
Project	Financial Instruments (Replacement of IAS 39)—Hedge accounting
Topic	Hedged items—aggregated exposures

Introduction

1. This paper addresses the designation of an *aggregated exposure* as the hedged item. Question 3 in the exposure draft *Hedge Accounting*'s (ED) invitation to comment relates to this issue.
2. The staff recommend:
 - (a) to confirm the proposal in the ED subject to adding some guidance and clarifications;
 - (b) that illustrative examples should accompany the final standard;
 - (c) to clarify that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value and to state in the basis for conclusions of the final requirements that in its redeliberations the Board noted that accounting for aggregated exposures is part of hedge accounting and hence different from 'synthetic accounting', which is not allowed;
 - (d) not to impose specific restrictions (that would require that hedge accounting is achieved between the items that constitute the aggregated exposure); and
 - (e) to clarify two aspects regarding:
 - (i) that the notion of an aggregated exposure includes a highly probable forecast transaction of an aggregated

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exposure if that aggregated exposure once executed is eligible as a hedged item; and

- (ii) how to apply the general requirements in the context of designating a derivative as part of an aggregated exposure.

- 3. This paper includes five questions to the Board.

Overview of the Board's proposal in the ED

- 4. The ED addresses aggregated exposures in paragraphs 15 and B9. Paragraphs BC48-BC51 of the Basis for Conclusions provide the rationale for the proposal.

Proposed change

- 5. The ED uses the term *aggregated exposure* to refer to exposures that are a *combination* of an exposure and a derivative.
- 6. The ED proposes that if an entity combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks) that aggregated exposure may be designated as a hedged item.

Rationale for the proposal

- 7. The proposed change would address the following aspects:
 - (a) Risk management often considers exposures by risk, irrespective of whether the exposure results from one or several contracts including exposures that result from the combined effect of a non-derivative and a derivative contract.
 - (b) Entities often use different risk management strategies for different risks.

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8. The proposal would mean that when designating hedging relationships, entities can take into account the effect of existing hedges on the hedged risk. For example:¹
- (a) a commodity hedge can affect the foreign currency exposure that results from a commodity transaction by fixing the amount in foreign currency that will be paid or received; or
 - (b) similarly, a cross currency interest rate swap in combination with a debt instrument in a foreign currency can give rise to a variable interest rate exposure in the entity's functional currency.
9. In the first example the proposal would allow an entity to designate as the hedged item the foreign currency risk on the basis of the currency amount that *includes* the effect of the commodity hedge. In the second example, the entity could designate as the hedged item the interest rate risk on the basis that *includes* the effect of the cross currency interest rate swap.
10. The proposal would therefore address problems that entities have when applying hedge accounting in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. While IAS 39 allows derivatives to be jointly designated as hedging instruments,² an entity cannot add a derivative after inception of the hedging relationship as a joint designation without first discontinuing the original hedging relationship and then starting a new one.
11. This creates the following problems when an entity does *not* hedge both of the risks involved from the outset (and only once for the entire period³):

¹ Illustrative examples are set out in Appendix A.

² See IAS 39.77.

³ If an entity uses a strategy where the second risk is hedged for a shorter period than the first risk the problems of discontinuing and re-starting hedging relationships would also occur. For example, for 10-year fixed rate debt denominated in a foreign currency an entity may hedge the foreign currency risk for the entire term of the debt instrument but require fixed rate exposure in its functional currency only for the short to medium term (say two years) and variable rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years (if the interest level is such that the entity wants to fix interest rates).

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- (a) When starting to hedge the second risk the hedging relationship regarding the first risk must be discontinued even though the hedging of that risk continues as before. This mischaracterises the economic phenomenon and presents as a discontinued activity what is a continuing activity.
- (b) When designating the two derivatives jointly as a hedging instrument the fact that the derivative entered into for the first hedging relationship has already changed in fair value (ie has moved into or out of the money) often gives rise to hedge ineffectiveness that is artificial (ie solely the result of technically discontinuing and restarting the hedging relationship for accounting purposes even though economically it does not exist).

Feedback from comment letters and outreach activities

- 12. The comment letter feedback showed overwhelming support for the proposal. The overall feedback was that the proposal is consistent with the ED's objective of hedge accounting because it helps align hedge accounting with risk management. Many comment letters also referred to the examples in the ED as relevant situations in practice.
- 13. Many commentators also noted that the proposal removes arbitrary restrictions and is a move to a principle-based requirement.
- 14. Very few respondents disagreed. Arguments cited for disagreement were:
 - (a) The criteria on how to aggregate were inadequately specified and could hence result in non-comparability across entities.

Every time the entity decides to enter into a two-year interest rate swap after the initial one it would have to discontinue the first hedging relationship involving the 10-year fixed rate foreign currency denominated debt and the related 10-year cross currency interest rate swap.

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- (b) Economically equivalent financial instruments might be accounted for differently because of including them in aggregated exposures.
 - (c) Aggregation allows circumvention of accounting for derivatives at fair value through profit or loss and structuring by entities to avoid showing real economic volatility resulting from the use of derivatives.
 - (d) Hedging aggregated exposures was not necessary as an entity could ‘directly’ hedge the risk such that it achieves the desired economic position (ie use only *one* derivative to hedge the exposure).
15. The *main* issues that respondents suggested to be addressed by the redeliberations are:
- (a) **Examples/further guidance:** the Board was asked to provide examples that would illustrate the accounting mechanics for aggregated exposures. That should include aspects such as how hedge ineffectiveness is recognised and the type of the hedging relationships involved.
 - (b) **Clarification regarding ‘synthetic accounting’:** the Board was asked to clarify that accounting for aggregated exposures is *not* tantamount to ‘synthetic accounting’.
 - (c) **Hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure:** the Board was asked to clarify whether an entity would have to achieve hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure as a precondition for the aggregated exposure being eligible as the hedged item in the other hedging relationship.
16. Other requests for clarifications related to specific aspects of designating and discontinuing hedging relationships in the context of aggregated exposures including:

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- (a) whether forecast transactions that will constitute aggregated exposures when executed can be designated as aggregated exposure type hedged items;
 - (b) whether derivatives must be designated in their entirety;
 - (c) whether a derivative for a shorter period than the non-derivative exposure can still be combined and designated as an aggregated exposure;
 - (d) whether derivatives that are basis swaps can be used when hedging aggregated exposures;
 - (e) how hedge accounting for aggregated exposures as the hedged item would be affected if hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure is discontinued.
17. The outreach feedback was consistent with the comment letter feedback.

Staff analysis

18. The feedback on the proposal that aggregated exposures should be eligible hedged items was *overwhelmingly supportive*. Hence, the main focus of the staff analysis is to address the requests for further guidance and clarifications.

Examples/further guidance

19. The most frequent request was that the accounting mechanics for an aggregated exposure as the hedged item be illustrated using an example (ie a numerical example).
20. The staff consider that a numerical example illustrating the mechanics would at the same time address many other questions raised such as how hedge ineffectiveness is recognised and the type of the hedging relationships involved. Hence, providing such an example would be a very efficient means of

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addressing large parts of the feedback. In particular, such an example would demonstrate that the proposed accounting for aggregated exposures is very different from ‘synthetic accounting’, which would provide another clarification many commentators requested (see section ‘Clarification regarding ‘synthetic accounting’’).

21. Therefore the staff have developed numerical examples. Those are set out in Appendix A and illustrate the accounting mechanics for aggregated exposures as a hedged item for the following situations:
 - (a) **Example 1:** The hedge of a forecast commodity purchase against commodity price risk using a commodity forward contract. These two items are both denominated in a foreign currency and in combination constitute the aggregated exposure that a period later is then hedged for the foreign exchange (FX) risk between the foreign currency and the entity’s functional currency using an FX forward contract.
 - (b) **Example 2:** The hedge of a fixed rate liability denominated in a foreign currency with a cross currency interest rate swap that swaps fixed cash flows in the foreign currency into variable cash flows in the entity’s functional currency. These two items in combination constitute the aggregated exposure that a period later is then hedged for the risk of variability in interest cash flows (in the entity’s functional currency) using an interest rate swap (pay fixed/receive variable).
 - (c) **Example 3:** The hedge of a variable rate liability denominated in a foreign currency with a cross currency interest rate swap that swaps variable cash flows in the foreign currency into fixed cash flows in the entity’s functional currency. These two items in combination constitute the aggregated exposure that a period later is then hedged for the fair value risk of a fixed rate exposure (in the entity’s functional currency) using an interest rate swap (pay variable/receive fixed).
22. In particular, the examples demonstrate that:

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- (a) hedge ineffectiveness *is measured and recognised*—for both derivatives involved in each situation;
- (b) accounting for aggregated exposures as a hedged item is *not* ‘synthetic accounting’.

Clarification regarding ‘synthetic accounting’

- 23. Another request from commentators was that the Board clarify that accounting for aggregated exposures is *not* tantamount to ‘synthetic accounting’. While most of those commentators correctly understood the ED they still wanted confirmation that ‘synthetic accounting’ was not permitted.
- 24. The staff consider that the confusion about ‘synthetic accounting’ arises from accounting debates in the past about whether two items should be treated for accounting purposes as if they were one single item. This would have had the consequence that a derivative could have assumed the accounting treatment for a non-derivative item (eg accounting at amortised cost).
- 25. In contrast, under the proposal for aggregated exposures the accounting for derivatives would always be at fair value and hedge accounting would be applied to them instead of changing their accounting to a different measurement basis.
- 26. The staff note that the examples in Appendix A demonstrate that accounting for aggregated exposures as hedged items and ‘synthetic accounting’ are entirely different matters.
- 27. Hence, the remaining question is whether an explicit statement that accounting for aggregated exposures is *not* tantamount to ‘synthetic accounting’ is needed in addition to those examples and that clarification.
- 28. The staff consider that the final requirements should not refer to ‘synthetic accounting’ because doing so would require describing or defining what ‘synthetic accounting’ is. Given that ‘synthetic accounting’ is not allowed, staff

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consider that introducing that term only to then explicitly prohibit that accounting would be confusing and unnecessary.

29. If the Board believes that an explicit statement is needed, the staff consider a better way of addressing the issue would be a statement that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value. However, the basis for conclusions of the final requirements could state that in its redeliberations the Board noted that accounting for aggregated exposures is part of hedge accounting and hence different from ‘synthetic accounting’ which is not allowed.

Hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure

30. Some commentators asked the Board to clarify whether an entity would have to achieve hedge accounting for the combination of the underlying exposure and the derivative that constitute the aggregated exposure (*first level* relationship) as a precondition for the aggregated exposure being eligible as the hedged item in the other hedging relationship (*second level* relationship).
31. The staff consider that this request relates to a wider issue than whether the *first level* relationship qualifies for hedge accounting. The wider issue is how the items that constitute the aggregated exposure (the first level relationship) affect profit or loss because that determines the compatibility of the accounting for that combination of items with accounting for the *second level* relationship that includes the aggregated exposure as the hedged item.
32. This wider issue covers three alternative situations:
- (a) Hedge accounting is achieved for the combination of the exposure and the derivative that constitute the aggregated exposure (ie the first level relationship).
 - (b) The exposure that is part of the aggregated exposure is already accounted for at fair value through profit or loss in accordance with IFRSs (ie there is no hedge accounting for the first level relationship).

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- (c) The exposure that is part of the aggregated exposure is not accounted for at fair value through profit or loss nor is hedge accounting achieved for the combination of the exposure and the derivative that constitute the aggregated exposure (ie all situations other than the two previous situations—‘other situations’, which are also without hedge accounting for the first level relationship).

Hedge accounting is achieved for the combination of the exposure and the derivative that constitute the aggregated exposure

33. In this situation, hedge accounting for the first level relationship ensures that the items involved affect profit or loss such that it is compatible with the second level relationship that uses the aggregated exposure as the hedged item. This applies to both risks hedged (eg for the examples above, commodity price risk and FX risk or interest rate risk and FX risk).
34. The workings for this situation have been demonstrated in the examples.⁴ Respondents also agreed that in this situation designating aggregated exposures as hedged items should be allowed.

The exposure that is part of the aggregated exposure is already accounted for at fair value through profit or loss in accordance with IFRSs

35. In this situation there is no hedge accounting for the first level relationship. However, if the exposure that is part of the aggregated exposure is already accounted for at fair value through profit or loss in accordance with IFRSs anyway, hedge accounting would not be needed if the first level relationship would otherwise be a *fair value hedge*. In that case, recognising in profit or loss the gain or loss from re-measuring the exposure (that is part of the aggregated exposure) to fair value regarding the hedged risk is already achieved by the accounting for that exposure at fair value through profit or loss.

⁴ See Appendix A.

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36. To illustrate, if in Example 2 the fixed rate FX liability was already measured at fair value through profit or loss⁵ under IFRS 9 *Financial Instruments* then achieving *fair value hedge* accounting for the combination of that liability and the cross currency interest rate swap would not change profit or loss. Hence, the workings for the hedge accounting for the second level relationship would work in the same way irrespective of whether there is hedge accounting for the first level relationship.
37. Hence, there was feedback advocating that when the exposure is a financial instrument for which the fair value option was applied to eliminate or significantly reduce an accounting mismatch that financial instrument should also qualify to be included in an aggregated exposure that can be designated as a hedged item for hedge accounting for the second level relationship.
38. The staff note that the compatibility of hedge accounting for the second level relationship with the designation as the hedged item of an aggregated exposure that is a combination of a derivative and a non-derivative financial instrument at fair value through profit or loss does *not* depend on the reason why that non-derivative financial instrument is accounted for at fair value through profit or loss because the effect on profit or loss would be the same:
- (a) If the fair value option is elected for a financial liability because it is part of a group that is managed and its performance evaluated on a fair value basis an entity could end up in a situation like Example 2, eg after having first entered into a cross currency interest rate swap to switch the fair value interest rate risk in the foreign currency back to cash flow interest rate risk in its functional currency and then later fixing the interest in its functional currency using an interest rate swap to avoid cash flow variability for some period. Similarly, if the fair value option is elected to avoid the separation of an embedded derivative an entity

⁵ For the purpose of this analysis that means entirely accounted for at fair value through profit or loss—including the ‘own credit’ related fair value changes.

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might still hedge the interest rate and currency risk like in Example 2 in order to balance fair value and cash flow interest rate risk over time.

- (b) If the non-derivative financial instrument is accounted for at fair value through profit or loss as a consequence of the mandatory classification requirements of IFRS 9 an entity could also end up in a situation similar to Example 2. For example, if because of the business model an entity classifies a fixed rate FX bond (ie an asset instead of a liability as in Example 2) as fair value through profit or loss the entity might enter into a cross currency interest rate swap to swap the fixed rate exposure in the foreign currency into a variable rate exposure in its functional currency and then later hedge the variability in interest cash flows in its functional currency with an interest rate swap.

39. Hence, for situations in which:

- (a) the exposure that together with a derivative constitutes the aggregated exposure is already accounted for at fair value through profit or loss; and
- (b) the first level relationship would be a fair value hedge (if hedge accounting was applied at that level),

the workings for hedge accounting for the second level relationship would be the same irrespective of whether hedge accounting is actually applied for the first level relationship.

40. This applies for all exposures that are already accounted for at fair value through profit or loss in accordance with IFRSs when they become part of an aggregated exposure that is designated as the hedged item for hedge accounting for the second level relationship. This also applies irrespective of whether the exposure is a non-derivative *financial* instrument or a *non-financial* item accounted for at fair value through profit or loss because the decisive aspect is *that* achieving fair hedge accounting would not change profit or loss in this situation (*not why* accounting at fair value through profit or loss applies).

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41. Hence, if the exposure that together with a derivative constitutes the aggregated exposure is already accounted for at fair value through profit or loss that aggregated exposure (if it otherwise would be a fair value hedge type) should be eligible as a hedged item for hedge accounting for the second level relationship.

Other situations

42. The remaining question is whether designating an aggregated exposure as the hedged item would work if:
- (a) hedge accounting is not achieved for the combination of the exposure and the derivative that constitute the aggregated exposure (ie for the first level relationship);
 - (b) nor is the non-derivative item that is part of the aggregated exposure already accounted for at fair value through profit or loss.
43. In that case the effect of designating an aggregated exposure as the hedged item depends on the situation.
44. In **Example 1** the commodity forward contract is denominated in a foreign currency. Hence, the fair value of that derivative in the foreign currency gives rise to FX gains or losses because it must be translated into the entity's functional currency. If hedge accounting is *not* achieved for the first level relationship those FX gains or losses are recognised in profit or loss. Hence, part of the change in fair value of the FX forward contract relates to an item for which FX gains or losses are recognised in profit or loss each period (ie in relation to the commodity forward contract) while another part relates to an item for which FX gains or losses are not recognised in profit or loss each period (ie in relation to the forecast commodity purchase).

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45. Applying the general requirements for cash flow hedges⁶ gives the following outcomes:
- (a) If the commodity price *declines* there is a loss on the commodity forward contract on the basis of its fair value in the foreign currency. That negative fair value in the foreign currency gives rise to FX gains or losses. At the same time the forecast purchase of the commodity in the foreign currency becomes cheaper resulting in a gain regarding the commodity price risk in the foreign currency. Changes in the FX rate give rise to FX gains or losses on that commodity price gain in the foreign currency. The combined effect is that the FX gain or loss on the commodity forward contract together with that on the forecast commodity purchase offsets⁷ the fair value change of the FX forward contract. However, the gain or loss on the forecast transaction is always *lower* (as an absolute amount) than that of the FX forward contract. Hence, a part of the gain or loss on the FX forward contract relates to the commodity forward contract. Therefore, the part of the change in fair value of the FX forward contract that is offset by the FX gain or loss on the commodity forward contract must be immediately transferred from the cash flow hedge reserve to profit or loss⁸ because the entire change in fair value of the commodity forward contract (in the entity's functional currency—ie including the related FX gain or loss) is recognised in profit or loss each period.
 - (b) Conversely, if the commodity price *increases* there is a gain on the commodity forward contract on the basis of its fair value in the foreign currency. That positive fair value in the foreign currency gives rise to FX gains or losses. At the same time the forecast purchase of the

⁶ See ED.33(b).

⁷ To the extent that the hedge of the aggregated exposure is effective. Changes in the commodity basis risk give rise to hedge ineffectiveness that is recognised in profit or loss.

⁸ See ED.32(b)(ii).

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commodity in the foreign currency becomes more expensive resulting in a loss regarding the commodity price risk in the foreign currency. Changes in the FX rate give rise to FX gains or losses on that commodity price loss in the foreign currency. The combined effect is that the FX gain or loss on the commodity forward contract together with that on the forecast commodity purchase offsets⁹ the fair value change of the FX forward contract. However, in contrast to the previous scenario, the gain or loss on the forecast transaction is always *higher* (as an absolute amount) than that of the FX forward contract. Hence, the gain or loss on the FX forward contract is too small to offset the FX gain or loss on the forecast transaction and consequently *no* part of the gain or loss on the FX forward contract relates to the commodity forward contract. Instead, the remaining part of the FX gain or loss on the forecast transaction is offset by the FX gain or loss on the *commodity forward contract*. However, because hedge accounting is not achieved for the first level relationship, the entire change in fair value of the commodity forward contract (in the entity's functional currency—ie including the related FX gain or loss) is recognised in profit or loss each period because it does not qualify as a hedging instrument. Hence, despite applying hedge accounting for the aggregated exposure that part of the FX gain or loss on the forecast transaction that is offset by the FX gain or loss on the *commodity forward contract* would be accounted for in the same way as if no hedge accounting applied at all.

46. In summary, in this example hedge accounting for the aggregated exposure means:

⁹ To the extent that the hedge of the aggregated exposure is effective. Changes in the commodity basis risk give rise to hedge ineffectiveness that is recognised in profit or loss.

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- (a) Hedge ineffectiveness is measured and recognised for the aggregated exposure as a whole. The effectiveness of hedging an aggregated exposure does *not* depend on the *accounting* for the related items but on any mismatches between the aggregated exposure (ie the hedged item) and the hedging instrument. Instead, the accounting for the related items determines how changes in fair value of the hedging instrument are recognised.
 - (b) Because hedge accounting is not achieved for the first level relationship (regarding the commodity price risk) any gain or loss on the FX forward contract that is related to the commodity forward contract must be transferred to profit or loss immediately each period.
 - (c) A cash flow hedge reserve is built up for the gain or loss on the FX forward contract that relates to the forecast commodity purchase. However, to the extent that the FX gain or loss on the forecast commodity purchase is offset by an FX gain or loss on the commodity forward contract hedge accounting is not achieved because the entire gain or loss (including the FX related part) on the commodity forward contract is recognised in profit or loss (given that it does not qualify as a hedging instrument).
47. Therefore, the staff consider that even without achieving hedge accounting for the first level relationship, designating an aggregated exposure as the hedged item would *not* violate any of the general requirements of the hedge accounting model (in particular hedge ineffectiveness is measured and recognised, and gains and losses on financial instruments at fair value through profit or loss are only deferred in the cash flow hedge reserve for qualifying hedging instruments).
48. In **Example 2** the variability of cash flows of the aggregated exposure is the same *irrespective of* whether hedge accounting is achieved for the first level relationship (ie the combination of the fixed rate FX liability and the cross currency interest rate swap). The consequence of not achieving hedge accounting for the first level relationship is that the fixed rate FX liability is not

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adjusted for interest rate related fair value changes but continues to be measured at amortised cost in the foreign currency. This also affects the currency translation under IAS 21 *The Effects of Changes in Foreign Exchange Rates* because the FX gain or loss is calculated by reference to the carrying amount of the fixed rate debt in the foreign currency.

49. However, the amounts that are recognised in other comprehensive income (OCI) and transferred from the cash flow hedge reserve (ie accumulated OCI—‘AOCI’) to profit or loss remain unaffected because the variability of cash flows of the aggregated exposure is the same as if fair value hedge accounting was achieved for the first level relationship. Hence, the hedge ineffectiveness of the cash flow hedge for the second level relationship is also the same as if fair value hedge accounting was achieved for the first level relationship. That hedge ineffectiveness must be measured each period and recognised in profit or loss and thus captures any mismatches between the cash flow variability of the aggregated exposure and that of the hedging instrument (ie the interest rate swap).
50. In summary, in this example hedge accounting for the aggregated exposure means:
- (a) Hedge ineffectiveness is measured and recognised for the aggregated exposure as a whole. The effectiveness of hedging an aggregated exposure does *not* depend on the *accounting* for the related items but on any mismatches between the aggregated exposure (ie the hedged item) and the hedging instrument. Instead, the accounting for the related items determines how changes in fair value of the hedging instrument are recognised.
 - (b) Because hedge accounting is not achieved for the first level relationship (regarding the interest rate risk and FX risk of the fixed rate FX debt) the fixed rate FX debt is not adjusted for interest rate related fair value changes in the foreign currency. However, the FX risk nonetheless

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affects profit or loss because of IAS 21 (but on the basis of the fixed rate FX debt's carrying amount, ie amortised cost).

- (c) A cash flow hedge reserve is built up for the gain or loss on the interest rate swap. The accounting for the cash flow hedge remains unaffected because the accounting changes that result from not achieving fair value hedge accounting for the first level relationship do not relate to the risk that is hedged by the second level relationship (ie *cash flow* interest rate risk in the functional currency of the entity).¹⁰

51. Therefore, the staff consider that even without achieving hedge accounting for the first level relationship, designating an aggregated exposure as the hedged item would *not* violate any of the general requirements of the hedge accounting model (in particular that hedge ineffectiveness is measured and recognised, and that gains and losses on financial instruments at fair value through profit or loss are only deferred in the cash flow hedge reserve for qualifying hedging instruments).
52. In **Example 3** the effect of achieving hedge accounting for the aggregated exposure is that the timing of transfers from the cash flow hedge reserve in relation to the cash flow hedge for the first level relationship to profit or loss changes (to 'immediate recycling' and also at that point in time starting the amortisation of the balance in the cash flow hedge reserve).
53. Hence, if cash flow hedging is *not* achieved for the first level relationship then designating the aggregated exposure (ie the combination of the variable rate FX debt and the cross currency interest rate swap) as the hedged item in a fair value hedge would not have any effect on the accounting (as there is no cash flow

¹⁰ Note: this is different from Example 1 where the accounting changes that result from not achieving cash flow hedge accounting for the first level relationship *affect* the risk that is hedged by the second level relationship (ie FX risk). In Example 1 the accounting for the commodity forward contract changes from that for a cash flow hedge with the effective hedging gain or loss being recognised in OCI to accounting at fair value through profit or loss. In contrast, in Example 2 the cross currency interest rate swap is accounted for at fair value through profit or loss when hedge accounting is achieved for the first level relationship (because it is a fair value hedge) as well as when it is not achieved.

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hedge reserve for which the timing of transfers to profit or loss could be changed).

54. Therefore, the staff consider that designating an aggregated exposure as the hedged item would *not* violate any of the general requirements of the hedge accounting model but also that given that hedge accounting would not make a difference entities would not seek to elect it. Hence, the staff consider that in this situation the question of whether the designation of an aggregated exposure should be allowed is not relevant.
55. As an *overall conclusion*, the staff consider that even if hedge accounting is not achieved for the first level relationship (and the non-derivative item that is part of the aggregated exposure is not already accounted for at fair value through profit or loss if the first level relationship would be a fair value hedge) designating an aggregated exposure as the hedged item would *not* violate any of the general requirements of the hedge accounting model. Hence, from that perspective no specific restrictions (ie in addition to the general requirements) are needed in such situations.

Other clarifications

56. This section addresses other requests for clarifications.¹¹

Whether forecast transactions that will constitute aggregated exposures when executed can be designated as aggregated exposure type hedged items

57. Some commentators have requested that the Board clarify whether aggregated exposures that are in their entirety forecast transactions would also qualify as hedged items. An example is a forecast debt issue that would take place in a foreign currency and would immediately be swapped into a functional currency exposure using a cross-currency interest rate swap.

¹¹ See paragraph 16.

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58. A particular problem under IAS 39 is that when an entity hedges the interest rate risk of a forecast debt issue but does not know in advance which transaction structures it will use cannot achieve hedge accounting. For example, an entity has a highly probable forecast issue of debt at variable rate that might be affected using two different structures depending on the market conditions at the time of placing the debt:
- (a) **Structure 1:** issue of variable rate debt in the entity's functional currency;
 - (b) **Structure 2:** issue of fixed rate debt in a liquid foreign currency that will be swapped into a variable rate functional currency exposure using a cross-currency interest rate swap.
59. Irrespective of the ultimate structure that is chosen, the entity can (economically) hedge the cash flow interest rate risk using a forward starting interest rate swap in its functional currency whereby it receives variable and pays fixed interest. However, since IAS 39 facilitates hedge accounting only for Structure 1 the entity cannot achieve hedge accounting as it is not certain to be used—even if Structure 1 is eventually chosen.
60. The ED would facilitate hedge accounting for both structures. Hence, the staff consider that (unlike under IAS 39) under the ED there is no need to disallow hedge accounting in this situation.
61. More generally, the staff consider that a forecast transaction in which the transaction is an aggregated exposure would qualify for hedge accounting in the same way as other forecast transactions if the aggregated exposure that results from the executing the forecast transactions qualifies for designation as a hedged item.
62. The staff consider that this treatment follows from the general accounting for hedges of forecast transactions. The reason why today hedge accounting for this type of forecast transactions is not allowed is that IAS 39 in general does not allow aggregated exposures to be designated as hedged items, which has the

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consequential effect of disqualifying hedging of forecast transactions that constitute aggregated exposures.

63. The staff note that the ED did not limit aggregated exposures to recognised assets or liabilities. The example in paragraph B9(a) of the ED clearly involves a forecast transaction. Also, as set out earlier,¹² the difference between Structure 1 and Structure 2 does not affect the interest rate hedge economically as long as it is highly probable that one of them will occur. Similar considerations already apply today because an entity can designate a hedging relationship for a hedge of the cash flow variability of interest rate cash flows without specifying in advance which particular transaction will give rise to the exposure (eg whether 3-month LIBOR variable interest payments are paid on a variable rate loan, a commercial paper programme with 3-monthly rolls or deposits bearing 3-month LIBOR interest).
64. However, the staff consider that in the final requirements to improve clarity the Board could expand the description of an aggregated exposure by a statement that the notion of an aggregated exposure includes a highly probable forecast transaction of an aggregated exposure if that aggregated exposure once executed is eligible as a hedged item.

Whether derivatives must be designated in their entirety

65. Another question raised was whether a derivative must be included in its entirety when forming part of an aggregated exposure, indicating that including only selected cash flows would not be appropriate.
66. The ED sets out how a hedging instrument can be designated if hedge accounting is achieved for the first level relationship¹³. Those requirements must then also apply in the context of the aggregated exposure that is designated as the hedged item for hedge accounting for the second level relationship. This

¹² See paragraph 59.

¹³ See ED.8-9.

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means that how a derivative is designated as the *hedging instrument* for hedge accounting for the *first level* relationship determines how the *hedged item* is designated for hedge accounting for the *second level* relationship. (For example, if an entity excludes forward points from the designation of the hedging instrument for hedge accounting for the first level relationship the hedged aggregated exposure must also exclude them—otherwise double counting issues would arise as the forward points are already accounted for separately).

67. Alternatively, if hedge accounting does not apply for the first level relationship (eg if the aggregated exposure consists of a non-derivative at fair value through profit or loss and a derivative and the first level relationship would otherwise be a fair value hedge), the derivative must be designated and included in the aggregated exposure in its entirety. Otherwise, an inconsistency with how derivatives can be generally treated would arise (because it is only hedge accounting that allows designating something else than the derivative in its entirety and only if the derivative is a hedging instrument). In other words, designation as part of an aggregated exposure does *not* allow splitting a derivative by risk (or parts of its term or cash flows) through the backdoor.
68. However, a derivative can be included in an aggregated exposure as a percentage of its nominal amount *irrespective of* whether hedge accounting is achieved for the first level relationship. The staff note that the general hedge accounting requirements permit designation as a percentage of a nominal amount for hedging instruments and hedged items alike—hence, this is a common denominator of designating hedging relationships. Therefore, a derivative that is part of an aggregated exposure and hence designated in at least one hedging relationship also qualifies for designation as a percentage of its nominal amount.
69. The staff note that this facilitates designation of aggregated exposures in a practicable way regarding their size *without* causing difficulties and complexities associated with splitting a derivative by risk (or parts of its term or cash flows).

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70. The staff consider that in the final requirements the Board could add application guidance on how to apply the general requirements in the context of aggregated exposures, ie:
- (a) that the way in which a derivative is designated as a *hedged item* as part of an aggregated exposure must be consistent with any designation of that derivative as the *hedging instrument* at the level of the aggregated exposure (ie the first level relationship); and
 - (b) that otherwise a derivative must be designated in its entirety or as a percentage of its nominal amount.

Whether a derivative for a shorter period than the non-derivative exposure can still be combined and designated as an aggregated exposure

71. This question is closely related to that addressed in the previous section ('Whether derivatives must be designated in their entirety') as it relates to partial designation of derivatives. The staff note that like IAS 39 the ED allows designating a 'partial term hedge' in which the *hedged item* is designated for only a part of its term.¹⁴ However, neither IAS 39 nor the ED allows designating a derivative as a hedging instrument for only a part of its term.¹⁵
72. Hence, the staff consider that a combination of a derivative designated for its entire term and a non-derivative exposure that is designated for only a part of its term would qualify as an aggregated exposure. Conversely, designating a derivative for only part of its term would not result in an aggregated exposure that is eligible as a hedged item (for similar reasons as set out in the previous section 'Whether derivatives must be designated in their entirety').
73. Hence, the staff consider that the issue is clear and no clarification of the proposal needed. The staff also note that this issue was raised by only one respondent.

¹⁴ See IAS 39.81 (and IG F.2.17) and ED.18.

¹⁵ See IAS 39.75 and ED.9.

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Whether derivatives that are basis swaps can be used when hedging aggregated exposures

74. A basis swap is a derivative that exchanges one variable payment for another variable payment (ie a variable/variable swap that has two floating legs). For example:
- (a) A swap that exchanges 1m LIBOR against 3m LIBOR variable interest payments.
 - (b) A swap that exchanges the price differential of a commodity between different locations, grades or both (eg exchange the price differential for crude oil based on Brent and WTI).
75. However, there are many more types of basis swaps and the term is typically used in a very broad sense. Therefore, it is difficult to analyse ‘basis swaps’ as if they were one type of financial instrument and a blanket statement for all ‘basis swaps’ cannot be made.
76. The problem with designating variable/variable swaps as a hedging instrument is that the definitions of a cash flow hedge and a fair value hedge require that an entity hedges either an exposure to variability in cash flows or an exposure to changes in fair value.¹⁶ Hence, basis swaps that *only change the type of the variability* in cash flows do not qualify as either a cash flow hedge or a fair value hedge. However, such variable/variable swaps can be *jointly* designated with another derivative as the hedging instrument if that combination qualifies as a cash flow hedge or a fair value hedge.¹⁷
77. Therefore, if achieving hedge accounting for the first level relationship¹⁸ was a precondition for designating an aggregated exposure as the hedged item variable/variable swaps could not be included in hedge accounting for

¹⁶ See ED.21(a)-(b) (and IAS 39.86(a)-(b) for current IFRSs).

¹⁷ See ED.10 (and IAS 39.77 for current IFRSs).

¹⁸ See section ‘Hedge accounting is achieved for the combination of the exposure and the derivative that constitute the aggregated exposure’.

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aggregated exposures¹⁹ because they would not qualify as a hedging instrument for hedge accounting for either the first level or the second level relationship.

78. This also applies if without achieving hedge accounting for the first level relationship designating aggregated exposures would only be allowed in situations in which:
- (a) the exposure that together with a derivative constitutes the aggregated exposure is already accounted for at fair value through profit or loss; and
 - (b) the first level relationship would be a *fair value hedge* (if hedge accounting was applied at that level).²⁰
79. Given that variable/variable swaps relate to exposures to variability in cash flows the first level relationship would be a cash flow hedge instead of a fair value hedge and hence would not be accommodated by such a requirement.
80. The remaining question is what the implications are of using a variable/variable swap when designating an aggregated exposure as the hedged item if:
- (a) achieving hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure (ie the first level relationship) is *not* a precondition; and
 - (b) the situation is *not* one in which the exposure that together with a derivative constitutes the aggregated exposure is already accounted for at fair value through profit or loss in a situation in which the first level relationship would be a *fair value hedge* (if hedge accounting was applied at that level).

¹⁹ Except if they qualify as part of a joint designation as a hedging instrument—see paragraph 76.

²⁰ See section ‘The exposure that is part of the aggregated exposure is already accounted for at fair value through profit or loss in accordance with IFRSs’.

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81. In such a situation the implications of using a variable/variable swap when designating an aggregated exposure as the hedged item depends on the circumstances.
82. An example that was mentioned in the comment letters was an entity that has:
- (a) a fixed rate bond (asset);
 - (b) a fixed to 3m Euribor interest rate swap (that swaps the bond into a variable exposure), which together with the fixed rate bond is considered an aggregated exposure; and
 - (c) a 3m Euribor to OIS²¹ basis swap.
83. The staff consider that *irrespective of* whether fair value hedge accounting is achieved for the aggregated exposure the basis swap would *not* qualify as a hedging instrument because the aggregated exposure gives rise to exposure to variability in interest cash flows and hence in this suggested designation the basis swap would only *change the type* of cash flow variability.²² However, using joint designation of the two swaps as the hedging instrument might still allow achieving hedge accounting for the basis swap.
84. The staff considered one more example (even though not raised by the feedback). Assume an entity has:
- (a) a variable rate liability (6m LIBOR);
 - (b) a 6m LIBOR to 3m LIBOR basis swap, which together with the variable rate liability is considered an aggregated exposure; and
 - (c) a 3m LIBOR to fixed interest rate swap.
85. The staff consider that the combination of the variable rate liability and the basis swap would *not* qualify for hedge accounting because it would only change the

²¹ Overnight Indexed Swap.

²² See paragraph 76.

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type of the cash flow variability.²³ Hence, the basis swap would be accounted for at fair value through profit or loss. Designating the combination of the variable rate liability and the basis swap as the hedged item (aggregated exposure) for hedge accounting for a second level relationship with the interest rate swap as the hedging instrument would not change the accounting for the basis swap (ie it would remain at fair value through profit or loss because hedge accounting is not achieved for the first level relationship²⁴).

86. Hence, even if hedge accounting applies for the second level relationship the basis swap would still give rise to volatility in profit or loss from the following sources:
- (a) fair value changes from changes in the basis spread between the two variable rates would immediately affect profit or loss (because the basis swap is accounted for at fair value through profit or loss and there is no corresponding basis in the interest rate swap that could offset that gain or loss);
 - (b) the accrual on the 6m LIBOR leg of the basis swap, which is measured at fair value whereas the 6m LIBOR interest accrual on the variable rate liability accounted for at amortised cost (unless the liability was classified as at fair value through profit or loss).
87. Hence, the staff consider that when using designation of aggregated exposures as hedged items the implications of using basis swaps still follow from the general requirements of the hedge accounting model. If the Board decides to impose preconditions on the designation of an aggregated exposure as the hedged item that would influence the outcomes but they would still follow from applying the general requirements in conjunction with such preconditions.

²³ See paragraph 76.

²⁴ See paragraph 25.

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88. Hence, the staff consider that specific requirements for basis swaps are not needed (and given the broad use of the term might result in unintended consequences).

How hedge accounting for aggregated exposures as the hedged item would be affected if hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure is discontinued

89. Some commentators asked for clarification of how hedge accounting for aggregated exposures as the hedged item would be affected if hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure is discontinued.
90. The staff consider that the general requirements²⁵ for discontinuing hedge accounting apply. For the examples of hedging aggregated exposures used in this paper this means:

- (a) **Example 1:** once the hedging relationship for the commodity price risk no longer qualifies for hedge accounting:
- (i) that hedging relationship between the forecast commodity purchase and the commodity forward contract that constitute the aggregated exposure must be discontinued. That means the cash flow hedge reserve for this hedging relationship is no longer adjusted for changes in the commodity price risk but retained until the forecast commodity purchase occurs and adjusts the cost of the commodity inventory.²⁶ Only if the forecast commodity purchase is no longer expected to occur is the cash flow hedge reserve immediately transferred to profit or loss.²⁷
 - (ii) the designated hedged item for hedge accounting for the second level relationship was the aggregated exposure.

²⁵ See ED.25, 28 and 30.

²⁶ See ED.30(a).

²⁷ See ED.30(b).

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Discontinuing hedge accounting for the first level relationship would generally mean that the aggregated exposure no longer qualifies as a hedged item (eg if the commodity forward contract has been closed out or if the forecast commodity purchase is no longer highly probable). In that case hedge accounting for the hedging relationship for the FX risk must also be discontinued. Similar to the commodity risk hedging relationship, the cash flow hedge reserve is no longer adjusted for changes in the FX risk but retained until the forecast commodity purchase occurs and adjusts the cost of the commodity inventory (unless the forecast commodity purchase is no longer expected to occur, in which case the cash flow hedge reserve would be immediately transferred to profit or loss).

- (b) **Example 2:** once the hedging relationship for the combined interest and FX risk using the cross currency interest rate swap no longer qualifies for hedge accounting:
- (i) that hedging relationship between the fixed rate FX liability and the cross currency interest rate swap that swaps fixed cash flows in the foreign currency into variable cash flows in the entity's functional currency (which in combination constitute the aggregated exposure) must be discontinued. That means that the fair value hedge adjustment of the fixed rate debt must be amortised using a recalculated effective interest rate.²⁸
 - (ii) the designated hedged item for hedge accounting for the second level relationship was the aggregated exposure. Discontinuing hedge accounting for the first level relationship would generally mean that the aggregated exposure no longer qualifies as a hedged item (eg if the

²⁸ See ED.28.

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cross currency interest rate swap has been closed out). In that case hedge accounting for the hedging relationship for the cash flow interest rate risk in the entity's functional currency must also be discontinued. That means the cash flow hedge reserve for this hedging relationship is no longer adjusted for changes in the interest rate risk but transferred to profit or loss over the remaining life of the fixed rate FX liability (unless the cash flows on the FX liability are no longer expected to occur, in which case the cash flow hedge reserve would be immediately transferred to profit or loss).²⁹

(c) **Example 3:** once the hedging relationship for the combined interest and FX risk using the cross currency interest rate swap no longer qualifies for hedge accounting:

- (i) that hedging relationship between the variable rate FX liability and the cross currency interest rate swap that swaps variable cash flows in the foreign currency into fixed cash flows in the entity's functional currency (which in combination constitute the aggregated exposure) must be discontinued. *Generally*, that means the cash flow hedge reserve for the hedging relationship is no longer adjusted for changes in the interest rate risk but transferred to profit or loss over the remaining life of the variable rate FX liability (unless the cash flows on the FX liability are no longer expected to occur, in which case the cash flow hedge reserve would be immediately transferred to profit or loss).³⁰ *However*, in this situation (ie Example 3) the effect of achieving hedge accounting for the aggregated exposure as the hedged item³¹ is that the timing of transfers from the cash flow hedge reserve in

²⁹ See ED.30.

³⁰ See ED.30.

³¹ Ie achieving hedge accounting for the second level relationship.

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relation to the cash flow hedge for the first level relationship to profit or loss changes to ‘immediate recycling’ and also that at that point in time the amortisation of the balance in the cash flow hedge reserve starts. Hence, discontinuing hedge accounting has the mere effect that instead of recognising amounts in OCI and immediately recycling them to profit or loss the amounts are not taken to OCI in the first place. This affects the presentation of interest expense but has no effect on profit or loss.

- (ii) the designated hedged item for hedge accounting for the second level relationship was the aggregated exposure. Discontinuing hedge accounting for the first level relationship would generally mean that the aggregated exposure no longer qualifies as a hedged item (eg if the cross currency interest rate swap has been closed out). In that case hedge accounting for the hedging relationship for the fair value interest rate risk in the entity’s functional currency must also be discontinued. *Generally*, that means the fair value hedge adjustment for the hedged item is no longer adjusted for changes in the interest rate risk but must be amortised to profit or loss over the remaining life of the variable rate FX liability.³² *However*, in this situation (ie Example 3) the effect of achieving hedge accounting for the aggregated exposure as the hedged item³³ is that the timing of transfers from the cash flow hedge reserve in relation to the cash flow hedge for the first level relationship to profit or loss changes to ‘immediate recycling’ and also that at that point in time the amortisation of the balance in the cash flow hedge reserve starts. Therefore, the accounting for

³² See ED.28.

³³ Ie achieving hedge accounting for the second level relationship.

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the hedging instrument (ie the interest rate swap) remains unaffected (ie fair value through profit or loss). Hence, given that hedge accounting for the first level relationship is already discontinued in accordance with subparagraph (i) above, discontinuing hedge accounting for the second level relationship has no additional consequence.

91. The staff also note that if hedge accounting for the second level relationship in which the aggregated exposure is the hedged item is discontinued the hedge accounting for the first level relationship between the non-derivative exposure and the derivative that in combination constituted the aggregated exposure remains unaffected³⁴ and would hence continue (assuming it still meets the qualifying criteria for hedge accounting).
92. In the light of the general requirements for discontinuing hedge accounting (and the examples that set out the accounting mechanics) the staff consider that no further guidance in addition to that in the ED is needed.

Analysis of the arguments cited for disagreement with the proposal

93. This section analyses the arguments cited for disagreement with the proposals.

The criteria on how to aggregate were inadequately specified and could hence result in non-comparability across entities

94. The staff consider that the clarifications discussed in section ‘Other clarifications’ above address at least some of the concerns over how to aggregate the items that constitute an aggregated exposure.
95. In addition, the examples in this paper illustrate the mechanics of combining items as aggregated exposures, which also addresses comparability concerns in that respect.

³⁴ ‘Unaffected’ means in Example 3 that the effect of the fair value hedge on the reclassification of the cash flow hedge reserve for the cash flow hedge for the first level relationship *ceases*.

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96. The staff note that the rationale for the proposal regarding aggregated exposures was to facilitate a better alignment of accounting with risk management in situations in which an entity combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks).³⁵ An overwhelming number of commentators supported this proposal for that reason.³⁶
97. Hence, the staff consider that specifying in more detail how to aggregate items in terms of what exposures must be aggregated with what derivatives would defeat the purpose of the proposal. Such specifications would create another disconnect of accounting from risk management, which would again create the danger of resulting in purely accounting driven designations rather than providing information about the underlying economic phenomenon (ie what hedging instruments an entity uses in relation to what risks).
98. The staff also note that the general qualifying criteria for hedge accounting apply to hedging relationships that have aggregated exposures as the hedged item.
99. Finally, the staff note that the use of joint designations of derivatives as hedging instruments, which is the designation used under IAS 39 in comparable situations,³⁷ does not provide specific guidance about what derivatives to combine for joint designations and what hedged items to choose either but also uses the general qualifying criteria instead. However, the need for discontinuing the existing hedging relationship in order to later on include another derivative in the hedging relationship results in mischaracterising an entity's activities given that the hedge that must be discontinued for accounting purposes still

³⁵ See paragraphs 7-9.

³⁶ See paragraphs 12-13.

³⁷ See paragraphs 10.

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continues to hedge the same risk economically and in artificial hedge ineffectiveness.³⁸ Both aspects are detrimental to comparability across entities:

- (a) Even though two entities hedge the first risk in the same way an entity that adds another derivative later on to hedge another risk would have to discontinue the first hedging relationship. That means the information about the comparable hedge of the first risk would become non-comparable (eg for the hedge of the commodity price risk using the commodity forward contract or the hedge of interest rate and FX risk using a cross currency interest rate swap in the examples in this paper—ie regarding the first hedging relationships).
- (b) Artificial hedge ineffectiveness can result in different consequences depending on the effectiveness assessment method that is applied.

Economically equivalent financial instruments might be accounted for differently because of including them in aggregated exposures

- 100. The staff note that it *is the purpose* of hedge accounting to change the default accounting treatment that would otherwise apply. Hence, if looking at an instrument in isolation outside the context of how it is used by an entity is considered like-for-like accounting then this view is a disagreement with the notion of hedge accounting altogether.
- 101. Conversely, when looking at an instrument in the context of how it is used by an entity that is a different perspective of like-for-like accounting. In Example 1, hedge accounting provides comparability with an entity that purchases the commodity using a fixed price executory contract denominated in the foreign currency and later hedges the FX risk. In Example 2, hedge accounting provides comparability with an entity that borrows in its functional currency at a variable rate and later swaps the exposure into fixed rate. In Example 3, hedge accounting provides comparability with an entity that borrows in its functional

³⁸ See paragraphs 11.

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currency at a fixed rate and later swaps the exposure into a variable rate. In those examples, without hedge accounting, the commodity forward contracts, FX forward contracts, cross currency interest rate swaps and interest rate swaps would be accounted for in the same way as if held in the trading book of an investment bank.

102. Moreover, as explained in the previous section,³⁹ the accounting under IAS 39 distorts comparability over time and between entities.

Aggregation allows circumvention of accounting for derivatives at fair value through profit or loss and structuring by entities to avoid showing real economic volatility resulting from the use of derivatives

103. The staff note that when accounting for aggregated exposures the gain or loss on the derivative that is a fair value hedge is recognised in profit or loss each period as its fair value changes. This applies even if the fair value hedge (for the first level relationship) constitutes an aggregated exposure that is the hedged item in a cash flow hedge (for the second level relationship—see Example 2). Consistent with the accounting for fair value hedges in general, the accounting for the hedged item is changed instead of changing the accounting for the derivative that is the hedging instrument.
104. For a derivative that is a hedging instrument in a cash flow hedge the general cash flow hedge mechanics result in recognising the part of the change in fair value that is an effective hedging gain or loss in OCI. Hence, the accounting for aggregated exposures does not allow the accounting for derivatives at fair value through profit or loss to be 'circumvented'—at least no more than cash flow hedges generally do. In contrast to fair value hedging, accounting at fair value through profit or loss is not any form of surrogate for cash flow hedge accounting. Hence, changing the recognition of fair value changes (to the extent they are effective hedging gains or losses) from profit or loss to OCI *is the purpose* of cash flow hedge accounting.

³⁹ See paragraph 99.

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105. Where the aggregated exposure includes a derivative for which cash flow hedging applies, accounting for an aggregated exposure results in immediate recycling into profit or loss when the aggregated exposure is the hedged item in a fair value hedge (see Example 3). Hence, this accounting results in recognising fair value changes as gains or losses in the same period as they arise (instead of avoiding their recognition in profit or loss).
106. In addition, the staff note that like for hedge accounting in general, when accounting for aggregated exposures hedge ineffectiveness must be determined and recognised in profit or loss as it arises (as demonstrated in the examples). Also, given that derivatives are always measured at fair value in the statement of financial position, economic volatility from those instruments is transparent.
107. Hence, the staff consider that the proposed accounting for aggregated exposures would *not* allow accounting for derivatives at fair value through profit or loss to be ‘circumvented’ nor allow structuring to avoid showing economic volatility resulting from the use of derivatives. The staff consider that these concerns might be the result of mistaking the proposal as ‘synthetic accounting’.

Hedging aggregated exposures was not necessary as an entity could ‘directly’ hedge the risk such that it achieves the desired economic position (ie use only one derivative to hedge the exposure)

108. One argument cited for disagreement with the proposal was that an entity could ‘directly’ hedge the risk hence using different derivatives in combination was unnecessary.
109. The staff note that the transaction structures are driven by market aspects such as competitive pricing and market liquidity. This has resulted in a frequent use of transaction structures such as those used in the examples in the ED. That was widely acknowledged by the feedback.⁴⁰

⁴⁰ See paragraph 12.

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110. The staff also note that unwinding the derivatives that are part of an aggregated exposure in order to enter into a single new derivative instead of adding a derivative that provides the incremental offset of risk that the entity seeks at the time would incur significant transaction costs and sometimes not even be feasible.
111. Therefore, the staff consider that this concern ignores the commercial reality and the suggested solution would result in transactions that are purely accounting driven without having any economic purpose (even resulting in detrimental economic outcomes for an entity).

Staff recommendations and questions to the Board

Finalisation of the proposal in the ED

112. The proposal on allowing an aggregated exposure to be designated as a hedged item received overwhelmingly supportive feedback. The staff recommend to confirm the proposal in the ED subject to adding some guidance and clarifications (refer to the subsequent staff recommendations).

<p>Question 1: Designation of an aggregated exposure as the hedged item</p> <p>Does the Board agree with the staff recommendation to confirm the proposal of allowing designating an aggregated exposure as the hedged item in a hedging relationship?</p> <p>If the Board does not agree, what does the Board prefer instead and why?</p>

Examples/further guidance

113. The staff consider that providing illustrative examples would:

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- (a) address the request most frequently raised in the feedback;
- (b) reinforce the general requirement that hedge ineffectiveness must be measured and recognised; and
- (c) clarify that accounting for aggregated exposures as a hedged item is not 'synthetic accounting'.

114. In providing illustrative examples the question is how to balance the volume of the additional guidance and the comprehensiveness of the situations illustrated.

The staff consider that:

- (a) The two examples included in the ED should be illustrated (ie Examples 1 and 2 in this paper) given the feedback confirmed their practical relevance.
- (b) Given that the mechanics that apply for a combination of a cash flow hedge for the first level relationship with a fair value hedge for the second level relationship are different (and resulted in requests for illustration by commentators) the staff consider that Example 3 would also be useful.

115. Given the volume and nature of this additional guidance the staff consider that it should be provided as illustrative examples accompanying the final standard.

116. Hence, the staff recommend that illustrative examples should accompany the final standard based on Examples 1-3 in this paper.

Question 2: Examples

Does the Board agree with the staff recommendation in paragraph 116?

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

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Clarification regarding ‘synthetic accounting’

117. The staff note that most respondents correctly understood the ED (ie that it does not allow ‘synthetic accounting’) but that there were still requests for an explicit clarification.
118. As explained in the staff analysis, the staff consider that a reference in the standard to ‘synthetic accounting’ would be confusing and unnecessary.⁴¹ However, the staff consider that any misconception that aggregated exposures are tantamount to ‘synthetic accounting’ would result in a fundamental accounting error.
119. Hence, in order to avoid any such risk the staff on balance recommend to clarify the issue as follows:
- (a) in the final standard add an explicit statement that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value; and
 - (b) state in the basis for conclusions of the final requirements that in its redeliberations the Board noted that accounting for aggregated exposures is part of hedge accounting and hence different from ‘synthetic accounting’, which is not allowed.

Question 3: Clarification regarding ‘synthetic accounting’

Does the Board agree with the staff recommendation in paragraph 119?

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

⁴¹ See paragraph 28.

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Hedge accounting for the combination of the exposure and the derivative that constitute the aggregated exposure

120. As explained in the staff analysis, the staff consider that that even if:

- (a) hedge accounting is *not* achieved for the *first level* relationship; and
- (b) the non-derivative item that is part of the aggregated exposure is *not* already accounted for at fair value through profit or loss if the first level relationship would be a *fair value hedge*,

designating an aggregated exposure as the hedged item would *not* violate any of the general requirements of the hedge accounting model. Hence, from that perspective no specific restrictions (ie in addition to the general requirements) are needed in such situations.

121. The staff consider that the Board has two alternatives:

- (a) **Alternative 1:** impose specific restrictions that require that an aggregated exposure only qualifies for designation as a hedged item if:
 - (i) hedge accounting is achieved between the items that constitute the aggregated exposure (ie the first level relationship achieves hedge accounting); **or**
 - (ii) all items that constitute the aggregated exposure are already accounted for at fair value through profit or loss in accordance with IFRSs if otherwise a hedging relationship between those items would be a fair value hedge.
- (b) **Alternative 2:** not impose specific restrictions.

122. The staff consider this decision gives rise to the following trade-off:

- (a) The usefulness of information resulting from applying hedge accounting based on aggregated exposures in situations other than those covered by Alternative 1. Hedge accounting is achieved for only the second level relationship and hence the question is whether achieving hedge accounting ‘partially’ is still better than not achieving it at all.

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- (b) The complexity of drawing and operating the boundary that Alternative 1 entails—even though such a restriction is not needed for the purpose of maintaining consistency with the general hedge accounting requirements.
123. The staff consider that in practice, the situation will be ‘self-regulating’ because of cost/benefit considerations. Entities will not seek to apply hedge accounting that has limited benefit given the effort involved to obtain it. The benefit of using accounting for aggregated exposures is much higher for entities when also achieving hedge accounting for the first level relationship (or all items are already accounted for at fair value through profit or loss in lieu of a fair value hedge). In Example 3 there would be no benefit at all without achieving hedge accounting for the first level relationship.⁴²
124. The staff consider that in Example 1 there would be some benefit of achieving hedge accounting even if only for the second level relationship. This would differentiate the situation from one where an entity has no commodity hedge, which means that the overall FX cash flow for the commodity purchase would fluctuate with the (full) commodity price whereas in Example 1 the commodity hedge ensures that the overall FX cash flow changes only because of commodity basis risk but is otherwise known.
125. In Example 2 the benefit of achieving hedge accounting only for the second level relationship depends on the magnitude of the fair value interest rate risk of the fixed rate FX liability compared to the magnitude of the cash flow variability of variable interest payments in the entity’s functional currency. This is a function of the volatility and level of interest rates in each currency and the remaining term of the fixed rate FX liability.
126. Given these considerations, the staff on balance recommend Alternative 2 (ie not to impose any specific restrictions).

⁴² See paragraph 53.

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Question 4: Specific restrictions regarding hedge accounting for the first level relationship

Does the Board agree with the staff recommendation in paragraph 126?

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

Other clarifications

127. Based on the staff analysis, the staff consider that clarification of two aspects would be useful and therefore recommend:

- (a) expanding the description of an aggregated exposure by a statement that the notion of an aggregated exposure includes a highly probable forecast transaction of an aggregated exposure if that aggregated exposure once executed is eligible as a hedged item;⁴³ and
- (b) adding application guidance on how to apply the general requirements in the context of aggregated exposures, ie:
 - (i) that the way in which a derivative is designated as a *hedged item* as part of an aggregated exposure must be consistent with any designation of that derivative as the *hedging instrument* at the level of the aggregated exposure (ie the first level relationship); and
 - (ii) that otherwise a derivative must be designated in its entirety or as a percentage of its nominal amount.⁴⁴

⁴³ See paragraph 64.

⁴⁴ See paragraph 70.

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Question 5: Other clarifications

Does the Board agree with the staff recommendation in paragraph 127?

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

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Appendix A

- A1. This appendix illustrates the accounting mechanics for aggregated exposures as a hedged item using three examples. The examples illustrate three different combinations of hedge accounting for first level and second level relationships:
- (a) cash flow hedge/cash flow hedge;
 - (b) fair value hedge/cash flow hedge; and
 - (c) cash flow hedge/fair value hedge.

Example 1—combined commodity price risk and FX risk hedge (cash flow hedge/cash flow hedge combination)***Fact pattern***

- A2. Entity A has the following exposures:
- (a) Commodity price risk exposure regarding a forecast purchase of coffee at the end of period 5.
 - (b) FX risk exposure because the commodity is purchased in a foreign currency (FC). Entity A's functional currency is its local currency (LC).
- A3. Entity A hedges its exposures using the following risk management strategy:
- (a) Entity A uses a *benchmark* commodity forward contract to hedge its coffee purchases four periods before delivery (ie at the end of period 1). The coffee price that Entity A actually pays for its purchase is different from the benchmark because of differences in the type of coffee, the location and delivery arrangement.⁴⁵ This gives risk to 'basis risk' for the hedging relationship, which can change over time. Entity A does not hedge its basis

⁴⁵ For the purpose of this example it is assumed that the hedged risk is *not* designated based on a benchmark coffee price risk component.

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risk because it is not considered economical under cost/benefit considerations.

- (b) Entity A also hedges its FX risk. However, the FX risk is hedged over a different horizon—only three periods before delivery (ie at the end of period 2). Entity A considers the FX exposure from the variable payments for the coffee purchase in FC and the gain or loss on the commodity forward contract in FC as one aggregated FX exposure. Hence, Entity A uses one single FX forward contract to hedge the FX cash flows from the forecast coffee purchase and the related commodity forward contract.

A4. The following table sets out the parameters used for the example:

Period	1	2	3	4	5
Interest rates for remaining maturity [FC]	0.26%	0.21%	0.16%	0.06%	0.00%
Interest rates for remaining maturity [LC]	1.12%	0.82%	0.46%	0.26%	0.00%
Forward price [FC/lb]	1.25	1.01	1.43	1.22	2.15
Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
FX rate (spot) [LC/FC]	1.38	1.33	1.41	1.46	1.43

Accounting mechanics

A5. Entity A uses cash flow hedging for both hedging relationships:

- (a) The commodity price risk hedging relationship between the forecast coffee purchase in FC as the hedged item and the commodity forward contract as the hedging instrument (ie for the *first level* relationship).
- (b) The FX risk hedging relationship between the aggregated exposure (ie the combined FX cash flows in FC of the two items designated in the commodity price risk hedging relationship) as the hedged item and the FX forward contract as the hedging instrument (ie for the *second level* relationship).

A6. The following table sets out the calculations of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserves and hedge ineffectiveness.

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		Period	1	2	3	4	5
Commodity price risk hedging relationship							
<i>Forward purchase contract for coffee</i>							
Volume (lbs)	112,500						
Forward price [FC/lb]	1.25	[FC/lb]	1.25	1.01	1.43	1.22	2.15
		Fair value [FC]	0.00	-26,943.42	20,218.66	-3,372.98	101,250.00
		Fair value [LC]	0.00	-20,258.21	14,339.48	-2,310.26	70,804.20
		Δ Fair value [LC]		-20,258.21	34,597.69	-16,649.73	73,114.45
<i>Hedged forecast coffee purchase</i>							
Hedge ratio	105.26%	Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
Hedged volume	118,421.05	Price [FC/lb]	1.19	0.95	1.34	1.18	2.00
Implied forward price	1.1875	Fair value [FC]	0.00	27,540.19	-18,527.86	1,062.78	-96,157.89
		Fair value [LC]	0.00	20,706.91	-13,140.33	727.93	-67,243.28
		Δ Fair value [LC]		20,706.91	-33,847.24	13,868.26	-67,971.22
<i>Accounting</i>							
Derivative			0.00	-20,258.21	14,339.48	-2,310.26	70,804.20
Cash flow hedge reserve			0.00	-20,258.21	13,140.33	-727.93	67,243.28
Δ Cash flow hedge reserve				-20,258.21	33,398.54	-13,868.26	67,971.22
Profit or loss				0.00	1,199.15	-2,781.47	5,143.24
Retained earnings			0.00	0.00	1,199.15	-1,582.32	3,560.91
FX risk hedging relationship							
FX rate [LC/FC]		Spot	1.38	1.33	1.41	1.46	1.43
		Forward	1.3683	1.3220	1.4058	1.4571	1.4300
<i>FX forward contract (buy FC/sell LC)</i>							
Volume [FC]	140,625.00	Fair value [LC]		0.00	-6,312.56	-9,840.12	-8,034.90
Forward rate (in P ₂)	1.3220						
<i>Hedged FX risk</i>							
Aggregated FX exposure [FC]			140,625.00	140,026.97	138,931.58	142,936.58	135,532.89
		Fair value [LC]		0.00	6,236.54	10,001.87	7,743.96
		Δ Fair value [LC]			6,236.54	3,765.32	-2,257.91
<i>Accounting</i>							
Derivative				0.00	-6,312.56	-9,840.12	-8,034.90
Cash flow hedge reserve				0.00	-6,236.54	-9,840.12	-7,743.96
Δ Cash flow hedge reserve					-6,236.54	-3,603.57	2,096.16
Profit or loss					-76.02	76.02	-290.95
Retained earnings				0.00	-76.02	0.00	-290.95

A7. The hedging relationship for the first level relationship is not affected by the start of hedge accounting for the second level relationship in period 2. In particular, the commodity price risk hedging relationship is *not* discontinued in order to jointly designate the two derivatives as a hedging instrument (as it is necessary under IAS 39).

A8. This results in the following summary performance statement and statement of financial position (for the sake of transparency the line items are disaggregated

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on the face of the statements by the two hedging relationships, ie for the commodity hedge and the FX hedge):

Statement of profit or loss and other comprehensive income						
Hedge ineffectiveness						
Commodity hedge			0.00	<1,199.15>	2,781.47	<5,143.24>
FX hedge			0.00	76.02	<76.02>	290.95
Profit or loss		0.00	0.00	<1,123.13>	2,705.46	<4,852.29>
Other comprehensive income (OCI)						
Commodity hedge			20,258.21	<33,398.54>	13,868.26	<67,971.22>
FX hedge			0.00	6,236.54	3,603.57	<2,096.16>
Total other comprehensive income		0.00	20,258.21	<27,161.99>	17,471.83	<70,067.38>
Comprehensive income		0.00	20,258.21	<28,285.12>	20,177.29	<74,919.67>
Statement of financial position						
Commodity forward		0.00	<20,258.21>	14,339.48	<2,310.26>	70,804.20
FX forward			0.00	<6,312.56>	<9,840.12>	<8,034.90>
Total net assets		0.00	<20,258.21>	8,026.91	<12,150.38>	62,769.29
Equity						
Accumulated OCI						
Commodity hedge		0.00	20,258.21	<13,140.33>	727.93	<67,243.28>
FX hedge			0.00	6,236.54	9,840.12	7,743.96
		0.00	20,258.21	<6,903.78>	10,568.05	<69,499.33>
Retained earnings						
Commodity hedge		0.00	0.00	<1,199.15>	1,582.32	<3,560.91>
FX hedge			0.00	76.02	0.00	290.95
		0.00	0.00	<1,123.13>	1,582.32	<3,269.96>
Total equity		0.00	20,258.21	<8,026.91>	12,150.38	<62,769.29>

A9. In this example all amounts recognised in profit or loss represent hedge ineffectiveness.

A10. The total cost of inventory after hedging are as follows:⁴⁶

<i>Cost of inventory</i>	
Cash price (at spot for commodity & FX risk)	165,582.44
Gain/loss from CFHR for commodity price risk	-67,243.28
Gain/loss from CFHR for FX risk	7,743.96
Cost of inventory	106,083.12

A11. The total overall cash flow from all transactions (coffee purchase at spot and the settlement of the two derivatives) is LC102,813.16. It differs from the hedge adjusted cost of inventory by LC3,269.96, which is the net amount of hedge

⁴⁶ CFHR = cash flow hedge reserve.

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ineffectiveness from the two hedging relationships (because it has a cash flow effect but is excluded from the measurement of the inventory).

Example 2—combined interest rate risk and FX risk hedge (fair value hedge/cash flow hedge combination)***Fact pattern***

A12. Entity B has the following exposures:

- (a) Fair value interest rate risk and FX risk exposure regarding a fixed rate liability denominated in FC with a term of four periods from the start of period 1 to the end of period 4.
- (b) Cash flow interest rate risk exposure that arises as a result of swapping the combined fair value interest rate risk and FX risk exposure associated with the fixed rate FX liability (see (a) above) into a variable rate exposure in LC (Entity B's functional currency).

A13. Entity B hedges its exposures using the following risk management strategy:

- (a) Entity B uses a cross currency interest rate swap to swap its fixed rate FX liability into a variable rate exposure in LC. Under the cross currency interest rate swap Entity B receives fixed interest in FC (used to pay the interest on the FX liability) and pays variable interest in LC. Entity B enters into the cross currency interest rate swap at the same time as it issues the FX liability (ie at the start of period 1). The cross currency interest rate swap uses a different day count method for interest payments than the FX liability, which gives rise to some hedge ineffectiveness.
- (b) Entity B considers the cash flows on the FX liability and on the cross currency interest rate swap as one aggregated variable rate exposure in LC. At the end of period 1, Entity B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC. Entity B uses an interest rate swap (denominated entirely in LC) under which it receives variable interest (used to pay the interest on

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the pay leg of the cross currency interest rate swap) and pays fixed interest. The day count method used for the interest swap also gives rise to some hedge ineffectiveness.

A14. The following table sets out the parameters used for the example:

	t ₀	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2	1.05	1.42	1.51	1.37
Interest curves (for each quarter on a p.a. basis)					
LC	2.50%	5.02%	6.18%	0.34%	[N/A]
	2.75%	5.19%	6.26%	0.49%	
	2.91%	5.47%	6.37%	0.94%	
	3.02%	5.52%	6.56%	1.36%	
	2.98%	5.81%	6.74%		
	3.05%	5.85%	6.93%		
	3.11%	5.91%	7.19%		
	3.15%	6.06%	7.53%		
	3.11%	6.20%			
	3.14%	6.31%			
	3.27%	6.36%			
	3.21%	6.40%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				
FC	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

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Accounting mechanics

A15. Entity B designates the following hedging relationships:

- (a) A fair value hedge for the hedging relationship for fair value interest rate risk and FX risk between the fixed rate FX liability as the hedged item and the cross currency interest rate swap as the hedging instrument (ie for the *first level* relationship).
- (b) A cash flow hedge for the hedging relationship between the aggregated exposure (ie the combined cash flows of the two items designated in the fair value hedge of the fair value interest rate risk and FX risk—see (a) above) as the hedged item and the interest rate swap as the hedging instrument (ie for the *second level* relationship).

A16. The following table sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve and hedge ineffectiveness.⁴⁷

⁴⁷ CCIRS = cross currency interest rate swap; IRS = interest rate swap; CF = cash flow; CFHR = cash flow hedge reserve.

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	t ₀	Period 1	Period 2	Period 3	Period 4
Fixed rate FX liability					
Fair value [FC]	<1,000,000.00>	<995,522.23>	<1,031,008.03>	<1,030,192.74>	<1,000,000.00>
Fair value [LC]	<1,200,000.00>	<1,045,298.35>	<1,464,031.40>	<1,555,591.04>	<1,370,000.00>
Change in fair value [LC]		154,701.65	<418,733.05>	<91,559.64>	185,591.04
CCIRS (receive fixed FC/pay variable LC)					
Fair value [LC]	0.00	<154,656.98>	264,127.39	355,540.47	170,025.63
Change in fair value [LC]		<154,656.98>	418,784.37	91,413.07	<185,514.83>
IRS (receive variable/pay fixed)					
Fair value [LC]		0.00	19,320.85	<60,013.91>	0.00
Change in fair value [LC]			19,320.85	<79,334.76>	60,013.91
CF variability of aggregated exposure					
Fair value [LC]		0.00	<19,263.36>	59,930.68	0.00
Change in fair value [LC]			<19,263.36>	79,194.04	<59,930.68>
CFHR					
Balance (end of period) [LC]		0.00	<19,263.36>	59,930.68	0.00
Change [LC]			<19,263.36>	79,194.04	<59,930.68>
CFH ineffectiveness			<57.49>	140.72	<83.23>

- A17. The hedging relationship for the first level relationship is not affected by the start of hedge accounting for the second level relationship at the end of period 1. In particular, the hedging relationship involving the cross currency interest rate swap and the fixed rate FX liability is *not* discontinued in order to jointly designate the two swaps as a hedging instrument (as it is necessary under IAS 39).
- A18. This results in the following summary performance statement and statement of financial position⁴⁸ (for the sake of transparency the line items are disaggregated on the face of the statements by the two hedging relationships, ie for the fair value and the cash flow hedge):

⁴⁸ For period 4 the fair values in the calculation overview in the previous table (see paragraph A16) differ from those in the following table. For periods 1 to 3 the 'dirty' fair values (ie including interest accruals) equal the 'clean' fair values (ie excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the FX liability. At the end of period 4 the previous table uses a clean fair value in order to calculate the fair value changes consistently over time. For the following table the dirty fair values are presented assuming the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts would be zero).

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<i>[All amounts in LC]</i>					
	<i>t₀</i>	Period 1	Period 2	Period 3	Period 4
Statement of profit or loss and other comprehensive income					
Interest expense					
FX liability		45,958	50,452	59,848	58,827
FVH adjustment		<12,737>	11,961	14,391	<49,400>
		33,222	62,413	74,239	9,427
Reclassifications (CFH)			7,506	<4,376>	60,508
Total interest expense		33,222	69,919	69,863	69,935
Other gains/losses					
CCIRS		154,657	<418,784>	<91,413>	185,515
FVH adjustment (FX liability)		<154,702>	418,733	91,560	<185,591>
FVH ineffectiveness (CF settlement)		25	0	0	0
CFH ineffectiveness			<57>	141	<83>
CFH ineffectiveness (CF settlement)			0	<125>	0
Total other gains/losses		<19>	<109>	163	<159>
Profit or loss		33,202	69,810	70,026	69,775
Other comprehensive income (OCI)					
Effective CFH gain/loss			<11,757>	74,818	577
Reclassifications			<7,506>	4,376	<60,508>
Total other comprehensive income			<19,263>	79,194	<59,931>
Comprehensive income		33,202	50,547	149,220	9,845
Statement of financial position					
FX liability	<1,200,000>	<1,045,298>	<1,464,031>	<1,555,591>	<1,397,984>
CCIRS	0	<154,657>	264,127	355,540	194,134
IRS		0	19,321	<60,014>	<65,807>
Cash	1,200,000	1,166,753	1,096,834	1,027,096	1,026,844
Total net assets	0	<33,202>	<83,749>	<232,969>	<242,813>
Accumulated OCI	0	0	<19,263>	59,931	0
Retained earnings	0	33,202	103,012	173,038	242,813
Total equity	0	33,202	83,749	232,969	242,813

A19. Both hedging relationships give rise to some hedge ineffectiveness.

- (a) For the fair value hedge that can be seen from the slight difference between the gain or loss on the cross currency interest rate swap and the fair value hedge adjustment for the FX liability (under ‘Other gains/losses’). In

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addition, there is a slight difference between the cash flows received under the cross currency interest rate swap and those paid on the FX liability, which also gives risk to some hedge ineffectiveness.⁴⁹

- (b) For the cash flow hedge some hedge ineffectiveness arises because the change in the variability in cash flows from the aggregated exposure is slightly different from that under the interest rate swap. This ineffectiveness is recognised in profit or loss as it arises (under 'Other gains/losses'). Similarly to the fair value hedge, there is also a slight difference between the net total of the cash flows paid regarding the aggregated exposure and those received under the interest rate swap, which also gives risk to some hedge ineffectiveness.

A20. The total interest expense in profit or loss reflects Entity B's borrowing costs under its risk management strategy:

- (a) In period 1 the risk management strategy results in interest expense reflecting variable interest rates in LC after taking into account the effect of the cross currency interest rate swap.
- (b) For periods 2 to 4 the risk management strategy results in interest expense reflecting fixed interest rates in LC (ie the lock-in of the 3-period fixed interest rate prevailing at the end of period 1) after taking into account the effect of the interest rate swap entered into at the end of period 1. In periods 2 and 4 the interest expense is slightly higher than the fixed rate payments locked in with the interest rate swap because the variable payments received under the swap are less than the net variable payment paid regarding the aggregated exposure (sometimes called 'underhedge'). In period 3 the interest expense is equal to the locked in rate because the variable payments received under the swap are more than the net variable

⁴⁹ From period 2 this mismatch in cash flows is part of the aggregated exposure and hence becomes part of the hedge ineffectiveness that is presented in the line item for the cash flow hedge.

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payment paid regarding the aggregated exposure (sometimes called ‘overhedge’). This results in a gain from hedge ineffectiveness of LC125 (under ‘Other gains/losses’).

A21. The following table sets out the interest cash flows on the different instruments:

Interest CFs (Dr/<Cr>)					
	Liability	42,895	58,010	61,686	55,967
	CCIRS receive	<42,869>	<57,975>	<61,819>	<55,934>
	CCIRS pay	33,222	62,378	74,372	9,394
	IRS receive		<62,357>	<74,364>	<9,355>
	IRS pay		69,863	69,863	69,863
		33,247	69,919	69,738	69,935

Example 3—combined interest rate risk and FX risk hedge (cash flow hedge/fair value hedge combination)

Fact pattern

A22. Entity C has the following exposures:

- (a) Cash flow interest rate risk and FX risk exposure regarding a variable rate liability denominated in FC with a term of four periods from the start of period 1 to the end of period 4.
- (b) Fair value interest rate risk exposure that arises as a result of swapping the combined cash flow interest rate risk and FX risk exposure associated with the variable rate FX liability (see (a) above) into a fixed rate exposure in LC (Entity C’s functional currency).

A23. Entity C hedges its exposures using the following risk management strategy:

- (a) Entity C uses a cross currency interest rate swap to swap its variable rate FX liability into a fixed rate exposure in LC. Under the cross currency interest rate swap Entity C receives variable interest in FC (used to pay the interest on the FX liability) and pays fixed interest in LC. Entity C enters into the cross currency interest rate swap at the same time as it issues the FX liability (ie at the start of period 1).

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- (b) Entity C considers the cash flows on the FX liability and on the cross currency interest rate swap as one aggregated fixed rate exposure in LC. At the end of period 1, Entity C decides to change its interest profile to variable and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC. Entity C uses an interest rate swap (denominated entirely in LC) under which it receives fixed interest (used to pay the interest on the pay leg of the cross currency interest rate swap) and pays variable interest.

A24. The following table sets out the parameters used for the example:

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	t ₀	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2	1.05	1.42	1.51	1.37
Interest curves (for each quarter on a p.a. basis)					
LC	2.50%	1.00%	3.88%	0.34%	[N/A]
	2.75%	1.21%	4.12%	0.49%	
	2.91%	1.39%	4.22%	0.94%	
	3.02%	1.58%	5.11%	1.36%	
	2.98%	1.77%	5.39%		
	3.05%	1.93%	5.43%		
	3.11%	2.09%	5.50%		
	3.15%	2.16%	5.64%		
	3.11%	2.22%			
	3.14%	2.28%			
	3.27%	2.30%			
	3.21%	2.31%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				
FC	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

Accounting mechanics

A25. Entity C designates the following hedging relationships:

- (a) A cash flow hedge for the hedging relationship for cash flow interest rate risk and FX risk between the variable rate FX liability as the hedged item

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and the cross currency interest rate swap as the hedging instrument (ie for the *first level* relationship).

- (b) A fair value hedge for the hedging relationship between the aggregated exposure (ie the combined cash flows of the two items designated in the cash flow hedge of the cash flow interest rate risk and FX risk—see(a) above) as the hedged item and the interest rate swap as the hedging instrument (ie for the *second level* relationship).

A26. The following table sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve.⁵⁰

	t ₀	Period 1	Period 2	Period 3	Period 4
Variable rate FX liability					
Fair value [FC]	<1,000,000.00>	<1,000,000.00>	<1,000,000.00>	<1,000,000.00>	<1,000,000.00>
Fair value [LC]	<1,200,000.00>	<1,050,000.00>	<1,420,000.00>	<1,510,000.00>	<1,370,000.00>
Change in fair value [LC]		150,000.00	<370,000.00>	<90,000.00>	140,000.00
PV of change in variable CFs [LC]	0.00	192,780.44	<260,834.64>	<282,700.59>	<170,000.00>
Change in PV [LC]		192,780.44	<453,615.09>	<21,865.95>	112,700.59
CCIRS (receive variable FC/pay fixed LC)					
Fair value [LC]	0.00	<192,780.44>	260,834.64	282,700.59	170,000.00
Change in fair value [LC]		<192,780.44>	453,615.09	21,865.95	<112,700.59>
CFHR					
Opening balance	0.00	0.00	42,780.44	28,779.77	14,521.21
Reclassification FX risk		<153,008.16>	378,220.28	91,029.85	<140,730.85>
Reclassification (current period CF)		8,229.51	17,982.98	<3,365.65>	<21,858.32>
Effective CFH gain/loss		187,559.10	<479,818.34>	<19,530.15>	135,289.76
Reclassification for interest rate risk		0.00	83,615.09	<68,134.05>	27,299.41
Amortisation of CFHR		0.00	<14,000.67>	<14,258.56>	<14,521.21>
Ending balance		42,780.44	28,779.77	14,521.21	0.00
IRS (receive fixed/pay variable)					
Fair value [LC]		0.00	<83,615.09>	<15,481.03>	<42,780.44>
Change in fair value			<83,615.09>	68,134.05	<27,299.41>
FV variability of aggregated exposure					
Fair value [LC]		0.00	83,615.09	15,481.03	42,780.44
Change in fair value [LC]			83,615.09	<68,134.05>	27,299.41

⁵⁰ For illustration purposes, in this example it is assumed that the hedges are perfectly effective in order to better focus on illustrating the mechanics in a cash flow hedge/fair value hedge combination. The measurement and recognition of hedge ineffectiveness has already been demonstrated in Example 1 and Example 2. (However, in reality such hedges are typically not perfectly effective).

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A27. In this example, the hedging relationship for the first level relationship is *affected* by the start of hedge accounting for the second level relationship at the end of period 1. The fair value hedge for the second level relationship affects the timing of the reclassification of amounts from the cash flow hedge reserve to profit or loss:

- (a) The fair value interest risk that is hedged by the fair value hedge relates to amount recognised in AOCI as a result of the cash flow hedge for the first level hedging relationship. This means that from the end of period 1 the fair value interest rate risk related change in the cash flow hedge reserve is immediately transferred to profit or loss to offset the gain or loss on the interest rate swap (see line item ‘Reclassification for interest rate risk’ in the reconciliation of the cash flow hedge reserve in the previous table). This is the equivalent of a fair value hedge adjustment. Because the two items that constitute the aggregated exposure are already at measured at fair value regarding the hedged risk (the cross currency interest rate swap is measured at fair value and the variable rate FX liability has a carrying amount that is not sensitive to interest rate changes⁵¹) the effect of a fair value hedge relates to the reclassification of amounts from the cash flow hedge reserve. This is the same treatment as for a fair value hedge of a financial asset classified as available for sale under IAS 39. The effect of a fair value hedge is that the fair value change (to the extent hedged) of the available-for-sale asset is immediately recognised in profit or loss.⁵² Because of the Board’s tentative decision to retain the fair value hedge mechanics of IAS 39 this treatment would apply to fair value hedges for which the hedged item is an aggregated exposure to which cash flow hedging applies (ie for the first level relationship).

⁵¹ Except for the effect of the accrued interest between payment dates.

⁵² See IAS 39.89(b) and 55.

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- (b) The amount in the cash flow hedge reserve at the end of period 1 (LC42,780.44) is amortised over the remaining life of the cash flow hedge (using an effective interest rate profile).
- A28. However, notwithstanding the change in the timing of reclassifications from the cash flow hedge reserve, the hedging relationship involving the cross currency interest rate swap and the fixed rate FX liability is *not* discontinued in order to jointly designate the two swaps as a hedging instrument (as it is necessary under IAS 39).
- A29. This results in the following summary performance statement and statement of financial position⁵³ (for the sake of transparency the line items are disaggregated on the face of the statements by the two hedging relationships, ie for the fair value and the cash flow hedge):

⁵³ For period 4 the fair values in the calculation overview in the previous table (see paragraph A26) differ from those in the following table. For periods 1 to 3 the 'dirty' fair values (ie including interest accruals) equal the 'clean' fair values (ie excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the FX liability. At the end of period 4 the previous table uses a clean fair value in order to calculate the fair value changes consistently over time. For the following table the dirty fair values are presented assuming the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts would be zero).

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<i>[All amounts in LC]</i>					
	<i>t₀</i>	Period 1	Period 2	Period 3	Period 4
Statement of profit or loss and other comprehensive income					
Interest expense					
FX liability		45,122	54,876	33,527	15,035
FVH adjustment		0	<20,898>	16,110	<27,204>
		45,122	33,978	49,638	<12,170>
Reclassifications (CFH)		<8,230>	<17,983>	3,366	21,858
		36,893	15,995	53,003	9,689
Amortisation of CFHR		0	14,001	14,259	14,521
Total interest expense		36,893	29,995	67,262	24,210
Other gains/losses					
IRS		0	83,615	<68,134>	27,299
FX gain/loss (liability)		<150,000>	370,000	90,000	<140,000>
FX gain/loss (interest)		<3,008>	8,220	1,030	<731>
Reclassification for FX risk		153,008	<378,220>	<91,030>	140,731
Reclassification for interest rate risk		0	<83,615>	68,134	<27,299>
Total other gains/losses		0	0	<0>	<0>
Profit or loss		36,893	29,995	67,262	24,210
Other comprehensive income (OCI)					
Effective gain/loss		187,559	<479,818>	<19,530>	135,290
Reclassifications (CFH)		8,230	17,983	<3,366>	<21,858>
Reclassification for FX risk		<153,008>	378,220	91,030	<140,731>
Reclassification for interest rate risk		0	83,615	<68,134>	27,299
Amortisation of CFHR		0	<14,001>	<14,259>	<14,521>
Total other comprehensive income		42,780	<14,001>	<14,259>	<14,521>
Comprehensive income		79,673	15,995	53,003	9,689
Statement of financial position					
FX liability	<1,200,000>	<1,050,000>	<1,420,000>	<1,510,000>	<1,375,306>
CCIRS	0	<192,780>	260,835	282,701	138,413
IRS		0	<83,615>	<15,481>	<10,088>
Cash	1,200,000	1,163,107	1,147,112	1,094,109	1,088,621
Total net assets	0	<79,673>	<95,668>	<148,671>	<158,360>
Accumulated OCI	0	42,780	28,780	14,521	0
Retained earnings	0	36,893	66,888	134,150	158,360
Total equity	0	79,673	95,668	148,671	158,360

A30. The total interest expense in profit or loss reflects Entity C's borrowing costs under its risk management strategy:

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- (a) In period 1 the risk management strategy results in interest expense reflecting fixed interest rates in LC after taking into account the effect of the cross currency interest rate swap.
- (b) For periods 2 to 4 the risk management strategy results in interest expense that *changes* with variable interest rates in the LC (ie the variable interest rate prevailing in each period) after taking into account the effect of the interest rate swap entered into at the end of period 1. However, the total interest expense is not equal to the ‘pure’ variable interest because of the amortisation of the amount that was in the cash flow hedge reserve at the end of period 1⁵⁴.

A31. The following table sets out the interest cash flows on the different instruments:

Interest CFs (Dr/<Cr>)					
Liability		42,114	63,096	34,557	14,304
CCIRS receive		<42,114>	<63,096>	<34,557>	<14,304>
CCIRS pay		36,893	36,893	36,893	36,893
IRS receive			<36,893>	<36,893>	<36,893>
IRS pay			15,995	53,003	9,689
		<u>36,893</u>	<u>15,995</u>	<u>53,003</u>	<u>9,689</u>

⁵⁴ See paragraph A27(b).