Introduction

1. The purpose of this paper is to discuss how derivatives designated within the Dynamic Risk Management (DRM) model should be presented in financial reporting. More specifically, how the designated derivatives should be presented in the statement of financial position and how the impact of the designated derivatives should be presented in the statement of profit or loss.

2. This paper is structured as follows:
   (a) Summary of staff recommendations (paragraph 3);
   (b) Scope / Objective (paragraphs 4 – 8);
   (c) Statement of financial position (paragraphs 9 – 19);
   (d) Other Comprehensive Income (paragraphs 20 – 24); and
   (e) Statement of profit or loss (paragraphs 25 – 65).

Summary of staff recommendations

3. In this paper the staff recommend that:
   (a) Disaggregation of designated derivatives would provide useful information to users of financial reporting and the DRM model should
communicate this information through disclosure rather than a separate line item in the statement of financial position;

(b) The DRM accounting model should not require presentation of accumulated changes in fair value of designated derivatives in a separate line item within Other Comprehensive Income, but this information should be clearly communicated to users through disclosure;

(c) Regarding the statement of profit or loss, the aligned portion should be presented as part of an entity’s net interest margin in a separate line item. In addition, during the outreach, the staff should seek for feedback on whether the costs involved with separate presentation on the statement of profit or loss would merit the benefits of increased transparency; and

(d) The misaligned portion should not be presented as part of an entity’s net interest margin. In addition, the DRM model should not mandate a specific line item for presentation of misalignment, but should require disclosure of that amount on a disaggregated basis and the line item in the statement of profit or loss where misalignment is presented.

Scope / Objective

4. The purpose of this paper is to discuss and recommend the presentation requirements for the DRM accounting model. More specifically, this paper discusses presentation of the following amounts related to the designated derivatives:

(a) accumulated changes in fair value recorded in the statement of financial position;

(b) accumulated changes in fair value recorded in other comprehensive income; and

(c) the amounts recognised in the statement of profit or loss.

5. This paper does not discuss the recognition and measurement aspects of the DRM accounting model regarding those financial assets designated as part of the asset profile or those financial liabilities designated when determining the target profile. This is because the DRM accounting model does not alter the recognition and
measurement requirements for those items and therefore, amortised cost information will be provided in the statement of financial position and the statement of profit or loss given tentative decisions to date. For similar reasons, this paper does not discuss presentation of interest revenue and interest expense on amortised cost financial assets and financial liabilities designated within the DRM model.

6. Regarding derivatives designated within the model, fair value is the applicable measurement method for all derivatives in the statement of financial position, including those that are designated in the DRM model. However, this paper considers the need for separate presentation of derivatives designated within the model versus those derivatives that are not designated. More specifically, separate presentation in the statement of financial position and disaggregation of the amount recorded in Other Comprehensive Income.

7. Similarly, this paper does not discuss recognition or measurement within in the statement of profit or loss because that has also been tentatively agreed by the Board. More specifically, the DRM accounting model will defer the change in fair value of the designated derivatives in Other Comprehensive Income and then reclassify a portion to the statement of profit or loss such that the statement of profit or loss reflects the target profile, assuming perfect alignment is achieved\(^1\). This paper specifically considers the presentation of:

(a) the amounts reclassified to the statement of profit or loss from Other Comprehensive Income; and

(b) gains or loss recognised directly in the statement of profit or loss due to misalignment.

8. Therefore, the objective and scope of this paper is to discuss how the designated derivatives should be presented in the statement of financial position, within other comprehensive income and the statement of profit or loss. More specifically, whether a disaggregated presentation of the derivatives in the statement of financial position, Other Comprehensive Income and the statement of profit or loss would provide useful information to users of financial reporting. While this

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\(^1\) See Appendix A for more details about the information provided in the statement of profit or loss
paper states disclosure will be required in some instances to facilitate communication, a complete discussion of disclosure will occur at a future Board meeting for two reasons. Firstly, the discussion on relevant information for disclosure is partly informed by the decisions on presentation and secondly, as discussed in this paper, there are some elements of the DRM accounting model that must be communicated to users through disclosure (such as the impact of misalignment from under-hedging). To discuss these elements in isolation would be inefficient.

**Statement of financial position**

9. In this section, the staff discuss presentation in the statement of financial position of derivatives designated within the DRM model. More specifically, whether users would benefit from disaggregating the fair value of those derivatives designated in the DRM accounting model from other derivatives.

**Current Requirements**

10. Paragraph 24A of IFRS 7: *Financial Instruments Disclosure* (IFRS 7) requires entities to separately disclose information regarding hedging instruments designated in a hedge accounting relationship. More specifically, tabular disclosure of the following is required:

    (a) The carrying amount of the hedging instruments (financial assets separately from financial liabilities);

    (b) The line item in the statement of financial position that includes the hedging instrument;

    (c) The change in fair value of the hedging instrument used at the basis for recognising hedge ineffectiveness for that period; and

    (d) The nominal amounts.

11. While there are no explicit presentation requirements for derivatives designated in a hedge accounting relationship within IFRS Standards, the most applicable conceptual guidance regarding presentation is found in IAS 1 *Presentation of Financial Statements* (IAS 1). Paragraph 59 of IAS 1 states that ‘the use of different
measurement basis for different classes of assets suggests that their nature or function differs and, therefore, that an entity presents them as separate line items’.

Paragraphs 6.4 through 6.22 of the Conceptual Framework describe the various types of measurement bases as the following:

(a) Historical Cost;
(b) Fair Value;
(c) Value in use and fulfilment value; and
(d) Current Cots.

12. As the only relevant measurement basis for derivatives is fair value IFRS Standards require all derivatives to be measured at fair value, regardless if the derivative has been designated in a hedging relationship. This implies that presentation of designated derivatives on a separate line item of the statement of financial position is not the most appropriate way to communicate such information to users of financial reporting. Nonetheless, the current requirements within IFRS Standards acknowledge there is information content to be communicated through disclosure regarding the fair value of derivatives designated in a hedge accounting relationship versus those that have not, as seen by the disclosure requirements of IFRS 7.

13. In the following paragraphs, given that there is information content to be communicated by separating the fair value of those derivatives designated in a hedge accounting relationship versus those that have not, the staff discuss the best method to enable communication:

(a) Approach 1: Disaggregated presentation through disclosure; or
(b) Approach 2: Disaggregated presentation in the statement of financial position.

**Approach 1: Disaggregated Presentation through Disclosure**

14. Paragraphs 10 - 12 indicate that IFRS Standards already acknowledge it is important to communicate certain information about derivatives designated in a hedge accounting relationship versus those that are not. However, the existing requirements imply this information is more effectively communicated through disclosures instead of presentation in separate line items of the statement of financial position.
15. Additionally, it could be argued that adding additional lines to the statement of financial position could over-burden the statement of financial position by increasing its length. Said differently, the statement of financial position is an aggregated statement by design. To increase the number of line items in that statement would be in conflict with the stated purpose of the statement itself.

**Approach 2: Disaggregated Presentation in the Statement of Financial Position**

16. The nature and function of a derivative designated in the DRM accounting model are explicitly different than those that are not designated. Therefore, because the nature and function are different, even though the measurement basis is the same, it could be argued that that designated derivatives in the DRM model should be presented as a separate line item in the statement of financial position.

17. Furthermore, while disclosures can be used for disaggregation, separate line presentation of derivatives designated within the DRM accounting model would more clearly communicate that disaggregation. Users have commented about difficulties in understanding an entity’s risk management strategy and the impact those actions have on the entity’s economic resources. Therefore, some could argue that presentation in a separate line item of the statement of financial position would provide more clarity around the derivatives designated in the DRM model.

18. Finally, the staff think additional costs would be limited because entities already need to capture the necessary data to comply with the existing IFRS 7 disclosure requirements. However, as the DRM model might expand the volume of derivatives designated compared with existing IFRS Standards, some additional cost may be incurred.

\[\text{2 The feedback was received through comment letters and public roundtable discussions around the Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach for Macro Hedging* (the ‘2014 DP’).}\]
Preliminary view

19. The staff think that the function of derivatives that are designated within the DRM model are explicitly different than those that are not and this disaggregation would provide useful information to users of financial reporting. This is supported by the fact that IFRS Standards have already acknowledged this as stated in paragraph 12. However, the existing requirements imply this information is more effectively communicated through disclosures instead of presentation in separate line items of the statement of financial position, and therefore the staff think the DRM model should remain consistent with existing IFRS Standards that require the disaggregation in disclosure.

Question for the Board

<table>
<thead>
<tr>
<th>Question for the Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Does the Board agree with the staff preliminary view in paragraph XX that disaggregation of designated derivatives would provide useful information to users of financial reporting and the DRM model should communicate this information through disclosure rather than a separate line item in the statement of financial position?</td>
</tr>
</tbody>
</table>

Other Comprehensive Income

20. In this section, the staff discuss presentation within Other Comprehensive Income and more specifically, whether users would benefit from disaggregating the change fair value of those derivatives designated in the DRM accounting model from other derivatives.

Current Requirements

21. Paragraph 82A of IAS 1 states that:

The other comprehensive income section shall present line items for the amounts for the period of:
(a) Items of other comprehensive income classified by nature and grouped into those that, in accordance with other IFRSs:

(i) Will not be reclassified subsequently to profit or loss;

(ii) Will be reclassified subsequently to profit or loss when specific conditions are met.

22. In addition, paragraph 24B(b)(i) of IAS 1 states that for cash flow hedges the balance in the cash flow hedge reserve accounted for in accordance with paragraph 6.5.11 of IFRS 9 should be disclosed in a tabular format. Disclosures are also required for the balances remaining in the cash flow hedge reserve from any hedging relationships for which hedge accounting is no longer applied.

23. Therefore, given the cash flow hedge reserve within Other Comprehensive Income is, in most cases, subsequently reclassified when specific conditions are met, existing IFRS Standards use disclosure to disaggregate the cash flow hedge reserve within Other Comprehensive Income. In addition, the staff would highlight that the existing requirements of IFRS Standards do not require separation of Cash Flow Hedges and Net Investment Hedges currently Other Comprehensive Income, other than through disclosure. While it could be argued that the DRM model is different than cash flow hedges and therefore should be presented on a separate line item, the staff would highlight that this distinction is also not made for Net Investment Hedges, which are clearly different in nature.

24. While the staff think that separating the amounts related to the DRM accounting model would provide useful information to users of financial reporting, the staff do not think there is a compelling reason that makes the DRM accounting model unique regarding presentation within Other Comprehensive Income considering the existing requirements of IFRS Standards. As such, while the amounts included in Other Comprehensive Income related to the DRM accounting model should be clearly communicated to users, the staff think this should be accomplished through disclosure. The details of these disclosures will be discussed at a future Board meeting.
Question for the Board

<table>
<thead>
<tr>
<th>Question for the Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>2) Does the Board agree with the staff preliminary view in paragraph 24 that the DRM accounting model should not require presentation of accumulated changes in fair value of designated derivatives in a separate line item within Other Comprehensive Income, but this information should be clearly communicated to users through disclosure?</td>
</tr>
</tbody>
</table>

Statement of profit or loss

25. As noted in paragraph 5, the DRM accounting model does not alter the presentation of interest revenue and interest expense on amortised cost financial assets and financial liabilities designated within the DRM model and therefore, this paper focuses on presentation of the results from designated derivatives in the statement of profit or loss. As discussed during the September 2018 Board meeting, the impact of the designated derivatives on the statement of profit or loss can be decomposed into two portions:

(a) Those amounts reclassified to the statement of profit or loss from Other Comprehensive Income (“the aligned portion”); and
(b) Those amounts recorded directly in the statement of profit or loss due to misalignment (“the misaligned portion”).

Aligned portion

26. As stated in paragraph 7, the Board tentatively decided that the results reported in the statement of profit or loss should reflect the entity’s target profile in the case of perfect alignment; deferral and reclassification of the changes in the fair value of the designated derivatives are the mechanisms by which the DRM accounting model ensures that the statement of profit or loss reflects the entity’s target profile. The aligned portion is reclassified to the statement of profit or loss such that the statement of profit or loss reflects the target profile for the period, assuming perfect
alignment has been achieved. Said differently, the combination of the aligned portion (ie the aligned cash flows from the designated derivatives) and the application of the effective interest method to those financial assets and liabilities designated in the DRM accounting model, will provide a faithful representation of performance for the period in question.

27. To illustrate the concept, consider an entity has CU 1,000 3-year floating rate financial assets yielding LIBOR + 1.00% and CU 1,000 of 3-year fixed rate financial liabilities that bear 3.00% interest. Assume that the entity’s risk management strategy is to stabilise the net of interest revenue and expense over a period of 3 years. Accordingly, the benchmark derivative is a CU 1,000 3-year receive fix, pay float interest rate swap that the entity executes and is perfectly aligned. Based on tentative decisions to date, the statement of profit or loss would be as illustrated in the next chart. Note that the amount reclassified (ie the aligned portion) each period from Other Comprehensive Income is equal to the period cash flows from the designated derivative. These amounts were determined by multiplying the notional of the derivative in question by the contractual interest rates for the relevant period.

*Chart 1*

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial assets (LIBOR + 1.00%)</th>
<th>Reclassification</th>
<th>Combined</th>
<th>Financial liability (3.00%)</th>
<th>Net of interest revenue and expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>45</td>
<td>5</td>
<td>50</td>
<td>(30)</td>
<td>20</td>
</tr>
<tr>
<td>20X2</td>
<td>40</td>
<td>10</td>
<td>50</td>
<td>(30)</td>
<td>20</td>
</tr>
<tr>
<td>20X3</td>
<td>35</td>
<td>15</td>
<td>50</td>
<td>(30)</td>
<td>20</td>
</tr>
</tbody>
</table>

28. The aligned portion of the is depicted in the column titled “Reclassification”.

*Presentation as part of an entity’s “Net Interest Margin”*

29. The term “net interest margin” is not defined in IFRS Standards, however, it is common for financial institutions to present a subtotal in the statement of profit of loss which reflect the net of interest income and expense and call that subtotal “net interest margin”. For the purpose of this paper the term “net interest margin” is
used to mean a subtotal that is the net of interest income and interest expense derived from financial assets and liabilities. This paper will not discuss what should be or what shouldn’t be included in “net interest margin” other than the derivatives designated within the DRM accounting model.

30. The first question the staff considered regarding the aligned portion was whether it should be presented as part of the entity’s net interest margin or elsewhere in the statement of profit or loss. The chart below illustrates the statement of profit or loss if the aligned portion was presented as part of the entity’s net interest margin versus elsewhere in the statement of profit or loss.

*Chart 2*

<table>
<thead>
<tr>
<th>Line Item</th>
<th>Included</th>
<th>Excluded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Revenue</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>DRM Derivative Contribution (aligned portion)</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td>(30)</td>
<td>(30)</td>
</tr>
<tr>
<td><strong>Net Interest Margin</strong></td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>Other Line Item 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Line Item 2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Line Item 3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DRM Derivative Contribution (aligned portion)</td>
<td></td>
<td>5</td>
</tr>
<tr>
<td><strong>Net Income After Tax</strong></td>
<td>20</td>
<td>20</td>
</tr>
</tbody>
</table>

*Staff Analysis*

31. The staff do not think there is any merit in presenting the aligned portion anywhere other than as part of the entity’s net interest margin. The risk management objective, at its most simplistic, is to manage how the net of interest revenue and interest expense change over time with changes in interest rates, and the objective of the DRM model is to faithfully represent those activities and actions in the financial statements. To separate them would present the results in a manner inconsistent with the underlying economic activity.

32. Said differently, the asset profile must be comprised of financial assets measured at amortised cost while the aligned portion of the designated derivatives represent the
portion necessary to transform the asset profile such that it equals the target profile. Therefore, the amounts recognised in the statement of profit or loss for all three are linked. More specifically, interest revenue from those assets designated in the asset profile, interest expenses from those financial liabilities designated and considered in determining the target profile, and the amounts reclassified from the designated derivatives are clearly linked. In fact, the existence of an economic relationship between the three is required to apply the DRM model in the first place. Separating these three items could confuse readers of financial reporting because they would not make decisions by examining net interest margin without considering the effect of these derivatives.

33. Furthermore, paragraph B6.6.14 of IFRS 9 requires that if items are hedged together as a group but the group does not have any offsetting risk positions, then the gains or losses on the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items on a systematic and rational basis. Therefore, the existing requirements of IFRS Standards already recognise the link between hedging instrument and hedged item, especially in the context of items that are hedged together as a group.

34. For the reasons stated in paragraphs 31 – 33, the staff think the aligned portion should be presented as part of the entity’s net interest margin.

**Question for the Board**

<table>
<thead>
<tr>
<th>Question for the Board</th>
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</thead>
<tbody>
<tr>
<td>3) Does the Board agree with the staff preliminary view in paragraph 34 that the aligned portion should be presented as part of an entity’s net interest margin?</td>
</tr>
</tbody>
</table>

**Separate line item presentation**

35. Assuming the Board agrees with the staff view that the aligned portion should be presented as part of the entity’s net interest margin, the question that follows is whether the aligned portion should be presented as part of:
(a) interest revenue;
(b) interest expense; or
(c) a separate line item within net interest margin.

36. While the staff considered whether an approach where the entity would apportion the amounts reclassified to the line items affected by the hedged items, the staff rejected such an approach because it would likely require separating the designated derivatives into components based on their fixed and floating legs and allocating each leg to either interest income or expense. The staff think such an approach would be complicated and requires entity’s to creates links between the designated derivatives and either the asset profile or the financial liabilities used when determining the target profile without a basis in the underlying economic activity. Furthermore, the staff would highlight IFRS 9 paragraph B6.6.15 requires that, if there are offsetting risk positions in the group, then the entity shall present the hedging gains and losses in a separate line item in the statement of profit or loss for the reasons stated in paragraph BC6.546 to BC5.549 of IFRS 9. Given the DRM accounting model is focused on the net of interest income and expense, the staff think these requirements from IFRS 9 are relevant.

37. The chart below illustrates the various possible approaches using the figures from chart 2 above:

*Chart 3*

<table>
<thead>
<tr>
<th>Line Item</th>
<th>Approach 1</th>
<th>Approach 2</th>
<th>Approach 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Revenue</td>
<td>50</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>Aligned portion</td>
<td></td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>(30)</td>
<td>(25)</td>
<td>(30)</td>
</tr>
<tr>
<td><strong>Net Interest Margin</strong></td>
<td><strong>20</strong></td>
<td><strong>20</strong></td>
<td><strong>20</strong></td>
</tr>
</tbody>
</table>

38. While the staff have listed approaches 1 and 2 above, the staff think these approaches are not appropriate because they ignore the linked nature of the items designated in the DRM accounting model as discussed in paragraph 32. Including the aligned portion with either interest revenue or interest expense, in its entirety,
would ignore the fact that the financial assets and financial liabilities are linked and potentially mis-represent the underlying economics and risk management activities.

39. The staff acknowledge paragraph B6.6.15 requires that if there are offsetting risk positions in the group, then the entity shall present the hedging gains and losses in a separate line item in the statement of profit or loss. Given the DRM accounting model attempts to reflect an entity’s ability to manage the net of interest income and expense, the staff think this requirement is relevant.

40. In addition, one of the objectives of the model is to increase transparency and a disaggregated presentation within net interest margin would enable users to more clearly understand the contribution from financial assets measured at amortised cost versus the contribution from those derivatives used to transform the asset profile. This clarity would undoubtedly increase transparency and enable users to better analyse and understand the impact of the entity’s risk management activities on its economic resources.

41. For the reasons discussed in paragraphs 38 - 40, the staff think approach 3 is the preferred approach.

42. While the staff think that the aligned portion should be clearly communicated to users of financial reporting, the staff are aware that additional costs would be incurred if a disaggregated presentation within net interest margin is required. This is because, as stated in paragraph 33, it is common that the gains or losses on the hedging instrument are reclassified to the same line item affected by the hedged item. Additionally, by increasing the number of line items in the statement of profit or loss, this would risk over-burdening that statement, which is intended to be an aggregated view by design. For example, instead of separately presenting interest revenue from interest expense, currently some entities simply present one line item called “net interest income”. For these entities, the proposed presentation would require adding three lines to the statement of profit or loss.

43. The staff also think that, similar to the discussion in paragraph 14 regarding the statement of financial position, information on the aligned portion could be effectively communicated through disclosure. Furthermore, it is important to highlight that the net interest margin implied by the target profile in this example is 20 (see Chart 3). Given the statement of profit or loss cannot include a figure
implied by the target profile, disclosures will be important for users to completely evaluate whether the entity has achieved perfectly alignment and in turn the risk management strategy. Given that disclosures will be required regardless, this adds further complication to evaluating benefits of additional transparency compared with the relevant costs.

44. The staff do not think there is an objective way in which to determine if the costs involved merit the benefits of transparency in this situation. Therefore, the staff think this question should be considered during outreach. The staff do think that disaggregated disclosure would be required at a minimum.

Preliminary View

45. For the reasons stated in paragraphs 38 - 40, the staff think that approach 3 is the preferred approach for presenting the aligned portion the statement of profit or loss, however, the staff think it is difficult to be certain about whether the costs involved with separate presentation of the aligned portion on the statement of profit or loss would merit the benefits of increased transparency. As such, the staff think this question should be further considered during outreach.

Question for the Board

<table>
<thead>
<tr>
<th>Question for the Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>4) Does the Board agree with the staff preliminary view in paragraph 45 that approach 3 is the preferred approach for presenting the aligned portion in the statement of profit or loss?</td>
</tr>
<tr>
<td>5) Does the Board agree that, during the outreach, the staff should seek for feedback on whether the costs involved with separate presentation of the aligned portion on the statement of profit or loss would merit the benefits of increased transparency?</td>
</tr>
</tbody>
</table>
Misaligned portion

46. As discussed during the September 2018 Board meeting, the misaligned portion of the designated derivative captures, in a single metric, the effects of imperfect alignment on the entity’s current and future economic resources. This single metric measures imperfect alignment arising from differences in the amount of expected future cash flows (ie notional and coupon), the period over which those cash flows are expected to occur (ie contractual maturity), and discount rates. Also, as previously discussed, the information contained in the statement of profit or loss is a function of whether the entity was over-hedged or under-hedged. More specifically:

(a) *Imperfect Alignment – Over Hedge:* In the case of over-hedging, the DRM accounting model will recognise the change in fair value of the excess cash flows contracted for reasons other than risk management in the statement of profit or loss as imperfect alignment.

(b) *Imperfect Alignment – Under Hedge:* In the case of under-hedging, while quantifying imperfect alignment provides valuable information to readers of financial statements, the ‘lower of’ test has be retained within the DRM accounting model because recognising gains or losses within the statement of profit or loss related to an asset or liability that does not exist (ie the benchmark derivative) is inconsistent with the Conceptual Framework. It was also tentatively agreed that, in the absence of recognition as a means of communication, disclosures are required to inform users about the impact of imperfect alignment in the case of under-hedging.

47. To illustrate, the example in paragraph 27 above was amended such that the entity executes and designates a CU 1,500 3-year receive fix 4.00%, pay float interest rate swap rather than the CU 1,000 3-year receive fix 4.00%, pay LIBOR benchmark derivative. Comparing the designated derivative and the benchmark derivative will highlight the misaligned portion (ie the cash flows the entity will receive in excess to those required to achieve alignment).
48. The misaligned portion in Chart 4 quantifies the difference between the cash flows of the benchmark and designated derivative. These are the cash flows that are not linked to the asset profile or the target profile because they are in excess to those required to transform the asset profile such that it equals the target profile. Because the cash flows attributable to the excess CU 500 notional are not linked to the asset and target profiles, those cash flows serve a purpose other than risk management, as tentatively agreed by the Board during the September 2018 Board meeting.

49. Prior to discussing the presentation of the misaligned portion in the statement of profit or loss, the staff would comment that the misaligned portion can itself be disaggregated into two components:

   (a) The current period impact of misalignment; and
   (b) The future period impact of misalignment.

50. As discussed at the September 2018 Board meeting, the total change in fair value of a derivative can be disaggregated into the impact during the period and the clean change in fair value which represents the impact on future periods. For example, chart 5 below shows the disaggregated fair value associated with the excess CU 500 notional are not linked to the asset and target profiles discussed in chart 4:

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**Chart 4**

<table>
<thead>
<tr>
<th>Year</th>
<th>Benchmark derivative (a)</th>
<th>Designated derivative (b)</th>
<th>Difference (b – a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>1,000 * (4% - LIBOR) = 10</td>
<td>1,500 * (4% - LIBOR) = 15</td>
<td>5</td>
</tr>
<tr>
<td>20X2</td>
<td>1,000 * (4% - LIBOR) = 10</td>
<td>1,500 * (4% - LIBOR) = 15</td>
<td>5</td>
</tr>
<tr>
<td>20X3</td>
<td>1,000 * (4% - LIBOR) = 10</td>
<td>1,500 * (4% - LIBOR) = 15</td>
<td>5</td>
</tr>
</tbody>
</table>

* Assuming LIBOR at 3.00% p.a., each year, for illustrative purposes.

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3 Note that the cash flows in Chart 4 are calculated by multiplying the notional of the interest rate swap in question by the difference between the contractual interest rate of the receive leg (4.00%) and the floating rate of the pay leg (LIBOR) of the interest rate swap. For example, assuming LIBOR at 3.00% p.a., the cash flows on the benchmark derivative in 20X1 is: CU 1,000 x [4.00% - 3.00%] = CU 10.
Chart 5

<table>
<thead>
<tr>
<th>Year</th>
<th>Changes in fair value (a)</th>
<th>Current Period Cash Flows (b)</th>
<th>Changes in fair value excluding (b) (a) - (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>31.3</td>
<td>5</td>
<td>26.3</td>
</tr>
<tr>
<td>20X2</td>
<td>0</td>
<td>5</td>
<td>(5)</td>
</tr>
<tr>
<td>20X3</td>
<td>(16.3)</td>
<td>5</td>
<td>(21.3)</td>
</tr>
<tr>
<td>Accumulated changes</td>
<td>15</td>
<td>15</td>
<td>0</td>
</tr>
</tbody>
</table>

51. Chart 5 shows the total change in the fair value of the excess CU 500 derivative and the change in fair value excluding the current period cash flows. The figures in the column (b) have been calculated based on the contractual terms (ie notional and coupon) of the CU 500 excess derivative whereas the figures presented in the changes in fair value column are assumed for illustrative purposes.

52. The staff would comment that each component conveys different information to users of financial reporting. The current period impact of misalignment (misaligned portion of the derivative cash flows in the period illustrated as the “accrual” column) is the portion that has occurred and is therefore not subject to change. It is the amount payable or receivable based on the contractual terms of the derivative for the period.

53. In contrast, the change in clean fair value (ie the future period impact of misalignment) is determined based on the present value of the future expected cash flows and the market interest rates at the measurement date. As such, this figure is subject to change for both changes in the expectation of future cash flows and the market discount rate. This amount quantifies the impact on the entity’s future economic resources based on the best estimate based market available data at the measurement date.

54. The staff think that the aligned and the misaligned portions communicate different information to users of financial reporting and therefore, the quantification of both
portions should be clearly communicated to users of financial reporting. Similarly, the staff think the same applies to the current and future periods impact from misalignment. Assuming the Board agrees, the subsequent paragraphs will discuss how to best communicate that information to users of financial reporting.

55. As tentatively decided by the Board at its September 2018 meeting, changes in fair value of the cash flows arising from the excess CU 500 derivative (see paragraph 46) would be treated as any other derivative held for trading purposes (ie recorded in profit or loss) given that there is a poor link, if any, between these cash flows and those from the financial assets and liabilities designated within the DRM accounting model. Therefore, the staff think it would be inappropriate to present the misaligned portion of the designated derivative in net interest margin because gains and losses from the excess portion would have the same accounting treatment as the aligned portion. The staff think this would not clearly delineate the misaligned and the aligned portions.

56. However, the staff would highlight a potential concern that could arise regarding the current portion of misalignment. To illustrate this, the chart below shows net interest margin including the current portion of misalignment and excluding that portion:

*Chart 6*

<table>
<thead>
<tr>
<th>Line Item</th>
<th>Included</th>
<th>Excluded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Revenue</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>DRM aligned portion</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>DRM current misaligned portion</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td>(30)</td>
<td>(30)</td>
</tr>
<tr>
<td><strong>Net Interest Margin</strong></td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>DRM current misaligned portion</td>
<td></td>
<td>5</td>
</tr>
<tr>
<td><strong>Net Income After Tax</strong></td>
<td>25</td>
<td>25</td>
</tr>
</tbody>
</table>

For simplification purposes, Chart 6 illustrates the current misalignment portion only.

57. If the current portion of misalignment is excluded from net interest margin, then this implies, in this example, net interest margin will reflect the target profile as if it
were perfectly achieved. Note the net interest margin in chart 6 under column “Excluded” shows CU 20. This approach could result in users concluding by mistake that the entity has achieved perfect alignment, assuming they knew CU20 represented perfect alignment. As illustrated in column ‘Included’ of Chart 6, this could be mitigated by including the current misaligned portion in net interest margin.

58. However, there are at least two reasons why the staff believe this concern can be addressed via other means. Firstly, the net interest margin implied by the entity’s target profile requires additional qualitative and quantitative information that can only be communicated through disclosures. Therefore, without knowing the entity’s target profile, users will not be able to evaluate whether the entity has achieved perfect alignment or not solely based on information provided in Chart 6. Disclosures would be required in addition and, while disclosures will be discussed at a future Board meeting, these disclosures would clearly indicate the entity is misaligned in this example.

59. Secondly, while the above examples have assumed the entity has over-hedged, misalignment can also arise from an under-hedge position. However, the impact of misalignment in a situation of under-hedging cannot be communicated through the statement of profit or loss for the reasons stated in paragraph 46(b) and those discussed during the September 2018 Board Meeting. Therefore disclosures will be required regardless to ensure a comprehensive communication of the impact of misalignment on net interest margin.

60. Therefore, the staff think that only the aligned portion should be presented as part of the entity’s net interest margin. The staff think that, since disclosures on the entity’s target profile are required regardless, it would be costly and potentially confusing for readers to present the current portion of misalignment as part of an entity’s net interest margin. Confusion could arise because presenting the current portion in net interest margin creates an asymmetric presentation of misalignment depending upon whether the entity is over or under aligned.
Preliminary View

61. For the reasons stated in paragraphs 55 – 60, the staff think that the misaligned portion should not be presented as part of the entity’s net interest margin.

Question for the Board

<table>
<thead>
<tr>
<th>Question for the Board</th>
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</thead>
<tbody>
<tr>
<td>6) Does the Board agree with the staff preliminary view in paragraph 61 that the misaligned portion should not be presented as part of an entity’s net interest margin?</td>
</tr>
</tbody>
</table>

Separate presentation vs disclosure

62. Assuming the Board agrees that the misaligned portion should not be presented as part of the entity’s net interest margin, the question that follows is how to best communicate the impact of misalignment to users of financial reporting. More specifically, on what line item should it be presented in the statement of profit or loss? The staff have considered three approaches:

(a) *Approach 1 – Where the current and future misaligned portions are presented in a single line in the statement of profit or loss:* Under this approach, a single line item would be included in the statement of profit or loss named “misalignment” where both current and future components would be presented. Requiring separate presentation of both components in the statement of profit or loss from other “trading” derivatives would increase transparency for users of financial reporting. Furthermore, as these derivatives are different in nature than ordinary “trading” derivatives, separate presentation would provide additional transparency regarding the impact the risk management activities have on the entities current and future economic resources, separate from the impact other derivatives have on those same resources. However, like the concerns raised in paragraph 18, this would require entities to incur additional cost and could reduce the understandability of the statement of profit or loss.
by including information that could be too granular. This approach would also require a disaggregated disclosure of the current and future portions.

(b) **Approach 2 – Where both the current and future misaligned portions are presented on separate lines in the statement of profit or loss:** Under this approach, two-line items would be included in the statement of profit or loss. One would present the current period impact (misaligned portion of the derivative cash flows in the period) and another the future period impact (the change in clean fair value). This approach would have the incremental benefit of separating the impact in the current period from the impact from future periods for users but would have the incremental cost necessary to separate the two figures. Having said that, the incremental costs will be incurred regardless because if disaggregation in the statement of profit or loss is not required, disaggregation in the notes will be.

(c) **Approach 3 – Where separate presentation is not required:** Under this approach, the DRM model would not mandate a specific line item for presentation of misalignment but would require disclosure of the amount on a disaggregated basis and the line item in the statement of profit or loss where misalignment is presented.

63. Chart 7 below compares the information that would be provided in the statement of profit or loss under the various approaches. The figures included are illustrative in nature:

**Chart 7**

<table>
<thead>
<tr>
<th>Line item</th>
<th>Approach 1</th>
<th>Approach 2</th>
<th>Approach 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Portion</td>
<td></td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Future Portion</td>
<td></td>
<td>26.3</td>
<td></td>
</tr>
<tr>
<td><strong>Total Misalignment</strong></td>
<td>31.3</td>
<td>31.3</td>
<td>31.3</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td>31.3</td>
</tr>
</tbody>
</table>

64. Regarding the three approaches, the staff have identical thoughts as discussed in paragraph 60. More specifically, given disclosures are required regardless of the
approach selected due to the existence of the ‘lower of test’, the staff do not think presentation alone can communicate the impact of misalignment in all instances. Furthermore, since the model must consider both situations of under and over hedging, the staff are concerned that requiring a separate line item for misalignment could lead to incorrect conclusions in situations of under-hedging. Said differently, since misalignment cannot be communicated through the statement of profit or loss in situations of under-hedging, the line item in the statement of profit or loss would be blank in such an instance. Such a presentation could lead users to conclude the entity has achieved perfect alignment although the entity is under aligned instead.

*Preliminary View*

65. For the reasons stated in paragraph 64, the staff think approach 3 is the preferred approach given the need to consider both situations of over and under alignment.

**Question for the Board**

<table>
<thead>
<tr>
<th>Question for the Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>7) Does the Board agree with the staff preliminary view in paragraph 65 that approach 3 is the preferred approach?</td>
</tr>
</tbody>
</table>