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**International
Accounting Standards
Board**

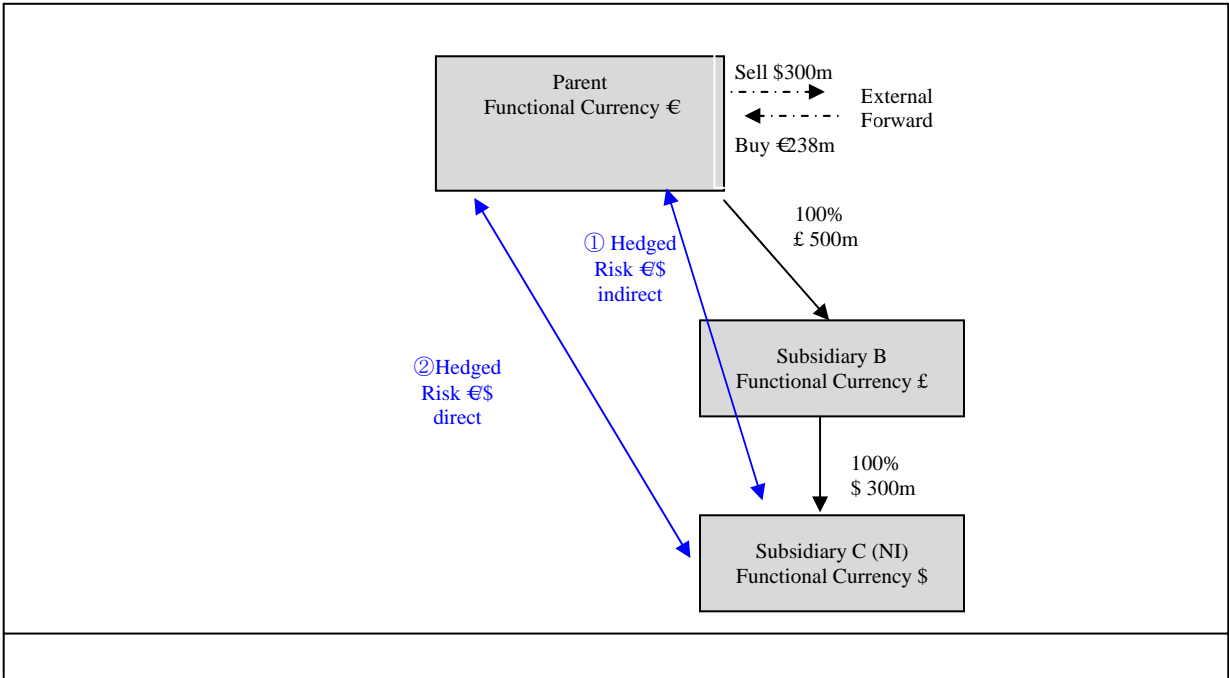
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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2008, London**
Project: **Situation 3A: Hedging instrument held by Parent —
Forward (Agenda Paper 2G)**

- 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 \$. 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. On 1 January 2005 the Parent enters into an external forward contract to sell \$300m for €238m in one year's time.. The Parent's only asset is 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. 3A-1 Forward 100% effective | N/A (Euro/\$ risk not present) |

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. 3A-2 Debt 100% effective | N/A (Euro/\$ risk not present) |

SITUATION 3A -1 FORWARD (step by step method): designate \$/Euro exposure from Entity C as hedged risk

| 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 | USD | 755 | | | | | | | | | | | 0 |
| Investment in B | JPY | | | | | | | | | | | | 0 |
| Investment in C | EUR | | | | | | 159 | -159 | | | | | -755 |
| Other assets | GBP | 0 | | | 300 | 159 | 341 | | 500 | 755 | | | 0 |
| | | 755 | 0 | 0 | 300 | 159 | 500 | | 500 | 755 | | | 755 |
| Opening | | -755 | | | -300 | -159 | -500 | 159 | -500 | -755 | | | 755 |
| FCTR | | | | | | | | | | | | | |
| Income | | | | | | | | | | | | | |
| Closing | | -755 | 0 | 0 | -300 | -159 | -500 | | -500 | -755 | | | -755 |
| Equity | | | | | | | | | | | | | |
| Forward | | 0 | | | 0 | 0 | 0 | | 0 | 0 | | | 0 |
| Check | | 0 | 0 | 0 | 0 | 0 | 0 | | 0 | 0 | | | 0 |

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

| 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 | | 755 | | | | | | | | | | | | 0 |
| Investment in B | | | | | | | | | | | | | | 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 | | -755 | | | -300 | -159 | -500 | 159 | | -500 | -755 | | | -755 |
| FCTR (Entity B)*2 | | | | | | | | | | | -4 | | | -4 |
| FCTR (Entity C)*3 | | | | | | -15 | | | | -15 | -23 | | | -23 |
| Income | | 26 | | | | | | | | | | | | 26 |
| Closing | | -729 | 0 | 0 | -300 | -174 | -500 | | | -515 | -781 | | | -755 |
| Forward | | -26 | | | 0 | 0 | 0 | 0 | | 0 | 0 | | | -26 |
| Check | | 0 | 0 | 0 | 0 | 0 | 0 | | | 0 | 0 | | | 0 |

SITUATION 3A -1 FORWARD (step by step method): designate \$/Euro exposure from Entity C as hedged risk

| | |
|--|------------------------------------|
| Hedged item (net assets in amounts) | USD 300m |
| change in value of net assets at forward rates (as per IE 15 of D22) | -26 Euro |
| Hedging instrument | Forward to sell \$300m and buy EUR |
| Change in P/L from forward | 26 Euro |
| | 26 |
| Hedge effectiveness | 100% |

| |
|--|
| |
|--|

| |
|---------------------------------|
| *2 EUR-4=EUR755-EUR781-(-EUR23) |
|---------------------------------|

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

| | | | |
|--|--------|---------------------|--------|
| The following entries would be recorded for hedging instrument (Forward) | | | |
| (P's separate F/S) | | | |
| Dr) Profit and loss | EUR 26 | Cr) Forward | GBP 26 |
| being the profit/loss arising from the forward | | | |
| (P's consolidated F/S) | | | |
| Dr) Equity (FCTR-Entity C) | EUR 26 | Cr) Profit and loss | EUR 26 |
| being the hedge accounting entry for the net investment in Entity C | | | |

| | | | |
|---|--------|-------------------|--------|
| 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 | | | |

Check: Equity (FCTR) EUR 4

<After hedge entry>

| | Before hedge PABC(EUR) | After hedge ABC(EUR) |
|------------------------|---------------------------|-------------------------|
| Investment in A | 0 | 0 |
| Investment in B | 0 | 0 |
| Investment in C | 0 | 0 |
| Other assets | 781 | 781 |
| | 781 | 781 |
| Opening | -755 | -755 |
| FCTR (Entity B) | -4 | -4 |
| FCTR (Entity C) | -23 | 26 |
| Income | 26 | -26 |
| Closing | 0 | 0 |
| | -755 | -755 |
| Forward | -26 | -26 |
| Check | 0 | 0 |

SITUATION 3A - 2 FORWARD (direct method): designate \$/Euro exposure from Entity C as hedged risk on P's consolidated F/

| | |
|--|------------------------------------|
| Hedged item (net assets in amounts) | USD 300m |
| change in value of net assets at forward rates (as per IE 15 of D22) | -26 Euro |
| Hedging instrument | Forward to sell \$300m and buy EUR |
| Change in P/L from forward | 26 Euro |
| | 26 |
| Hedge effectiveness | 100% |

*2 EUR-3=EUR515-EUR517

*3 EUR-24=EUR240-EUR300*0.88

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

| | | | |
|--|--------|---------------------|--------|
| (P's separate F/S) | | | |
| Dr) Profit and loss | EUR 26 | Cr) Forward | GBP 26 |
| being the profit/loss arising from the forward | | | |
| (P's consolidated F/S) | | | |
| Dr) Equity (FCTR-Entity C) | EUR 26 | Cr) Profit and loss | EUR 26 |
| being the hedge accounting entry for the net investment in Entity C | | | |

The following entries would be recorded for hedged item

| | | | |
|---|--------|--------------------|--------|
| (P's consolidated F/S) | | | |
| Dr) Other assets | EUR 24 | Cr) FCTR(Entity C) | EUR 24 |
| retranslation of exchange difference arising from Entity C | | | |

Check: Equity (FCTR) EUR 2

SITUATION 3A FORWARD

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

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

| | | |
|---|----|----------------|
| Forward matures in one year time, ie. 1/1/02 | | |
| Buy | € | 237,725,118.48 |
| Sell | \$ | 300,000,000.00 |

| Forward rate (E/\$) | Forward rate (E/\$) |
|---------------------|---------------------|
| 0 -> 1 | 1 -> 2 |
| 1.26 | 1.15 |

| 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 |

| 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 |

| 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 |

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

SITUATION 3A 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 | 1.1472 |
| | |
| 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