EXAMPLES ILLUSTRATING APPLICATION OF FASB STATEMENT NO. 138, *ACCOUNTING FOR CERTAIN DERIVATIVE INSTRUMENTS AND CERTAIN HEDGING ACTIVITIES*

Introduction

The following examples illustrate the application of Statement 138, which amends FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The examples address hedging relationships related to (1) hedging the benchmark interest rate, (2) hedging recognized foreign-currency-denominated assets and liabilities, and (3) applying hedge accounting in the consolidated financial statements to internal derivatives that are offset on a net basis by third-party contracts. The examples do not address all possible hedging relationships related to the above issues. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated in an example.

Section 1: Hedging the Benchmark Interest Rate

In the United States, hedging the benchmark rate of interest refers to hedging either the risk-free rate or the LIBOR swap rate. An example of a fair value hedge of the LIBOR swap rate is provided below.

Example: Fair Value Hedge of the LIBOR Swap Rate in a $100 Million A1-Quality 5-Year Fixed-Rate Noncallable Debt

On April 3, 20X0, Global Tech issues at par a $100 million A1-quality 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon payable semiannually. On that date, Global Tech enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of the $100 million liability. Under the terms of the swap, Global Tech will receive a fixed interest rate at 8 percent and pay variable interest at LIBOR plus 78.5 basis points (current LIBOR 6.29%) on a notional amount of $101,970,000 (semiannual settlement and interest reset dates). A duration-weighted hedge ratio was used to calculate the notional amount of the swap necessary to offset the debt's fair value changes attributable to changes in the LIBOR swap rate.

?? PV01 debt = 4.14

?? PV01 swap = 4.06

?? Hedge ratio = PV01 debt / PV01 swap = 4.14/4.06 = 1.0197

?? Swap notional = 1.0-197 x $100 million = $101,970,000

The example assumes that the LIBOR swap rate increased 100 basis points to 9 percent on June 30, 20X0. The change in fair value of the swap for the period from April 3 to June 30, 20X0 is a loss of $4,016,000. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period April 3 to June 30, 20X0 is calculated as follows:

Period	Principal Balance	Coupon Rate	Cash Flow – Interest	Cash Flow - Principal	Present Value
0.5	$100,000,000	0.08	2,000,000		1,956,464
1.5	$100,000,000	0.08	4,000,000		3,744,429
2.5	$100,000,000	0.08	4,000,000		3,583,185
3.5	$100,000,000	0.08	4,000,000		3,428,885
4.5	$100,000,000	0.08	4,000,000		3,281,230
5.5	$100,000,000	0.08	4,000,000		3,139,933
6.5	$100,000,000	0.08	4,000,000		3,004,721
7.5	$100,000,000	0.08	4,000,000		2,875,331
8.5	$100,000,000	0.08	4,000,000		2,751,513
9.5	$100,000,000	0.08	4,000,000	100,000,000	68,458,689
Present Value					96,224,380

As of June 30, 20X0, 9.5 periods remain and the cash flows are discounted at 9 percent; determined as the initial 8-percent yield plus a 100 basis point increase attributable to the 100 basis point increase in the LIBOR swap rate. The accrual for the first quarter interest was excluded. The following journal entries illustrate the swap and debt fair value changes, attributable to changes in the LIBOR swap rate, excluding accruals:

Dr. Debt	3,775,620	
Cr. Earnings		3,775,620
Dr. Earnings	4,016,000	
Cr. Swap liability		4,016,000

The net earnings impact of the hedge was $240,380 due to some imprecision in the calculated hedge ratio.

Section 2: Hedging Recognized Foreign-Currency-Denominated Assets and Liabilities

Fair value hedges could be used for all recognized foreign-currency-denominated asset or liability hedging situations and cash flow hedges could be used for recognized foreign-currency-denominated

asset or liability hedging situations in which all of the variability in the functional-currency-equivalent cash flows are eliminated by the effect of the hedge.

Example 1: Fair Value Hedge of a Fixed-Rate Foreign-Currency-Denominated Loan in Which all of the Variability in the Functional-Currency-Equivalent Cash Flows is not Eliminated (Fixed to Variable Scenario)

Company ABC's functional currency is the US Dollar. On January 3, 200X, Company ABC borrows 100 million fixed-rate Euro (EUR) at a yield to maturity of 5.68 percent. The loan has a term of 5 years and pays an annual coupon of 5.68 percent. This yield at inception is equivalent to Euribor plus 0.52 percent or (on a swapped basis) to USD LIBOR plus 0.536 percent.

Also on January 3, 200X, Company ABC enters into a 5-year cross-currency swap in which it will receive fixed EUR at a rate of 5.68 percent on EUR 100 million and pay floating USD at USD LIBOR plus 0.536 percent on USD 102 million. There will be a final exchange of principal on maturity of the contract. Both the debt and the swap will pay annual coupons on December 31. The company designates the cross-currency swap as a fair value hedge of the changes in the fair value of the loan due to both interest and exchange rates.

The spot FX rates for EUR/USD, LIBOR flat EUR swap rates, EUR/USD basis swap spreads and 1 year USD LIBOR on December 31 each year over the life of the hedge were as follows:

Years	**0**	**1**	**2**	**3**	**4**	**5**
Spot FX	1.0200	1.0723	1.0723	1.1273	1.1851	1.2458
EUR Swap Rate	5.160%	5.151%	5.040%	4.854%	4.480%	N/A
Basis Swap Spread	(0.02)%	(0.02)%	(0.02)%	(0.02)%	(0.02)%	N/A
1 year USD LIBOR	6.00%	5.50%	6.00%	6.50%	7.00%	N/A

The changes in fair value of the debt attributable to changes in both Euro interest rates and spot FX rates, and the values and changes in value (in USD) of the receive-fixed Euro, pay-floating USD swap, are shown in the following table:

(in USD millions)

A.	Spot FX	1.0200	1.0723	1.0723	1.1273	1.1851	1.2458
B.	Fair Value of Debt (in EUR)	(100.000)	(100.032)	(100.322)	(100.567)	(100.647)	0.0000
C.	Debt at Spot (in USD) (A*B)	(102.000)	(107.265)	(107.575)	(113.366)	(119.274)	-
D.	Cum. change on debt		(5.265)	(5.575)	(11.366)	(17.274)	-
E.	*Change in Period*		*(5.265)*	*(0.310)*	*(5.791)*	*(5.908)*	*17.274*
F.	***EUR fixed to USD Floating Swap***	0.000	5.333	5.642	11.472	17.357	-
G.	*Change in Period*		*5.333*	*0.310*	*5.830*	*5.885*	*(17.357)*

As a fair value hedge, changes in the value of the debt and the swap are recognized immediately in earnings. The income statement effect, including interest expense, is set out below.

Years	**0**	**1**	**2**	**3**	**4**	**5**
Interest Expense*		(6.667)	(6.157)	(6.667)	(7.177)	(7.687)
Change in Value of Debt (E)		(5.265)	(0.310)	(5.791)	(5.908)	17.274
Hedge Gain/Loss (G)		5.333	0.310	5.830	5.885	(17.357)
Net		(6.599)	(6.157)	(6.628)	(7.200)	(7.770)

* The interest expense is calculated based on USD LIBOR plus .536 percent on USD 102 million. The fixed Euro interest expense remeasured into the US dollar functional currency is adjusted by the net cash payment on the cross currency swap to reflect the variable US interest rate (LIBOR + .536 percent) inherent in the cross currency swap.

Example 2: Cash Flow Hedge of a Fixed-Rate Foreign-Currency-Denominated Loan in Which All of the Variability in the Functional-Currency-Equivalent Cash Flows are Eliminated by the Effect of the Hedge (Fixed to Fixed Scenario)

On July 1, 1999, Company DEF, a USD functional currency entity, issues a zero-coupon debt instrument with a notional amount of FC154,766.79 for FC96,098.00. The interest rate implicit in the debt is 10 percent. The debt will mature on June 30, 2004. DEF enters into a forward contract to buy FC154,766.79 in 5 years at the forward rate of 1.090148194 (USD cost $168,718.74) and designates the forward contract as a hedge of the variability of the USD functional currency equivalent cash flows on the debt. Because the currency, notional amount, and maturity of the debt and the forward contract match, the entity concludes that no ineffectiveness will result. The USD interest rate implicit in the forward contract is 11.028 percent. The market data, period end balances, and journal entries from cash flow hedge accounting are shown below.

Period	**Spot Rate USD/FC**	**Forward Rate USD/FC**	**Forward Rate Difference**	**FC Present Value**	**USD Spot Amounts**	**USD Debt (@11.028%)**	**Fair Value Forward USD**
5	1.040604383	1.090148194	0	96,098.00	100,000.00	100,000.00	0.00
4	1.1	1.184985966	0.094837771	105,707.80	116,278.58	111,028.04	9,327.97
3	1.1	1.163142906	0.072994712	116,278.58	127,906.44	123,272.25	8,041.09
2	1.1	1.141702484	0.051554290	127,906.44	140,697.08	136,866.76	6,360.72
1	1.1	1.120657277	0.030509083	140,697.08	154,766.79	151,960.48	4,215.89
0	1.1	1.1	0.009851806	154,766.79	170,243.47	168,718.74	1,524.73

	Cash	**Forward**	**Debt**	**OCI**	**Interest Expense**	**Transaction Loss**

		Cash	Forward	Debt	OCI	Interest Expense	Transaction Loss
7/1/99	Borrow Money	$100,000.00		($100,000.00)			
6/30/00	Accrue Interest on Debt			(10,570.78)		$10,570.78	
6/30/00	Mark Debt to Spot			(5,707.80)			($5,707.80)
6/30/00	Mark Forward to FV		$9,327.97		($4,077.43)	457.26	(5,707.80)
6/30/00	Balances	100,000.00	9,327.97	(116,278.58)	(4,077.43)	11,028.04	0.00
6/30/01	Accrue Interest on Debt			(11,627.86)		11,627.86	
6/30/01	Mark Forward to FV		(1,286.88)		670.53	616.35	
6/30/01	Balances	100,000.00	8,041.08	(127,906.44)	(3,406.90)	23,272.25	
6/30/02	Accrue Interest on Debt			(12,790.64)		12,790.64	0.00
6/30/02	Mark Forward to FV		(1,680.37)		876.50	803.87	
6/30/02	Balances	100,000.00	6,360.71	(140,697.08)	(2,530.40)	36,866.76	
6/30/03	Accrue Interest on Debt			(14,069.71)		14,069.71	
6/30/03	Mark Forward to FV		(2,144.84)		1,120.83	1,024.01	
6/30/03	Balances	100,000.00	4,215.88	(154,766.79)	(1,409.57)	51,960.48	
6/30/04	Accrue Interest on Debt			(15,476.68)		15,476.68	
6/30/04	Mark Forward to FV		(2,691.15)		1,409.57	1,281.58	
6/30/04	Balances	$100,000.00	$1,524.72	($170,243.47)	$0.00	$68,718.74	$0.00

Journal Entries at Inception of the Loan and at the End of the First Year

	DR	CR
7/1/99		
Cash	100,000.00	
FC Debt at spot		100,000.00
To record FC borrowing in USD.		

	DR	CR
6/30/00		
Interest Expense	10,570.78	
Debt		10,570.78
To accrue interest. Period end spot rate used for simplicity.		
Transaction Loss	5,707.80	
Debt		5,707.80
To record a transaction loss on the debt.		
Derivative asset	9,327.97	
OCI		9,327.97
To record a derivative at fair value and record effective portion in OCI.		

	DR	CR
OCI	5,250.54	
Interest Expense	457.26	
Earnings		5,707.80

To reclassify an amount out of OCI (1) to increase interest expense to the USD yield of 11.028% and (2) to offset the transaction loss on the debt.

Journal entries for the remaining 4 years are not displayed.

The above example would also be relevant for a non-interest bearing foreign-currency-denominated receivable or payable instrument. An amount based on the rate implicit in the forward contract would be reported in earnings each period. Given the short maturities of many receivables and payables, the amount reported in earnings each period may be small.

Section 3: Hedge Accounting in the Consolidated Financial Statements Applied to Internal Derivatives That are Offset on a Net Basis by Third-Party Contracts

The purpose of this example is to illustrate the application of paragraphs 40A and 40B of the proposed amendment of Statement 133. Specifically, this example illustrates the mechanism for offsetting risks assumed by a Treasury Center using internal derivative contracts on a net basis with third-party contracts. This example does not demonstrate the computation of fair values and as such makes certain simplifying assumptions.

Company XYZ is a U.S. company with the U.S. dollar as both its functional currency and its reporting currency. Company XYZ has three subsidiaries: Subsidiary A is located in Germany and has the Euro as its functional currency, subsidiary B is located in Japan and has the Japanese yen (JPY) as its functional currency, and subsidiary C is located in the United Kingdom and has the British pound (BP) as its functional currency. Company XYZ utilizes a Treasury Center to manage foreign exchange risk on a centralized basis. Foreign exchange risk assumed by Subsidiaries A, B, and C through transactions with external third parties is transferred to the Treasury Center via internal contracts. The Treasury Center then offsets that exposure to foreign currency risk via third-party contracts. To the extent possible, the Treasury Center offsets exposure to each individual currency on a net basis with third-party contracts.

On January 1, Subsidiaries A, B, and C decides that various foreign-currency-denominated forecasted transactions with external third parties for purchases and sales of various goods are probable. Also on January 1, Subsidiaries A, B, and C enter into internal foreign currency forward contracts with the Treasury Center to hedge the foreign exchange risk of those transactions with respect to their individual functional currencies. The Treasury Center has the same functional currency as the parent company (U.S. dollar).

Subsidiaries A, B, and C have the following foreign currency exposures and enter into the following internal contracts with the Treasury Center:

				Internal Contracts with TC	
Subsidiary	Functional Currency	Forecasted Exposures	Expected Transaction Date	Currency Received	Currency Paid
A (German)	Euro	JPY payable 12,000 BP receivable 50	June 1 June 1	JPY 12,000 Euro 80*	Euro 115* BP 50
B (Japanese)	JPY	U.S. Dollar payable 100 Euro receivable 100	June 15 June 15	USD 100 JPY 10,432*	JPY 10,160* Euro 100
C (U.K.)	BP	U.S. Dollar receivable 330	June 30	BP 201*	USD 330

**Computed based on forward exchange rates as of January 1.*

Subsidiaries A, B, and C designate the internal contracts with the Treasury Center as cash flow hedges of their foreign currency forecasted purchases and sales. Those internal contracts may be designated as hedging instruments in the consolidated financial statements if the requirements of Statement 133, as amended by the Exposure Draft, are met. From the Subsidiaries' perspectives, the requirements of paragraph 40A for foreign currency cash flow hedge accounting, as amended, are satisfied as follows:

a. From the perspective of the hedging affiliate, the hedging relationship must meet the requirements of paragraph 40 of Statement 133 for cash flow hedge accounting. *Subsidiaries A, B, and C meet those requirements. In each hedging relationship, the forecasted transaction being hedged is denominated in a currency other than the subsidiary's functional currency, and the individual subsidiary that has the foreign currency exposure relative to its functional currency is a party to the hedging instrument. In addition, the criteria in paragraphs 28 and 29 of Statement 133 are met. Specifically, each subsidiary prepares formal documentation of the hedging relationships, including the date on which the forecasted transactions are expected to occur and the amount of foreign currency being hedged. The forecasted transactions being hedged are specifically identified, are probable of occurring, and are transactions with external third parties that create cash flow exposure that would affect reported earnings. Each subsidiary also documents its expectation of high effectiveness based on the internal contracts designated as hedging instruments.*

b. The affiliate that issues the hedge must offset the internal derivative either individually or on a net basis. *The Treasury Center determines that it will offset the exposure arising from the internal derivative contracts with Subsidiaries A, B, and C on a net basis with third-party contracts. Each currency for which a net exposure exists at the Treasury Center is offset by a third-party contract based on that currency.*

In order to determine the net currency exposure arising from the internal contracts with Subsidiaries A, B, and C, the Treasury Center performs the following analysis:

Subsidiary Perspective—Internal Contracts with the Treasury Center

		Currency Received / (Currency Paid)			
Subsidiary	Contract with TC	Euro	JPY	BP	USD
A (German)	Internal Contract 1	(115)	12,000		
	Internal Contract 2	80		(50)	
B (Japanese)	Internal Contract 3		(10,160)		100
	Internal Contract 4	(100)	10, 432		
C (U.K.)	Internal Contract 5			201	(330)
Net Exposure		***(135)***	***12, 272***	***151***	***(230)***

Treasury Center Perspective—Internal Contracts with the Subsidiaries

		Currency Received / (Currency Paid)			
Subsidiary	Contract with TC	Euro	JPY	BP	USD
A (German)	Internal Contract 1	115	(12,000)		
	Internal Contract 2	(80)		50	
B (Japanese)	Internal Contract 3		10,160		(100)
	Internal Contract 4	100	(10, 432)		
C (U.K.)	Internal Contract 5			(201)	330
Net Exposure		***135***	***(12, 272)***	***(151)***	***230***

In order for Subsidiaries A, B, and C to designate the internal contracts as hedging instruments in the consolidated financial statements, the Treasury Center must meet certain required criteria outlined in paragraph 40B of Statement 133, as amended by the Exposure Draft, in determining how it will offset exposure arising from multiple internal derivatives that it has issued. Based on a determination that those

requirements are satisfied (see below), the Treasury Center determines the net exposure in each currency with respect to the U.S. dollar (its functional currency). The Treasury Center determines that it will enter into the following three third-party foreign currency forward contracts. The Treasury Center enters into the contracts on January 1. The contracts mature on June 30.

Treasury Center's Contracts with Unrelated Third Parties				
	Currency Bought / (Currency Sold)			
	Euro	JPY	BP	USD
Third-Party Contract 1	(135)			138*
Third-Party Contract 2		12, 272		(121)*
Third-Party Contract 3			151	(247)*
Net Exposure	***(135)***	***12, 272***	***151***	***(230)***

**Computed based on forward exchange rates as of January 1.*

From the Treasury Center's perspective, the required criteria in paragraph 40B are satisfied as follows:

a. The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts, and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates. *The Treasury Center enters into third-party derivative contracts to offset the exposure of each foreign currency on a net basis. The Treasury Center offsets 100 percent of the net exposure to each currency; that is, the Treasury Center does not selectively keep any portion of that exposure. In this example, the Treasury Center's third-party contracts generate losses that are equal to the losses on internal contracts designated as hedging instruments by Subsidiaries A, B, and C (see analysis below).*

b. Internal derivatives that are not designated as hedging instruments and all nonderivative contracts are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative. *The Treasury Center does not include in the determination of net exposure any internal derivatives not designated as hedging instruments or any nonderivative contracts.*

c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that involve the same currency and that mature within the same 31-day period. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.

The Treasury Center's third-party net contracts involve the same currency (that is, not a tandem currency) as the net exposure arising from the internal derivatives issued to Subsidiaries A, B, and C. The Treasury Center's third-party derivative contracts mature within the same 31-day period as the internal contracts that involve currencies that are offset on a net basis. In this example, for simplicity, all internal contracts and third-party derivatives are entered into on the same date.

d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party. *The Treasury Center maintains documentation supporting linkage of third-party contracts and internal contracts throughout the hedge period.*

e. The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate the offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative. *Based on Company XYZ's policy, the Treasury Center may not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action.*

f. If an internal derivative that is included in determining the foreign currency exposure on a net basis is modified or dedesignated as a hedging instrument, compliance with this paragraph must be reassessed. *For simplicity, this example does not involve a modification or dedesignation of an internal derivative.*

At the end of the quarter, each subsidiary determines the functional currency gains and losses for each contract with the Treasury Center:

Subsidiary	Contract with Treasury Center	Beginning of Period Functional Currency Amount Receive / (Pay)*	End of Period Functional Currency Amount Receive/ (Pay)*	Functional Currency Gain /(Loss)**	U.S. Dollar Gain / (Loss)***
A (German)	Internal Contract 1	(115)	(115)	0	0
	Internal Contract 2	80	83	(3)	(3)
B (Japanese)	Internal Contract 3	(10,160)	(10,738)	578	5
	Internal Contract 4	10,432	10,421	11	0
C (U.K.)	Internal Contract 5	201	204	(3)	(5)
				Net U.S. Dollar Gain / (Loss)	***(3)***

**Computed based on forward exchange rates as of January 1 and March 31.*
***For simplicity, functional currency gains or losses are not discounted in this example.*
****Functional currency gains and losses converted to U.S. dollars based on current spot rates.*

At the end of the quarter, the Treasury Center determines its gains or losses on third-party contracts:

Contracts with Third Parties	Beginning of Period USD Amount Receive / (Pay)*	End of Period USD Amount Receive / (Pay)*	U.S. Dollar Gain / (Loss)**
Third-Party Contract 1	138	131	7
Third-Party Contract 2	(121)	(114)	(7)
Third-Party Contract 3	(247)	(244)	(3)
		Net U.S. Dollar Gain / (Loss)	***(3)***

**Computed based on forward exchange rates as of January 1 and March 31.*
***For simplicity, gains or losses are not discounted in this example.*

Journal Entries at March 31
Note: All journal entries are in U.S. dollars.

Subsidiaries' Journal Entries

German Subsidiary A

There is no entry for Contract 1 because the U.S. dollar gain or loss is zero.

OCI	3	
Derivative Liability		3

To record the loss on Internal Contract 2.

Japanese Subsidiary B

Derivative Asset	5	
OCI		5

To record the gain on Contract 3.

There is no entry for Internal Contract 4 because the U.S. dollar gain or loss is zero.

U.K. Subsidiary C

OCI	5	
Derivative Liability		5

To record the loss on Internal Contract 5.

Treasury Center's Journal Entries

Journal Entries for Internal Contracts with Subsidiaries

There is no entry for Internal Contract 1 because the U.S. dollar gain or loss is zero.

Derivative Asset	3	
Earnings		3

To record the gain on Internal Contract 2 with German Subsidiary A.

Earnings	5	
Derivative Liability		5

To record the loss on Internal Contract 3 with Japanese Subsidiary B.

There is no entry for Internal Contract 4 because the U.S. dollar gain or loss is zero.

Derivative Asset	5	
Earnings		5

To record the gain on Internal Contract 5 with U.K. Subsidiary C.

Journal Entries for Third-Party Contracts

Derivative Asset	7	
Earnings		7

To record the gain on Third-Party Contract 1.

Earnings	7	
Derivative Liability		7

To record the loss on Third-Party Contract 2.

Earnings	3	
Derivative Liability		3

To record the loss on Third-Party Contract 3.

Results in Consolidation

Derivative Asset	7	
OCI	3	
Derivative Liability		10

In consolidation, the amounts in Subsidiaries A, B, and C's balance sheets reflecting derivative assets and derivative liabilities arising from internal derivatives acquired from the Treasury Center eliminate against the Treasury Center's derivative liabilities and derivative assets arising from internal derivatives issued to the subsidiaries. The amount reflected in consolidated other comprehensive income (OCI) reflects the net entry to OCI of Subsidiaries A, B, and C. The Treasury Center's gross derivative asset and gross derivative liability arising from third-party contracts are also reflected in the consolidated balance sheet. Based on the assumptions in this illustration, the Treasury Center's net loss on third-party derivatives used to offset the exposure, on a net basis, of internal contracts with Subsidiaries A, B, and C *equals* the net loss on internal contracts with the subsidiaries. Therefore, within the Treasury Center, the gains on internal contracts issued to Subsidiaries A, B, and C, and the losses on third-party contracts are equal and offsetting. However, if the Treasury Center's net gain or loss on third-party contracts does not equal the net gain or loss on internal derivatives designated as hedging instruments by affiliates, the difference must be recognized as ineffectiveness in consolidated earnings.

The reclassification of amounts out of consolidated OCI is based on Subsidiaries A, B, and C's internal contracts with the Treasury Center. That is, the reclassification of amounts out of consolidated OCI into earnings is based on the timing and amounts of the individual subsidiaries' forecasted transactions. In this illustration, at June 30, the forecasted transactions at Subsidiaries A, B, and C have been consummated and the net debit amount in consolidated OCI of 3 has been reversed.