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**International
Accounting Standards
Board**

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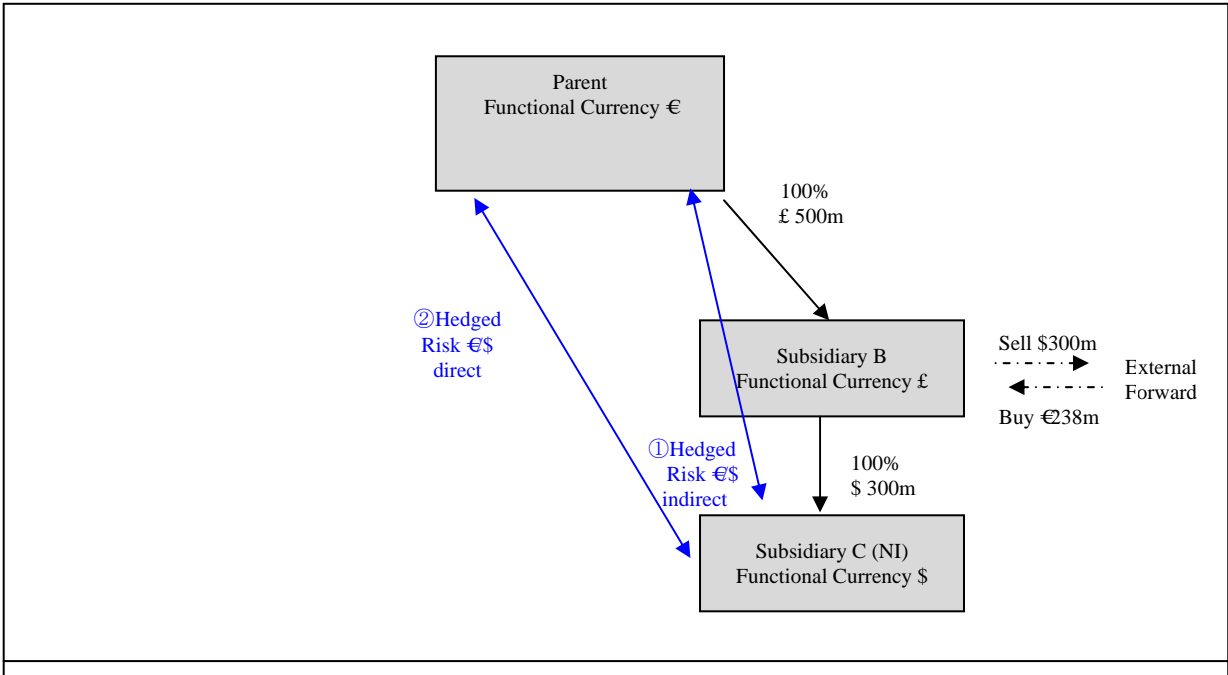
Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: March 2008, London

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

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 \$. . On 1 January 2005 Subsidiary B enters into an external forward contract to sell \$300m for €238m 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 has no assets other than the investment in Subsidiary B. The Parent designates the forward as a hedge of the forward foreign exchange risk associated with the net investment in the first \$300m net assets of Subsidiary C in its consolidated financial statements.



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 Forward 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 Forward 100% effective	N/A (there is no Euro/\$ exposure within these financial statements)

SITUATION 2 -1 FORWARD (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											0
Investment in C						159	-159					0
Other assets				300	159	341		500	755			755
	755	0	0	300	159	500		500	755			755
Opening	-755			-300	-159	-500	159	-500	-755		755	-755
FCTR												
Income												
Closing	-755	0	0	-300	-159	-500		-500	-755			-755
Equity	-755	0	0	-300	-159	-500		-500	-755			-755
Forward	0			0	0	0		0	0		0	0
Check	0	0	0	0	0	0		0	0			0

Year 1		average		B accounts			
USD	1	1		GBP		EUR	
JPY	125	121.5		Year 0	0	0	
EUR	0.88	0.84		Forward	Year 1	-17	
GBP	0.58	0.555		P/L		-17	
						-26	

	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				300	174	341		515	781			781
	755	0	0	300	174	500		515	781			781
Opening	-755			-300	-159	-500	159	-500	-755		755	-755
FCTR(Entity B)-assets*2									-4			-4
FCTR(Entity B)-forward*3												
FCTR (Entity C)					-15			17	2			4
Income						17		-17	0			0
Closing	-755	0	0	-300	-174	-483		-498	-755			-755
Forward	0			0	0	-17	0	-17	-26		0	-26
Check	0	0	0	0	0	0		0	0			0

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

Hedged risk	USD/EUR exposure from C
Hedged item (in amounts)	USD 300
change in value of net assets at forward rates per IE 15 of IFRIC D22	-26 EUR
Hedging instrument	Forward
Change in P/L	17 GBP
Hedge effectiveness	100%

$$*2 \text{ EUR} - 4 = (\text{EUR}755 - \text{EUR}781) - (\text{EUR}0 - \text{EUR}26) - 4$$

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

(B's separate F/S)			
Dr) Profit and loss	GBP 17	Cr) Forward	GBP 17
being the profit/loss arising from the forward			
(B's consolidated F/S)			
Dr) Equity (FCTR-Entity C)	GBP 17	Cr) Profit and loss	GBP 17
being the hedge accounting entry for the net investment in Entity C			

The following entries would be recorded for hedged item

(B's consolidated F/S)			
Dr) Other assets	GBP 15	Cr) Equity(FCTR-Entity C)	GBP 15
being translation of Entity C's GBP financial statements (after elimination) into GBP			

Check: Equity (FCTR) GBP 2

<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
FCTR(Entity B)-a	-4	-4
FCTR(Entity B)-forward*3		
FCTR (Entity C)	4	4
Income	0	0
Closing	0	0
	<u>-755</u>	<u>-755</u>
Forward	-26	-26
Check	0	0

SITUATION 2 - 2 FORWARD (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 value of net assets at forward rates per IE 15 of IFRIC D22	-26 Euro
Hedging instrument	Forward
Change in P/L	26 Euro
Hedge effectiveness	100%

*1 Change in FCTR arising from Entity B's forward retranslation of income at closing rate (= GBP17/0.58*0.88-EUR26)	0
retranslation of opening of forward at closing rate	0
	0

*2 EUR-3=EUR515-EUR517

*3 EUR0=GBP17/0.58*0.88-EUR26

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

(B's separate F/S)			
Dr) Profit and loss	GBP 17	Cr) Forward	GBP 17
being the profit/loss arising from the forward			
(P's consolidated F/S)			
Dr) Profit and loss	EUR 26	Cr) Forward	EUR 26
being translation of Entity B's GBP profit/ loss into EUR at the average rate			
Dr) Equity (FCTR-Entity B)	EUR 0	Cr) Forward	EUR 0
being retranslation of Entity B's GBP profit/ loss into EUR at the closing rate			
Dr) Equity (FCTR-Entity B)	EUR 0	Cr) Forward	EUR 0
being retranslation of Entity B's opening balance of forward into EUR at the closing rate			
Dr) Other assets	EUR 3	Cr) FCTR-EntityB-assets	EUR 3
being translation of Entity B's assets into Euro at closing rate			
Dr) Equity (FCTR-EntityC)	EUR 26	Cr) Profit and loss	EUR 26
being the hedge accounting entry for the net investment in Entity C			
Dr) Equity (FCTR-Entity C)	EUR 0	Cr) Equity (FCTR-Entity B)	EUR 0
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 2

<After hedge entry>

	Before hedge	After hedge	2-1(step)	
	PABC(EUR)	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	781	781	781	0
	781	781	781	0
Opening	-755	-755	-755	0
FCTR(Entity B)-asse	-3	-3	-4	-1
FCTR(Entity B)-forwa	0	0	0	0
FCTR(Entity C)	-24	2	4	1
Income	26	-26	0	0
Closing		0		
Equity	-755	-755	-755	0
Forward	-26	-26	-26	0
Check	0	0	0	

SITUATION 2 FORWARD

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

Forward 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 GBP	
Buy €		227,488,151.66	150,710,900.47
Sell \$		284,360,189.57	150,710,900.47
TOTAL			0.00

Fair Value @ 31/12/01	Leg		
Buy €		237,725,118.48	156,682,464.45
Sell \$		300,000,000.00	174,000,000.00
TOTAL			-17,317,535.55

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

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

Forward rate (E/\$)	
	1.26

Exchange rates		
Period	0	1
\$/Yen	118	125
\$/GBP	0.53	0.58
\$/€	0.8	0.88
Yen/\$	0.008475	0.008
Yen/GBP	0.004492	0.00464
Yen/€	0.00678	0.00704
GBP/\$	1.886792	1.724138
GBP/Yen	222.6415	215.5172
GBP/€	1.509434	1.517241
€/ \$	1.25	1.136364
€/Yen	147.5	142.0455
€/GBP	0.6625	0.659091

SITUATION 2 FORWARD

Net assets (\$m)	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 running to 31/12/01	1.2620
€/\$ 1-y forward rate @ 31/12/01	1.1364
Change in hedged item at forward rates*	-26,274,881.5166

* 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