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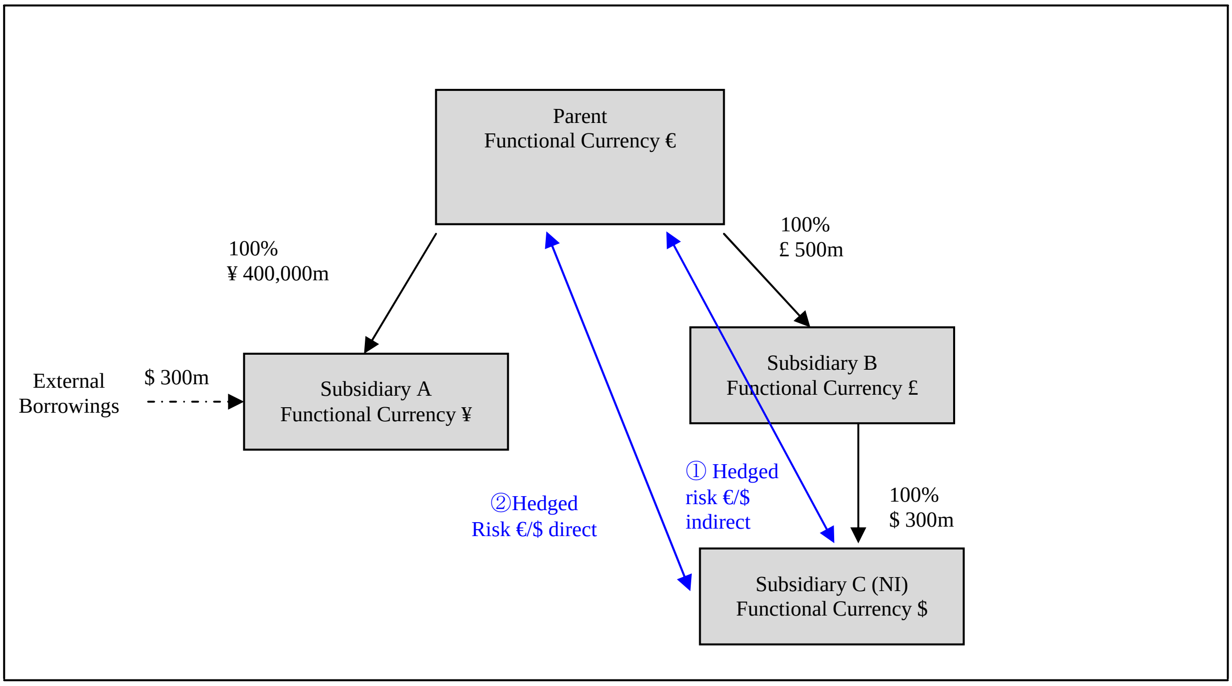
International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2008, London**

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

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. Subsidiary A has an external borrowing of $300m on 1 January 2005. The net assets of Subsidiary A on 1 January 2005 are ¥400,000m including the proceeds of the external borrowing of $300m. 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 $300m external borrowing in Subsidiary A as a hedge of the spot foreign exchange risk associated <u>with the net investment in the first $300m net assets of Subsidiary C</u> in its consolidated financial statements. Alternatively, the Parent could have designated the $300m external borrowing in Subsidiary A as a hedge of the £/$ spot foreign exchange risk between Subsidiary C and Subsidiary B in Parent's consolidated financial statements. This alternative designation is not illustrated in the related spreadsheet.



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 No. 1-1 Debt 100% effective**	**N/A** $ debt held by Subsidiary A cannot be used as hedging instrument because it is held outside of 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	**Spreadsheet No. 1-2 Debt 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 DEBT (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		435400	2952	300	159	341		500	755		3707
	3467	435400	2952	300	159	500		500	755		3707
Opening	-3467	-400000	-2712	-300	-159	-500	159	-500	-755	3467	-3467
FCTR											
Income											
Closing											
	-3467	-400000	-2712	-300	-159	-500		-500	-755		-3467
Debt	0	-35400	-240	0	0	0	0	0	0	0	-240
Check	0	0	0	0	0	0		0	0		0

	Year 1	average
USD	1	1
JPY	125	121.5
EUR	0.88	0.84
GBP	0.58	0.555

A accounts		JPY
USD 300m borrowings	Year 0	35400
USD 300m borrowings	Year 1	37500
P/L from translation of Debt		2100

	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*4		435400	3065	300	174	341		515	781			3847
	3467	435400	3065	300	174	500		515	781			3847
Opening	-3467	-400000	-2712	-300	-159	-500	159	-500	-755	3467		-3467
FCTR (Entity A) from assets*3			-113									-113
FCTR (Entity A) from debt*3			9									9
FCTR (Entity B)*5									-4			-4
FCTR (EntityC)*6					**-15**			**-15**	**-23**			**-23**
Income (Debt)		2100	15									15
Closing												
Equity	-3467	-397900	-2801	-300	-174	-500		-515	-781			-3583
Debt	0	-37500	-264	0	0	0	0	0	0	0	0	-264
Check	0	0	0	0	0	0		0	0			0

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

Hedged risk	USD/EUR exposure from C	
Hedged item (in amounts)	USD 300	
Change in year 1 *2	-23	Euro
Hedging instrument	USD borrowings	
Change in P/L from debt	15	Euro
Change in FCTR*1	9	Euro
	24	
Hedge effectiveness	**100%**	Considered rounding effect

*1 Hedging instrument (FCTR)	
retranslation of income from debt at closing rate	0
(=JPY2100/125*0.88-Euro15)	
retranslation of opening balance of debt at closing rate	9
(=EUR-240-(JPY-35400/125*0.88))	9

*2 Change in year 1
Translation of Entity C's GBP FCTR into Euro at closing rate
(=GBP-15/0.58*0.88)

*3 Formula
FCTR (Entity A)from assets EUR2952-JPY435400/125*0.88=EUR-113
FCTR (Entity A)from debt (EUR-240-(JPY-35400/125*0.88))+(JPY2100/125*0.88-Euro15)=EUR9

*4 Assumption: Entity A deposited US$ cash into JPY cash account on 1 Jan. 2005

*5 EUR755-GBP515/0.58*0.88- (EUR-23)=EUR-4

*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 borrowings)

(A's separate F/S)

Dr) Profit and loss (debt)	JPY 2100	Cr) Debt	JPY 2100

being the profit/loss arising from the Debt

(P's consolidated F/S - before hedging)

Dr) Profit and loss (debt)	EUR 15	Cr) Debt	EUR 15
being tranlation of Entity A's JPY profit/loss into EUR at the average rate			
Dr) Equity (FCTR-Entity A)	EUR 0	Cr Debt	EUR 0
being retranslation of Entity A's JPY profit/loss into EUR at the closing rate			
Dr) Equity (FCTR-Entity A)	EUR 9	Cr)Debt	EUR 9
being translation of Entity A's opening balance of debt into EUR at the closing rate			
Dr) Other assets	EUR 113	Cr) Equity (FCTR-Entity A)	EUR 113
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 15	Cr) Profit and loss (debt)	EUR 15
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR- Entity C)	EUR 9	Cr) Equity (FCTR-Entity A)	EUR 9
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	1

<After hedge entry>

	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	3847		3847
	3847		3847
Opening	-3467		-3467
FCTR (Entity A)from assets*3	-113		-113
FCTR (Entity A)from debt*3	9	-9	0
FCTR (Entity B)	-4		-4
FCTR (EntityC)	**-23**	**24**	**1**
Income (Debt)	15	-15	0
Closing			
Equity	-3583	0	-3583
Debt	-264		-264
Check	0		0

SITUATION 1-2 DEBT (direct 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(EUR)	B(GBP)	B(EUR)	consol adj pre-acq	PABC(EUR)	**1-1(step)** PABC(EUR)	diff.
Investment in A	2712							-2712	0	0	0
Investment in B	755							-755	0	0	0
Investment in C						159	240	-240	0	0	0
Other assets		435400	2952	300	240	341	515		3707	3707	0
	3467	435400	2952	300	240	500	755		3707	3707	0
Opening	-3467	-400000	-2712	-300	-240	-500	-755	3707	-3467	-3467	0
FCTR											
Income											
Closing											
	-3467	-400000	-2712	-300	-240	-500	-755		-3467	-3467	0
Debt	0	-35400	-240	0	0	0	0	0	-240	-240	0
Check	0	0	0	0	0	0	0		0	0	

	Year 1	average
USD	1	1
JPY	125	121.5
EUR	0.88	0.84
GBP	0.58	0.555

	P (EUR)	A(JPY)	A(EUR)	C(USD)	C(EUR)	B(GBP)	B(EUR)	consol adj pre-acq	PABC(EUR)	**1-1(step)** PABC(EUR)	
Investment in A	2712							-2712	0	0	0
Investment in B	755							-755	0	0	0
Investment in C						159	240	-240	0	0	0
Other assets*4		435400	3065	300	264	341	517		3847	3847	0
	3467	435400	3065	300	264	500	757		3847	3847	0
Opening	-3467	-400000	-2712	-300	-240	-500	-755	3707	-3467	-3467	0
FCTR (Entity A) from assets*3			-113						-113	-113	0
FCTR (Entity A) from debt*3			9						9	9	0
FCTR (Entity B)*5							-3		-3	-4	-1
FCTR (EntityC)*6					**-24**				**-24**	**-23**	1
Income (debt)		2100	15						15	15	0
Closing											
Equity	-3467	-397900	-2801	-300	-264	-500	-757		-3583	-3583	0
Debt	0	-37500	-264	0	0	0	0	0	-264	-264	0
										0	
Check	0	0	0	0	0	0	0	0	0	0	0

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

Hedged risk	USD/EUR exposure from C	
Hedged item (in amounts)	USD 300	
Change in year 1	-24	Euro
Hedging instrument	USD borrowings	
Change in P/L	15	Euro
Change in FCTR*1	9	Euro
	24	
Hedge effectiveness	**100%**	

*1 Change in FCTR	
retranslation of income (debt) at closing rate	0
(=JPY2100/125*0.88 - Euro15)	
retranslation of opening balance of debt at closing rate	9
(=EUR240-JPY35400/125*0.88)	9

*3 Formula	
FCTR (Entity A) from assets	EUR2952-JPY435400/125*0.88=EUR-113
FCTR (Entity A) from debt	(EUR-240-(JPY-35400/125*0.88))+(JPY2100/125*0.88-Euro15)=EUR9

*4 Assumption: Entity A deposited US$ cash into JPY cash account on 1 Jan. 2005

*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 borrowings)

(A's separate F/S)

Dr) Profit and loss (debt)	JPY 2100	Cr) Debt	JPY 2100

being the profit/loss arising from the Debt

(P's consolidated F/S)

Dr) Profit and loss (debt)	EUR 15	Cr) Debt	EUR 15
being translation of Entity A's JPY profit/loss into EUR at the average rate			
Dr) Equity (FCTR-Entity A)	EUR 0	Cr)Debt	EUR 0
being retranslation of Entity A's JPY profit/loss into EUR at the closing rate			
Dr) Equity (FCTR-Entity A)	EUR 9	Cr)Debt	EUR 9
being translation of Entity A's opening balance of debt into EUR at the closing rate			
Dr) Other assets	EUR 113	Cr) Equity (FCTR-Entity A)	EUR 113
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 15	Cr) Profit and loss (debt)	EUR 15
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR- Entity C)	EUR 10	Cr) Equity (FCTR-Entity A)	EUR 10
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	0

<After hedge entry>

	Before hedge PABC(EUR)	hedge entry	After hedge PABC(EUR)
Investment in A	0		0
Investment in B	0		0
Investment in C	0		0
Other assets*4	3847		3847
	3847		3847
Opening	-3467		-3467
FCTR (Entity A)from assets*	-113		-113
FCTR (Entity A)from debt*3	9	-10	0
FCTR (Entity B)	-3		-3
FCTR (EntityC)	**-24**	**24**	**0**
Income (debt)	15	-15	0
Closing	0		0
Equity	-3583	0	-3583
Debt	-264		-264
Check	0		0