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International Accounting Standards Board

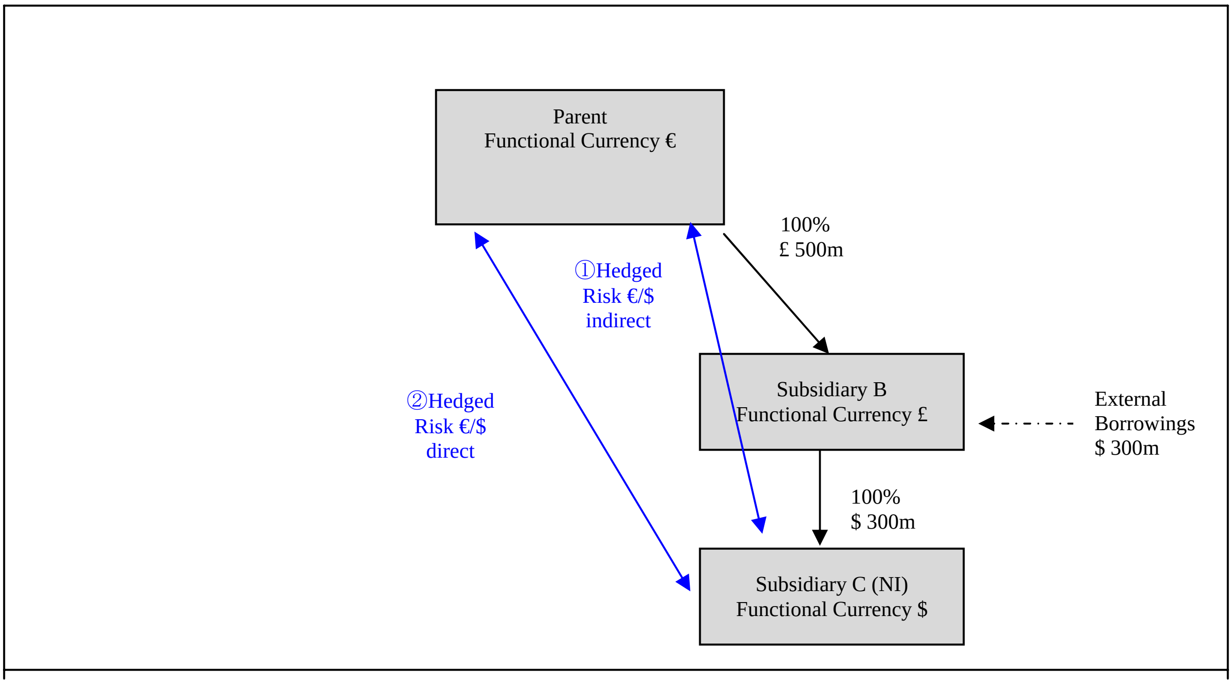
INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2008, London**

Project: **Situation 2: Hedging instrument held by Subsidiary B — Debt (Agenda Paper 2D)**

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 $. Subsidiary B borrows $300m externally on 1 January 2005. 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 investment in Subsidiary B. The Parent designates the $300m external borrowing in Subsidiary B 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 $300m external borrowing in Subsidiary B could have been designated as a hedge of the £/$ spot foreign exchange risk between Subsidiary C and Subsidiary B in both the consolidated financial statements of Parent and in the consolidated financial statements of Subsidiary B. 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. 2-1 Debt 100% effective**	**N/A (there is no Euro/$ exposure within these financial statements)**

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. 2-2 Debt 100% effective**	**N/A (there is no Euro/$ exposure within these financial statements)**

SITUATION 2 -1 DEBT (step by step method): designate $/Euro exposure from Entity C as hedged risk

	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)	pre-acq	consol adj	PABC(EUR)
Investment in A												0
Investment in B	755										-755	0
Investment in C						159	-159					0
Other assets				300	159	500		659	995			995
	755	0	0	300	159	659		659	995			995
Opening	-755			-300	-159	-500	159	-500	-755		755	-755
FCTR												
Income												
Closing												
Equity	-755	0	0	-300	-159	-500		-500	-755			-755
Debt	0			0	0	-159		-159	-240		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

B accounts		GBP	EUR
USD 300m borrowings	Year 0	159	
USD 300m borrowings	Year 1	174	
P/L		-15	-23

	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	0
Investment in B	755										-755	0
Investment in C						159	-159					0
Other assets				300	174	500		674	1023			1023
	755	0	0	300	174	659		674	1023			1023
Opening	-755			-300	-159	-500	159	-500	-755		755	-755
FCTR (Entity B)*1									-4			-4
FCTR (Entity C)					**-15**		**15**	**0**	**0**			**0**
Income						15	-15	0	0			0
Closing												
	-755	0	0	-300	-174	-485		-500	-759			-759
Debt	0			0	0	-174	0	-174	-264		0	-264
Check	0	0	0	0	0	0		0	0			0

SITUATION 2 -1 DEBT (step by step method): designate $/Euro exposure from Entity C as hedged risk

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

*2 EUR-4=(EUR995-EUR240)-(GBP674-GBP174)/0.58*0.88

The following entries would be recorded for hedging instrument (USD borrowings)

(B's separate F/S)

Dr) Profit and loss	GBP 15	Cr) Debt	GBP 15

being the profit/loss arising from the Debt

(B's consolidated F/S)

Dr) Equity (FCTR-Entity C)	GBP 15	Cr) Profit and loss	GBP 15

being the hedge accounting entry for the net investment in Entity (

The following entries would be recorded for hedged iten

(B's consolidated F/S)

Dr) Other assets	GBP 15	Cr) Equity(FCTR-EntityC)	GBP 15

being translation of Entity C's GBP financial statements (after elimination) into GBI

Check:	Equity (FCTR)	GBP	0

<After hedge entry>

	Before hedge		After hedge
P	ABC(EUR)	hedge	ABC(EUR)
Investment in A	0		0
Investment in B	0		0
Investment in C	0		0
Other assets	1023		1023
	1023		1023
Opening	-755		-755
FCTR (Entity B)	-4		-4
FCTR (Entity C)	**0**		**0**
Income	0		0
Closing			0
	-759		-759
Debt	-264		-264
Check	0		0

SITUATION 2 - 2 DEBT (direct method): designate $/Euro exposure from Entity C as hedged risk on P'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)
Investment in A									
Investment in B	755							-755	0
Investment in C						159	240	-240	0
Other assets				300	240	500	755		995
	755	0	0	300	240	659	995		995
Opening	-755			-300	-240	-500	-755	995	-755
FCTR									
Income									
Closing									
	-755	0	0	-300	-240	-500	-755		-755
Debt	0			0	0	-159	-240	0	-240
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

B accounts		GBP	EUR
USD 300m borrowings	Year 0	159	
USD 300m borrowings	Year 1	174	
P/L		-15	-23

	P (EUR)	A(JPY)	A(EUR)	C(USD)	C(EUR)	B(GBP)	B(EUR)	consol adj pre-acq	PABC(EUR)
Investment in A									0
Investment in B	755							-755	0
Investment in C						159	240	-240	0
Other assets				300	264	500	759		1023
	755	0	0	300	264	659	999		1023
Opening	-755			-300	-240	-500	-755	995	-755
FCTR(Entity B)-assets*2							-5		-5
FCTR(Entity B)-debt*3							1		1
FCTR(Entity C)					**-24**				**-24**
Income						15	23		23
Closing									
Equity	-755	0	0	-300	-264	-485	-736		-760
Debt	0			0	0	-174	-264	0	-264
Check	0	0	0	0	0	0	-1	0	-2

SITUATION 2 - 2 DEBT (direct method): designate $/Euro exposure from Entity C as hedged risk on P'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	23 Euro
Change in FCTR*1	1 Euro
	24
Hedge effectiveness	**100%**

*1 Change in FCTR arising from Entity B's debt	
retranslation of income at closing rate	0
(= GBP15/0.58*0.88-EUR23)	
retranslation of opening of debt at closing rate	1
(=EUR240-GBP159/0.58*0.88)	1

*2 EUR-5=EUR995-GBP659/0.58*0.88

*3 EUR1=GBP174/0.58*0.88-EUR240-EUR23

The following entries would be recorded for hedging instrument (USD borrowings)

(B's separate F/S)			
Dr) Profit and loss	GBP 15	Cr) Debt	GBP 15
being the profit/loss arising from the Debt			
(P's consolidated F/S)			
Dr) Profit and loss	EUR 23	Cr) Debt	EUR 23
being translation of Entity B's GBP profit/ loss into EUR at the average rate			
Dr) Equity (FCTR-Entity B)	EUR 0	Cr)Debt	EUR 0
being retranslation of Entity B's GBP profit/ loss into EUR at the closing rate			
Dr) Equity (FCTR-Entity B)	EUR 1	Cr)Debt	EUR 1
being retranslation of Entity B's opening balance of debt into EUR at the closing rate			
Dr) Other assets	EUR 5	Cr) FCTR-EntityB-assets	EUR 5
being translation of Entity B's assets into Euro at closing rate			
Dr) Equity (FCTR-EntityC)	EUR 23	Cr) Profit and loss	EUR 23
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR-Entity C)	EUR 1	Cr) Equity (FCTR-Entity B)	EUR 1
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 24	Equity(FCTR-Entity C)	EUR 24
exchange difference arising from translation of Entity C's assets into EUR			

Check: Equity (FCTR) EUR 0

<After hedge entry>

	Before hedge		After hedge	**2-1(step)**	
	PABC(EUR)	hedge entr	PABC(EUR)	PABC(EUR)	
Investment in A	0		0	0	0
Investment in B	0		0	0	0
Investment in C	0		0	0	0
Other assets	1023		1023	1023	0
	1023		1023	1023	0
Opening	-755		-755	-755	0
FCTR(Entity B)-asse	-5		-5	-4	1
FCTR(Entity B)-debt'	1	-1	0	0	0
FCTR(Entity C)	-24	24	0	0	0
Income	23	-23	0	0	0
Closing			0		0
Equity	-760	0	-760	-759	1
Debt	-264		-264	-264	0
Check	-2		-2	0	