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**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**

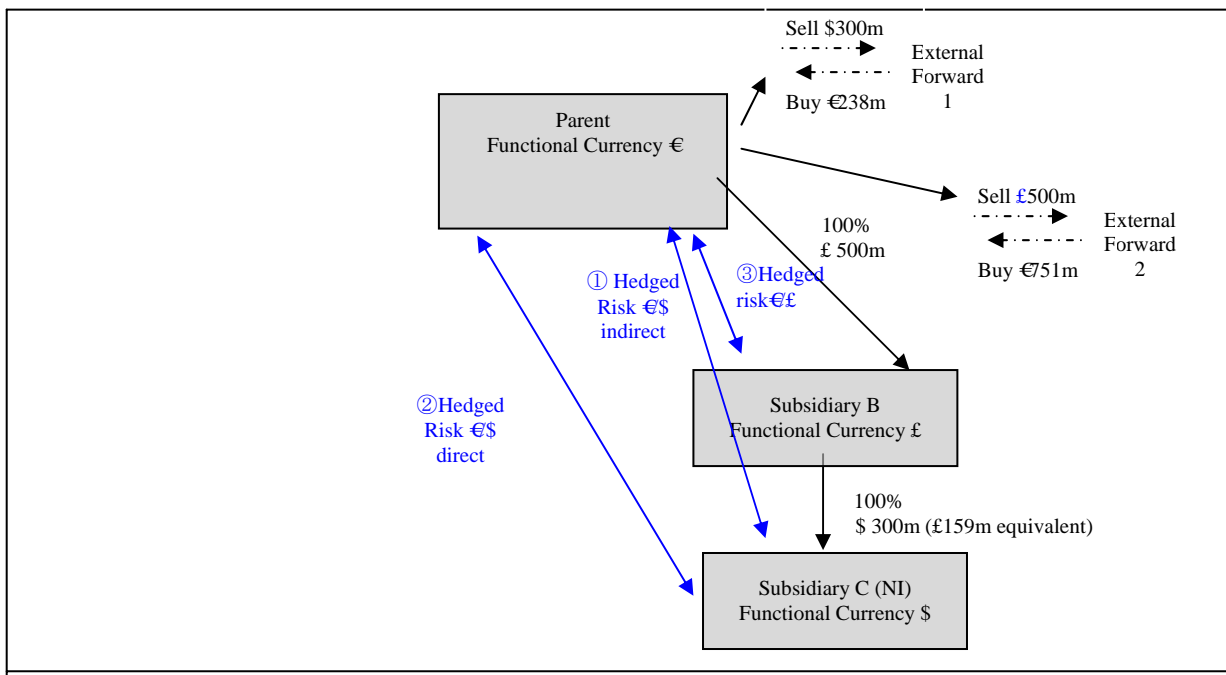
**IFRIC meeting: March 2008, London**  
**Project: Situation 3B: Hedging instruments held by Parent —  
Forwards (Agenda Paper 2I)**

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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. On 1 January 2005 the Parent entered into two external forward contracts. The first contract sells \$300m for €238m in one year's time. The second forward sells £500m for €751m in one year's time. 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 net assets comprise the investment in Subsidiary B and the two forwards. The Parent designates the \$300m 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. The Parent also designates the £500m forward as a hedge of £341m 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 into €. It would result in an overhedge of a net investment in Subsidiary B in Parent's consolidated financial statements.

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



## 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	<b>Spreadsheet No. 3B-1 Forwards</b> <b>100% effective</b>	N/A
③ Euro/£ exposure from a net investment in B between parent and Subsidiary B	<b>Spreadsheet No. 3B-1 Forwards</b> <b>100% effective</b>	

### Direct 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	<b>Spreadsheet No. 3B-2 Forwards</b> <b>100% effective</b>	N/A
③ Euro/£ exposure from a net investment in B between parent and Subsidiary B	<b>N0. 3B-2</b> <b>100% effective</b>	

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

Year 0		P (EUR)	A(JPY)	A(EUR)	C(USD)	C(GBP)	B(GBP)	consol adj	BC(GBP)	BC(EUR) pre-acq	consol adj	PABC(EUR)
Investment in A												0
Investment in B		755										0
Investment in C							159	-159				0
Other assets		0			300	159	341		500	755		755
		755	0	0	300	159	500		500	755		755
Opening												
FCTR		-755			-300	-159	-500	159	-500	-755	755	-755
Income												
Closing												
Equity		-755	0	0	-300	-159	-500		-500	-755		-755
Fwd #1		0										
68.2% of Fwd #2		0										
31.2% of Fwd #2		0										
Fwd #1 & #2		0			0	0	0		0	0		0
Check		0	0	0	0	0	0		0	0		0

Year 1		average		EUR		EUR		68.2% Fwd	31.8% Fwd
USD		1	1	P accounts	Year 0			EUR	EUR
JPY		125	121.5	Forward #1	Year 1	0		0	0
EUR		0.88	0.84	Forward #1		-26		-5	-2
GBP		0.58	0.555	P/L		-26		-5	-2

helper  
0.318  
0.682

Year 1		P (EUR)	A(JPY)	A(EUR)	C(USD)	C(GBP)	B(GBP)	consol adj hedge	BC(GBP)	BC(EUR) pre-acq	consol adj	PABC(EUR)
Investment in A												0
Investment in B		755										0
Investment in C							159	-159				0
Other assets		0			300	174	341		515	781		781
		755	0	0	300	174	500		515	781		781
Opening												
FCTR (Entity B)*2		-755			-300	-159	-500	159	-500	-755	755	-755
FCTR (Entity C)*3						-15			-15	-4		-4
Income (USD forward)		26								-23		-23
Income (£341 forward)		5										5
Income (£159 forward)		2										2
Closing		-721	0	0	-300	-174	-500		-515	-781		-748
Fwd #1		-26										-26
68.2% of Fwd #2		-5										-5
31.2% of Fwd #2		-2										-2
Fwd #1 & #2		-34			0	0	0	0	0	0		-34
Check		0	0	0	0	0	0		0	0		0

**SITUATION 3B - 1 FORWARD (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 USD 300m	EUR/£ exposure from B GBP341m
Hedged item (in amounts) change in value of net assets at forward rates (as per IE 15 of D22)	-26 Euro	-5 EUR
Hedging instrument	USD300m forward	GBP341m forward
Change in P/L	26 EUR	5 EUR
<b>Hedge effectiveness</b>	<b>100%</b>	<b>100%</b>

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$$*2 \text{ EUR-4} = -(\text{GBP}515/0.58 \cdot 0.88 - \text{EUR}755 - \text{EUR}23)$$

$$*3 \text{ GBP-15} = \text{GBP}159 - \$300 \cdot 0.58$$

$$\text{EUR-23} = \text{GBP-15} / 0.58 \cdot 0.88$$

The following entries would be recorded for hedging instruments

(P's separate F/S)

Dr) Profit and loss	EUR 26	Cr) Forward	EUR 26
<b>being profit/loss arising from US\$ forward</b>			
Dr) Profit and loss	EUR 5	Cr) Forward	EUR 5
<b>being profit/loss arising from 68.2% of the £/GBP forward</b>			
Dr) Equity (FCTR-Entity C)	EUR 26	Cr) Profit and loss	EUR 26
<b>being the hedge accounting entry for the net investment in Entity C</b>			
Dr) Equity (FCTR-Entity B)	EUR 5	Cr) Profit and loss	EUR 5
<b>being the hedge accounting entry for the net investment in Entity B</b>			

The following entries would be recorded for hedged item

(P's consolidated F/S)

Dr) Other assets	EUR 23	Cr) FCTR(Entity C)	EUR 23
<b>retranslation of exchange difference arising from Entity C</b>			
Dr) Other assets	EUR 4	Cr) FCTR(Entity B)	EUR 4
<b>retranslation of exchange difference arising from Entity B</b>			

Check: Equity (FCTR) EUR 5

<After hedge entry>	Before hedge	After hedge
	PABC(EUR)	ABC(EUR)
Investment in A	0	0
Investment in B	0	0
Investment in C	0	0
Other assets	781	781
	<u>781</u>	<u>781</u>
Opening	-755	-755
<b>FCTR (Entity B)*2</b>	-4	<b>5</b> 1
<b>FCTR (Entity C)*3</b>	-23	<b>26</b> 4
Income (USD forward)	26	-26 0
Income (£341 forward)	5	-5 0
Income (£159 forward)	2	2
Closing	<u>-748</u>	<u>-748</u>
Forward (USD 300m)	-26	-26
Forward (GBP 341m)	-5	-5
Forward (GBP 159m)	-2	-2
Forward	<u>-34</u>	<u>-34</u>
Check	0	0



**SITUATION 3B - 2 FORWARD (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 value of net assets at forward rates (as per IE 15 of D22)	-26 Euro	-5 EUR
Hedging instrument	USD300m forward	GBP341m forward
Change in P/L	26 EUR	5 EUR
<b>Hedge effectiveness</b>	<b>100%</b>	<b>100%</b>

\*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 26	Cr) Forwa	EUR 26
<b>being profit/loss arising from US\$ forward</b>			
Dr) Profit and loss	EUR 5	Cr) Forwa	EUR 5
<b>being profit/loss arising from 68.2% of the €GBP forward</b>			
Dr) Equity (FCTR-Entity C)	EUR 26	Cr) Profit :	EUR 26
<b>being the hedge accounting entry for the net investment in Entity C</b>			
Dr) Equity (FCTR-Entity B)	EUR 5	Cr) Profit :	EUR 5
<b>being the hedge accounting entry for the net investment in Entity B</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
<b>retranslation of exchange difference arising from Entity C</b>			
Dr) Other assets	EUR 3	Cr) FCTR(EntityB)	EUR 3
<b>retranslation of exchange difference arising from Entity B</b>			

Check: Equity (FCTR) EUR 5

**SITUATION 3B FORWARD  
Forward Calculation Sheet**

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

Fair Value @ 31/12/00		Leg	in EUR
Buy €	227,488,151.66		227,488,151.66
Sell \$	284,360,189.57		227,488,151.66
TOTAL			0.00

Fair Value @ 31/12/01		Leg	
Buy €	237,725,118.48		237,725,118.48
Sell \$	300,000,000.00		264,000,000.00
TOTAL			-26,274,881.52

<b>Forward #2</b> matures in one year time, ie. 1/1/02		
Buy	€	751,123,090.75
Sell	GBP	500,000,000.00

Fair Value @ 31/12/00		Leg	in EUR
Buy €	718,778,077.27		718,778,077.27
Sell GBP	476,190,476.19		718,778,077.27
TOTAL			0.00

Fair Value @ 31/12/01		Leg	
Buy €	751,123,090.75		751,123,090.75
Sell GBP	500,000,000.00		758,620,689.66
TOTAL			-7,497,598.91

Spot rates				
t	€	£	Yen	\$
1		0.8	0.53	118
0		0.88	0.58	125

Interest rates				
t	€	£	Yen	\$
0	4.50%		5.00%	5.50%
1	4.70%			5.70%

Exchange rates		
Period	0	1
\$/Yen	118	125
\$/GBP	0.53	0.58
\$/€	0.8	0.88
Yen/\$	0.008474576	0.008
Yen/GBP	0.004491525	0.00464
Yen/€	0.006779661	0.00704
GBP/\$	1.886792453	1.724137931
GBP/Yen	222.6415094	215.5172414
GBP/€	1.509433962	1.517241379
€/€	1.25	1.136363636
€/Yen	147.5	142.0454545
€/GBP	0.6625	0.659090909

Forward rate (E/\$)
1.26

Forward rate (E/GBP)
0.67

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



**SITUATION 3B FORWARD**

Net assets (\$)	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	1.2620

Change in hedged item at forward rates\* -26,274,881.5166

Net assets (GBP)	341,000,000.0000
GBP/€ spot rate @ 31/12/00	1.5094
GBP/€ spot rate @ 31/12/01	1.5172
€/GBP 1-y forward rate @ 31/12/00	0.6657

Change in hedged item at forward rates\* -5,113,362.4562

\* 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