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Project	<b>Financial Instruments: Hedge Accounting</b>
Topic	<b>Accounting for forward points</b>

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## Introduction

### *Background*

1. In the exposure draft *Hedge Accounting* (the ED), the Board proposed a change to the accounting for the time value of options under IAS 39 *Financial Instruments: Recognition and Measurement*. Question 10 in the ED's invitation to comment relates to this issue. In commenting on question 10 of the ED, respondents have also raised the issue of extending the proposed accounting for the time value of options to forward points.
2. This issue has also been raised by participants in the outreach activities.
3. At the 2 June 2011 meeting the Board discussed the different types of costs of hedging in a wider sense, which fall into the following broad types:
  - (a) transaction costs;
  - (b) the time value of options; and
  - (c) forward points in non-option type hedging instruments.

At that meeting, the Board also tentatively confirmed the accounting outcomes for the time value of options as proposed in the ED.

4. At the April 2011 meeting the Board began discussions on an issue that was raised in the feedback received from comment letters and outreach on the ED by financial institutions in Asia—that of 'funding swaps'. At that meeting, the

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Board noted that the current accounting for funding swaps under IAS 39 and the ED might not reflect the economics of such transactions. The Board did not make decisions at that meeting but indicated that it intends to explore possible alternatives to better reflect the economics of such transactions. One such possible alternative is extending the treatment proposed in the ED for the time value of options to forward points.

5. This paper addresses the accounting for forward points. It contains one question to the Board.
6. This paper asks the Board whether it wants to permit recognising the forward points that exist at inception of the hedging relationship in profit or loss over time on a rational basis as the hedged item affects profit or loss and accumulating subsequent fair value changes *in the forward points* in accumulated other comprehensive income (AOCI).
7. The staff recommend that the Board permit recognising the forward points that exist at inception of the hedging relationship in profit or loss over time on a rational basis and accumulate subsequent fair value changes in AOCI.

**Proposal in the ED**

8. Like IAS 39 today, paragraph 8 of the ED proposes that entities can designate as a hedging instrument a forward contract:
  - (a) in its entirety; or
  - (b) only the change in the spot element of a forward contract (ie exclude the interest element)<sup>1</sup>.

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<sup>1</sup> Paragraph 8 of the ED and IAS 39.74(b).

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9. Under the ED, when the entity only designates the change in the spot element of a forward contract as the hedging instrument changes in the interest element are recognised as a trading gain or loss in profit or loss—like under IAS 39 today<sup>2</sup>.
10. In other words, the ED did not propose any changes to how a forward contract can be designated as a hedging instrument and how an undesignated interest element (ie forward points) is accounted for.

**Feedback from comment letters and outreach activities**

***Extending the proposed accounting for the time value of options***

11. In responding to question 10 of the ED (which relates to the accounting for the time value of options), some respondents suggested that the Board consider extending the proposal on the accounting for time value of options to forward points.
12. These respondents noted that like the time value of options, the interest element of a forward contract is also a cost of hedging because it is an unavoidable cost if the entity wants to be hedged. Hence, these respondents think that the accounting requirements should be consistently applied, ie the accounting treatment for forward points and that of the accounting for the time value of options should be aligned.
13. Participants in outreach activities provided the same feedback.

***Funding swaps***

14. Financial institutions in Asia commented that IAS 39 today fails to reflect the economic substance of ‘funding swap’ transactions. Financial institutions in Asian countries often enter into these transactions to manage their exposures to

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<sup>2</sup> IAS 39.74, 55(a), AG108 and IG F.5.6.

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foreign exchange rate risk arising from borrowing in one currency and lending in another. This issue was raised in outreach activities in various Asian countries. The Board began discussions on this issue at the April 2011 meeting (see appendix A for extracts of that paper).

15. To better reflect the economic substance of funding swap transactions, financial institutions in Asia suggested that the Board consider extending the treatment proposed in the ED for the accounting for the time value of options to forward points. These financial institutions argue that in a funding swap transaction, risk management views the forward points as an adjustment of the investment yield on foreign currency denominated assets. In their view, this gives rise to a similar need for adjusting profit or loss against other comprehensive income (OCI) regarding the cost of achieving a fixed economic return (or consideration received as a result of fixing that return) as in the case of the time value of options.
16. The staff note that although this issue was predominantly raised in Asia, the situation of a mismatch between ‘funding’ and ‘investing’ currencies also exists in other jurisdictions (and is not an issue only particular to Asian financial institutions).

**Staff analysis*****Time value of options versus forward points***

17. The time value of options and forward points are an integral element of the fair value of the contract as discussed in agenda paper 7A of the 2 June 2011 meeting. Like the time value of options, the fair value of the forward points changes over time. The staff note that like the time value of options, the fair value of forward points reaches zero at the end of the contract as the forward price becomes the spot price.
18. At the 2 June meeting, the Board tentatively confirmed the ED’s proposals on the accounting for the time value of options. When an entity separates the time value of the option and designates as the hedging instrument only the intrinsic value

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element, the changes in the fair value of the time value are accumulated in AOCI and recognised in profit or loss depending on the type of hedged item:

- (a) for transaction related hedged items: remove from AOCI in accordance with the general requirements (eg like a basis adjustment if capitalised into a non-financial asset or reclassify into profit or loss when eg hedged sales affect profit or loss); or
- (b) for time period related hedged items: reclassify from AOCI to profit or loss on a rational basis over the period for which the hedge adjustment for intrinsic value can affect profit or loss.

Some respondents suggested that the accounting treatment for forward points should be aligned with that of the proposed accounting for the time value of options.

19. The staff note that under IAS 39 today, although the accounting requirements are identical for forwards and options, the actual accounting implications are different—leading to different accounting outcomes.
20. However, unlike in the case of options, the fair value of the hedged item can also have a corresponding forward points element. The entity can choose to designate the forward contract in its entirety and use the forward rate method to measure the hedged item<sup>3</sup> (the forward rate method). However, for financial assets and liabilities denominated in foreign currency IAS 39 requires an entity to apply IAS 21 *The Effects of Changes in Foreign Exchange Rates* to monetary financial assets and liabilities that are denominated in a foreign currency (ie use spot exchange rates)<sup>4</sup>. This means that using the forward rate method does not provide a solution.<sup>5</sup>

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<sup>3</sup> IAS 39.AG108 and IG F.5.6.

<sup>4</sup> IAS 39.AG83.

<sup>5</sup> See paragraph 48.

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21. Under the forward rate method, forward points are essentially included in the hedging relationship by measuring the change in the value of the hedged item on the basis of forward prices or rates. Entities then recognise the forward points as a cost of hedging using the forward rate method for example by:

- (a) capitalising the forward points to the cost of the acquired asset or liability assumed; or
- (b) reclassifying the forward points into profit or loss when eg hedged sales affect profit or loss.

Entities therefore have an accounting solution available that avoids the changes in forward points being recognised as a trading gain or loss. (In contrast, entities often exclude the time value of options under IAS 39 from designation so that the hedge would be less likely to fail the 80-125 per cent test for hedge effectiveness.)

22. Under the proposals in the ED (tentatively confirmed by the Board), for *transaction related* hedged items, the initial time value is deferred in OCI and recognised in accordance with the general requirement (eg like a basis adjustment if capitalised into a non-financial asset or reclassified into profit or loss when eg hedged sales affect profit or loss). Hence, using the forward rate method under IAS 39 today leads to the equivalent accounting outcome as the Board's tentative decision for *transaction related* hedged items for the time value of options.

23. However, under IAS 39 and the ED entities *cannot* achieve an equivalent accounting outcome for forward points regarding *time period* related hedged items. IAS 39 does not allow forward points to be amortised. If an entity hedges the fair value changes resulting from price changes of commodity inventory (ie a *time-period* related hedged item) under IAS 39 and the ED it can either:

- (a) use the forward rate method—forward points are capitalised into the cost of inventory, rather than expensed over the time of the hedge; or
- (b) designate the spot element only—fair value changes in the forward points are recognised as a trading gain or loss.

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Both of the above accounting outcomes are not aligned with the treatment for time value of options for *time period related* hedged items where the time value is amortised on a rational basis.

24. To align the accounting outcomes for the time value of options and forward points, the Board could consider permitting entities to recognise the forward points that exist at inception in profit or loss over time on a rational basis and accumulate subsequent changes in forward points in AOCI. As illustrated below, this would have the benefit of allowing the economic situation and the consequences of risk management activities that use forward contracts to be better reflected.

***Amortisation of forward points and funding swap***

25. Funding swap transactions are very common amongst financial institutions in Asian countries. These financial institutions have argued that in a funding swap transaction risk management views the forward points as an adjustment of the investment yield in the foreign currency, which is fixed at inception.
26. These financial institutions have requested that the Board consider allowing entities to recognise the forward points fixed at inception in profit or loss over time on a rational basis and accumulate subsequent changes in the forward points in AOCI.
27. The following example illustrates the issue under IAS 39 (with and without hedge accounting) and the profit or loss impact of amortising forward points.

***Example***

28. On 1/1/10, Bank A holds customer deposits in its local currency (LC) of LC100,000 at an interest rate of 5%. It enters into the following 'funding swap' transactions regarding a foreign currency (FC):
  - (a) Exchanging LC100,000 into FC150,000 at the spot FX rate of 1LC:1.5FC.

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- (b) Investing FC150,000 into a financial asset denominated in FC at an interest rate of 20% for 1 year.
  - (c) Entering into a forward exchange contract (FX forward) to convert FC180,000 back to Bank A's LC at 31/12/10 at the forward rate of 1LC:1.64FC.
29. The combination of the three transactions described above is a typical funding swap transaction.
30. The net interest margin of the funding swap transaction is fixed at the beginning of the investment period and consists of the following elements:
- (a) the accrued interest revenue at the end of the period;
  - (b) the FX gain/loss on the accrued interest;
  - (c) the gain or loss from the fair value changes of the FX derivative to the extent that they offset the FX gain or loss on the accrued interest (ie (b) above); and
  - (d) the accrued interest expense on the deposits.
31. Bank A has in effect 'locked in' a net interest margin and generates a fixed economic return of LC4,565.22<sup>6</sup> over the period from 1/1/10 to 31/12/10—*irrespective of* how the exchange rate and interest rates move in the meantime.
- Profit or loss over the total period*
32. Bank A can apply cash flow hedge accounting under IAS 39 and the ED. The FX forward (hedging instrument) hedges the variability (in LC) in the future cash flow from the foreign investment in a year's time (hedged item).
33. Assume that the spot rate at 31/12/10 is 1LC:2.80FC.

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<sup>6</sup>  $((150,000 \times 1.2) / 1.64) - (100,000 \times 1.05) = 4,565.22$ .



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34. Profit or loss over the total investment period with and without hedge accounting under IAS 39 and the ED are as follows:

	Profit or loss (no HA)	HA adj	Profit or loss (after HA)
	LC	LC	LC
FX gain or loss on investment	- 46,428.57	46,428.57	-
Interest revenue	10,714.29	- 1,149.07	9,565.22
Interest expense	- 5,000.00		- 5,000.00
Gain or loss from derivative	45,279.50	- 45,279.50	-
	<u>4,565.22</u>		<u>4,565.22</u>
<i>Net interest margin (NIM)</i>	<i>5,714.29</i>		<i>4,565.22</i>

35. Under cash flow hedge accounting, Bank A reclassifies the gain or loss from the FX derivative as a reclassification adjustment to the related line items (FX gain or loss on investment and interest revenue) at the end of the reporting period.
36. If the reporting period is the same as the total investment period, the difference between applying and not applying hedge accounting is presentation. Without hedge accounting, the gain or loss from the FX forward contract is presented as a trading gain or loss. With hedge accounting, the gain or loss from the FX derivative is offset against the FX gain or loss on investment and investment revenue.
37. The net interest margin over the total investment period is determined by adjusting the yield of the investment (after translation into the local currency) for the forward points (of the FX derivative) and then deducting the interest expense. (The FX gains and losses from the investments are offset by the changes of the FX spot rate of the derivative).
38. When the reporting period is the same as the investment period applying cash flow hedge accounting provides an accurate portrayal of the economics of the

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transaction. However, this is not the case if there are reporting dates<sup>7</sup> within the total investment period.

*Interim periods*

39. Assume that the spot and forward FX rates and the benchmark interest rates of the respective currencies move as follows during the total investment period (ie from 1/1/2010 to 31/12/10).

	01/01/2010	31/03/2010	30/06/2010	30/09/2010	31/12/2010
Spot FX rate	1.50	1.90	1.10	4.00	2.80
Benchmark interest rate (LC)	5%	4%	7%	6%	5%
Benchmark interest rate (FC)	15%	13%	9%	12%	11%
Forward FX rate	1.643	2.05	1.11	4.06	2.80

40. Profit or loss for interim periods is presented and discussed under the following three scenarios:
- (a) Scenario 1: without hedge accounting.
  - (b) Scenario 2: cash flow hedge accounting using the spot rate method.
  - (c) Scenario 3: cash flow hedge accounting using the spot rate method and amortisation of forward points.

Scenario 1: profit or loss without hedge accounting

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<sup>7</sup> To the end of an interim or annual reporting period.

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41. Profit or loss for Bank A without hedge accounting in the four quarterly interim periods are as follows:

<b>Scenario 1</b>					
<b>Profit or loss without HA</b>					
	31/03/2010	30/06/2010	30/09/2010	31/12/2010	Total
	LC	LC	LC	LC	LC
FX gain or loss on investment	- 21,052.63	60,093.88	- 108,299.69	18,426.40	- 50,832.04
FX gain or loss on accrued interest	- 433.14	1,774.91	- 1,089.34	505.48	757.91
Interest revenue	4,114.87	4,881.00	3,005.07	2,358.91	14,359.85
Interest expense	- 1,227.22	- 1,242.28	- 1,257.53	- 1,272.96	- 5,000.00
Gain or loss from derivative	21,080.11	- 71,894.62	115,052.30	- 18,958.28	45,279.50
<b>Profit or loss</b>	<b>2,481.97</b>	<b>- 6,387.12</b>	<b>7,410.81</b>	<b>1,059.55</b>	<b>4,565.22</b>
<b>NIM</b>	<b>2,887.64</b>	<b>3,638.71</b>	<b>1,747.54</b>	<b>1,085.95</b>	<b>9,359.85</b>

42. Even though Bank A has in effect ‘locked in’ an interest margin over the total investment period by entering into the above described transactions, profit or loss in the interim periods fluctuates significantly because of the FX movements. The net interest margin (a key performance metric for banks) is very volatile in the interim periods and can even be negative (depending on the FX rate movements).

Scenario 2: cash flow hedge accounting using the spot rate under IAS 39 and the ED

43. Under IAS 39 and the ED, Bank A can designate the spot element of the FX derivative as the hedging instrument in the cash flow hedge<sup>8</sup>. The forward points are not part of the hedging relationship and hence changes in the fair value of the forward points are recognised as a trading gain or loss. This example assumes that the hedge is perfectly effective.

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<sup>8</sup> Paragraph 8 of the ED and IAS 39.74(b).

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<b>Scenario 2</b>					
<b>Performance statement with CFH using the spot rate method</b>					
	31/03/2010	30/06/2010	30/09/2010	31/12/2010	Total
	LC	LC	LC	LC	LC
<i>Profit or loss</i>					
FX gain or loss on investment	-	-	-	-	-
Interest after hedging	4,663.51	4,881.00	5,108.62	5,346.86	20,000.00
Interest expense	- 1,227.22	- 1,242.28	- 1,257.53	- 1,272.96	- 5,000.00
Gain or loss from derivative	- 1,669.00	- 7,349.47	351.33	- 1,767.66	- 10,434.78
<b>Profit or loss</b>	<b>1,767.29</b>	<b>3,710.75</b>	<b>4,202.43</b>	<b>2,306.25</b>	<b>4,565.22</b>
<i>Other comprehensive income</i>					
FV change of spot element	22,749.10	-64,545.16	114,700.96	- 17,190.62	55,714.29
Reclassification of FX gain or loss	-22,034.42	61,868.79	- 111,492.58	15,943.92	- 55,714.29
	714.68	- 2,676.37	3,208.39	- 1,246.70	-
Comprehensive income	2,481.97	- 6,387.12	7,410.81	1,059.55	4,565.22
<i>Equity</i>					
Retained earnings	1,767.29	- 1,943.46	2,258.97	4,565.22	
AOCI	714.68	- 1,961.69	1,246.70	- 0.00	
	2,481.97	- 3,905.15	3,505.67	4,565.22	
<b>NIM</b>	<b>3,436.29</b>	<b>3,638.71</b>	<b>3,851.09</b>	<b>4,073.90</b>	<b>15,000.00</b>

44. In a cash flow hedge the gain or loss from the hedging instrument (ie the fair value changes of the spot element) is deferred in OCI<sup>9</sup>. The gain or loss is immediately reclassified to profit or loss to offset the changes in the FX gain or loss on the investment and interest revenue (ie the accrued interest)<sup>10</sup>.
45. The remaining deferred gain or loss in AOCI is attributable to the cumulative FX translation effect on the difference between the present value of the maturity cash flow amount (ie the present value of FC180,000 in this example) discounted at the benchmark interest rate and the carrying amount of the investment (principal of FC150,000 plus interest accrued to date<sup>11</sup>).

<sup>9</sup> IAS 39.95 and paragraph 29(b) of the ED.

<sup>10</sup> IAS 39.100 and paragraph 29(d)(ii) of the ED.

<sup>11</sup> This is a present value discounted at the investment's interest rate.

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46. From the above table, profit or loss during the interim periods is volatile due to the interim fair value changes of the forward points presented as a trading gain or loss.
47. Under this scenario, the net interest margin is stable as the fluctuations from interim FX changes are offset with the changes in the spot element of the derivative under cash flow hedge accounting. However, the fair value changes of the forward points produce interim profit or loss volatility: Profit or loss during the interim periods is volatile because of the fair value changes of the interest element (ie the forward points) of the FX forward contract (LC-1,669.00 for 31/3/2010, LC-7,349.47 for 30/6/2010, LC351.33 for 30/9/2010, and LC-1,767.66 for 31/12/2010) even though the total period profit or loss (LC4,565.22) is know from the outset. The staff also note that entities view the forward points at inception as an adjustment to the investment yield (ie interest revenue), which should also affect the net interest margin. (The net interest margin can even be negative if the investment yield before adjusting for the forward points (ie the interest differential between the currencies) is less than the interest expense on the deposits).

The forward rate method?

48. Bank A cannot use the forward rate method to measure the FX investment because of the requirement to measure the FX gain or loss in accordance with IAS 21<sup>12</sup>. Under IAS 21, foreign monetary items are remeasured using spot exchange rates and the changes to their carrying amounts are recognised in profit or loss.

Scenario 3: cash flow hedge accounting using the spot rate and amortisation of forward points

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<sup>12</sup> IAS 39.AG83, IG.F.5.6, F.2.18 and IAS 21.28.

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49. Under this scenario, Bank A designates the spot element of the FX derivative as the hedging instrument in the cash flow hedge<sup>13</sup>. The forward points that exist at inception are amortised over the period in which the hedged item affects profit or loss and subsequent changes in forward points are recognised in OCI. The treatment for forward points is in line with the accounting treatment for *time period* related hedged items (see paragraph 18).

<b>Scenario 3</b>					
<b>Performance statement with CFH using the spot rate method and amortisation of forward points</b>					
	31/03/2010	30/06/2010	30/09/2010	31/12/2010	Total
	LC	LC	LC	LC	LC
<i>Profit or loss</i>					
FX gain or loss	-	-	-	-	-
Interest after hedging	4,663.51	4,881.00	5,108.62	5,346.86	20,000.00
Amortisation of forward points	- 2,608.70	- 2,608.70	- 2,608.70	- 2,608.70	- 10,434.78
Interest revenue	2,054.82	2,272.30	2,499.93	2,738.17	9,565.22
Interest expense	- 1,227.22	- 1,242.28	- 1,257.53	- 1,272.96	- 5,000.00
<b>Profit or loss</b>	<b>827.59</b>	<b>1,030.02</b>	<b>1,242.40</b>	<b>1,465.21</b>	<b>4,565.22</b>
<i>Other comprehensive income</i>					
Fair value change of forward contract	21,080.11	- 71,894.62	115,052.30	- 18,958.28	45,279.50
Reclassification of forward points amortisation	2,608.70	2,608.70	2,608.70	2,608.70	10,434.78
Reclassification of FX gain or loss	- 22,034.42	61,868.79	- 111,492.58	15,943.92	- 55,714.29
	1,654.38	- 7,417.14	6,168.42	- 405.66	-
Comprehensive income	2,481.97	- 6,387.12	7,410.81	1,059.55	4,565.22
<i>Equity</i>					
Retained earnings	827.59	1,857.61	3,100.01	4,565.22	
AOCI	1,654.38	- 5,762.76	405.66	0.00	
	2,481.97	- 3,905.15	3,505.67	4,565.22	
<b>NIM</b>	<b>827.59</b>	<b>1,030.02</b>	<b>1,242.40</b>	<b>1,465.21</b>	<b>4,565.22</b>

<sup>13</sup> Paragraph 8 of the ED and IAS 39.74(b).

## IASB Staff paper

50. Like in scenario 2, fair value changes of the spot element are deferred in OCI<sup>14</sup> but are immediately reclassified to profit or loss to offset the changes in the FX gain or loss on the investment and interest revenue<sup>15</sup>.
51. Fair value changes of the forward points are also deferred in OCI<sup>16</sup> and then are released to profit or loss over time on a rational basis consistent with the accounting for *time period related* hedged items. The amortisation of the forward points is presented as an adjustment to the interest revenue.
52. By allowing for amortisation of forward points under scenario 3:
- (a) interim profit or loss volatility from fair value changes of forward points is eliminated—this interim *profit or loss* volatility is arguably inappropriate since total profit or loss (ie the entire margin from the transaction over the total period) is known from the outset; and
  - (b) the net interest margin provides a more faithful presentation of the economic substance of the transaction and economic performance over the total investment period (as the forward points represent the interest differential between the two currencies at inception).

This provides more useful information to fully assess the economic return of the transaction.

*Summary of the three scenarios*

53. The following two graphs show the profit or loss and net interest margin of the funding swap transaction under the three scenarios.

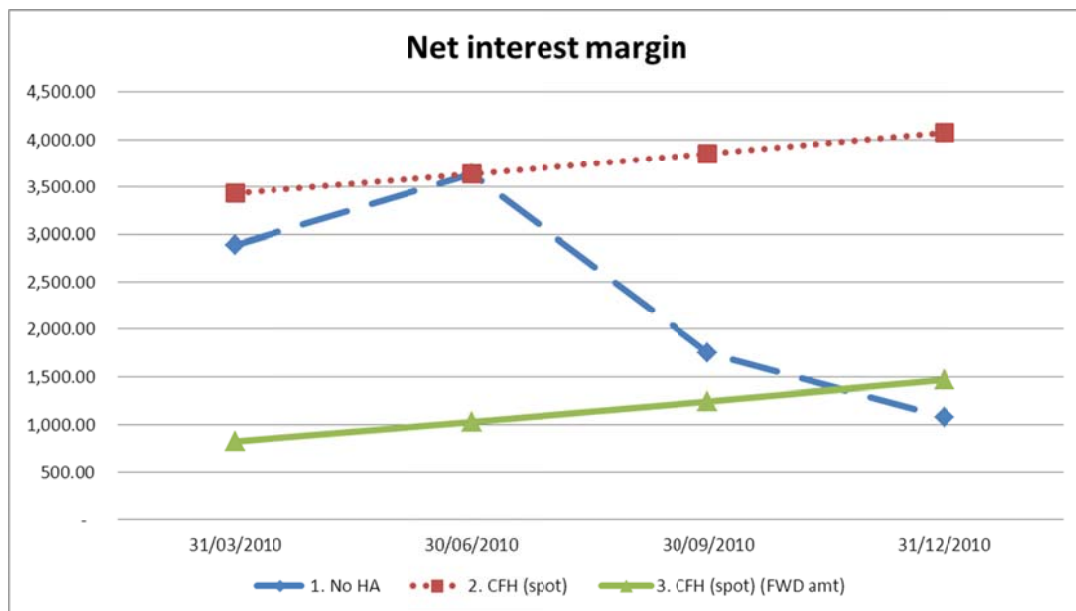
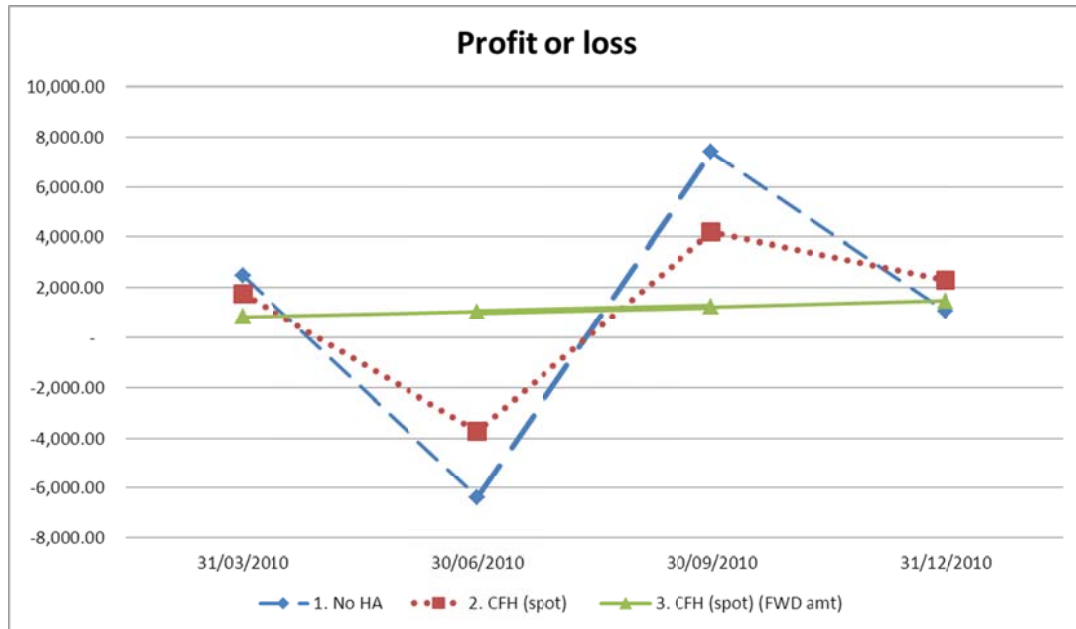
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<sup>14</sup> IAS 39.95 and paragraph 29(b).

<sup>15</sup> IAS 39.100 and paragraph 29(d)(ii) of the ED.

<sup>16</sup> Essentially, to the extent they are effective, the entire fair value changes of the hedging instrument are recognised in OCI.

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54. From the above graphs the staff note that:

- (a) Without hedge accounting (scenario 1), profit or loss and net interest margin are volatile across the interim periods although the economic return for the total period has been fixed at inception. This is



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inconsistent with a key objective of the hedge accounting project, which is to better reflect risk management activity.

- (b) With cash flow hedge accounting by designating the spot element only but without amortisation of forward points (scenario 2), profit or loss is still volatile. The net interest margin is stable across interim periods but does not include the effect of the interest differential, which is viewed as an adjustment to the yield. (The net interest margin could also be *negative* if the investment yield before adjustment for the forward points is less than the interest expense on the deposits.)
  - (c) With cash flow hedge accounting by designating the spot element and amortisation of forward points (scenario 3), profit or loss is stable across interim periods. The net interest margin is also stable and takes into account the interest differential of the two currencies. This more accurately reflects the economic yield achieved through the risk management activity.
55. By allowing for amortisation of forward points the issue of misrepresentation of the economic characteristics of forward points as a trading gain or loss is avoided and hence also undue profit or loss volatility. Adjusting for forward points also facilitates better comparison of the net interest margin across different entities that have:
- (a) different percentages of their investments in foreign versus domestic assets—eg Bank A invested more in domestic assets while Bank B invested more in foreign assets.
  - (b) have investments in a different foreign currencies—eg Bank A invested in Euro denominated assets and Bank B invested in US dollar denominated assets.

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**Additional considerations**

56. To avoid treating forward points as transaction costs when the forward points do not solely relate to the hedged item, the Board could consider using the same requirement as for the time value of options of *time period related* hedged items:
- (a) If at inception of the hedging relationship the absolute amount of actual forward points is higher than the absolute amount of aligned<sup>17</sup> forward points, the amount that is amortised on a rational basis should be determined only on the basis of the aligned forward points, whereas the remainder of the actual forward points should be accounted for at fair value through profit or loss.
  - (b) If at inception of the hedging relationship the absolute amount of actual forward points is lower than the absolute amount of aligned forward points, the amount that is recognised in AOCI would have to be determined by reference to the lower of the absolute cumulative fair value change of:
    - (i) the actual forward points (determined from the hedging instrument ie the derivative); and
    - (ii) the aligned forward points (determined from the hedged item).

The staff note that the scenario where there is significant misalignment between actual and aligned forward points would be less frequent than for the time value of options. For example, for hedges of foreign exchange (FX) risk, misalignment for forward points would mainly result from the differences in maturity of the hedging instrument and hedged item as opposed to a basis difference between the underlyings.

57. The Board could also consider using the same impairment test as for the time value of options for *time period related* hedged items. That essentially means

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<sup>17</sup> The forward points from a forward contract that perfectly matches the hedged item.

## IASB Staff paper

that where there is impairment on the financial asset, hedge accounting would be discontinued. This would trigger the immediate recognition of the forward points that have not yet been amortised.

**Staff recommendation and question to the Board**

58. Respondents have suggested that the Board consider extending the proposal on the accounting for time value of options to the interest element in forward contracts (ie forward points).
59. The staff note that under IAS 39 and the ED, entities that hedge *transaction related* hedged items with forward type contracts can achieve the equivalent accounting outcome using the forward rate method (see paragraph 20).
60. The staff note that the accounting outcomes for forward points and time value of options can be further aligned thus achieving a better representation of the economic position if the Board allows for amortisation of the forward points for *time period related* hedged items. It would provide consistent accounting outcomes for forward points and the time value of options, which are both considered as costs of hedging.
61. Financial institutions in Asia have raised the issue that current IFRSs do not provide a true reflection of the economic substance of funding swap transactions as a whole. Forward points represent the interest differential between the two currencies at inception and are economically viewed as an adjustment to the investment yield (ie interest revenue) in a funding swap transaction.
62. The staff note that by permitting entities to amortise forward points over time on a rational basis, financial statements under IFRSs would provide a better representation of the economic substance of the funding swap transaction and the performance of the net interest margin. The staff note that amortisation of forward points over time on a rational basis provides more useful information for investors. Information provided would be more forward looking as it provides investors with better information about the future cash flows to be realised and

IASB Staff paper

the ultimate profitability at the end of the investment period. It also facilitates better net interest margin analysis across periods and across entities (see paragraphs 52 and 55).

63. Permitting amortisation of forward points would also provide better alignment with risk management, which is consistent with the objective of the ED to reflect the risk management activities that use financial instruments to manage exposures.
64. Hence, the staff recommend that the Board permit recognising the forward points that exist at inception of the hedging relationship in profit or loss over time on a rational basis and accumulate subsequent fair value changes in AOCI (see paragraphs 24, 56 and 57).

**Question 1: Accounting for forward points**

Does the Board agree with the staff recommendation in paragraph 64 above?

If the Board does not agree, what does the Board prefer instead and why?

## IASB Staff paper

**Appendix A—Extract from agenda paper 11 of 11 April 2011 meeting****Funding swaps**

5. In Asia, financial institutions often have more funding in their local currency (for example from their strong customer deposit basis) than they can invest in financial assets (eg loans, commercial paper, and money market products etc) in their domestic currency. To generate an economic return on their surplus funds, many Asian financial institutions exchange these funds into a foreign currency (usually US dollars and euros) and invest in assets denominated in that foreign currency.
6. In order to protect the investments against foreign exchange (FX) risk and to stabilise the net interest margin in such a scenario, the banks typically enter into FX derivatives (eg currency swaps or forwards). These hedging derivatives are commonly referred as ‘funding swaps’.
7. A funding swap transaction usually simultaneously involves the following:
  - (a) swap the local currency surplus funds into foreign currency, eg US dollars or euros at the spot rate; and
  - (b) invest the funds into the foreign currency-denominated financial assets for a period of time; and
  - (c) enter into an FX derivative to convert the foreign currency funds back into the local currency at the end of the investment period. This amount typically covers the principal plus interest at maturity.
8. The difference between the forward rate and the spot rate (ie forward points) represents the interest differential between the two currencies at inception. The net economic return (ie the interest margin) over the investment period is determined by adjusting the yield of the investment in the foreign currency for the forward points (of the FX derivative) and then deducting the interest expense. (The FX gains and losses from the investment are offset by the FX gains and

IASB Staff paper

losses of the FX derivative from changes for the spot rate.) The combination of the three transactions described above in effect allows the financial institution to ‘lock in’ a net interest margin and generate a fixed economic return over the investment period.

**Staff analysis of the issue**

9. This section of the paper analyses accounting implications of the FX funding swap transaction under IFRSs and under the ED.
10. The following table sets out the measurement of the different items in a funding swap transaction in the balance sheet:

	Balance sheet
Investment in foreign currency	At spot FX rate (IAS 21)
Interest revenue in foreign currency	At spot FX rate (IAS 21 and IFRS 9)
FX forward contract	At fair value (IFRS 9)
Borrowings (eg customer deposits) in local currency	At amortised cost (IFRS 9)

11. At the end of the investment period the following elements generate a fixed net interest margin or net economic return of the funding swap transaction:
  - (a) the gain or loss on the foreign investment from the change in the spot FX rate;
  - (b) the accrued interest revenue at the end of the period (including the related FX gain/loss);
  - (c) the gain or loss from the fair value changes of the FX derivative; and
  - (d) the accrued interest expense.
12. Under hedge accounting today and the ED, entities can designate the spot element of the forward contract and leave the change in the forward points undesignated. The gain or loss from the changes in the forward points is presented like a trading gain or loss. This is not consistent with how the forward

**IASB Staff paper**

points are perceived economically, ie risk management views the forward points as part of interest revenue in the context of the funding swap transaction. This is similar to the issue that the Board addressed for options used as hedging instruments.