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Project	<b>Financial Instruments: Replacement of IAS 39</b>
Topic	<b>Illustrative examples of three alternatives to accounting for fair value hedges</b>

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## Introduction

1. This paper contains illustrative examples of each of the alternative approaches discussed in agenda paper 8A. This paper also provides illustrations of how linked presentation discussed in agenda paper 8B could apply in each of these situations.
2. This paper illustrates two scenarios:
  - (a) Scenario 1: hedging the foreign exchange risk of a firm commitment.
  - (b) Scenario 2: hedging the interest rate risk of a fixed rate liability.

## Scenario 1

3. An entity has entered into a contract to deliver a ship in three years' time for CU 100 million. The contract is denominated in a currency different from the entity's functional currency. The company enters into a forward exchange contract to hedge the foreign currency risk. This is the only derivative contract and hedging transaction the entity has.
4. At the end of the financial year the local functional currency weakened significantly against the foreign currency and the forward contract liability has a

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fair value of CU 10 million. The firm commitment asset is measured at CU 9 million and therefore results in CU 1 million of hedge ineffectiveness<sup>1</sup>.

5. For illustrative purposes we assume the entity has other assets of CU 5 million and capital of CU 5 million.
6. Example 1:

Alternative 1 – Hedging a firm commitment using cash flow hedge accounting	
<b>Balance sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>5</b>
Other assets	5
<b>Liabilities</b>	<b>(10)</b>
Derivatives	(10)
<b>Equity</b>	<b>5</b>
Capital	(5)
Retained earnings	1
AOCI <sup>2</sup>	9
Debt to equity ratio	-200%
Note:	
Linked presentation is not applicable when cash flow hedge accounting is applied.	

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<sup>1</sup> You may assume that the source of ineffectiveness is eg due to timing differences between the maturity date of the forward exchange contract and the date of the transaction (firm commitment).

<sup>2</sup> Accumulated Other Comprehensive Income.

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7. Example 2:

Alternative 2 – Hedging a firm commitment using the proposed ‘separate balance sheet item’	
<b>Balance sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>14</b>
Other assets	5
Hedge adjustment	9
<b>Liabilities</b>	<b>(10)</b>
Derivative	(10)
<b>Equity</b>	<b>(4)</b>
Capital	(5)
Retained earnings	1
AOCI	0
Debt to equity ratio	250%

8. Example 3:

Alternative 2 – Linked presentation	
<b>Balance sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>5</b>
Other assets	5
<b>Liabilities</b>	<b>(1)</b>
Derivative	(10)
Hedge adjustment	9
<b>Equity</b>	<b>(4)</b>
Capital	(5)
Retained earnings	1
AOCI	0
Debt to equity ratio	0.25%

Using linked presentation results in the hedge adjustment (CU 9) being subtracted from the derivative liability (CU 10). This then reflects the ‘net’

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position after the hedging relationship is taken into account. This results in a decrease in the debt to equity ratio from 250% to 0.25%.

9. Example 4:

Alternative 2a – ‘Separate balance sheet item’	
<b>Statement of comprehensive income</b>	
	201X CU (m)
Other losses	(1)
<b>(Loss) for the year</b>	<b>(1)</b>
<b>Total other comprehensive income</b>	<b>(0)</b>
<b>Total comprehensive income</b>	<b>(1)</b>

10. Example 5:

Alternative 2b – ‘Separate balance sheet item’ through OCI approach	
<b>Statement of comprehensive income</b>	
	201X CU (m)
Other losses	(1)
<b>(Loss) for the year</b>	<b>(1)</b>
<b>Other comprehensive income</b>	
Gain/(loss) from hedging instrument	(10)
Gain/(loss) on the hedged item attributable to the hedged risk	9
Hedge ineffectiveness transferred to profit or loss	1
<b>Total other comprehensive income</b>	<b>0</b>
<b>Total comprehensive income</b>	<b>(1)</b>

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11. Example 6:

Alternative 3 – Hedging a firm commitment using fair value hedge mechanics currently in IAS 39		
<b>Balance sheet</b>		
	201X CU (m)	
<b>Assets</b>		<b>14</b>
Other assets	5	
Firm commitment	9	
<b>Liabilities</b>		<b>(10)</b>
Derivative	(10)	
<b>Equity</b>		<b>(4)</b>
Capital	(5)	
Retained earnings	(1)	
AOCI	0	
Debt to equity ratio		250%

12. Example 7:

Alternative 3 – Linked presentation		
<b>Balance sheet</b>		
	201X CU (m)	
<b>Assets</b>		<b>5</b>
Other assets	5	
<b>Liabilities</b>		<b>(1)</b>
Derivative	(10)	
Firm Commitment	9	(1)
<b>Equity</b>		<b>(4)</b>
Capital	(5)	
Retained earnings	(1)	
AOCI	0	
Debt to equity ratio		0.25%

Using linked presentation results in the firm commitment (CU 9) being subtracted from the derivative liability (CU 10), reflecting the ‘net’ position of the hedging relationship. This results in a decrease in the debt to equity ratio

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from 250% to 0.25%. Note, however, that for firm commitments the fair value hedge adjustment is often close to or tantamount to the hedged item in its entirety.

**Scenario 2**

13. Assume that an entity enters into an agreement whereby it hedges the interest rate risk of a fixed rate liability (loan) using an interest rate swap. The notional amount of the loan is CU 100 million. At the end of the first year the fair value of the interest rate swap liability is CU 10 million. The gain on the loan attributable to the hedged risk is CU 9 million.<sup>3</sup>
14. For illustrative purposes we assume the entity has other assets of CU 105 million and capital of CU 5 million.
15. Example 8:

Alternative 1 – Interest rate swap using cash flow hedge mechanics	
<b>Balance Sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>105</b>
Other assets	105
<b>Liabilities</b>	<b>(110)</b>
Loan	(100)
Interest rate swap	(10)
<b>Equity</b>	<b>5</b>
Capital	(5)
Retained earnings	1
AOCI	9
Debt to equity ratio	-2,200%
Note:	
Linked presentation is not applicable when cash flow hedge accounting mechanics are applied.	

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<sup>3</sup> You may assume that the source of ineffectiveness is due to the timing differences between the reset/payment dates of the liability and the swap.

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16. Example 9:

Alternative 2 – Interest rate swap using the proposed ‘separate balance sheet item’	
<b>Balance Sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>105</b>
Other assets	105
<b>Liabilities</b>	<b>(101)</b>
Loan	(100)
Hedge adjustment	9 <sup>4</sup>
Interest rate swap	(10)
<b>Equity</b>	<b>(4)</b>
Capital	(5)
Retained earnings	1
Debt to equity ratio	2,525%

17. Example 10:

Alternative 2 – Linked presentation	
<b>Balance Sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>105</b>
Other assets	105
<b>Liabilities</b>	<b>(101)</b>
Loan	(100)
Hedge adjustment	9
Interest rate swap	(10)
<b>Equity</b>	<b>(4)</b>
Capital	(5)
Retained earnings	1
Debt to equity ratio	2,525%

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<sup>4</sup> Consistent with IAS 39.89A, under alternative 2, the gain or loss attributable to the hedged item is presented in a single separate line item within asset (liabilities) for those periods for which the hedged item is a asset (liability).

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Using linked presentation results in the hedge adjustment (CU 9) being subtracted from the interest rate swap liability (CU 10). This reflects the ‘net’ position of the hedging relationship. Linked presentation does not really affect the debt to equity ratio in this example because of the requirements of paragraph 89A of IAS 39.

18. Example 11:

Alternative 3 – Interest rate swap using fair value hedge mechanics currently in IAS 39	
<b>Balance Sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>105</b>
Other assets	105
<b>Liabilities</b>	<b>(101)</b>
Loan	(91)
Interest rate swap	(10)
<b>Equity</b>	<b>(4)</b>
Capital	(5)
Retained earnings	1
Debt to equity ratio	2,525%

19. Example 12:

Alternative 3 –Linked presentation	
<b>Balance Sheet</b>	
	201X CU (m)
<b>Assets</b>	<b>105</b>
Other assets	105
<b>Liabilities</b>	<b>(101)</b>
Loan	(91)
Interest rate swap	(10)
<b>Equity</b>	<b>(4)</b>
Capital	(5)
Retained earnings	1
Debt to equity ratio	2,525%



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Using linked presentation does not work in conjunction with the IAS 39 fair hedge accounting model because the latter already adjusts the carrying amount of the hedged item for the change in value of the hedged risk. Hence, without first undoing the fair value hedge outcome, linked presentation could at best be approximated to some degree by netting the hedged item (CU 91) and the interest rate swap liability (CU 10). However, linked presentation would not affect the debt to equity ratio in this example anyway.