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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2008, London**
Project: **Situation 3B: Hedging instruments held by Parent — Debt (Agenda Paper 2H)**

On 1 January 2005, Parent entity, which presents consolidated financial statements in €, holds 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 B has a functional currency of Pound Sterling (£) and Subsidiary C has a functional currency of $. Parent entity wishes to hedge its foreign exchange exposures from its investment in Subsidiary C and Subsidiary B. Parent borrows $300m and £500m externally on 1 January 2005 and deposits the proceeds into a € account. 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's assets are the investment in Subsidiary B and the cash raised from the external borrowings that has been deposited in €. The Parent designates the $300m external borrowing as a hedge of the spot foreign exchange risk associated with the net investment in the first $300m net assets of Subsidiary C in its consolidated financial statements. The Parent also designates £341 of the £500m external borrowing as a hedge of the first £341 of its net investment in the net assets of Subsidiary B in its consolidated financial statements. Although €/$ risk from a net investment in Subsidiary C between Parent and Subsidiary C is different risk from €/£ risk from a net investment in Subsidiary B between Parent and Subsidiary B, hedging the remaining £159m of net assets in Subsidiary B, which represent the net investment in Subsidiary C, would amount to hedging the same net assets, those of Subsidiary C, twice for the same risk, ie retranslation from £ into €. It would result in an overhedge of a net investment in Subsidiary B in Parent's consolidated financial statements.

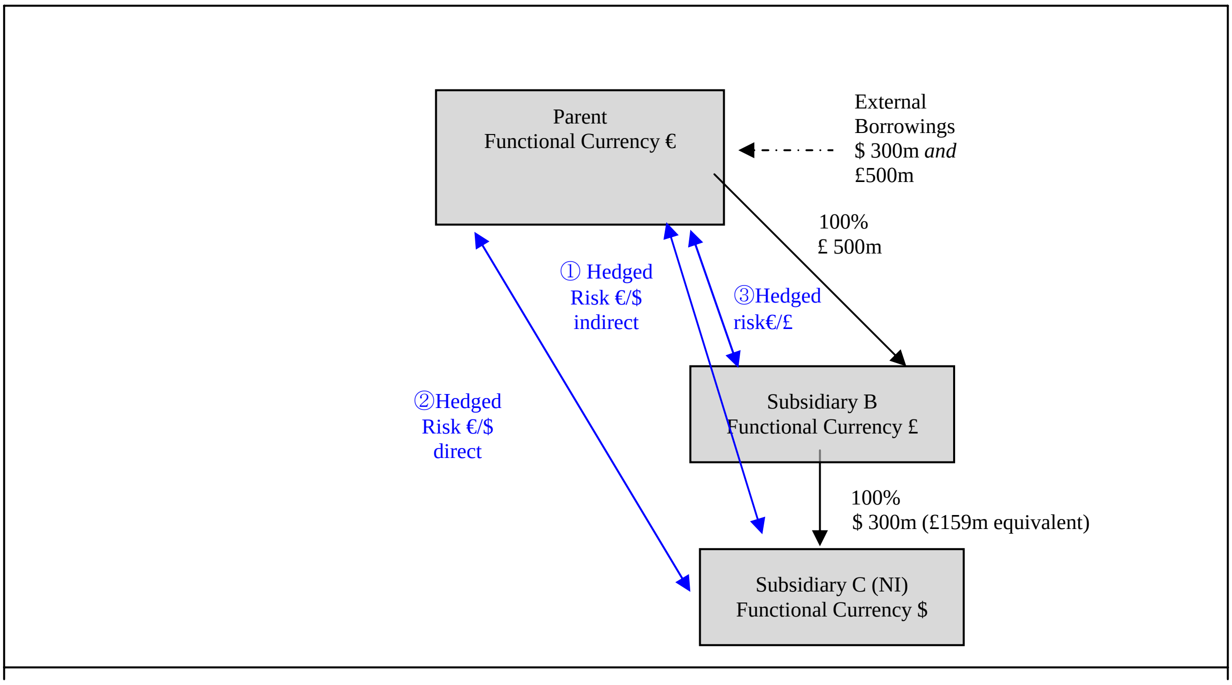
As the external borrowings are not within the consolidated financial statements of Subsidiary B the question of designation at that level is not applicable.

The Parent could also have made one of the following designations. These alternative designations are not illustrated in the related spreadsheets:

- External $300m borrowing designated as a hedge of the first $300m of net assets in Subsidiary C with the risk being the spot foreign exchange exposure (€/$) between Parent and Subsidiary C; *and no other designation (*as illustrated in Situation 3A*)*

- External $300m borrowing designated as a hedge of the first $300m of net assets in Subsidiary C with the risk being the spot foreign exchange exposure (£/$) between Subsidiary B and Subsidiary C; *and* the whole of the external £500m borrowing designated as a hedge of the first £500m of net assets in Subsidiary B with the risk being the spot foreign exchange exposure (€/£) between Parent and Subsidiary B (in this case the net assets of Subsidiary C would <u>not be designated twice for the same risk</u> as they are designated twice but for two different but consistent risks, ie £/$ risk between Subsidiary B and Subsidiary C and €/£ risk between Parent and Subsidiary C)

- the whole of the external £500m borrowing designated as a hedge of the first £500m of net assets in Subsidiary B with the risk being the spot foreign exchange exposure (€/£) between Parent and Subsidiary B; *and no other designation*



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
①Euro/$ exposure from a net investment in Subsidiary C between Parent and Subsidiary C	**Spreadsheet No. 3B-1** **Debt** **100% effective**	**N/A**
③Euro/£ exposure from a net investment in B between parent and Subsidiary B	**Spreadsheet No. 3B-1** **Debt** **100% effective**	

Direct method of consolidation

Hedged risk	In which financial statements?	
	In Parent's consolidated F/S	In Sub B's consolidated F/S
①Euro/$ exposure from a net investment in Subsidiary C between Parent and Subsidiary C	**Spreadsheet No. 3B-2** **Debt** **100% effective**	**N/A**
③Euro/£ exposure from a net investment in B between parent and Subsidiary B	**Spreadsheet No. 3B-2** **Debt** **100% effective**	

SITUATION 3B - 1 DEBT (step-by-step method): designate $/Euro exposure from Entity C and £/Euro exposure from Entity B as hedged risks

	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 pre-acq	PABC(EUR)
Investment in A											0
Investment in B	755									-755	0
Investment in C						159	-159				0
Other assets*1	995			300	159	341		500	755		1749
	1749	0	0	300	159	500		500	755		1749
Opening	-755			-300	-159	-500	159	-500	-755	755	-755
FCTR											
Income											
Closing											
Equity	-755	0	0	-300	-159	-500		-500	-755		-755
Debt (USD 300m)	-240										
Debt (GBP 341m)	-515										
Debt (GBP 159m)	-240										
Debt	-995			0	0	0		0	0	0	-995
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 accounts		EUR
USD 300m borrowings	Year 0	240
USD 300m borrowings	Year 1	264
P/L		24

		£341mDebt	£159mDebt
P accounts		EUR	EUR
GBP 500m borrowings	Year 0	515	240
GBP 500m borrowings	Year 1	517	241
P/L		3	1

	P (EUR)	A(JPY)	A(EUR)	C(USD)	C(GBP)	B(GBP)	consol adj	hedge	BC(GBP)	BC(EUR)	consol adj pre-acq	PABC(EUR)
Investment in A											0	0
Investment in B	755										-755	0
Investment in C						159	-159					0
Other assets	995			300	174	341			515	781		1776
	1749	0	0	300	174	500			515	781		1776
Opening	-755			-300	-159	-500	159		-500	-755	755	-755
FCTR (Entity B)*2										**-4**		**-4**
FCTR (Entity C)*3					**-15**				**-15**	**-23**		**-23**
Income (USD borrowing)	24											24
Income (£341 borrowing)	3											3
Income (£159 borrowing)	1											1
Closing												
	-727	0	0	-300	-174	-500			-515	-781		-754
Debt (USD 300m)	-264											
Debt (GBP 341m)	-517											
Debt (GBP 159m)	-241											
Debt	-1023			0	0	0	0		0	0	0	-1023
Check	0	0	0	0	0	0			0	0		0

SITUATION 3B - 1 DEBT (step-by-step method): designate $/Euro exposure from Entity C and £/Euro exposure from Entity B as hedged risks

Hedged risk	USD/EUR exposure from C	EUR/£ exposure from B
Hedged item (in amounts)	USD 300m	GBP341m
Change in year 1	-23 Euro	-4 EUR
Hedging instrument	USD300m borrowings	GBP341m borrowings
Change in P/L	24 EUR	3 EUR
Hedge effectiveness	**100%** Considered rounding effect	**100%** Considered rounding effect

*1Assumption:Parent deposited both US$ cash and GBP cash into Euro account on 1 Jan.2005

*2 EUR-4=-(GBP515/0.58*0.88-EUR755-EUR23)

*3 GBP-15=GBP159-$300*0.58
EUR-23=GBP-15/0.58*0.88

The following entries would be recorded for hedging instruments

(P's separate F/S)

Dr) Profit and loss	EUR 24	Cr) Debt	EUR 24
being profit/loss arising from US$ Debt			
Dr) Profit and loss	EUR 3	Cr) Debt	EUR 3
being profit/loss arising from GBP341m Debt			
Dr) Equity (FCTR-Entity C)	EUR 24	Cr) Profit and loss	EUR 24
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR-Entity B)	EUR 3	Cr) Profit and loss	EUR 3
being the hedge accounting entry for the net investment in Entity B			

The following entries would be recorded for hedged item

(P's consolidated F/S)

Dr)Other assets	EUR 23	Cr)FCTR(EntityC)	EUR 23
retranslation of exchange difference arising from Entity C			
Dr)Other assets	EUR 4	Cr)FCTR(EntityB)	EUR 4
retranslation of exchange difference arising from Entity B			

Check:	Equity (FCTR)	EUR	0

<After hedge entry>	Before hedge PABC(EUR)	hedge	After hedge ABC(EUR)
Investment in A	0		0
Investment in B	0		0
Investment in C	0		0
Other assets	1776		1776
	1776		1776
Opening	-755		-755
FCTR (Entity B)*2	-4	**3**	-1
FCTR (Entity C)*3	-23	**24**	1
Income (USD borrowir	24	-24	0
Income (£341 borrowir	3	-3	0
Income (£159 borrowir	1		1
Closing			
	-754		-754
Debt (USD 300m)	0		0
Debt (GBP 341m)	0		0
Debt (GBP 159m)	0		0
Debt	-1023		-1023
Check	0		0

SITUATION 3B - 2 DEBT (direct method): designate $/Euro exposure from Entity C and £/Euro exposure from Entity B as hedged risks

	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)
Investment in A									
Investment in B	755							-755	0
Investment in C						159	240	-240	0
Other assets*1	995			300	240	341	515		1749
	1749	0	0	300	240	500	755		1749
Opening	-755			-300	-240	-500	-755	995	-755
FCTR									
Income									
Closing									
	-755	0	0	-300	-240	-500	-755		-755
Debt (USD 300m)	-240								
Debt (GBP 341m)	-515								
Debt (GBP 159m)	-240								
Debt	-995			0	0	0	0	0	-995
Check	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 accounts		EUR
USD 300m borrowings	Year 0	240
USD 300m borrowings	Year 1	264
P/L		24

		£341mDebt	£159mDebt
P accounts		EUR	EUR
GBP 500m borrowings	Year 0	515	240
GBP 500m borrowings	Year 1	517	241
P/L		3	1

	P (EUR)	A(JPY)	A(EUR)	C(USD)	C(EUR)	B(GBP)	B(EUR)	consol adj pre-acq	hedge	PABC(EUR)	3B-1(Step) PABC(EUR)	
Investment in A										0	0	0
Investment in B	755							-755		0	0	0
Investment in C						159	240	-240		0	0	0
Other assets	995			300	264	341	517			1776	1776	0
	1749	0	0	300	264	500	757			1776	1776	0
Opening	-755			-300	-240	-500	-755	995		-755	-755	0
FCTR (Entity B)*2							**-3**		**3**	**0**	-1	**1**
FCTR(Entity C)*3					**-24**				**24**	**0**	1	**-1**
Income (USD borrowing)	24								-24	0	0	0
Income (£341 borrowing)	3								-3	0	0	0
Income (£159 borrowing)	1									1	1	
Closing												0
Equity	-727	0	0	-300	-264	-500	-757			-754	-754	0
Debt (USD 300m)	-264									-264	0	
Debt (GBP 341m)	-517									-517	0	
Debt (GBP 159m)	-241									-241	0	
Debt	-1023			0	0	0	0			-1023	-1023	0
Check	0	0	0	0	0	0	0	0	0	0	0	0

SITUATION 3B - 2 DEBT (direct method): designate $/Euro exposure from Entity C and £/Euro exposure from Entity B as hedged risks

Hedged risk	USD/EUR exposure from C	EUR/£ exposure from B
Hedged item (in amounts)	USD 300m	GBP341m
Change in year 1	-24 Euro	-3 EUR
Hedging instrument	USD300m borrowings	GBP341m borrowings
Change in P/L	24 EUR	3 EUR
Hedge effectiveness	**100%**	**100%**

*1Assumption:Parent deposited both US$ cash and GBP cash into Euro account on 1 Jan.2005

*2 EUR-3=EUR515-EUR517

*3 EUR-24=EUR240-EUR300*0.88

The following entries would be recorded for hedging instruments

(P's separate F/S)

Dr) Profit and loss	EUR 24	Cr) Debt	EUR 24
being profit/loss arising from US$ Debt			
Dr) Profit and loss	EUR 3	Cr) Debt	EUR 3
being profit/loss arising from GBP341m Debt			
Dr) Equity (FCTR-Entity C)	EUR 24	Cr) Profit and loss	EUR 24
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR-Entity B)	EUR 3	Cr) Profit and loss*4	EUR 3
being the hedge accounting entry for the net investment in Entity B			

The following entries would be recorded for hedged item

(P's consolidated F/S)

Dr)Other assets	EUR 24	Cr)FCTR(EntityC)	EUR 24
retranslation of exchange difference arising from Entity C			
Dr)Other assets	EUR 3	Cr)FCTR(EntityB)	EUR 3
retranslation of exchange difference arising from Entity B			

Check:	Equity (FCTR)	EUR	0