30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

**International Accounting Standards Board**

*This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.*

*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:** **January 2008, London**

**Project:** **IAS21 - Hedges of a Net Investment in a Foreign Operation (Agenda Paper 6B)**

# Introduction

1 This paper provides an overview of the comment letter analysis on the proposals in D22 *Hedges of a Net Investment in a Foreign Operation*.

2 The purpose of the paper is to ask the IFRIC to redeliberate the key issues raised in the comment letters. Those key issues are the same ones the IFRIC discussed the most in reaching the consensuses in the draft Interpretation. They are:

**Issue 1 –** which parent entity (immediate, intermediate, ultimate) can hedge its net investment risk?

**Issue 2 –** what can be hedged? (how to determine the amount of net investment eligible to be hedged)

**Issue 3 –** where can the hedging instrument be held? (how to determine hedge effectiveness)

3 The staff's approach to the redeliberations is to ask the IFRIC to reconsider its conclusions on these fundamental issues before considering subsidiary and drafting issues. If the IFRIC's conclusions are confirmed in this meeting, the staff will present the remainder of the issues and a revised interpretation for approval in March.

4 For each main issue, this paper provides the reasons for the IFRIC's conclusion (extracting from previous papers if possible), the staff recommendation and the question to the IFRIC.

## Overview of comments

5 The IFRIC received 44 comment letters. The commentators did not always clearly express an overall view whether they supported the proposals of the draft interpretation. However, the staff believes that the views can be grouped broadly as follows:

*Views on the proposal "What the hedged risk/item is (D22 paragraph 9 and 10)"*[1]

| A<br>Support proposal (with editorial comments, if any) | B<br>Support proposal with specific comments on application | C<br>Disagree |
|---|---|---|
| **31** | **12** | **0** |

Note: one commentator did not express a clear overall view on the proposal.

*Views on the proposal "where the hedge instruments can be held" and "how to apply hedge accounting (D22 paragraph12, 13 and 14)"*[2]

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[1] Issues 1 and 2 in paragraph 2 are related to this box. See Appendix A for the analysis of the comment letters [omitted from the observer note].

[2] Issue 3 in paragraph 2 is related to this box. See Appendix B for the analysis of the comment letters [omitted from the observer note].

| A<br>Support proposal (with editorial comments, if any) | B<br>Support proposal with specific comments on application | C<br>Disagree |
|---|---|---|
| **21** | **17** | **6** |

6 6 commentators disagreed on key issue 3 – where the hedging instrument can be held (how to determine hedge effectiveness).

### *Issue 1 – Which parent entity ( immediate, intermediate, ultimate) can hedge its net investment risk?*

7 The comment letters support the IFRIC consensus that permits any parent entity (immediate, intermediate and ultimate parent)[3] to hedge its net investment. In reaching this conclusion, the IFRIC also noted that, in financial statements that include a foreign operation, an entity cannot hedge the same risk more than once. The staff believes that no further redeliberation of this issue is necessary.

### *Issue 2 – Determining the amount of net investment eligible to be hedged*

8 Although no commentators disagreed with the IFRIC consensus, one commentator requests further clarification as to whether the amount of net assets that can be hedged can be based on the sub-consolidated net assets[4] of a foreign operation or simply the net assets of the individual foreign operations. Other commentators also propose a change to paragraph 14 to clarify the amount of net assets that can be hedged by more than one parent entity within the group (for example, a direct and an indirect parent entity).

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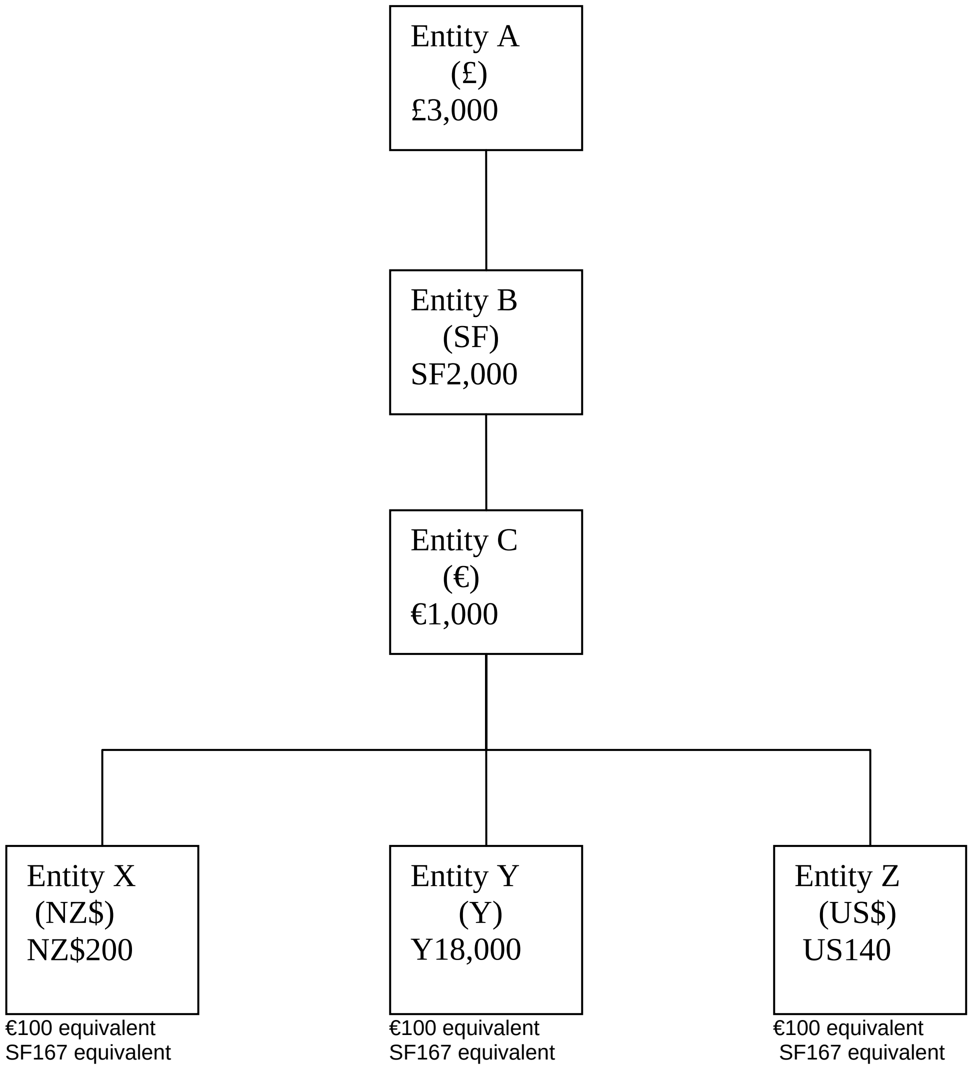
[3] Refer to paragraphs 9, 14 and BC14 -18 of D22

[4] The definition was not clearly described in the comment letter. However, the staff believes that "sub-consolidated net assets" are defined as the net assets of an intermediate company in the group in its consolidated financial statements.

We believe the draft interpretation should be clearer in its illustrative example in paragraphs IE1 to IE7 about what are the net assets that can be designated at each level. We recognise that the draft interpretation is clear that any parent in the group structure may in principle try and achieve net investment hedging (but the same foreign operation cannot be hedged twice) but the draft interpretation does not make clear what are the net assets of the foreign operation that can be hedged. The critical issue is whether in determining the amount of net assets that can be hedged, is it permitted for this to be based on the sub-consolidated net assets of a foreign operation or simply the net assets of the individual foreign operations?

We have recreated the diagram in paragraph IE2 below showing the amount of net assets in each individual entity and have also listed the designations in paragraph IE3 showing how the net assets of each designation will vary depending on whether the net assets can be hedged as a sub-consolidated amount of net assets or simply the net assets of each individual foreign operation.

All net assets of an entity exclude the consolidated net assets of subsidiaries beneath it (ie the net assets are not sub-consolidated net assets)




Foreign exchange rates:
£1 = SF2.5
£1 = €1.5
SF1 = €0.6
€1 = NZ$2
€1 = Y180
€1 = US$1.4

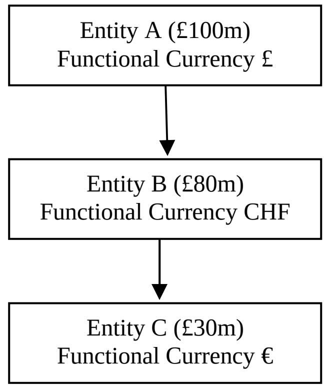
| Designation | Company only net assets | Sub-consolidated net assets |
|---|---|---|
| a) the exposure between Entity A(£) and Entity B (SF) | SF2,000 | SF4,167 (ie SF2,000 being Entity B, plus SF1,667 being the net assets of Entity C, plus SF500 being the net assets of X, Y and Z [total €300/0.6] |
| b) the exposure between Entity A (£) and Entity C (€) | €1,000 | €1,300 (ie €1,000 being Entity C plus net assets of X, Y and Z) |
| (c) the exposure between Entity A (£) and Entity X (NZ$) | NZ$200 | n/a as X is not a parent |
| (d) the exposure between Entity A (£) and Entity Y (¥) | Y18,000 | n/a as Y is not a parent |
| (e) the exposure between Entity A (£) and Entity Z (US$) | US$140 | n/a as Z is not a parent |
| (f) the exposure between Entity B (SF) and Entity C (€) | €1,000 | €1,300 (ie €1,000 being Entity C plus net assets of X, Y and Z) |
| (g) the exposure between Entity B (SF) and Entity X (NZ$) | NZ$200 | n/a as X is not a parent |
| (h) the exposure between Entity B (SF) and Entity Y (¥) | Y18,000 | n/a as Y is not a parent |
| (i) the exposure between Entity B (SF) and Entity Z (US$) | US$140 | n/a as Z is not a parent |
| (j) the exposure between Entity C (€) and Entity X (NZ$) | NZ$200 | n/a as X is not a parent |
| (k) the exposure between Entity C (€) and Entity Y (¥) | Y18,000 | n/a as Y is not a parent |
| (l) the exposure between Entity C (€) and Entity Z (US$) | US$140 | n/a as Z is not a parent |

> We believe either the individual net assets of each foreign operation or the sub-consolidated net assets of a foreign operation may be hedged by a parent and believe the draft interpretation should make this clear. We further believe that the meaning of foreign operation could be clarified in this respect. Additionally, it would be useful to highlight the consequences of designating sub-consolidated net assets of a foreign operation on hedge effectiveness.
>
> In addition, paragraph 14 states that the same risk cannot be hedged twice. We believe this could be misinterpreted to mean that a foreign operation cannot be hedged twice even if two or more parents are hedging different net assets of the same foreign operation. For example, we believe, using our numbers above, that Entity B could hedge the first NZ$100 of net assets of Entity X and Entity C could hedge the next NZ$100 of net assets of Entity X. Paragraph 14 could be read as disallowing this as an exposure to foreign currency risk arising from the net investment in Entity X is being hedged twice (ie the NZ$ of Entity X are being hedged twice). *CL29 Deloitte*

9 In the staff's view, this question is essentially the same as an issue the IFRIC considered in developing the draft Interpretation. At its May 2007 meeting, the IFRIC discussed whether an entity should look through its directly held net investment to consider the full extent of its foreign currency exposure at the lowest possible level of net investment. The IFRIC considered the following example in which Entity A holds a 100 percent investment in Entity B and Entity B holds a 100 per cent investment in Entity C:

- Entity A – functional currency of pound sterling (£) with a carrying amount of £100m, including (where relevant) any net investments it holds;
- Entity B – functional currency of Swiss Francs (CHF) and a carrying amount of £80m, including (where relevant) any net investments it holds; and
- Entity C – functional currency of Euro (€) with a carrying amount of £30m including, (where relevant) any net investments it holds.

This is illustrated in the following diagram:




10 Entity A wants to hedge the risk arising from its net investment in Entity B. What is the amount of the risk to changes in the £ / CHF exchange rate that Entity A is exposed to? Is Entity A's exposure the £80m equivalent of CHF? Or should Entity A look through its investment in Entity B to its investment in Entity C and assess its exposure to be £50m of CHF exposure and £30m of € exposure in Entity C?

11 The IFRIC concluded that Entity A does not have to look through its investment in Entity B to its investment in Entity C and assess its exposure to be £50m of CHF. The IFRIC concluded that an entity can hedge up to the full amount of its carrying amount in a net investment regardless of whether that net investment has investments in other foreign operations as long as it is not hedging the same risk twice in the same consolidated financial statements. The IFRIC reached this conclusion because IAS 39 does not require a risk reduction notion when applying hedge accounting. [5]

12 The main question is whether the amount of net assets of a foreign operation to be hedged can be based on its sub-consolidated net assets or only on its individual net assets (without considering its investments in other foreign operations). Using the commentator's illustration, the question is whether the amount of net assets of Entity C that can be hedged in Entity B's consolidated financial statements is

[5] Refer to paragraphs 25-29 in agenda paper 6 of the May 2007 IFRIC meeting.

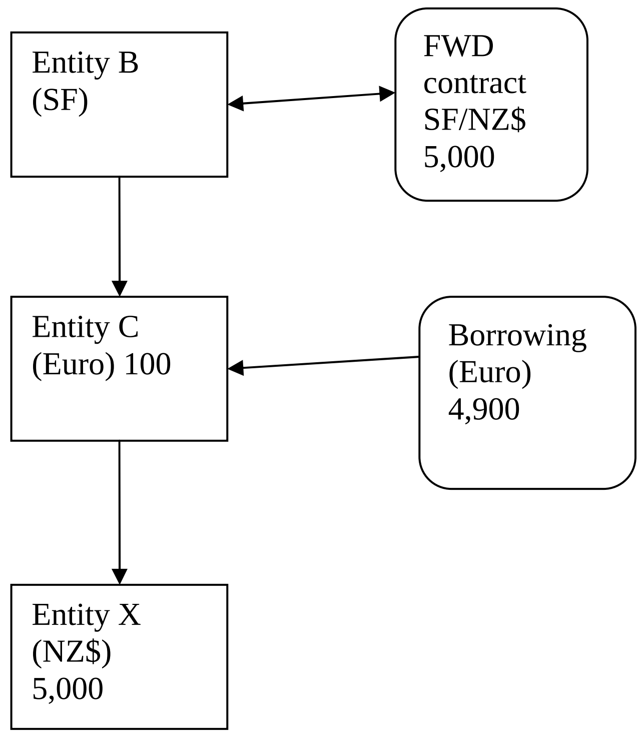
€1,300 (sub-consolidated net assets) or simply €1,000. The staff believe that such hedging amounts would depend on whether C has also hedged the net assets of X, Y, Z. B can hedge the net assets of C based on the sub-consolidated amounts of €1,300 unless C has also hedged the net assets of X, Y, Z of €300 in aggregate. This is because, if C has already hedged X, Y, Z's net assets of €300 in aggregate, the foreign currency exposures between C and X, Y, Z would be hedged twice and this should be prohibited. Therefore, B could hedge €1,000. At A level, only B's net assets of SF2, 000 can be hedged because B has already hedged the net assets of C, X, Y and Z. Therefore, the staff thinks that the amount of net assets to be hedged at each parent level depends on whether any lower parent companies have already hedged the net assets of their subsidiaries. Further, the hedging strategy in the group should be clearly documented.

13 A corollary to this question was raised by another commentator – if a parent has hedged its net investment in a foreign operation directly, does this change the amount of the net investment at an intermediate parent?

> *Identifying the net investment*
>
> Section 9 of the consensus section of the draft Interpretation states that … '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.' We are unsure as to how this principle would apply in determining the amount of the net investment with respect to a hedging relationship between a parent and a second-tier or lower subsidiary. To highlight this issue, consider the following fact pattern. Using the organisation structure identified in paragraph IE1 and IE2 of the draft Interpretation, assume that:
>
> - Entity B (SF) has a 100 Euro equivalent net investment in Entity C (Euro).
> - Entity C (Euro) has a 5,000 Euro equivalent net investment in Entity X (NZ$) and no other assets.
> - Entity C has borrowings of Euro 4,900.

- Entity B holds the hedging instrument, which is a SF/NZ$ forward contract with a notional amount of 5,000 Euro equivalent.

*Note: Numbers are expressed as Euro equivalents for simplicity.*



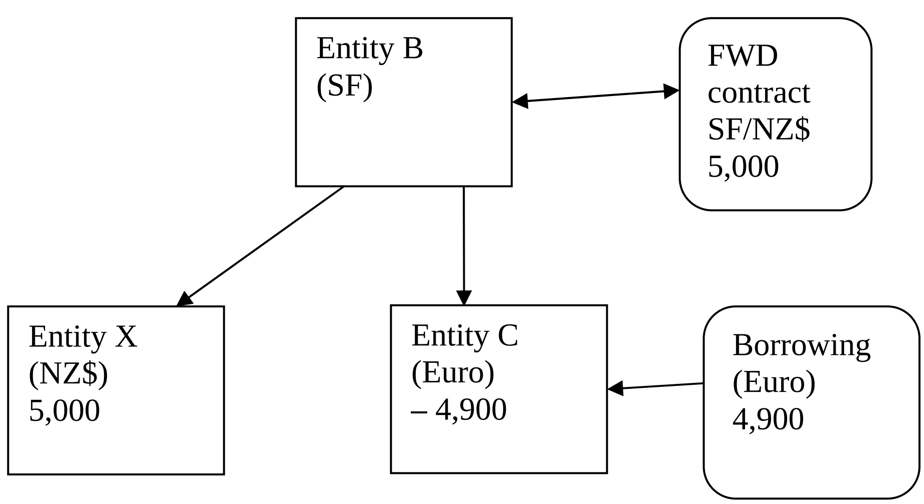

The question is whether Entity B, in its consolidated financial statements, may identify as the hedged item the group's 5,000 EUR equivalent net investment in Entity X, designating changes in the SF/NZ$ exchange rate as its hedged risk. Under one approach (Approach 1), the group structure is unimportant and thus the group can be seen to consist only of a series of parent entities and a number of groups of net assets denominated in different functional currencies. Based on Approach 1, the group's 5,000 EUR equivalent exposure to the NZ$ functional currency of Entity X may be measured directly by reference to Entity B's functional currency i.e. SF. We note that this approach seems to be the one taken within the implementation guidance of the Interpretation.

In our view, this approach raises a question with respect to identifying the amount of the group's net investment in Entity C, assuming that the group also wishes to hedge Entity B's net investment in Entity C. Is the group's Euro/SF exposure with respect to Entity C based on a net investment amount 100 EUR equivalent or is it negative because Entity C has net liabilities, excluding its net investment in X?

We note that there is an alternative approach (Approach 2), under which the group structure is considered to be more significant. Under that approach, the group's SF exposure to Entity C is limited to the net investment amount 100EUR equivalent, being Entity B's net investment in Entity C. The NZ$ net investment in Entity X may be hedged only for the NZ$/Euro risk arising from Entity C's net investment in Entity X i.e. 5,000 Euro equivalent.

Whilst we do not object to the principle on identifying a net investment, we do not believe that the implementation examples and guidance reflect the possible alternative (Approach 2 above) that can be deduced from the principle. Therefore, we would encourage the IFRIC to clarify the implementation guidance. *CL24 KPMG*

14 Consistent with its conclusion above, the staff believes that Entity B could adopt either Approach 1 or Approach 2 because the IFRIC has concluded that the group structure is not important to which entity can hedge a net investment and where the hedging instrument can be held. However, if Entity B adopts Approach 1, it needs to reconfigure the group structure notionally to match the hedging strategy. Consequently, its net investment in Entity C will be negative because it has hedged Entity C's net investment in Entity X directly. The notional chart would be:



15 The staff recommends that the IFRIC confirm the conclusions in the draft Interpretation. However, to clarify the application of those conclusions, the staff proposes changing the wording of paragraphs 9 and 14 as follows:

> **Paragraph 9** "In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity**. The carrying amount of net assets of a foreign operation that may be hedged in the consolidated financial statements of any parent depends on whether any lower parent of the foreign operation has hedged net assets of that foreign operation.** 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 hedging strategy in the group should be clearly documented to qualify for hedge accounting.**

> **Paragraph 14** "An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once. Therefore, if the same ~~**risk is**~~ **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) only one hedge relationship will qualify for hedge accounting in the consolidated financial statements."

In addition, the staff recommends changing or adding to the illustrative examples to demonstrate the application of these conclusions as discussed above.

**16 Do you agree with the staff recommendation in paragraph 15? If not, why and what alternative do you propose?**

***Issue 3 – Where can the hedging instrument be held?***

17 At its May 2007 meeting, the IFRIC discussed whether the functional currency of the entity holding the hedging instrument is relevant to the effectiveness of the

hedging instrument. The example the IFRIC considered is included in Appendix C, and is referred to in the following paragraphs.

18 In Scenario 2 of the example, the amount recorded in profit or loss (£46,440), when combined with the amounts in foreign currency translation reserve relating to that derivative (£5,160 and £20,657), gives rise to the same amount that would be recorded in profit or loss had the derivative instrument been held by Entity A (£72,257). The IFRIC also considered similar examples in which the hedging instrument was a non-derivative (such as borrowings). For both cases, the IFRIC discussed whether only the amount recorded in profit or loss should be considered when determining the effectiveness of the hedging instrument or if the foreign currency translation reserve relating to the hedging instrument also should be considered.

19 IFRIC concluded that the foreign currency translation reserve relating to the hedging instrument should be considered when determining its effectiveness. That is, the functional currency of the entity holding the hedging instrument is not relevant in assessing its effectiveness. In other words, the hedging instrument can be held anywhere within the group. The IFRIC noted the Implementation Guidance in IAS39 Question F.2.14[6], on the location of the hedging instrument, and concluded that that guidance could be applied by analogy to a net investment hedge. The analogy to this implementation guidance is the only rationale for the conclusion discussed in the Basis for Conclusions of the draft Interpretation.

20 Some commentators disagreed with the consensus in the draft Interpretation. They think that the foreign currency translation reserve relating to the hedging instrument should not be considered when determining the effectiveness of a hedging instrument because considering the translation reserve in the hedge effectiveness test is mixture of translation gain/loss and transaction gain/loss (which contradicts with IAS21). They believe that Scenario 2 means that the

[6] F.2.14 Intragroup and intra-entity hedging transactions state that " IAS39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument"

hedge is ineffective because effectiveness determined considering only the change in profit or loss shows only 64%. Therefore, in their view the functional currency of the entity holding the hedging instrument is relevant to its effectiveness. They also disagree with using the Implementation Guidance in IAS39 Question F.2.14 as a basis of the consensus because IAS39 is inappropriately extended.

**21** The staff agrees with the commentators that the Implementation Guidance in IAS39 Question F.2.14 deals with only the hedge of the foreign currency exchange arising from a forecast purchase transaction. Consequently, it does not refer to the foreign currency translation reserve.

**22** The staff believes that the conclusion in the draft Interpretation is appropriate and should be reaffirmed. However, that conclusion should be supported by a more compelling rationale than the application of IAS 39 Implementation by analogy. This rationale rests on the purpose of a hedge of a net investment. Those who disagree with the draft Interpretation emphasise the profit or loss effect of the hedge. Those who support it emphasise the change in value of the investment no matter where the standards require the change to be recognised.

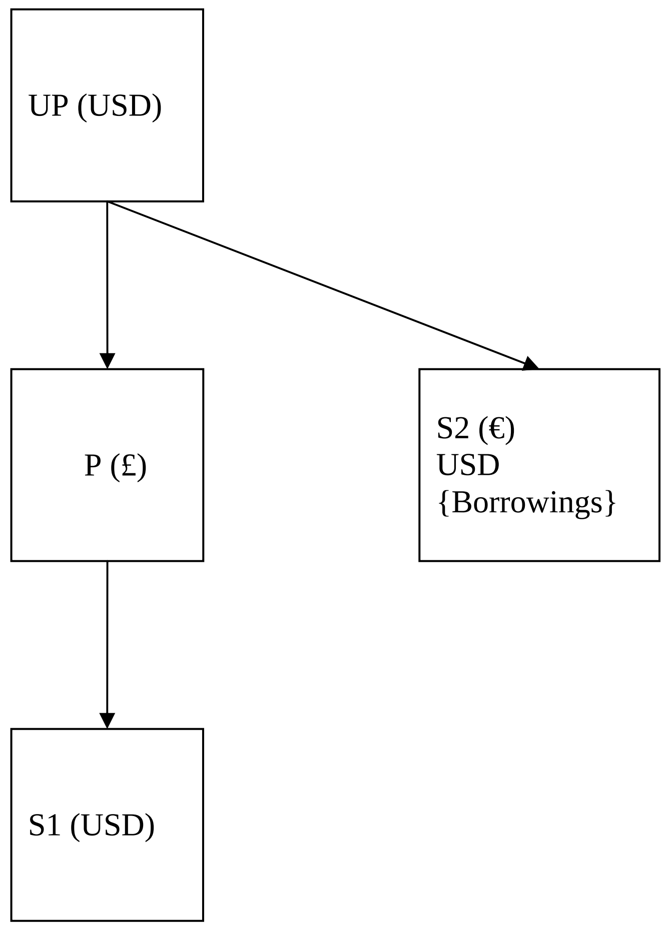
**23** IAS 21 requires the total change in value of the net investment as a result of changes in foreign currency rates to be recognised in comprehensive income in the period of the change. It also requires that total change to be recognised partially in profit or loss and partially in the foreign currency translation reserve/other comprehensive income. Because the objective of a net investment hedge is to hedge the change in value of the entire investment, the staff believes that related amounts recognised in both components of comprehensive income should be considered in assessing the effectiveness of a hedging instrument.

**24** The staff also notes that IAS 21 requires the amount recognised in the foreign currency translation reserve to be reclassified to profit or loss when it disposes of the investment in the foreign operation. Consequently the amount included in the FCTR will be included in profit or loss in a future period.

**25** Another consideration the IFRIC took into account in reaching its consensus was convergence with US GAAP. This was not discussed in the Basis for Conclusions but it was raised by a number of commentators and is relevant to the conclusion on this issue. Unlike the draft Interpretation, US GAAP does not permit hedging a net investment by an entity whose functional currency is not the same as the immediate parent. However, US GAAP permits internal contracts to qualify as hedging instruments in hedges of net investments, unlike IAS 39. In its previous discussion, the IFRIC concluded that including both components of comprehensive income in the evaluation of hedge effectiveness resulted in substantial convergence with the application of US GAAP.

**26** **Do you agree with the staff recommendation in paragraph 22? If not, why and what alternative do you propose?**

27 Some commentators believe that the IFRIC's proposals result in imputing foreign exchange risks that do not exist within a hedging instrument, and do not support the proposal for this reason.

> We do not support imputing foreign exchange risks that do not exist within a hedging instrument. … Consider the group illustrated below where brackets indicate each entity's functional currency:
>
> 
> 
>
> Assume that in UP's consolidated accounts, entity P hedges its net investment in entity S1 using the USD borrowing in S2. Entity P has £/USD exposure relating to its net investment. However, entity S2 has €/USD exposure relating to its debt. The consolidation of S2 into the UP group does not create £/USD exposure. In order for entity P to apply hedge accounting, it would need to impute a notional £/USD risk within the debt (i.e. by imputing €/£ and £/USD exposures). Thus, UP's

consolidated books would recognize a €/£ risk that does not exist within the entity.

On the other hand, if entity S2 held a derivative instrument that contained £/USD risks such as a £/USD forward contract, the £/USD risk would exist within the hedging instrument and would not need to be imputed. *CL22 PricewaterhouseCoopers*

**28** The commentator argues that the draft Interpretation is too permissive if the hedging instrument is a non-derivative because it allows imputing foreign exchange risks that do not exist within the hedging instrument. The staff believes that the commentator has misinterpreted the IFRIC's conclusions. In the example cited, the staff does not believe that entity P can designate S2's USD borrowings as a hedge of its net investment in S1. The draft Interpretation indicates that the hedging instrument can be held anywhere within the group. S2's USD borrowings are not within P's group; they are only within the UP group. Consequently, they could only qualify as a hedging instrument at the UP level.

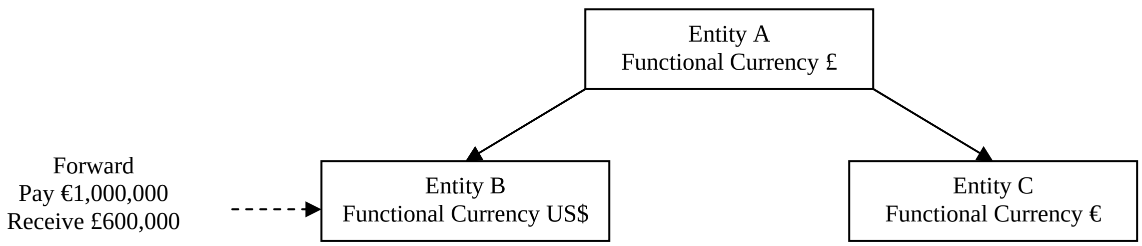
**29** The staff does not recommend that the IFRIC change its conclusion. However, this point should be clarified. The staff will consider whether the clarification should be included in the Interpretation, in an illustrative example or both.

**30 Do you agree with the staff recommendation in paragraph 29? If not, why and what alternative do you propose?**

# APPENDIX C – Example of hedge effectiveness

**Example of a Hedge of a Net Investment Using a Forward Contract**

Entity A has a functional currency of Pound Sterling (£) and holds two investments – Entity B (functional currency of United States Dollars (US$)) and Entity C (functional currency of Euro (€)). At 31 December 20X1 Entity A is hedging its net investment in Entity C (the £ / € exposure) using a forward contract held by Entity B. The forward contract is pay €1,000,000 receive £600,000 and it matures on 1 January 20X3.




The detailed calculations of the value of the forward follow.

Spot exchange rates are as follows:

| | 31/12/X1 | 31/12/X2 | Average X2 |
|---|---|---|---|
| £ / € | 2.000 | 2.300 | 2.150 |
| £ / US$ | 2.200 | 1.800 | 2.000 |
| US$ / € | 0.909 | 1.278 | 1.093 |

At 31/12/X1 one year interest rates are as follows:

| | |
|---|---|
| £ | 5.00% |
| US$ | 5.50% |
| € | 4.50% |

The fair value of the forward contract is as follows:

| | 31/12/X1 | *Calculations* | 31/12/X2 | *Calculations* |
|---|---|---|---|---|
| £ | 92,960 | *(600,000 / (1 + 0.05)) – (((1000,000 / (1 + 0.045)) / 2.000)* | 165,217 | *600,000 – (1,000,000 / 2.300)* |
| US$ | 204,511 | *((600,000 / (1 + 0.05)) * 2.20) – ((1000,000 / (1 + 0.045)) / 0.909)* | 297,391 | *(600,000 * 1.800) – (1,000,000 / 1.278)* |
| € | 185,919 | *((600,000 / (1 + 0.05)) * 2.000) – (1000,000 / (1 + 0.045)* | 380,000 | *(600,000 * 2.300) – 1,000,000* |

**Scenario 1 - Forward contract is held by Entity A**

The forward contract is held by Entity A. Entity A's opening consolidated balance sheet shows:

| | £ |
|---|---|
| Forward contract | 92,960 |

Entity A's closing consolidated balance sheet shows:

| | £ | |
|---|---|---|
| Forward contract | 165,217 | *(92,960 + 72,257)* |

The journal entries in Entity A's own and consolidated accounts for y/e 31/12/X2 are as follows:

| | £ | £ | *Calculations* |
|---|---|---|---|
| Dr Forward contract | 72,257 | | *(165,217 – 92,960)* |
| Cr Profit and Loss | | 72,257 | |

*-being the profit arising from remeasuring the forward contract in GBP*

**Scenario 2 – Forward contract is held by Entity B**

The forward contract is held by Entity B. Entity B’s opening balance sheet shows:

| | US$ | *Calculations* |
|---|---|---|
| Forward contract | 204,511 | *(92,960 * 2.200)* |

Entity B’s closing balance sheet shows:

| | US$ | *Calculations* |
|---|---|---|
| Forward contract | 279,391 | *(165,217 * 1.800)* |

The journal entries in Entity B's own accounts for y/e 31/12/X2 are as follows:

| | US$ | US$ | *Calculations* |
|---|---|---|---|
| Dr Forward contract | 92,880 | | *(297,391 - 204,511)* |
| Cr Profit and Loss | | 92,880 | |

*-being the profit arising from remeasuring the forward contract in US$*

Entity A's closing consolidated balance sheet shows:

| | £ | £ | *Calculations* |
|---|---|---|---|
| Forward contract | £165,217 | | *(297,391 / 1.800)* |

Translation journal entries in Entity A's consolidated accounts to translate Entity B's financial statements:

| | | | |
|---|---|---|---|
| Dr Forward | 46,440 | | *(92,880 / 2.000)* |
| Cr Profit and Loss | | 46,440 | |

*-being the translation of B's USD profits into GBP at the average rate*

| | | | |
|---|---|---|---|
| Dr Forward | 5,160 | | *(92,880 / 1.800) – (92,880 / 2.000)* |
| Cr Equity | | 5,160 | |

*-being the retranslation of Entity B's USD profits into GBP at the closing rate*

| | | | |
|---|---|---|---|
| Dr Forward | 20,657 | | *(204,511 / 1.80) – (204,511 / 2.200)* |
| Cr Equity | | 20,657 | |

*-being the retranslation of Entity B's opening USD balance sheet into GBP at the closing rate*

## Hedge Effectiveness

Assuming €1,000,000 of Entity C's net assets are subject to the hedge, the whole of the forward contract is used as the hedging instrument and effectiveness is assessed by comparing the changes in the value of the forward contract to changes in the value of €1,000,000 attributable to forward exchange rates.

| | 31/12/X1 | *Calculations* | 31/12/X2 | *Calculations* |
|---|---|---|---|---|
| Forward £ / € rates to 1/1/X3 | 1.972 | *1,000,000 / (600,000 – 92,960)* | 2.30 | *1,000,000 / (600,000 – 165,217)* |
| £ value of €1,000,000 at forward rate | £507,040 | *(1,000,000 / 1.972)* | £434,783 | *(1,000,000 / 2.30)* |
| Change in value of net investment | | | (£72,258) | *(434,783 – 507,040)* |
| Profit or loss – Scenario 1 | | | £72,258 | 100% effective |
| Profit or loss – Scenario 2 | | | £46,440 | 64% effective |