3572	-3572
	<u>-3572</u>	<u>-3572</u>
forward	-26	-26
	<u>-26</u>	<u>-26</u>
Check	0	0

SITUATION 1 FORWARD

Interest rates			
t	€	\$	
0		4.50%	5.50%
1		4.70%	5.70%

Spot rates				
€	£	Yen	\$	
	0.8	0.53	118	1
	0.88	0.58	125	1

Forward matures in one year time, ie. 1/1/02			
Buy	€		237,725,118.48
Sell	\$		300,000,000.00

Forward rate (E/\$)	
	1.26

Fair Value @ 31/12/00	Leg	in Yen	in Euro
Buy €		227,488,151.66	227,488,151.66
Sell \$		33,554,502,369.67	227,488,151.66
TOTAL		33,554,502,369.67	0.00

Exchange rates		
Period	0	1
\$/Yen	118	125
\$/GBP	0.53	0.58
\$/€	0.8	0.88
Yen/\$	0.008475	0.008
Yen/GBP	0.004492	0.00464
Yen/€	0.00678	0.00704
GBP/\$	1.886792	1.724138
GBP/Yen	222.6415	215.5172
GBP/€	1.509434	1.517241
€/\$	1.25	1.136364
€/Yen	147.5	142.0455
€/GBP	0.6625	0.659091

Fair Value @ 31/12/01	Leg	in Yen	in Euro
Buy €		237,725,118.48	237,725,118.48
Sell \$		33,767,772,511.85	264,000,000.00
TOTAL		37,500,000,000.00	-26,274,881.52

check based on spot of net amount in Yen compared to Euro net amount 0

NB: all hedges assume that both the spot and forward component are designated

SITUATION 1 FORWARD

Net assets (\$m)	300,000,000.0000
\$/€ spot rate @ 31/12/00	0.8000
\$/€ spot rate @ 31/12/01	0.8800
€/\$ 1-y forward rate @ 31/12/00 running to 31/12/01	1.2620
€/\$ 1-y forward rate @ 31/12/01	1.1364
Change in hedged item at forward rates*	-26,274,881.5166

* this calculation involves retranslating the net assets at the forward rate to 31/12/01 @ 31/12/00 and then again at the forward rate to that date at 31/12/01 itself (ie at the spot rate)
this is consistent with the methodology used in IE 15 of IFRIC D22