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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**

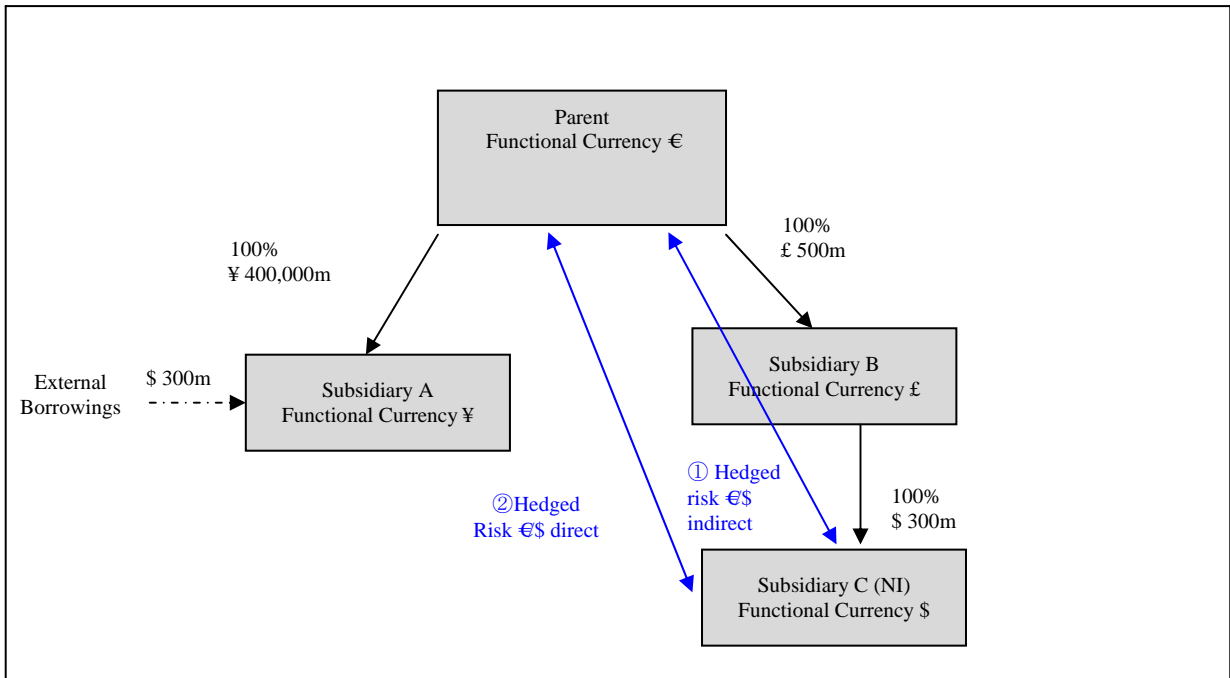
**IFRIC meeting:**      **March 2008, London**  
**Project:**            **Situation 1: Hedging instrument held by Sub A — Debt  
(Agenda Paper 2B)**

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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 with the net investment in the first \$300m net assets of Subsidiary C 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	<b>Spreadsheet No. 1-1 Debt 100% effective</b>	<b>N/A</b> \$ 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	<b>Spreadsheet No. 1-2 Debt 100% effective</b>	<b>N/A</b> 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					159	-159			-755	0
Investment in C											0
Other assets		435400	2952	300	159	341		500	755		3707
	<u>3467</u>	<u>435400</u>	<u>2952</u>	<u>300</u>	<u>159</u>	<u>500</u>		<u>500</u>	<u>755</u>		<u>3707</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>
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										
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					159	-159			-755	0
Investment in C											0
Other assets*4		435400	3065	300	174	341		515	781		3847
	<u>3467</u>	<u>435400</u>	<u>3065</u>	<u>300</u>	<u>174</u>	<u>500</u>		<u>515</u>	<u>781</u>		<u>3847</u>
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
<b>FCTR (Entity C)*6</b>					<b>-15</b>			<b>-15</b>	<b>-23</b>		<b>-23</b>
Income (Debt)		2100	15								15
Closing	<u>-3467</u>	<u>-397900</u>	<u>-2801</u>	<u>-300</u>	<u>-174</u>	<u>-500</u>		<u>-515</u>	<u>-781</u>		<u>-3583</u>
Equity											
Debt	0	-37500	-264	0	0	0	0	0	0	0	-264
Check	0	0	0	0	0	0		0	0		0

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

**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
<b>Hedge effectiveness</b>	<b>100%</b> Considered rounding effect

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

*2 Change in year 1 Translation of Entity C's GBP FCTR into Euro at closing rate (=GBP-15/0.58*0.88)
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*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
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**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
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**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
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**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
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**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
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**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
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**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
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**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
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**being translation of Entity C's USD financial statements (after elimination) into EUR**

Check: Equity (FCTR) EUR 1

<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	3847		3847
	3847		3847
Opening	-3467		-3467
FCTR (Entity A) from assets*	-113		-113
FCTR (Entity A) from debt*3	9	-9	0
FCTR (Entity B)	-4		-4
<b>FCTR (Entity C)</b>	<b>-23</b>	<b>24</b>	<b>1</b>
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) pre-acq	consol adj	PABC(EUR)
Investment in A	2712						-2712		0
Investment in B	755						-755		0
Investment in C						159	240	-240	0
Other assets		435400	2952	300	240	341	515		3707
	3467	435400	2952	300	240	500	755		3707
Opening	-3467	-400000	-2712	-300	-240	-500	-755	3707	-3467
FCTR									
Income									
Closing	-3467	-400000	-2712	-300	-240	-500	-755		-3467
Debt	0	-35400	-240	0	0	0	0	0	-240
Check	0	0	0	0	0	0	0		0

1-1(step)	diff.
PABC(EUR)	
0	0
0	0
0	0
0	0
3707	0
3707	0
-3467	0
-3467	0
-240	0
0	0

	Year 1 average								
USD	1								
JPY	125								
EUR	0.88								
GBP	0.58								
	P (EUR)	A(JPY)	A(EUR)	C(USD)	C(EUR)	B(GBP)	B(EUR) pre-acq	consol adj	PABC(EUR)
Investment in A	2712						-2712		0
Investment in B	755						-755		0
Investment in C						159	240	-240	0
Other assets*4		435400	3065	300	264	341	517		3847
	3467	435400	3065	300	264	500	757		3847
Opening	-3467	-400000	-2712	-300	-240	-500	-755	3707	-3467
FCTR (Entity A) from assets*3			-113						-113
FCTR (Entity A) from debt*3			9						9
FCTR (Entity B)*5							-3		-3
<b>FCTR (Entity C)*6</b>					-24				<b>-24</b>
Income (debt)		2100	15						15
Closing	-3467	-397900	-2801	-300	-264	-500	-757		-3583
Equity									
Debt	0	-37500	-264	0	0	0	0	0	-264
Check	0	0	0	0	0	0	0		0

1-1(step)	diff.
PABC(EUR)	
0	0
0	0
0	0
0	0
3847	0
3847	0
-3467	0
-113	0
9	0
-4	-1
-23	1
15	0
-3583	0
-264	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
<b>Hedge effectiveness</b>	<b>100%</b>

*1 Change in FCTR	
retranslation of income (debt) at closing rate (=JPY2100/125*0.88 - Euro15)	0
retranslation of opening balance of debt at closing rate (=EUR240-JPY35400/125*0.88)	9
	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
<b>being the profit/loss arising from the Debt</b>			
(P's consolidated F/S)			
Dr) Profit and loss (debt)	EUR 15	Cr) Debt	EUR 15
<b>being translation of Entity A's JPY profit/loss into EUR at the average rate</b>			
Dr) Equity (FCTR-Entity A)	EUR 0	Cr)Debt	EUR 0
<b>being retranslation of Entity A's JPY profit/loss into EUR at the closing rate</b>			
Dr) Equity (FCTR-Entity A)	EUR 9	Cr)Debt	EUR 9
<b>being translation of Entity A's opening balance of debt into EUR at the closing rate</b>			
Dr) Other assets	EUR	113 Cr) Equity (FCTR-Entity A)	EUR 113
<b>being translation of Entity A's opening balance of other assets into EUR at the closing rate</b>			
(P's consolidated F/S - hedging entry)			
Dr) Equity (FCTR-Entity C)	EUR 15	Cr) Profit and loss (debt)	EUR 15
<b>being the hedge accounting entry for the net investment in Entity C</b>			
Dr) Equity (FCTR- Entity C)	EUR 10	Cr) Equity (FCTR-Entity A)	EUR 10
<b>being reclassification entry within Equity (FCTR) for hedging (ie. eliminating FCTR- Entity C)</b>			

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
<b>being translation of Entity C's USD financial statements into EUR</b>			

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
	<u>3847</u>		<u>3847</u>
Opening	-3467		-3467
FCTR (Entity A)from assets*	-113		-113
FCTR (Entity A)from debt*3	9	-10	0
FCTR (Entity B)	-3		-3
<b>FCTR (EntityC)</b>	<b>-24</b>	<b>24</b>	<b>0</b>
Income (debt)	15	-15	0
Closing	0		0
Equity	<u>-3583</u>	0	<u>-3583</u>
Debt	<u>-264</u>		<u>-264</u>
Check	0		0