IFRS for SMEs (2009) + Q&As

IFRS Foundation: Training Material for the *IFRS® for SMEs*

Module 12 – Other Financial Instruments Issues

IFRS®

IFRS Foundation: Training Material for the *IFRS® for SMEs*

including the full text of
Section 12 *Other Financial Instruments Issues*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board in July 2009

with extensive explanations, self-assessment questions and case studies

IFRS Foundation®
30 Cannon Street
London EC4M 6XH
United Kingdom

Telephone: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Email:info@ifrs.org

Publications Telephone: +44 (0)20 7332 2730
Publications Fax: +44 (0)20 7332 2749
Publications Email: publications@ifrs.org
Web: www.ifrs.org

Contents

Module 12 – Other Financial Instruments Issues

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB).
The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the *International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

This training material includes a number of illustrative journal entries. Please note that these are intended to illustrate one way, not necessarily the only way, in which the journal entries might be structured, because the *IFRS for SMEs* is not written at the journal entry level.

This training material includes some notes based on guidance appended to and accompanying IAS 39; in the absence of explicit guidance in the *IFRS for SMEs* an entity can (but is not required to), in accordance with paragraph 10.6, consider the requirements and guidance in full IFRSs.

INTRODUCTION

An entity must choose to account for financial instruments by applying either:

(a) the requirements, in full, of both Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*; or

(b) the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (of full IFRSs) and the disclosure requirements of Sections 11 and 12 of the *IFRS for SMEs*.

Whichever of the two options above that an entity applies, it must also apply Section 22 *Liabilities and Equity* as and where applicable.

This training material covers only the first option (ie it does not cover the option to apply the requirements of IAS 39). In April 2012 the SME Implementation Group (SME IG) issued non-mandatory guidance on whether an entity could choose to apply the recognition and measurement requirements of IFRS 9 *Financial Instruments* rather than of IAS 39 (see http://www.ifrs.org/IFRS-for-SMEs/Documents/IFRSforSMEsFinal_FallbacktoIFRS9FinancialInstruments.pdf). That guidance clarifies that SMEs are not permitted to apply IFRS 9.

This module, issued in October 2015, focuses on the accounting and reporting of financial instruments and transactions, other than those covered by Section 11, in accordance with Section 12 of the *IFRS for SMEs* that was issued in July 2009 and the related non-mandatory guidance subsequently provided by the IFRS Foundation SME Implementation Group. Section 12 applies to financial instrument issues not covered by Section 11 and hence covers more complex financial instruments and related transactions including hedge accounting.

Module 12 introduces the learner to the subject, guides the learner through the official text of Section 12, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in accounting for financial instruments, other than those covered by Section 11. In addition, the module includes questions designed to test the learner's knowledge of the requirements and case studies to develop the learner's ability to account for financial instruments, other than those covered by Section 11, in accordance with Section 12 of the *IFRS for SMEs*.

Module 12 – Other Financial Instruments Issues

Learning objectives

Upon successful completion of this module you should know the financial reporting requirements for financial instruments in accordance with the *IFRS for SMEs*, issued in July 2009, as they relate to Section 12. In addition, through the completion of case studies that simulate aspects of the real world application of that knowledge, you should have enhanced your ability to account for financial instruments in accordance with Section 12 of the *IFRS for SMEs*. In particular, within the context of Section 12, you should be able to:

- identify financial assets and financial liabilities that are within the scope of Section 12;
- explain when to recognise and when to derecognise a financial instrument;
- apply the measurement requirements for financial instruments on initial recognition and subsequently;
- identify and apply appropriate methods of determining fair value for financial instruments;
- identify the types of transactions to which an entity may apply hedge accounting and be able to apply hedge accounting to those scenarios;
- prepare appropriate information about financial instruments that would satisfy the disclosure requirements in Section 12; and
- demonstrate an understanding of the significant judgements that are required in accounting for financial instruments and related transactions.

IFRS for SMEs

The *IFRS for SMEs* is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* includes mandatory requirements and other material (non-mandatory) that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a disclosure checklist;
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*; and
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue*. Those appendices are non-mandatory guidance.

Further non-mandatory guidance was subsequently published by the IFRS Foundation SME Implementation Group (SME IG) in the form of Q&As. The Q&As are intended to provide non-mandatory and timely guidance on specific accounting questions that are being raised with the SME IG by users implementing the *IFRS for SMEs*.

When the *IFRS for SMEs* was issued in July 2009, the IASB undertook to assess entities' experience of applying the *IFRS for SMEs* following the first two years of application. To this end, in June 2012, the IASB issued a *Request for Information* and in October 2013 it issued an Exposure Draft proposing amendments to the *IFRS for SMEs*.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, financial performance and cash flows that is useful for economic decision-making by a broad range of users (for example, owners who are not involved in managing the business, potential owners, existing and potential lenders and other creditors) who are not in a position to demand reports tailored to meet their particular information needs.

Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* specify the financial reporting requirements for financial instruments. A financial instrument is defined as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

The *IFRS for SMEs* contains two options for accounting for financial instruments:

- applying the requirements of both Section 11 and Section 12 in full; or
- applying the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (of full IFRSs) and the disclosure requirements of Sections 11 and 12.

Whichever option is selected, an entity must also apply Section 22 *Liabilities and Equity*, which establishes principles for classifying financial instruments as either liabilities or equity. Section 22 also addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as owners).

Section 11 applies to basic financial instruments and is relevant to all entities that assert compliance with the *IFRS for SMEs*, unless they have chosen instead to apply IAS 39 to recognise and measure their financial instruments. For the purposes of Section 11, basic financial instruments consist of:

- cash;
- debt instruments (such as an account, note, or loan receivable or payable) that meet specified conditions (including that returns to the holder are either fixed and/or variable, and if variable are based on a single referenced quoted or observable interest rate);
- commitments to receive a loan that cannot be settled net in cash where the loan is expected to meet the same conditions as the debt instruments in the bullet point above; and
- investments in non-convertible preference shares and non-puttable ordinary shares or preference shares.

This module focuses on the requirements in Section 12. Section 12 applies to other, more complex, financial instruments and transactions. Apart from exemptions to particular financial instruments, which are generally dealt with in another Section of the *IFRS for SMEs* (see paragraph 12.3), Section 12 applies to all financial instruments and related transactions that are outside the scope of Section 11.

Section 12 requires a financial asset or financial liability to be recognised by an entity when the entity becomes a party to the contractual provisions of the instrument. Financial assets and financial liabilities are initially recognised at fair value, which is normally the transaction price. Paragraph 12.12 provides further guidance on the treatment of transaction costs and deferred payments as they relate to the initial measurement of financial assets and financial liabilities.

On subsequent measurement, with one exception, all financial instruments within the scope of Section 12 are measured at fair value with changes in fair value recognised in profit or loss. The exception is for equity instruments within the scope of Section 12 that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments—such instruments are measured at cost less impairment, rather than at fair value.

Entities are required to apply the guidance on fair value and derecognition contained in Section 11 when dealing with these areas in accordance with Section 12.

Section 12 also provides guidance on hedge accounting. If specified criteria are met, an entity may designate a hedging relationship between a hedging instrument and a hedged item in such a way as to qualify for hedge accounting. Hedge accounting permits the gain or loss on the hedging instrument, and on the hedged item, to be recognised in profit or loss at the same time.

The following risks are the only risks for which Section 12 permits hedge accounting:

- interest rate risk of a debt instrument measured at amortised cost;
- foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction;
- price risk either of a commodity held or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity; and
- foreign exchange risk in a net investment in a foreign operation.

Foreign exchange risk of a debt instrument measured at amortised cost is not in the list above because hedge accounting would not have any significant effect on the financial statements in the light of the accounting requirements of the *IFRS for SMEs*.

Module 12 – Other Financial Instruments Issues

REQUIREMENTS AND EXAMPLES

The contents of Section 12 *Other Financial Instruments Issues* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary of the *IFRS for SMEs* are also part of the requirements. Those terms are in **bold type** the first time they appear in the text of Section 12. The notes and examples inserted by the IFRS Foundation education staff are not shaded. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

Scope of Sections 11 and 12

12.1 Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* together deal with recognising, derecognising, measuring, and disclosing **financial instruments** (**financial assets** and **financial liabilities**). Section 11 applies to basic financial instruments and is relevant to all entities. Section 12 applies to other, more complex financial instruments and transactions. If an entity enters into only basic financial instrument transactions then Section 12 is not applicable. However, even entities with only basic financial instruments shall consider the scope of Section 12 to ensure they are exempt.

Notes

Section 12 applies to:

- all financial instruments except those within the scope of Section 11 and those specifically excluded from the scope of Section 12 by paragraphs 12.3(b)−(g); and
- some contracts to buy or sell non-financial items (see paragraphs 12.4 and 12.5).

Financial instruments are within the scope of Section 11 if they meet the criteria in paragraph 11.8 and are not otherwise excluded from the scope of Section 11 by paragraph 11.7. Instruments that are within the scope of Section 11 in accordance with paragraph 11.8 are:

- cash;
- debt instruments (for example, accounts, notes, or loans receivable or payable) meeting specified conditions;
- commitments to receive a loan that cannot be settled net in cash and where the loan is expected to meet the same conditions as for the aforementioned debt instruments; and
- investments in non-convertible preference shares and non-puttable ordinary shares or preference shares.

For additional guidance on the identification of financial instruments within the scope of Section 11, consult Module 11. If an entity has any other financial instrument it must consider Section 12.

Even entities that normally only have simple transactions may occasionally enter into transactions within the scope of Section 12. For example a fixed-term loan with interest payable at EURIBOR plus 2 per cent is accounted for in accordance with Section 11, because the variable rate is a single referenced quoted or observable interest rate, whereas if the interest was payable at a rate equal to the change in the published price of gold, the instrument would be outside the scope of Section 11 and within the scope of Section 12 and accounted for accordingly.

Some financial instruments that are outside the scope of Section 11 nevertheless do not need to be accounted for in accordance with Section 12 because they are exempted by paragraph 12.3.

If there are no financial instruments and no contracts that are required to be accounted for in accordance with Section 12, the entity does not need to apply Section 12. However the entity should continue to evaluate any new or substantially revised financial instruments or related transactions on an ongoing basis, to identify whether it needs to apply Section 12 to any of them.

Definitions

The following definitions are reproduced from the Glossary.

A **financial instrument** is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A **financial asset** is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

- (i) to receive cash or another financial asset from another entity; or
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and:

- (i) under which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
- (ii) that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A **financial liability** is any liability that is:

(a) a contractual obligation:

  (i) to deliver cash or another financial asset to another entity; or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and:

  (i) under which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

  (ii) will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Equity is the residual interest in the assets of the entity after deducting all its liabilities. Section 22 *Liabilities and Equity* establishes requirements for classifying financial instruments as either liabilities or equity.

Notes on definitions

Financial instruments arise from rights and obligations under contracts. The terms 'contract' and 'contractual' refer to an agreement between two or more parties and is usually enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. For a contract to be valid, both parties must give their approval. Approval may be given indirectly, for example, by an entity acting in such a way that the other parties involved believe the entity's intention is to make a contract.

See Module 11 for the following:

- Examples 5 to 15 in Module 11 are examples of items that are not financial instruments and therefore are not within the scope of Section 11 or Section 12.
- Examples 16 to 17 and 19 to 21 are examples of common financial instruments and they illustrate how to identify financial instruments. Example 16 illustrates a financial instrument that may be within the scope of Section 12. The financial instruments in Examples 17 and 19 to 21 are within the scope of Section 11.
- Examples 23 to 32 illustrate how to identify financial instruments that are within the scope of Section 11. All of the financial instruments in these examples are within the scope of Section 11.

Paragraphs 11.6 and 11.11 of the *IFRS for SMEs* list the following examples of financial instruments that are normally within the scope of Section 12 (although exceptions exist; see, for example, paragraph 12.5):

- Asset-backed securities, such as collateralised mortgage obligations (bonds that represent claims to specific cash flows from large pools of mortgages), repurchase agreements (a type of short-term loan whereby the seller of a security agrees to buy it back at a specified price and time) and securitised packages of receivables (instruments such as bonds in a special purpose vehicle that holds receivables).
- Options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument.
- Financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in Section 12, for example, a foreign currency forward exchange contract.
- Commitments to make a loan to another entity. A commitment to make a loan is a firm commitment to provide credit under pre-specified terms and conditions; for example, a commitment to provide, in six months' time, a three-year loan of CU100,000 with interest fixed at 4 per cent per annum.
- Commitments to receive a loan if the commitment can be net settled in cash.
- An investment in another entity's equity instruments, other than non-convertible preference shares and non-puttable ordinary and preference shares. A puttable instrument gives the holder the right to put the instrument back to the issuer for cash or another financial asset or the instrument is automatically put back to the issuer on the occurrence of certain events.
- An interest rate swap that returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow.
- Investments in convertible debt.
- A loan receivable from a third party that gives the third party the right or obligation to prepay if the applicable taxation or accounting requirements change.

Module 12 – Other Financial Instruments Issues

Accounting policy choice

12.2 An entity shall choose to apply either:

(a) the provisions of both Section 11 and Section 12 in full, or

(b) the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the disclosure requirements of Sections 11 and12

to account for all of its financial instruments. An entity's choice of (a) or (b) is an accounting policy choice. Paragraphs 10.8–10.14 contain requirements for determining when a change in accounting policy is appropriate, how such a change should be accounted for, and what information should be disclosed about the change in accounting policy.

Notes

An entity must select, as an accounting policy choice, either the option in paragraph 12.2(a) or the option in paragraph 12.2(b). It must apply the option selected to account for all of its financial instruments. This is identical to the choice set out in paragraph 11.2.

IAS 39 is more complex and difficult to apply than Sections 11 and 12. Nevertheless, an entity may wish to choose the option in paragraph 12.2(b), and 11.2(b), to apply IAS 39 rather than Sections 11 and 12; for example, because it may wish to adopt hedge accounting using hedging instruments that qualify for hedge accounting under IAS 39 but not under Section 12.

In April 2012 the SME Implementation Group (SME IG) issued non-mandatory guidance (Q&A 2012/03) on whether an entity could choose to apply the recognition and measurement requirements of IFRS 9 *Financial Instruments* rather than of IAS 39 (see http://www.ifrs.org/IFRS-for-SMEs/Documents/IFRSforSMEsFinal_FallbacktoIFRS9FinancialInstruments.pdf). That guidance clarified that SMEs are not permitted to apply IFRS 9. In paragraph BC3 to Q&A 2012/03, the SME IG stated that a SME electing to follow the recognition and measurement principles of IAS 39 would apply the version of IAS 39 that was in effect at the SME's reporting date.

Once an entity has chosen (a) or (b) as its accounting policy, a change to the other (for example, a change from (a) to (b)) would be a change in accounting policy, which is covered by paragraphs 10.8–10.14. It would not be acceptable to adopt one policy each year that a particular instrument was held and to adopt the other policy in a year when such an instrument had not been held. In order to change the accounting policy, the new policy must result in reliable and more relevant information and must be applied retrospectively by restating comparative information.

Whichever of the options above an entity applies, it must also apply Section 22 *Liabilities and Equity* as and where applicable.

Module 12 – Other Financial Instruments Issues

Scope of Section 12

12.3 Section 12 applies to all financial instruments except the following:

(a) those covered by Section 11.

(b) interests in subsidiaries (see Section 9 *Consolidated and Separate Financial Statements*), associates (see Section 14 *Investments in Associates*) and joint ventures (see Section 15 *Investments in Joint Ventures*).

(c) employers' rights and obligations under employee benefit plans (see Section 28 *Employee Benefits*).

(d) rights under insurance contracts unless the insurance contract could result in a loss to either party as a result of contractual terms that are unrelated to:

(i) changes in the insured risk;

(ii) changes in foreign exchange rates; or

(iii) a default by one of the counterparties.

(e) financial instruments that meet the definition of an entity's own equity (see Section 22 *Equity* and Section 26 *Share-based Payment*).

(f) leases (see Section 20 *Leases*) unless the lease could result in a loss to the lessor or the lessee as a result of contractual terms that are unrelated to:

(i) changes in the price of the leased asset;

(ii) changes in foreign exchange rates; or

(iii) a default by one of the counterparties.

(g) contracts for contingent consideration in a business combination (see Section 19 *Business Combinations and Goodwill*). This exemption applies only to the acquirer.

12.4 Most contracts to buy or sell a non-financial item such as a commodity, inventory, or property, plant and equipment are excluded from this section because they are not financial instruments. However, this section applies to all contracts that impose risks on the buyer or seller that are not typical of contracts to buy or sell tangible assets. For example, this section applies to contracts that could result in a loss to the buyer or seller as a result of contractual terms that are unrelated to changes in the price of the non-financial item, changes in foreign exchange rates, or a default by one of the counterparties.

12.5 In addition to the contracts described in paragraph 12.4, this section applies to contracts to buy or sell non-financial items if the contract can be settled net in cash or another financial instrument, or by exchanging financial instruments as if the contracts were financial instruments, with the following exception: contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are not financial instruments for the purposes of this section.

Notes—scope of Section 12

The following is a flow chart that can be used to identify if there are any financial instruments within the scope of Section 12 at a point in time:

Step 1: using the definitions of a financial asset, a financial liability and equity, identify all the entity's financial instruments.

↓

Step 2: identify which of those financial instruments are excluded from the scope of Section 11 by paragraphs 11.7(a), (b) and (d). These are also excluded from the scope of Section 12 (by paragraphs 12.3(b), (e) and (c) respectively).

↓

Step 3: identify which of the remaining financial instruments are within the scope of Section 11 (ie they meet the criteria in paragraph 11.8 and are not excluded from the scope of Section 11 by paragraph 11.7(c)). All financial instruments identified in this step should be accounted for under Section 11.

Module 11 Basic Financial Instruments *illustrates how to identify such instruments.*
Financial instruments within the scope of Section 11 consist of cash; debt instruments (for example, accounts, notes, or loans receivable or payable) meeting specified conditions; commitments to receive a loan that cannot be settled net in cash and where the loan is expected to meet the same conditions as for the aforementioned debt instruments; and investments in non-convertible preference shares and non-puttable ordinary shares or preference shares.

↓

Step 4: For the financial instruments not identified in steps 2 or 3, identify those that are excluded from the scope of Section 12 by paragraphs 12.3(d), (f) and (g).

↓

Step 5: Any remaining financial instruments should be accounted for under Section 12.

In addition, any contracts to buy or sell non-financial items that are specifically included within the scope of the section by paragraphs 12.4 and 12.5 should be accounted for under Section 12.

Notes—scope of Section 12

A number of financial instruments that would otherwise be within the scope of Section 12 do not have to be accounted for in accordance with Section 12. In general, these are items that, although meeting the definition of financial instruments, and falling outside the scope of Section 11, fall within other Sections of the *IFRS for SMEs*, such as interests in a subsidiary. A holding of convertible preference shares in a third party company will be within the scope of Section 12, but such a holding in a subsidiary is accounted for in accordance with Section 9.

For several categories of contracts, the determining factor of whether the contract is within or outside the scope of Section 12 is whether the contract exposes the parties to the contract to one or more risks that are not usually expected in an equivalent 'plain vanilla' contract. Specifically, an insurance contract, a lease or a contract to buy or sell a non-financial item is within the scope of Section 12 if the contract terms expose the parties to risk of a possible loss as a result of something other than:

- one of the parties to the contract defaulting;
- changes in foreign exchange rates; or
- changes in the pricing of whatever the contract is for, for example, changes in the price of gold if it is a forward contract to buy gold, changes in the price of a particular machine if it is a lease of the machine, or an increase in the insurance premiums due to a change in the insured risk such as an increase in the insurance premiums for a factory that recently flooded during bad weather if it is buildings insurance of the factory.

Contracts that expose the parties to risk of loss for these three things are outside the scope of Section 12, but contracts that expose the parties to risk of other losses are accounted for, in accordance with Section 12, as financial instruments.

Paragraph 12.3(d)—rights under insurance contracts

Under insurance contracts most rights of policyholders, beneficiaries or any insurers within the scope of the *IFRS or SMEs* are outside the scope of Section 12 and hence are accounted for under other sections. For example, for policyholders, any contingent assets would be within the scope of Section 21 *Provisions and Contingencies*.

However, as explained above, paragraph 12.3(d) requires any rights under insurance contracts to be accounted for in accordance with Section 12 if they could result in a loss to the policyholder or the insurer as a result of contractual terms that are unrelated to: changes in the insured risk; changes in foreign exchange rates; or a default by one of the counterparties. For example, a life insurance contract with a maturity payout linked to the price of a specific commodity, for example, gold, will be accounted for in accordance with Section 12. This is because the terms of the financial instrument include a financial risk component that alters the settlement amount of the contract in a way that is unrelated to the actual insuring of the insured item.

Paragraph 12.3(e)—entity's own equity

The exemption in paragraph 12.3(e) applies only to the issuer of the equity instrument and not to the holder. Section 11 contains the same exemption. Section 22 *Liabilities* *and Equity* specifies how an issuer classifies financial instruments as either financial liabilities or equity. Consequently, before applying Section 11 and Section 12, the entity must decide in accordance with Section 22 whether a financial instrument is a financial liability, equity or an instrument that contains both equity and liability components. Section 11 and Section 12 apply to instruments that are financial liabilities, and to the liability component of a financial instrument with both equity and liability components. Neither Section 12 nor Section 11 applies to financial instruments, or components of financial instruments, that are that entity's own equity instruments.

Share-based payment transactions accounted for as equity in accordance with Section 26 *Share-based Payment* are outside the scope of Section 12 and Section 11.

Paragraph 12.3(f)—leases

Most leases result in financial instruments—the lessor has a contractual right to receive cash (future lease payments) and the lessee has a contractual obligation to pay cash (future lease payments). Because Section 20 *Leases* specifies requirements for accounting for leases, they are generally excluded from the scope of Section 12. However, as explained above, in accordance with paragraph 12.3(f), a lease that could result in a loss to the lessee or the lessor as a result of contractual terms that are unrelated to: changes in the price of the leased asset; changes in foreign exchange rates; or a default by one of the counterparties, is to be accounted for in accordance with Section 12 and is excluded from the scope of Section 20 (see also paragraph 20.1(e)). Such leases are within the scope of Section 12 because their terms include a component that alters the settlement amount of the contract that is unrelated to the actual leasing of the asset.

An example of a lease that would fall within the scope of Section 12 would be a lease for a retail unit in a large shopping mall for which the payments are a fixed annual amount plus a contingent rental equal to one per cent of profit after tax made by the lessee on its business from that retail unit. However, an example of a lease that would be outside the scope of Section 12 (and within the scope of Section 20) would be a lease for a retail unit in a large shopping mall for which the payments are increased each year by a percentage equal to the percentage change in fair value of the shopping mall. The change in payment would be related to the change in the price of the leased asset and so the lease would not be within the scope of Section 12.

A provision for an onerous operating lease contract, for example, a lessee's provision made for vacant leasehold property that it has been unable to sublet, is accounted for in accordance with Section 21 *Provisions and Contingencies* (see paragraph 21.1(a)) unless it meets the exception in paragraph 12.3(f).

Judgement needs to be applied in interpreting 'unrelated' as used in paragraphs 12.3(d), 12.3(f) and 12.4.

Examples—scope of Section 12—paragraph 12.3

Ex 1 **On 1 January 20X1, Entity A, a company manufacturing bicycles, took out a CU100,000[1] five-year variable-interest rate loan from Bank B. Interest is payable on the loan at LIBOR plus 100 basis points. LIBOR increased twice during 20X3. Concerned about rising expectations that interest rates are to increase again in the near future, Entity A, on 1 January 20X4, takes out an interest rate swap with Bank C for the final two years of the loan; the combined effect of the swap and the loan is a loan with interest fixed at 4.5 per cent for 20X4 and 20X5. In accordance with the swap, which assumes a principal amount of CU100,000, Entity A pays 3.5 per cent fixed interest and receives variable interest calculated at LIBOR. LIBOR is reset quarterly under both the loan and the swap.**

The loan is within the scope of Section 11; it is a variable-rate loan meeting the conditions in paragraph 11.9. Accounting in accordance with Section 11 will apply throughout the full five-year life of the loan.

The swap, on the other hand, is accounted for under Section 12, because it is a financial instrument but it is not any of the instruments listed in paragraph 11.8 and is not exempt under paragraph 12.3.

If Entity A had not taken out the swap, but had instead repaid the loan at the end of 20X3 and taken out a new two-year loan with interest fixed at 4.5 per cent, both the original loan and the replacement loan would have been within the scope of Section 11.

The swap would be eligible for hedge accounting under Section 12 if specified criteria are met; see paragraph 12.23 and Example 32 and Example 33. The impact of hedge accounting on profit or loss in each of 20X4 and 20X5 would be the same as the impact of a two-year loan with interest fixed at 4.5 per cent, that is within the scope of Section 11.

Ex 2 **Entity A, a company manufacturing bicycles, contracted on 1 November 20X1 to purchase a new machine from an overseas supplier. The new machine is expected to be ready for delivery on 31 January 20X2, at which time, Entity A is contractually required to pay the manufacturer FCU10,000[2], the full price of the machine. Entity A is concerned about the effect on its cash flow of fluctuating exchange rates. Consequently, on 1 November 20X1 it also entered into a forward contract with Bank B to receive FCU10,000 in exchange for CU5,000 on 31 January 20X2.**

The contract to purchase the machine is outside the scope of Section 12 unless it falls within paragraph 12.4 or 12.5—see Example 6.

The forward contract to purchase FCU is within the scope of Section 12, because it is a financial instrument but is not any of the instruments listed in paragraph 11.8 and is not exempt under paragraph 12.3.

The forward contract to purchase FCU would be eligible for hedge accounting under Section 12 if specified criteria are met. See paragraph 12.15 onwards.

---

[1] In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

[2] In this example, and in all other examples in this module, foreign currency monetary amounts are denominated in 'foreign currency units (FCU)'.

Ex 3 **Entity A, a company manufacturing bicycles, purchases a subsidiary, which manufactures scooters, from Entity B. Entity A pays CU50,000 on the date of acquisition and agrees to pay a further CU50,000 to Entity B two years later if the subsidiary meets specified performance targets (ie the second CU50,000 is contingent consideration). It is expected that the subsidiary will meet those targets throughout the two years.**

The contingent consideration payable/receivable meets the definition of a financial liability of Entity A and a financial asset of Entity B.

Contingent consideration payable (Entity A's financial liability) is specifically excluded from the scope of Section 12 by paragraph 12.3(g) because it is accounted for in accordance with Section 19 *Business Combinations and Goodwill*. The contingent consideration receivable (Entity B's financial asset), on the other hand, is within the scope of Section 12.

Ex 4 **Entity A, based in Japan, is both the policyholder and the beneficiary in a life insurance (also known as life assurance) contract. The contract, which is for ten years, requires the insurer to pay a sum of money upon the occurrence of the death or terminal illness of the owner-manager of Entity A or, if earlier, at the end of the ten-year contract. Under the contract, Entity A is required to pay a stipulated amount annually (premiums) until the earlier of ten years and the insured event (death or illness) occurring. The payment to Entity A (in its capacity as policyholder) at the end of the ten years, or, if earlier, on death or terminal illness of the owner-manager, will be equal to the premiums paid into the plan, net of a pre-agreed administration fee, plus or minus a return equal to the percentage increase or decrease in the Nikkei 225.**

The contract is outside the scope of Section 11 because, as a result of containing the bonus variable with the performance of the Nikkei 225, returns to the entity are not fixed or variable based on a single referenced quoted or observable interest rate.

Entity A's rights under the insurance contract could result in a loss, as defined in Section 12, to either party. The variable payment is related to the movement in the Nikkei 225 and is not related to the insured risk (the owner-manager's health), foreign exchange rates or default by one of the counterparties. Consequently, Entity A's rights under the insurance contract are included in the scope of Section 12 (see paragraph 12.3(d)).

Ex 5 **Entity A leases a machine from Entity B under a five-year finance lease in accordance with which fixed annual rental payments are made. The payments are denominated in FCU.**

Entity A's functional currency is the CU. Entity B's functional currency is the FCU.

If the FCU strengthens against the CU, the lessee will pay higher annual rental payments when translated into its functional currency. However, because the loss to the lessee results from changes in exchange rates, the lease is accounted for under Section 20, because it is not within the scope of Section 12 (see paragraph 12.3(f)(ii)).

Examples—scope of Section 12—paragraph 12.4—contracts to buy or sell a non-financial item

Ex 6 **On 1 January 20X1 a machine manufacturing entity, whose functional currency is the CU, enters into a contract to export an item of machinery to a buyer whose functional currency is the FCU. In accordance with the contract, the machine will be delivered on 1 July 20X2 and at that time payment of CU10,000 will be made by the buyer.**

In this example, the payment in CU exposes the buyer to currency risk, because the cash flows under the contract will vary with the CU/FCU exchange rate (for example, a 'stronger' than expected CU against FCU would result in a higher purchase price for the buyer than under a similar fixed-price contract denominated in FCU using the CU:FCU spot rate on the date of contracting). Because the risk imposed relating to the change in the purchase price is due only to changes in foreign exchange rates, this contract is outside the scope of Section 12 for both the buyer and the seller.

Before delivery of the machine, the contract is equally unperformed from the perspective of both the buyer and of the seller. In practice, obligations under such contracts that are equally unperformed are generally not recognised as liabilities in the financial statements. If the contract is onerous it must be accounted for in accordance with Section 21.

Ex 7 **On 1 January 20X0, Entity A contracts to purchase a fixed quantity of copper rods from Entity B for delivery on 30 June 20X1. The copper rods are intended for use in Entity A's business. Entity A and Entity B operate in the same jurisdiction. The purchase price is the market price in the jurisdiction on 1 January 20X0 plus an adjustment for the jurisdiction's producer price index (PPI) between 1 January 20X0 and 30 June 20X1.**

The PPI measures average changes in prices received by domestic producers for their output. It is one of several price indexes. The percentage change in the PPI is a measure of inflation in that jurisdiction.

In this example, the adjustment for inflation exposes both the buyer and seller to the risk of uncertain future cash flows. However, it is unlikely that the price of the copper rods is related to the PPI; it is more likely that the price of the rods is related to the price of copper. Consequently, this contract would be within the scope of Section 12 for both the buyer and the seller.

Ex 8 **On 1 January 20X0, Entity A contracts to purchase a fixed quantity of copper rods from Entity B for delivery on 30 June 20X1. The copper rods are intended for use in Entity A's business. Entity A and Entity B operate in the same jurisdiction. The purchase price is the market price in the jurisdiction on 1 January 20X0 plus or minus an adjustment for the change in the price of copper between 1 January 20X0 and 30 June 20X1.**

In this example, the pricing of the rods would generally be expected to vary in line with the price of copper. Consequently, this contract is outside the scope of Section 12 for both the buyer and the seller.

Notes—scope of Section 12—paragraph 12.5

Contracts to buy or sell a non-financial item are also accounted for as financial instruments within the scope of Section 12 if they can be settled net in cash or another financial instrument or by exchanging financial instruments as if the contracts were financial instruments. For example, a contract in which Entity A agrees to purchase 100,000 kilograms of silver in eight months' time for CU360,200 from Entity B and which allows the parties to settle net in cash. Assume that on settlement date (ie eight months after the contract date) the spot price of 100,000 kilograms of silver was CU310,900. If Entities A and B were to settle net in cash, rather than to settle with physical delivery, Entity A would pay CU49,300 (being the price specified in the contract, CU360,200, less the spot price on settlement date, CU310,900) to Entity B.

However, paragraph 12.5 specifies that even contracts that can be settled net in cash are outside the scope of Section 12 if they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (sometimes called 'the own use exception'). For example, extending the illustration above, even though Entity A can settle the contract net in cash, if Entity A entered into the contract because it wants 100,000 kilograms of silver to use in its business (for example, it makes flutes with solid silver mouth pieces), the contract will not be within the scope of Section 12.

Examples—scope of Section 12—paragraph 12.5—contracts to buy or sell non-financial items (net settlement and expected usage exemption)

Ex 9 **An entity enters into a contract to purchase one million kilograms of copper in 12 months' time at a fixed price in accordance with its expected usage requirements (a fixed-price forward contract). The contract permits the entity to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the spot price of copper at the end of the contract.**

If the entity entered into the contract because it wants the copper to use in its business, and this is still the case, the contract satisfies the exception from the inclusion in paragraph 12.5 and so is not within the scope of Section 12.

Ex 10 **An entity enters into a contract to purchase 10,000 kilograms of bananas on 1 September. Over the shelf life of those bananas the entity expects to sell between 9,000 and 10,000 kilograms of the bananas in its shops. Any excess/unsold bananas are either treated as waste or are given to the local animal charity.**

The contract is not within the scope of Section 12, because it was entered into in accordance with the entity's expected purchase/usage requirements, and so satisfies the exception from the inclusion in paragraph 12.5. The entity sells the bananas in the normal course of business.

Ex 11 **Entity A, a company manufacturing bicycles, was concerned about the future price of rubber. Consequently, it entered into a fixed-price forward contract to purchase 5,000 bicycle tyres, 1,000 in each of five sizes, in ten months' time for CU20,000.**

The tyres, when purchased, will be recognised as inventory to be used in the manufacture of bicycles.

The contract is not within the scope of Section 12, because it was entered into in accordance with the entity's expected purchase/usage requirements. The entity will use the tyres in the normal course of business manufacturing bicycles.

Initial recognition of financial assets and liabilities

12.6 An entity shall recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

Notes—initial recognition

Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

A forward contract within the scope of Section 12 under paragraph 12.5, such as a firm commitment to buy or sell non-financial items that can be net settled, is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the rights and obligations are often equal, so the net fair value of the forward contract at that point is zero. If the net fair value of the rights and obligations is not zero, the contract is recognised as an asset or liability.

Initial measurement

12.7 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value, which is normally the transaction price.

Examples—initial recognition and initial measurement

Ex 12 **The facts are the same as in Example 2. That is, Entity A, a company manufacturing bicycles, contracted on 1 November 20X1 to purchase a new machine from an overseas supplier. The new machine is expected to be ready for delivery on 31 January 20X2, at which time, Entity A is contractually required to pay the manufacturer FCU10,000, the full price of the machine. Entity A is concerned about the effect on its cash flow of fluctuating exchange rates. Consequently, on 1 November 20X1 it also entered into a forward contract with Bank B to receive FCU10,000 in exchange for CU5,000 on 31 January 20X2.**

Assuming the contract to purchase the machine is not within paragraph 12.4 or 12.5, the contract for the purchase of the machine is outside the scope of Section 12. The entity's accounting policy for obligations under such contracts that are equally unperformed is not to recognise a liability in the financial statements unless the contract is onerous.

The forward contract to purchase FCU is within the scope of Section 12, because it is a financial instrument and neither is it any of the instruments listed in paragraph 11.8 nor exempt under paragraph 12.3. The forward contract for FCU will therefore be recognised on 1 November 20X1 when Entity A becomes a party to the forward contract; and it will be recognised at its fair value. If Bank B, the party with whom Entity A enters into the forward contract for FCU, is an independent third party, the price paid by Entity A is likely to be the fair value of the forward FCU contract. In this forward contract the exchange rate is FCU2.00:CU1.00 (Entity A will pay CU5,000 to receive FCU10,000) and, if this is priced at fair value, the forward rate will be based on the spot price at 1 November 20X1(for example, FCU1.98:CU1.00) adjusted to reflect the 3-month interest rates in the two jurisdictions. Consequently, at 1 November 20X1 CU5,000 payable in three months' time is equal to FCU10,000 receivable in three months' time. In this example it is assumed that the fair value at inception, and thus the price paid to Bank B, was nil. See Example 17 for an illustration of calculating the fair value of the forward contract part way through the contract.

Ex 13 **Entity A, a company manufacturing bicycles, had some surplus cash and decided to invest it in shares of a listed company operating in the same line of business as itself. On 12 June 20X3 it purchased 1,000 listed convertible preference shares for CU5,000.[3] Entity A incurred a transaction fee and stamp duty on the purchase; these totalled CU100.**

Entity A will recognise the shares on 12 June 20X3. They have to be recognised at fair value. Paragraph 12.12 explains that transaction costs are excluded from the initial measurement of financial assets (and financial liabilities) that will be subsequently measured at fair value through profit or loss. Consequently, Entity A will measure the shares, when it recognises them on 12 June 20X3, at CU5,000 (not CU5,100—see paragraph 12.12).

Ex 14 **The facts are the same as in Example 1. That is, On 1 January 20X1, Entity A, a company manufacturing bicycles, took out a CU100,000 five-year variable-interest rate loan from Bank B. Interest is payable on the loan at LIBOR plus 100 basis points. LIBOR increased twice during 20X3.**

Concerned about rising expectations that interest rates are to increase again in the near future, Entity A, on 1 January 20X4, takes out an interest rate swap with Bank C for the final two years of the loan; the combined effect of the swap and the loan is a loan with interest fixed at 4.5 per cent for 20X4 and 20X5. In accordance with the swap, which assumes a principal amount of CU100,000, Entity A pays 3.5 per cent fixed interest and receives variable interest calculated at LIBOR. LIBOR is reset quarterly under both the loan and the swap.

As explained in Example 1, the loan is within the scope of Section 11 throughout its full five-year life, whereas the swap is accounted for under Section 12.

The swap will be recognised on 1 January 20X4 at its then fair value. If Bank C, the party with whom Entity A enters into the swap, is an independent third party, the price paid by Entity A, if any, is likely to be the fair value.

[3] The voting rights attached to the 1,000 shares purchased are less than a significant influence.

Subsequent measurement

12.8 At the end of each **reporting period**, an entity shall measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss, except as follows: equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment.

Examples—subsequent measurement

Ex 15 **The facts are the same as in Examples 2 and 12. That is, Entity A, a company manufacturing bicycles, contracted on 1 November 20X1 to purchase a new machine from an overseas supplier. The new machine is expected to be ready for delivery on 31 January 20X2, at which time, Entity A is contractually required to pay the manufacturer FCU10,000, the full price of the machine. Entity A is concerned about the effect on its cash flow of fluctuating exchange rates. Consequently, on 1 November 20X1 it also entered into a forward contract with Bank B to receive FCU10,000 in exchange for CU5,000 on 31 January 20X2. Entity A does not apply hedge accounting.**

The forward contract to purchase FCU had a nil fair value when entered into on 1 November 20X1, but two months later, at Entity A's year-end (31 December 20X1), it had a fair value of CU(97).

As stated above, the forward contract to purchase FCU is recognised on 1 November 20X1 when Entity A becomes a party to the forward contract. However, because the fair value of the contract on that date was nil, it was recognised at nil.

Two months later, the fair value of the forward contract to purchase FCU has a fair value of CU(97). Consequently, Entity A recognises the forward contract as a financial liability at CU97 and recognises an expense of CU97, in profit or loss.

Notes—subsequent measurement (equity instruments)

The principle of Section 12 is that instruments within the scope of Section 12 are measured at fair value with changes in fair value recognised in profit or loss. The exception to this principle applies to equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably and contracts linked to such instruments that, if exercised, will result in delivery of such instruments; for example, an option to purchase unquoted shares whose fair value cannot be measured reliably. The exception extends to contracts resulting in delivery of such shares, because if the shares cannot be measured reliably then it follows that a derivative for such shares also cannot be measured reliably.

The term 'measured reliably' is not explained in Section 12 or in the Glossary of the *IFRS for SMEs*. Paragraph AG80 of IAS 39[4] explains that 'The fair value of investments in equity instruments that do not have a quoted price in an active market for an identical instrument (ie a Level 1 input) and derivatives that are linked to and must be settled by delivery of such an equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value'.

If such shares are not measured at fair value, paragraph 12.8 requires them to be measured at cost less impairment. Financial assets within the scope of Section 12 are outside the scope of Section 27 which deals with the impairment of assets. Impairment tests should be performed in accordance with paragraphs 11.21–11.26. If the entity does not have access to the company's budgets, management accounts and other internal information, other sources of information that might be useful in determining whether there has been any impairment include the company's financial statements. In addition, as explained in paragraph 11.23, significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the company operates may provide evidence of impairment.

12.9 If a reliable measure of fair value is no longer available for an equity instrument that is not publicly traded but is measured at fair value through profit or loss, its fair value at the last date the instrument was reliably measurable is treated as the cost of the instrument. The entity shall measure the instrument at this cost amount less impairment until a reliable measure of fair value becomes available.

Notes

The requirement to measure at cost less impairment discussed in paragraph 12.8 applies when fair value cannot be measured reliably for an unquoted equity instrument or an option or a forward for such an instrument. When such an instrument has been measured at fair value in earlier periods but its fair value can no longer be measured reliably, paragraph 12.9 specifies that cost for this purpose is deemed to be the last reliable measurement of fair value.[5] Any fair value gains and losses that had previously been recognised in profit or loss for that instrument to that date must not be reversed. If there is objective evidence of impairment of the instrument, an impairment test should be performed in accordance with paragraphs 11.21–11.26.

---

[4] Here and subsequently, some notes are based on guidance appended to and accompanying IAS 39: in the absence of explicit guidance in the *IFRS for SMEs* an entity can (but is not required to), in accordance with paragraph 10.6, consider the requirements and guidance in full IFRSs.

[5] This is a change in circumstance. It is not a change in accounting policy.

Fair value

12.10 An entity shall apply the guidance on fair value in paragraphs 11.27–11.32 to fair value measurements in accordance with this section as well as for fair value measurements in accordance with Section 11.

Notes

Guidance on measuring the fair value of unquoted equity instruments in the context of IFRS 9 can be found in the Educational material on 'Measuring the fair value of unquoted equity instruments within the scope of IFRS 9 *Financial Instruments*' (see IFRS Foundation website at http://www.ifrs.org/Use-around-the-world/Education/FVM/Pages/FVM.aspx). Although an entity applying the *IFRS for SMEs* cannot apply IFRS 9, this guidance may nevertheless be useful when measuring fair value of unquoted equity instruments for the purposes of Section 12, because it illustrates, at a high level, the application of valuation techniques within the context of financial reporting.

Example—determining fair value

Ex 16 **The facts are the same as in Examples 2, 12 and 15. That is, Entity A, a company manufacturing bicycles, contracted on 1 November 20X1 to purchase a new machine from an overseas supplier. The new machine is expected to be ready for delivery on 31 January 20X2, at which time, Entity A is contractually required to pay the manufacturer FCU10,000, the full price of the machine. Entity A is concerned about the effect on its cash flow of fluctuating exchange rates. Consequently, on 1 November 20X1 it entered into a forward contract with Bank B to receive FCU10,000 in exchange for CU5,000 on 31 January 20X2. Entity A does not apply hedge accounting.**

The forward contract to purchase FCU had a nil fair value when entered into on 1 November 20X1.

The following table lists key rates of exchange:

Date	Spot rate, FCU:CU	Forward rate, FCU:CU, to 31 January 20X2
1 November 20X1	1.98:1.00	2.00:1.00
31 December 20X1	2.03:1.00	2.04:1.00

As stated above, the forward contract to purchase FCU is recognised on 1 November 20X1 when it is purchased. However, because the fair value of the contract on that date was nil, it was recognised at nil.

Under the contract, Entity A will pay CU5,000 to receive the FCU10,000 that it needs to pay to the manufacturer of the machine. However, if it had not entered into the three-month forward contract on 1 November 20X1 but instead entered into a one-month forward contract on 31 December 20X1, it would need to pay only CU4,902;

that is, CU98 less than under the forward contract that Entity A purchased on 1 November 20X1.

Paragraph 11.27 states that the best evidence of fair value is the current bid price. This represents the highest price that a buyer would be willing to pay to buy the forward contract from Entity A. If a third party were to 'buy' the forward contract from Entity A, Entity A would need to compensate that third party for taking on the contract (rather than the third party paying money to Entity A). To be in the same position as if it took out a one-month forward contract at 31 December, the third party would need to receive from Entity A the present value of CU(98) in one-month; for example, CU(97).

If no other risk were priced for, on 31 December 20X1 the fair value of the 1 November forward contract to purchase FCU is CU(97); that is, it has a negative fair value, and so is a financial liability rather than a financial asset, of CU97.

Consequently, Entity A recognises the forward contract as a liability at CU97 and recognises the loss, a debit of CU97, in profit or loss.

12.11 The fair value of a financial liability that is due on demand is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Example—financial liability due on demand

Ex 17 **On 1 January 20X0 Entity A borrows CU100,000 from a bank with a maximum term of five years and 'interest' payments indexed to the price of oil. The debt instrument is repayable in full on demand. Because the interest payments are indexed to the price of oil, and are neither fixed nor referenced to a quoted or observable interest rate, the debt instrument is within the scope of Section 12 rather than within the scope of Section 11.**

On 31 December 20X0, the fair value of an identical financial liability with interest payments indexed to the price of oil but without a demand feature, is CU90,000. This reflects a steep fall in the price of oil that has resulted in interest being paid at less than a market rate.

The bank has not indicated that it would demand immediate repayment.

At 31 December 20X0 the debt instrument is measured as CU100,000 because of the demand feature. Because the full amount, CU100,000, is repayable immediately it is not discounted.

Ex 18 **The facts are identical to those in Example 17, except the debt instrument is repayable in full on demand at any time after 31 December 20X2 (rather than at any time).**

At 31 December 20X0 the debt instrument is measured at the present value of CU100,000 discounted back from 1 January 20X3 (which is the earliest date that the bank could demand immediate repayment) if this is higher than fair value. For example, if the present value of CU100,000 discounted back from 1 January 20X3 is CU91,000, it will be measured at CU91,000 whereas if the present value of CU100,000 discounted back from 1 January 20X3 is CU89,000, it will be measured at CU90,000.

12.12 An entity shall not include transaction costs in the initial measurement of financial assets and liabilities that will be measured subsequently at fair value through profit or loss. If payment for an asset is deferred or is financed at a rate of interest that is not a market rate, the entity shall initially measure the asset at the present value of the future payments discounted at a market rate of interest.

Notes

Transaction costs, in this context, are incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability. An incremental cost is one that would have been avoided if the entity had not acquired or issued the financial instrument. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents, if such costs are incremental), advisers, brokers and dealers; levies by regulatory agencies and securities exchanges; and transfer taxes and duties. Fees included in transaction costs include those that are an integral part of becoming a party to a financial instrument (for example, negotiating the terms of the instrument, and preparing and processing documents). Transaction costs do not include debt premiums or discounts, financing (interest) costs or internal administrative costs.

For financial instruments that will be measured at fair value through profit or loss subsequent to initial recognition, transaction costs are not taken into account when determining the amount to be recognised initially. Transaction costs on such instruments will be charged to profit or loss. See Example 13.

Example—deferred payment

Ex 19 **Entity X buys, in an arm's length transaction, 10,000 convertible preference shares in Company Z for cash payments of CU40,000, with CU25,000 payable immediately and CU15,000 payable in two years' time.**

The market rate of annual interest for a two-year loan to the entity would be 6 per cent.

The holding of the convertible preference shares is within the scope of Section 12. Because payment of CU15,000 is deferred for two years, the fair value of the consideration given for the shares is equal to CU25,000 plus the present value of CU15,000.

The present value of CU15,000 is CU13,350 (= $15{,}000 \div 1.06^2$).

Entity X will recognise the shares purchased at CU38,350 (namely, CU25,000 + CU13,350).

Because this transaction took place at arm's length, this is considered to be equal to fair value on initial recognition in the absence of evidence to the contrary.

The difference between the CU40,000 cash paid out and the CU38,350, namely CU1,650, will be recognised as interest payable/paid in profit or loss over the two financial years.

Module 12 – Other Financial Instruments Issues

Impairment of financial instruments measured at cost or amortised cost

12.13 An entity shall apply the guidance on impairment of a financial instrument measured at cost in paragraphs 11.21–11.26 to financial instruments measured at cost less impairment in accordance with this section.

Notes

The only financial instruments within the scope of Section 12 to which paragraph 12.13 applies are equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments.

At the end of each reporting period, an entity must assess whether there is objective evidence of impairment of any of these instruments; for example, the introduction of a new competitor or a competing product might have an adverse effect on the investee's profitability and thus on the value of its shares.
See Section 11 and Module 11 for guidance.

Derecognition of a financial asset or financial liability

12.14 An entity shall apply the derecognition requirements in paragraphs 11.33–11.38 to financial assets and financial liabilities to which this section applies.

Notes

See Section 11.
Module 11 provides explanations and examples on how to apply paragraphs 11.33 to 11.38. There are a few examples below illustrating how these paragraphs apply to the derecognition of financial instruments within the scope of Section 12.

Example—Continued recognition of a financial asset

Ex 20 **Entity Z transfers its holding of 1,000 convertible preference shares in Company C to a bank for CU575. The shares, which are not listed or traded on any securities exchange, are measured at fair value under Section 12 and have a fair value of CU600 on the transfer date. Entity Z had paid CU500 to purchase the shares 18 months earlier. On transfer of the shares Entity Z provides the bank with a put option that expires in 60 days. At the end of 60 days the bank may exercise the put option and sell the shares back to Entity Z for CU585. In addition, Entity Z has a call option that also expires after 60 days; at the end of 60 days Entity Z may exercise the call option and buy the shares back from the bank for CU585.**

If, after 60 days, the fair value of the shares is below CU585 it is expected that the bank will exercise its put option and sell the shares back to Entity Z. On the other hand, if the fair value of the shares is above CU585 it is expected that Entity Z will exercise its call option and purchase the shares back from the bank. Either way, at inception, it is anticipated that Entity Z will own the shares again after 60 days. Consequently, Entity Z has retained substantially all of the risks and rewards of ownership of the shares.

The transaction should be accounted for as a 60-day loan of CU575. The loan is secured by the shares. Interest of CU10 is payable during the 60-day period and this should be amortised to profit or loss using the effective interest rate method. If the full 60-day period falls within one accounting period, the CU10 will be recognised in profit or loss in full in that period.

Example—derecognition of a financial asset

Ex 21 **The facts are the same as in Example 20. However, in this example, the bank pays CU600 for the shares, Entity Z does not have a call option, and at the end of 60 days the bank may exercise the put option and sell the shares back to the entity for CU600.**

At inception, it is uncertain whether or not the put option will be exercised by the bank; it is priced at an amount equal to fair value at the date of sale. In addition, Entity Z does not hold a call option. Consequently, Entity Z has retained some of the risks and rewards of ownership; if the fair value of the shares falls below CU600, the bank may sell the shares back to Entity Z, but equally the bank may choose not to sell them back to Entity Z (for example, the bank might have already sold the shares to a third party).

Because Entity Z has retained some significant risks and rewards of ownership, paragraph 11.33(c) requires Entity Z to consider whether it has transferred control of the shares to the bank by determining whether the bank has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. In this instance, the bank does have such a practical ability; there is no call option so it cannot be compelled by Entity Z to sell the shares back to Entity Z and its put option is not priced in a way to make it highly likely that it would be exercised by the bank, such as if it were priced at a large premium above the transaction date fair value. If it were priced in such a way that the bank expected to exercise the option, then the bank would either not sell the shares or it would sell them with restrictions attached to ensure that it received the shares back after 60 days so that it could exercise the option and sell the shares back to Entity Z. The fact that the bank may or may not choose to sell the shares is not relevant; it is whether the bank has the practical ability to do so that is important.

Under the *IFRS for SMEs*, in this example, derecognition is appropriate because Entity Z has transferred control of the shares to the bank. Consequently, Entity Z must derecognise the shares and recognise separately the written put option, ie the option of the bank to put (sell) the shares back to Entity Z for CU600 in 60 days' time.

In Example 20 the bank legally owns the shares and so might appear also to have the practical ability to sell the shares at any time during the 60 days. However, if it sells them it will need to repurchase 1,000 convertible preference shares in Company C at some point before the end of the 60 days, because the expectation is that either the put or the call option will be exercised. Because the shares are not listed or traded on any securities exchange, it may be difficult to ensure that it can purchase 1,000 convertible preference shares in Company C in the required timescale. Consequently, the bank may not have the practical ability to sell the shares or to sell them without attaching a condition that they must be sold back on a specific date. This is because the expectation, as a result of the put and call options, was that Entity Z would buy the shares back at the predetermined, fixed, price at the end of the 60 days. Thus, Entity Z had not transferred the risks and rewards of ownership; it had received a 60-day loan secured on the shares.

Hedge accounting

12.15 If specified criteria are met, an entity may designate a hedging relationship between a **hedging instrument** and a **hedged item** in such a way as to qualify for hedge accounting. Hedge accounting permits the gain or loss on the hedging instrument and on the hedged item to be recognised in profit or loss at the same time.

Notes

On occasion, entities enter into transactions with the aim of reducing their exposure to a specified risk or to reduce the variability in cash flows. For example, an entity may have a variable rate bank loan but has become concerned that interest rates may rise in the near future. It therefore enters into an interest rate swap with a different bank, in which it pays a fixed interest and receives a variable interest. The net effect, assuming the same principal amount, is that the entity will pay a fixed rate of interest—see Examples 1 and 14. When an entity enters into a transaction with another party to reduce or eliminate its exposure to a particular risk or to the variability in cash flows, that transaction is known as a hedging transaction.

In some hedging transactions, the gain or loss attributable to the risk being hedged in the hedged item is accounted for, under the normal accounting requirements of the *IFRS for SMEs*, in the same period as the gain or loss on the hedging instrument. In such cases, there is no need for any special accounting treatment. For example, if a derivative is used to hedge a debt instrument that is within the scope of Section 12, both the derivative and the debt instrument would be required to be accounted for at fair value with changes in fair value being recognised in profit or loss. Consequently, if the hedge is fully effective, the effect on profit or loss of the hedging instrument is equal and opposite to the effect of the hedged risk in the hedged item, thereby ‘cancelling out’ the effect on profit or loss of the hedged risk.

In other hedging transactions, the accounting for the financial instrument acquired to hedge the exposure (the hedging instrument) and the underlying exposure being hedged (the hedged item) will affect profit or loss in different periods under the *IFRS for SMEs;* for example, if a derivative is used to hedge a debt instrument that is within the scope of Section 11. Some view this as an ‘accounting mismatch’, because, although there is an economic hedge, it is not reflected in the accounting. Consequently, Section 12 contains some special rules for hedge accounting, which ‘correct’ this timing mismatch. These rules modify the normal basis for recognising income and expenses on associated hedging instruments and/or hedged items so that both are recognised in profit or loss in the same accounting period. Hedge accounting does not change the overall performance/profits of the entity: it affects only the timing and presentation of income and expenses in profit or loss.

Section 12 limits the circumstances in which hedge accounting can be applied by specifying four conditions. One of the conditions is that the hedging instrument must be one of four specific instruments and meet a number of criteria. Another of the conditions is that the hedged risk must be one of five specified risks, notwithstanding that these are expressed in paragraph 12.17 in only four bullet points. Consequently, an entity may have a hedge that does not qualify for hedge accounting in accordance with Section 12 despite being a valid economic hedging strategy.

If an entity wishes to apply hedge accounting to one or more of its hedging transactions, the entity must comply with the four criteria in paragraph 12.16. Entities are not required to apply hedge accounting to all their hedging transactions that would otherwise meet the criteria in paragraph 12.16; they can choose to apply hedge accounting to only some, or none, of those transactions. If the entity does not designate and document a hedging relationship for a particular transaction in accordance with paragraph 12.16(a), hedge accounting would not be permitted for that transaction. On the other hand, if the entity does designate and document a hedging relationship in accordance with paragraph 12.16(a) for a different transaction, hedge accounting would be permitted for that transaction, assuming all the other criteria are satisfied.

12.16 To qualify for hedge accounting, an entity shall comply with all of the following conditions:

(a) the entity designates and documents the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified and the risk in the hedged item is the risk being hedged with the hedging instrument.

(b) the hedged risk is one of the risks specified in paragraph 12.17.

(c) the hedging instrument is as specified in paragraph 12.18.

(d) the entity expects the hedging instrument to be highly effective in offsetting the designated hedged risk. The **effectiveness of a hedge** is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

Notes

Hedging documentation

Section 12 does not provide any specific format for the hedging documentation required by paragraph 12.16(a). The only requirements are that there is documentation that specifies:

- the risk being hedged;
- the hedged item; and
- the hedging instrument.

By documenting these items, it will be clear from the documentation that the risk in the hedged item is the risk being hedged by the hedging instrument.

Section 12 limits the risks that can be hedged if hedge accounting is to be applied. Consequently, the risk being hedged must be one of the five listed in paragraph 12.17, notwithstanding that these are expressed in paragraph 12.17 in only four bullet points. One of the risks for which hedge accounting is permitted is interest rate risk of a debt instrument measured at amortised cost. For example, if an entity takes out a loan paying a fixed rate of interest of 7 per cent, which includes a credit spread of 2 per cent, it may, for example, choose to hedge the fixed interest excluding the credit spread by taking out an interest rate swap to swap fixed 5 per cent for variable equal to LIBOR. If so, it would be necessary to document that the risk being hedged was the fixed interest excluding the credit spread.

Hedge effectiveness

Hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. For the purposes of this comparison, only the change in the fair value or cash flows of the hedged item *that are attributable to the hedged risk* are considered.

In order to use hedge accounting, an entity is required to assess whether it expects the hedging relationship to be highly effective in achieving offset in the future. The *IFRS for SMEs* does not include guidance on when a hedging relationship is considered to be 'highly' effective.

If a hedging transaction qualifies for hedge accounting, but, at some future point, ceases to meet the conditions in paragraph 12.16, the hedge accounting must be discontinued (see paragraphs 12.21 and 12.25). Consequently, the assessment of whether the hedging relationship is expected to be highly effective needs to be revisited over the life of the hedging relationship. For example, a hedge may initially be expected to be highly effective, but if the creditworthiness of the counterparty for the hedging instrument deteriorates, then ineffectiveness might be introduced because the changes in the fair value of the hedging instrument would be dominated by the changes in credit risk, which will not necessarily be offset by the changes in the fair value of the hedged item attributable to the hedged risk. If so, the entity would need to assess whether the ineffectiveness is such that the hedge is no longer considered to be highly effective.

Because the continuing use of hedge accounting is dependent on the conditions in paragraph 12.16 continuing to be met, an entity might wish, as a minimum, to assess expected effectiveness when preparing the annual financial statements.

Section 12 contains no requirements for assessing expected hedge effectiveness. When performing such an assessment an entity may, for example, use one or more of the following approaches:

(a) a comparison of the principal terms of the hedging instrument with those of the hedged item. If the principal terms of the hedging instrument match those of the hedged item there would usually be an expectation of high effectiveness. This is possibly the most straightforward way of assessing hedge effectiveness and is expected to be the one used most often, because matching the principal terms does not require any calculations.

The comparison would be of terms such as notional and principal amount, term, timing of payments, re-pricing dates, denominated currency and maturity.

The principal terms of the hedging instrument and hedged items are those that are critical to the assessment of hedge effectiveness, ie those that relate to the risk being hedged. For example, if a variable-rate foreign currency debt instrument is the hedged item, changes in the cash flows may arise because of changes in exchange rates as well as because of changes in interest rates. However, if the hedging instrument is an interest rate swap and is only hedging the interest rate risk associated with the debt instrument, changes in cash flows due to movement in exchange rates are not considered and so will not lead to the hedging relationship being ineffective.

(b) simple mathematical models such as ratio analysis (sometimes called the dollar offset test) can be used. Ratio analysis involves a comparison of:

- changes in the fair value or cash flows of the hedging instrument; with
- changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk.

This approach can be used to assess the effectiveness of a hedge prospectively by considering the effect of a hypothetical change in the underlying hedged risk on both the hedging instrument and the hedged item (for example, a five per cent change in the exchange rate if foreign exchange risk is being hedged or a movement of one per cent in the benchmark interest index, for example, LIBOR, if interest rate risk is being hedged).

(c) by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item that are attributable to the hedged risk and those of the hedging instrument, for example, using regression analysis.

The appropriateness of a given approach in assessing expected hedge effectiveness will depend on the nature of the risk being hedged, the type of hedging instrument used and the information available. The approach adopted when assessing hedge effectiveness must be reasonable, be applied consistently over the period of the hedging relationship and be consistent with other similar hedges, unless different methods are explicitly justified. Depending on which approach is used, it might also be appropriate to assess whether credit risk changes the expected hedge effectiveness.

12.17 This IFRS permits hedge accounting only for the following risks:

(a) interest rate risk of a debt instrument measured at amortised cost.

(b) foreign exchange or interest rate risk in a firm commitment or a **highly probable forecast transaction**.

(c) price risk of a commodity that it holds or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity.

(d) foreign exchange risk in a net investment in a foreign operation.

Foreign exchange risk of a debt instrument measured at amortised cost is not in the list above because hedge accounting would not have any significant effect on the financial statements. Basic accounts, notes and loans receivable and payable are normally measured at amortised cost (see paragraph 11.5(d)). This would include payables denominated in a foreign currency. Paragraph 30.10 requires any change in the carrying amount of the payable because of a change in the exchange rate to be recognised in profit or loss. Therefore, both the change in fair value of the hedging instrument (the cross-currency swap) and the change in the carrying amount of the payable relating to the change in the exchange rate would be recognised in profit or loss and should offset each other except to the extent of the difference between the spot rate (at which the liability is measured) and the forward rate (at which the swap is measured).

Notes

Section 12 permits hedge accounting only for changes in the fair value or cash flows of the hedged item that are attributable to the specific risks listed in the bullet points in paragraph 12.17, and not for any other risks. For example, paragraph 12.17(a) permits hedge accounting for the interest rate risk of a debt instrument measured at amortised cost. Hedge accounting is therefore permitted for hedges of changes in the cash flows of variable rate debt that are due to changes in interest rates or for changes in the fair value of fixed rate debt as a result of changes in interest rates, but not for changes in the fair value that are due to other risks, such as credit risk or foreign exchange risk.

Firm commitments

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates (see *Glossary*), ie a firm commitment must have a fixed quantity, a fixed price and a fixed timing. For example, if a company signs a contract to sell a machine to a customer on a fixed date in the future for CU10,000, both the company and the customer have a firm commitment. Because a firm commitment is a binding agreement, it is usually legally enforceable.

Forecast transactions

A forecast transaction is defined as an uncommitted but anticipated future transaction (see *Glossary*). For example, if a company anticipates taking out a loan in six months' time to finance an expansion of its business, it has a forecast transaction. Paragraph 12.17 permits hedge accounting only for forecast transactions that are considered highly probable. The term 'highly probable' is defined as 'significantly more likely than probable' (see *Glossary*) and indicates a much greater likelihood of occurrence than the term 'more likely than not', ie the chances of the transaction occurring is considered to be significantly greater than a 50 per cent chance.

Examples of circumstances that may affect the likelihood that a transaction will occur include the following:

(a) the frequency of similar past transactions;

(b) the financial and operational ability of the entity to carry out the transaction;

(c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

(d) the extent of loss of or disruption to operations that could result if the transaction does not occur;

(e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash in a forecast transaction may have several ways of doing so, ranging from a short-term bank loan to an issue of ordinary shares); and

(f) the entity's business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable. For example, a transaction that is forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when sales for the past three months have averaged 950,000 units per month.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question an entity's ability to predict forecast transactions accurately and thus the propriety of using hedge accounting in the future for similar forecast transactions.

If a forecast transaction is being hedged it must be identifiable and documented in such a way that when a transaction occurs it is clear whether or not it is the hedged transaction. For example, it is possible to hedge the sale of the first 15,000 units of a specific product during a specific three-month period. However, the last 15,000 units of that product sold during a three-month period cannot be hedged, because it is not possible to identify, at the time of sale, which are the last 15,000 units sold.

An entity is not required to predict and document the exact date when a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, in order to assess whether a hedging relationship is expected to be highly effective; to assess whether a hedging relationship is expected to be highly effective, it is necessary to ensure that changes in the fair value of the expected cash flows associated with the hedged risk are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur in close proximity to each other.

Net investment in a foreign operation

An entity’s net investment in a foreign operation is the amount of the entity’s interest in the net assets of that operation. A foreign operation may be a subsidiary, associate, joint venture or branch (see paragraph 30.5). In accordance with Section 12, the foreign exchange risk in a net investment in a foreign operation may be ‘hedged’.

Hedge accounting for the foreign exchange risk in a net investment in a foreign operation is relevant when the operation has been consolidated or has been accounted for using equity accounting, because in these instances exchange differences arising on translating the operation’s net assets are recognised in other comprehensive income.

Without hedge accounting, the gain or loss on the hedging instrument would be recognised in profit or loss and so there would be a mismatch, with one being recognised in other comprehensive income and the other in profit or loss. The training module on Section 30 deals with a net investment in a foreign operation in more detail. Paragraph 12.23 looks at the accounting for net investment hedges.

Paragraph 30.12 of the *IFRS for SMEs* explains that when an entity has a monetary item receivable from or payable to a foreign operation, and settlement of the monetary item is neither planned nor likely to occur in the foreseeable future, that monetary item is, in substance, a part of the entity's net investment in that operation. See Module 30 for more information. Paragraph 30.13 requires the exchange differences on any such monetary items to be recognised in other comprehensive income in the entity's consolidated financial statements. Such monetary items therefore form part of the net investment that can be hedged.

Examples of hedged risks that are permitted by paragraph 12.17

Examples of risks that are permitted to be hedged by paragraph 12.17 and that expose the entity to a risk of changes in future cash flows include:

- **Interest rate risk of a debt instrument measured at amortised cost (paragraph 12.17(a))** Under variable-rate debt instruments, the entity is exposed to the risk of changes in future interest payments (cash outflows or inflows) due to changes in market interest rates. For example:
  - o if the entity has a loan with interest payable at EURIBOR plus 200 points and EURIBOR increases, the entity will be required to pay more interest; or
  - o if the entity has an investment in a variable-rate bond with interest payments linked to LIBOR, and LIBOR decreases, the entity will receive less interest income.
- **Foreign exchange risk in a firm commitment (paragraph 12.17(b))**
  A firm sales commitment exposes the entity to the risk of changes in receipts to the extent they are not fixed in the reporting entity's functional currency in the contract. For example, an entity may enter into an agreement to sell goods to an overseas customer at a fixed amount of foreign currency in three months' time. The entity is exposed to the risk of a movement in the exchange rate between the foreign currency and its functional currency, ie the currency of the primary economic environment in which the entity operates, within the next three months. If the foreign currency weakens against the entity's functional currency, the entity will, on sale, receive a lower cash inflow when translated into the functional currency.
- **Commodity price risk in a highly probable forecast purchase (paragraph 12.17(c))**
  A highly probable purchase transaction exposes the entity to the risk of changes in expected payments. For example, if the entity needs to buy copper for use within the business and it intends to make its next purchase in three months' time, the entity is exposed to the risk of the price of copper increasing significantly over the next three months, resulting in a higher cash outflow on purchase.

Examples of risks that are permitted to be hedged by paragraph 12.17 and that expose the entity to a risk of changes in fair value include:

- **Interest rate risk of a debt instrument measured at amortised cost (paragraph 12.17(a))** A fixed-rate debt instrument held as an investment exposes the entity to the risk of changes in the fair value of the debt instrument due to changes in market interest rates. For example, if market interest rates increase, the fair value of the fixed-rate debt instrument would decrease. If the entity holds the instrument to maturity it is unaffected by changes in the fair value of the debt investment attributable to changes in interest rates. However, if the fixed-rate debt instrument is sold in the open market, the decrease in fair value would result in a lower price on sale.
- **Commodity price risk on stocks held (paragraph 12.17(c))**
  Holding a commodity exposes an entity to the risk of changes in the fair value of the commodity due to changes in market price. If the entity holds a large inventory of gold and the price of gold falls, the fair value of the inventory will be lower.

12.18 This IFRS permits hedge accounting only if the hedging instrument has all of following terms and conditions:

(a) it is an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract or a commodity forward exchange contract that is expected to be highly effective in offsetting a risk identified in paragraph 12.17 that is designated as the hedged risk.

(b) it involves a party external to the reporting entity (ie external to the **group**, segment or individual entity being reported on).

(c) its **notional amount** is equal to the designated amount of the principal or notional amount of the hedged item.

(d) it has a specified maturity date not later than

(i) the maturity of the financial instrument being hedged,

(ii) the expected settlement of the commodity purchase or sale commitment, or

(iii) the occurrence of the highly probable forecast foreign currency or commodity transaction being hedged.

(e) it has no prepayment, early termination or extension features.

Notes

Paragraph 12.18(a)

Paragraph 12.17 limits the risks for which hedge accounting may be used when applying the *IFRS for SMEs*. Paragraph 12.18(a) similarly limits the instruments that can be used as hedging instruments when using hedge accounting. For example, one of the risks that paragraph 12.17 permits to be hedged is the foreign exchange risk in a highly probable forecast transaction. If an entity with a functional currency of CU has a highly probable forecast transaction, such as a suitably highly anticipated sale of goods, that will be in a foreign currency, for example FCU, the entity could, under paragraph 12.18(a), use an FCU/CU swap or forward contract to hedge the sale, but it could not designate a loan in FCU as the hedging instrument, because this is not permitted by paragraph 12.18(a).

Paragraph 12.18(b)

For hedge accounting purposes, only hedging instruments that involve a party external to the reporting entity, ie external to the group or to the individual entity that is being reported on, can be designated as hedging instruments. An individual entity within a consolidated group may enter into an instrument that it wishes to designate as a hedging instrument, with another entity in the same group. However, that instrument will be eliminated on consolidation. Consequently, it is not possible to use hedge accounting in the consolidated financial statements of the group. Hedge accounting may nevertheless be possible in the individual or separate financial statements of the first entity if the other entity is external to the first entity.

Paragraph 12.18(c)

The notional amount is the quantity of currency units, shares, bushels, pounds or other units specified in a financial instrument contract (see *Glossary*). In other words, the notional amount is an amount of currency, a number of shares, a number of units of weight, for example, a number of kilograms, or volume, for example, a number of litres, or other units specified in the contract. For example, an entity may enter into an interest rate swap with a notional amount of CU10,000 that requires the entity to pay a fixed rate of interest, say 7.5 per cent, and receive a variable rate of interest, say three-month LIBOR. Under the swap, regular net settlements would be calculated by applying the difference between 7.5 per cent and three-month LIBOR to the notional principal of CU10,000. For example, if LIBOR is 7 per cent during a three-month period then a net payment of CU12.5 (=10,000 × (7.5 less 7) per cent) ÷ 4) is required by the entity under the swap for that three-month period.

Paragraph 12.18(d)

The maturity date of the hedging instrument must be on or before the date the hedged item matures; hedge accounting is not permitted if the hedging instrument matures later than the hedged item, because this would leave the entity exposed to risk after the maturity of the original item being hedged. In contrast, an entity is permitted to designate a hedging instrument as hedging only a portion of the time period to maturity of a hedged item. For example, an interest rate swap could be taken out to hedge the interest rate risk in the first six months of a two-year loan, but the first six months of a two-year interest rate swap could not be used to hedge the last six months of a loan.

Paragraph 12.18(e)

Hedge accounting is not permitted under Section 12 if the hedging instrument has prepayment, early termination or extension features.

Overall consideration

Hedge accounting is only permitted if an entity expects the hedging instrument to be highly effective in offsetting the designated hedged risk.

If, in addition to the notional amount of the hedging instrument being equal to the designated amount of the principal or notional amount of the hedged item (see paragraph 12.18(c)), the other principal terms of the hedging instrument and of the hedged item giving rise to the hedged risk are such that they move in opposite directions, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, thereby increasing the likelihood that the hedging instrument will be highly effective. For example, an interest rate swap is likely to be an effective hedge for the fixed interest rate risk in a loan if the swap is to receive fixed interest and pay variable interest and the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the swap and the loan. Similarly when a commodity forward exchange contract is used to hedge the price risk in a highly probable forecast purchase of a commodity, in addition to the quantity of the commodity being the same in the forward contract as in the forecast purchase, effectiveness is increased if the two are for the same grade of commodity, if relevant, and the delivery time and location are the same.

Sometimes the hedging instrument offsets only part of the hedged risk. For example, the hedge may not be fully effective if the credit rating of the counterparty to the hedging instrument decreases significantly.

Examples—hedged risks and hedging instruments

Ex 22 **An entity acquires a 10 per cent fixed-rate government bond with a remaining term to maturity of ten years. To hedge itself against fair value exposure on the bond associated with the interest rate payments until Year five, the entity acquires a five-year pay-fixed, receive-floating interest rate swap.**

Interest rate risk is one of the risks that paragraph 12.17 permits to be hedged. Interest rate swaps are permitted hedging instruments, provided the conditions in paragraph 12.18(b)-(d) are met. An entity is permitted to designate a hedging instrument as hedging only a portion of the time period to maturity of a hedged item. Provided the other conditions in paragraph 12.18 are met, the swap may be designated as hedging the exposure to fixed interest rate risk in the debt instrument for the five-year period.

Ex 23 **An entity acquires a 10 per cent fixed-rate government bond with a remaining term to maturity of six years. To hedge itself against fair value exposure on the bond associated with the interest rate payments for the six years, the entity acquires a ten-year pay-fixed, receive-floating interest rate swap.**

The entity is not permitted to apply hedge accounting to the hedging relationship between the interest rate swap and the government bond. Because the interest rate swap matures later than the government bond, the interest rate swap does not satisfy the condition in paragraph 12.18(d).

To qualify for hedge accounting the entity should instead enter into a six-year pay-fixed, receive-floating interest rate swap, ensuring that the six-year swap meets the other conditions in paragraph 12.18.

Ex 24 **An entity whose functional currency is the CU obtains a five-year fixed rate, foreign currency-denominated loan for FCU10,000 (financial liability) from its bank. The entity holds a FCU10,000 five-year fixed rate bond (financial asset). Both the bond and loan meet the requirements to be measured at amortised cost under Section 11. Can the entity designate its FCU loan as a hedging instrument for the foreign currency risk from its FCU bond and use hedge accounting?**

No. The FCU loan is not one of the hedging instruments listed in 12.18(a)—only specified derivatives are hedging instruments under the *IFRS for SMEs*.

Consequently, the entity cannot apply hedge accounting to this transaction. However, hedge accounting would not have had any significant effect on the entity's financial statements. This is because the change in the amortised cost of both the FCU loan and the FCU bond relating to the change in the exchange rate would be recognised in profit or loss and would effectively offset each other in the same accounting periods.

Ex 25 **Entity A, whose functional currency is the CU, enters into a contract with Entity B, whose functional currency is the FCU, for the sale of ten machines to Entity B for FCU10,000, payable on delivery. Delivery will take place in eight months' time. At the same time as entering into the contract, Entity A enters into a foreign currency forward exchange contract to sell FCU10,000 and buy CU15,000 in eight months' time.**

This sales contract is a firm commitment between Entity A and Entity B. Foreign exchange risk in a firm commitment is one of the risks that paragraph 12.17 permits to be hedged. The foreign currency forward exchange contract is a hedging instrument permitted by paragraph 12.18(a). Consequently, assuming the other criteria for hedge accounting are met, the foreign currency forward exchange contract can be designated as a hedging instrument to hedge the foreign currency risk of the firm commitment (the hedged item) and hedge accounting can be used.

Ex 26 **An entity whose functional currency is the CU obtains from its bank a five-year variable-rate (linked to the FCU LIBOR) foreign currency-denominated loan for FCU10,000 (financial liability) which meets the requirements to be measured at amortised cost in Section 11. In order to hedge its exposure to interest rate movements it enters into an interest rate swap to receive variable-rate interest (linked to the FCU LIBOR) in FCU and pay 5 per cent fixed-rate interest in FCU. The swap satisfies the requirements in paragraph 12.18 and the entity wishes to designate the swap as a hedge of the FCU interest rate risk on the loan.**

Paragraph 12.17 permits hedge accounting for interest rate risk of a debt instrument measured at amortised cost. The swap is a hedging instrument permitted by paragraph 12.18(a) and consequently, assuming the other criteria for hedge accounting are met, hedge accounting is permitted.

Ex 27 **An entity regularly purchases sheets of steel as a raw material for use in production. The steel company agrees to sell steel sheets to the entity in four months' time at the market price at that date and the entity considers this to be a highly probable forecast transaction to buy steel. Because the entity is concerned that the price of the steel sheets will increase during that four-month period, the entity enters into a four-month forward contract indexed to the price of iron ore (a significant component of steel), which it intends to net settle, and wishes to designate the contract as a hedge of the price risk of the steel sheets that it intends to purchase.**

Steel production generally constitutes a significant portion of the consumption of iron ore. Consequently, changes in the price of iron ore will affect changes in the price of steel, but are unlikely to account for the entire change in the price of the steel sheets. If the entity is able to demonstrate that the hedging instrument (ie the iron ore forward exchange contract) is expected to be highly effective in hedging the price risk linked to the purchase of the steel sheets, it will be able to designate the forward contract as a hedging instrument in the hedging transaction. Provided that the other conditions for hedge accounting are met, the entity can use hedge accounting under Section 12.

Ex 28 **Entity X, whose functional currency is LCX (the local currency of Country X), has highly probable forecast purchases denominated in the local currency of Country Y (LCY). Entity X is wholly owned by Entity Z (whose functional currency is the local currency of Country Z (LCZ)), which prepares consolidated financial statements in LCZ. The consolidated financial statements of Entity Z include Entity X. Entity Z enters into a forward contract to hedge the change in LCY relative to LCX. Does this hedge qualify for hedge accounting in the consolidated financial statements of Entity Z, or must Entity X, which has the foreign currency exposure, be a party to the hedging transaction in order for the hedge to qualify?**

The hedge can qualify for hedge accounting in the consolidated financial statements, provided that the other hedge accounting criteria in paragraphs 12.16 to 12.18 are met. In the consolidated financial statements, the reporting entity is the group; the group is exposed to the risk and holds the hedging instrument. In both Entity X's and Entity Z's separate financial statements, hedge accounting would not be appropriate.

Hedge of fixed interest rate risk of a recognised financial instrument or commodity price risk of a commodity held

12.19 If the conditions in paragraph 12.16 are met and the hedged risk is the exposure to a fixed interest rate risk of a debt instrument measured at amortised cost or the commodity price risk of a commodity that it holds, the entity shall:

(a) recognise the hedging instrument as an asset or liability and the change in the fair value of the hedging instrument in profit or loss, and

(b) recognise the change in the fair value of the hedged item related to the hedged risk in profit or loss and as an adjustment to the carrying amount of the hedged item.

12.20 If the hedged risk is the fixed interest rate risk of a debt instrument measured at amortised cost, the entity shall recognise the periodic net cash settlements on the interest rate swap that is the hedging instrument in profit or loss in the period in which the net settlements accrue.

Notes

Paragraph 12.19 covers the following two types of hedging transactions:

(a) An entity holds a fixed-rate debt instrument and enters into an interest rate swap, which hedges the risk of changes in the fair value of the debt due to changes in interest rates.

An entity may enter into an interest rate swap on a debt instrument that is expected to be held to maturity (ie the entity will not be affected by changes in the fair value of the instrument) if it wishes to swap the fixed interest payments for variable interest payments. For example, the entity may want to offset the variable cash flows of the swap with other payments/receipts on other instruments linked to variable rates.

If the fixed-rate debt instrument is a financial liability, for example, a fixed-rate bank loan, interest at the fixed rate will be paid. Consequently, the entity would enter into a pay-variable, receive-fixed interest rate swap. The net effect of the loan and swap together will be that the entity would pay interest at the variable rate (note: this may be the variable rate plus a number of basis points, to take into account the entity's credit rating).

If the fixed-rate debt instrument is a financial asset, for example an investment in fixed-rate bonds, a fixed amount of interest income will be received. Consequently, the entity would enter into a pay-fixed, receive-variable interest rate swap. The net effect of the bonds and swap together will be that the entity would receive interest income at the variable rate.

(b) An entity holding a particular type of commodity as inventory enters into a commodity forward contract (to sell) in order to hedge the risk of decreases in the fair value of the commodity due to price risk over the period of the forward contract. On maturity of the forward contract, the entity, if it is to net settle the forward contract, will merely pay/receive the difference between the spot price of the commodity at maturity and the fixed price under the forward contract. Hence, this provides a hedge against the inventory's exposure to price risk.

For the two types of hedges above, the accounting is as follows:

Accounting for the hedging instrument

Hedge accounting under paragraph 12.19 has no impact on the accounting for the hedging instrument. The hedging instrument will be accounted for the same way, regardless of whether it is included as part of a designated hedging relationship in accordance with paragraphs 12.19 or not. The hedging instruments permitted to be used in Section 12 are all derivatives. For that reason, they will be accounted for at fair value, with gains or losses recognised in profit or loss of the period in which the change in fair value occurs.

In addition, when the fixed interest rate risk of a debt instrument is hedged as in (a) above, the periodic net cash settlements on the swap are recognised in profit or loss when they accrue. See the illustrative journals below; this may be incorporated together with the recognition of the change in fair value of the swap, or it may be recognised separately, in which case the journal for the change in fair value of the swap is adjusted accordingly.

Accounting for the hedged item

Hedge accounting under paragraph 12.19 involves changing how the hedged item is accounted for, ie the hedge accounting overrides the 'normal' accounting for the hedged item. In the two instances above, if an entity applies hedge accounting to a hedging relationship, changes in the fair value of the hedged item that are attributable to the hedged risk are recognised in profit or loss and as an adjustment to the carrying amount of the hedged item (debt instrument or commodity) in the statement of financial position.

Hedge ineffectiveness

Because the change in fair value of the hedging instrument and the change in the fair value of the hedged item attributable to the hedged risk are both recognised in profit or loss, any hedge ineffectiveness (the extent to which changes in the fair value or cash flows of the hedged item and of the hedging instrument do not match) is automatically recognised in profit or loss in the period in which it occurs. This is true regardless of whether the changes in the fair value of the hedging instrument are less than, or exceed, the changes in the fair value of the hedged item that are attributable to the hedged risk.

Examples—Comparisons of not applying hedge accounting (Example 29) with applying hedge accounting (Example 30)

Ex 29 On 1 January 20X0 Entity A took out a CU50,000 six-year fixed-rate bank loan with Bank B. One year later, on 1 January 20X1, because it was concerned about press reports that interest rates would fall shortly, Entity A entered into an interest rate swap with another external party to convert the loan from fixed rate to variable rate, so that the interest expense is now effectively at a variable rate. Further details about the loan and interest rate swap are:

- Entity A pays interest at a fixed rate of five per cent annually in arrears on the bank loan. At five per cent, the fixed interest rate on the loan is 100 basis points, ie one per cent, higher than the five-year swap rate as a result of Entity A's credit rating.
- The swap is a five-year interest rate swap in which the entity will pay LIBOR and receive a fixed four per cent based on a nominal value of CU50,000. The floating leg of the swap is reset on an annual basis on 31 December. The interest rate swap is on-market, and has a fair value of zero, at inception. The swap does not have any prepayment, early termination or extension features.

The combined effect of the loan and the swap is that, for the last five years of the loan, the entity pays variable rate interest equal to LIBOR plus 1 per cent on its loan of CU50,000.

Entity A does not wish to apply hedge accounting to this transaction. Consequently, Entity A neither designates nor documents the hedging relationship. Entity A has a 31 December year-end. Transaction fees have been ignored for the purpose of this example.

Details about the swap are as follows:

	31 December 20X1	*31 December 20X2*
	CU	*CU*
Fair value at the beginning of the year	0	2,000
Fair value change in the year	2,500	(3,500)
Cash settlement during the year (received)/paid (interest rate is 3% (20X0) and 5% (20X1))	(500)	500
Fair value of interest rate swap asset/(liability) at end of year	2,000	(1,000)

Note: the figures in the table have not been calculated accurately and are for illustration purposes only.

The journal entries[6] on initial recognition (1 January 20X0) of the transaction and subsequently are:

1 January 20X0

Loan

Dr	Asset: financial asset—cash	CU50,000	
	Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash

31 December 20X0

Loan—amortised cost

Dr	Expense: profit or loss—finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest

At 31 December 20X0 the carrying amount of the loan is a liability of CU50,000.

1 January 20X1

Swap

As the swap has a fair value of zero on 1 January 20X1, no entries are required on initial recognition.

31 December 20X1

Loan—amortised cost

Dr	Expense: profit or loss—finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Asset: financial asset—swap	CU2,500	
	Cr Income: profit or loss— change in fair value of swap		CU2,500

To record the change in fair value of interest rate swap

Swap—periodic net cash settlement (LIBOR is 3 per cent)

Dr	Asset: financial asset—cash	CU500	
	Cr Asset: financial asset—swap		CU500

To record the cash flow under the swap agreement (CU50 000 x (4% (fixed rate) – 3% (LIBOR))

At 31 December 20X1 the carrying amount of the loan is a liability of CU50,000 and the swap is an asset of CU2,000 (at fair value).

---

[6] This training material includes a number of illustrative journal entries. Please note that these are intended to illustrate one way, not necessarily the only way, in which the journal entries might be structured, because the *IFRS for SMEs* is not written at the journal entry level.

The net effect on profit or loss in 20X1 is nil, which is made up of CU2,500 finance costs less a CU2,500 change in fair value of the swap.

31 December 20X2

Loan—amortised cost

Dr	Expense: profit or loss—finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Expense: profit or loss— change in fair value of swap	CU3,500	
	Cr Asset/Liability: financial asset/liability—swap		CU3,500

To record the change in fair value of interest rate swap

Swap—periodic net cash settlement (LIBOR is 5 per cent)

Dr	Liability: financial liability—swap	CU500	
	Cr Asset: financial asset—cash		CU500

To record the cash flow under the swap agreement (CU50 000 x (4% (fixed rate) – 5% (LIBOR))

At 31 December 20X2, the carrying amount of the loan is CU50,000 (financial liability) and the swap is a financial liability of CU1,000 (moved from a CU2,000 asset at 31 December 20X1).

The net effect on profit or loss in 20X2 is a debit of CU6,000, which is made up of CU2,500 finance costs plus a CU3,500 change in fair value of the swap.

Note: this example shows only the journal entries for the first three years of the loan and the first two years of the swap. If it showed the journal entries for all five years of the swap, it would show that the fair value of the swap at the end of the five years is zero and that the cumulative effect of the swap on profits over the five years equals the sum of the annual net cash settlements.

The entries recognised in profit or loss for the three years illustrated above would be:

	20X0	20X1	20X2
Loan interest payable	(2,500)	(2,500)	(2,500)
Swap—change in fair value*	-	2,500	(3,500)
	(2,500)	(-)	(6,000)

* The change in fair value is the total change since the start of the accounting period. It is therefore made up of two elements:

	20X1	20X2
Attributable to the current accounting period (also equal to the net cash settlement accruing for the accounting period)	500	(500)
Attributable to the future periods	2,000	(3,000)
	2,500	(3,500)

This example shows the result of the entity taking out an interest rate swap as an economic hedge of the interest rate risk of its fixed-rate bonds. The swap has the effect of transforming a fixed-rate loan into a variable-rate loan. However, because the loan is accounted for at amortised cost and the swap is recognised at fair value each year, the resulting profits are volatile over the five-year period.

Ex 30 **The facts are the same as in Example 29. However, in this example, Entity A wishes to designate a hedging relationship between the interest rate swap and the interest rate risk of the loan in such a way as to qualify for hedge accounting. Consequently, on 1 January 20X1 Entity A designates and documents the hedging relationship in accordance with paragraph 12.16(a).**

The journal entries on initial recognition (1 January 20X0) of the transaction and subsequently are:

1 January 20X0

Loan

Dr Asset: financial asset—cash	CU50,000	
Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash

31 December 20X0

Loan—amortised cost

Dr Expense: profit or loss— finance costs	CU2,500	
Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest

At 31 December 20X0 the carrying amount of the loan is a liability of CU50,000.

1 January 20X1

Swap

Because the swap has a fair value of zero on 1 January 20X1, no entries are required on initial recognition.

31 December 20X1

Loan—amortised cost

Dr	Expense: profit or loss— finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest

Hedge accounting: loan—change in fair value due to interest rate risk

Dr	Expense: profit or loss— change in fair value (Hedged item)	CU2,000	
	Cr Liability: financial liability—loan		CU2,000

To record the change in fair value of the loan attributable to interest rate risk

Swap—change in fair value (LIBOR is 3 per cent)

Dr	Asset: financial asset—swap	CU2,500	
	Cr Income: profit or loss—change in fair value: accrued net cash settlement (Hedging instrument)		CU500
	Cr Income: profit or loss—change in fair value (Hedging instrument)		CU2,000

To record the change in fair value and the accrued net cash settlement of the interest rate swap

Swap—periodic net cash settlement (LIBOR is 3 per cent)

Dr	Asset: financial asset—cash	CU500	
	Cr Asset: financial asset—swap		CU500

To record the cash flow under the swap agreement (CU50 000 x (4% (fixed rate) – 3% (LIBOR))

The net effect on profit or loss is that the entity has variable rate interest; it pays the bank fixed interest and the effect of the interest rate swap is to adjust that interest to a variable rate.

The net effect on profit or loss in 20X1, when LIBOR is 3 per cent, is a debit of CU2,000 (which is made up of CU2,500 interest expense less CU500 accrual for net cash payment on the swap, with the CU2,000 other change in fair value of the swap, and the CU2,000 change in fair value of the loan due to interest rate risk, netting to zero).

At 31 December 20X1 the carrying amount of the loan is a financial liability of CU52,000 (= CU50,000 + CU2,000) and the swap is a financial asset of CU2,000 (= CU2,500 less CU500).

31 December 20X2

Loan—amortised cost

Dr	Expense: profit or loss— finance costs	CU2,500	
	Cr Asset: financial asset—cash		CU2,500

To record the finance costs for the period and the payment of coupon interest

Hedge accounting: loan—change in fair value due to interest rate risk

Dr	Liability: financial liability—loan	CU3,000	
	Cr Income: profit or loss— hedge accounting effect		CU3,000

To record the change in fair value of the loan attributable to interest rate risk

Swap—change in fair value (LIBOR is 5 per cent)

Dr	Expense: profit or loss—change in fair value: accrued net cash settlement (Hedging instrument)	CU500	
Dr	Expense: profit or loss— change in fair value (Hedging instrument)	CU3,000	
	Cr Asset/Liability: financial asset/liability—swap		CU3,500

To record the change in fair value and the accrued net cash settlement of the interest rate swap

Swap—periodic net cash settlement (LIBOR is 5 per cent)

Dr	Asset: financial asset—swap	CU500	
	Cr Asset: financial asset—cash		CU500

To record the cash flow under the swap agreement (CU50 000 x (4% (fixed rate) – 5% (LIBOR))

The net effect on profit or loss is that the entity has variable-rate interest; it pays the bank fixed interest and the effect of the interest rate swap is to adjust that interest to a variable rate.

The net effect on profit or loss in 20X2, when LIBOR is 5 per cent, is a credit of CU3,000 (which is made up of CU2,500 interest expense plus CU500 accrual for net cash payment on the swap, with the CU3,000 other change in fair value of the swap, and the CU3,000 change in fair value of the loan due to interest rate risk, netting to zero).

At 31 December 20X2 the carrying amount of the loan is a financial liability of CU49,000 (= CU50,000 less CU1,000) and the swap is a financial liability of CU1,000 (= CU2,000 asset plus CU500 less CU3,500).

The entries recognised in profit or loss for the three years illustrated above would be:

	20X0	20X1	20X2
Loan interest payable	(2,500)	(2,500)	(2,500)
Loan—change in fair value	n/a	2,000	(3,000)
Swap—change in fair value:			
accrual for periodic net cash settlement	n/a	500	(500)
other change in fair value	n/a	2,000	(3,000)
	(2,500)	(2,000)	(3,000)

The swap was not taken out until 1 January 20X1. The net effect on profit or loss in 20X1 and 20X2 is still variable (although less variable than in Example 29, when hedge accounting was not applied), but that is because the combined effect of the loan and the swap is to create a loan with an effective interest rate variable at LIBOR plus one per cent.

12.21 The entity shall discontinue the hedge accounting specified in paragraph 12.19 if:

(a) the hedging instrument expires or is sold or terminated;

(b) the hedge no longer meets the conditions for hedge accounting specified in paragraph 12.16; or

(c) the entity revokes the designation.

12.22 If hedge accounting is discontinued and the hedged item is an asset or liability carried at amortised cost that has not been derecognised, any gains or losses recognised as adjustments to the carrying amount of the hedged item are amortised into profit or loss using the effective interest method over the remaining life of the hedged instrument.

Notes

If the hedging instrument expires, is sold or terminated (paragraph 12.21(a)), the hedging instrument no longer exists and hence it should be derecognised.

If hedge accounting is discontinued without the hedged item being sold or extinguished, the hedged item ceases to be adjusted for future changes in its fair value that are attributable to the hedged risk. The cumulative adjustment to the hedged item, for changes in its fair value attributable to the hedged risk during the period of hedge accounting, is not reversed out of the carrying amount of the hedged item. The cumulative adjustment is treated as follows:

- If the hedged risk is the exposure to the commodity price risk of a commodity, the cumulative adjustment remains as part of the carrying amount of the asset up to the date of its use, sale, or impairment.
- If the hedged risk is the exposure to a fixed interest rate risk of a debt instrument measured at amortised cost, the cumulative adjustment is amortised through profit or loss using the effective interest method over the remaining life of the debt instrument.

If the hedge no longer meets the conditions for hedge accounting specified in paragraph 12.16 but without the hedging instrument having expired, been sold or terminated (paragraph 12.21(b)), for example, if the hedging instrument is no longer expected to be highly effective, or if an entity revokes the hedge designation but without the hedging instrument having expired, been sold or terminated (paragraph 12.21(c)), the entity will still hold the hedging instrument. The entity should stop hedge accounting. The entity should, however, continue to account for the hedging instrument in accordance with Section 12, that is, at fair value with changes in fair value recognised in profit or loss. In addition, the entity should account for the hedged item, if it is still held, as above. In particular, the hedged item is not adjusted for future changes in its fair value that are attributable to the hedged risk.

Examples—discontinued hedge accounting

Ex 31 **The facts are the same as in Example 30 (ie the facts from Example 29, but the entity applies hedge accounting). At 31 December 20X2 the carrying amount of the loan is CU49,000 and the swap is a liability of CU1,000 (see Example 30). However, in this example, on 1 January 20X3 the entity decides to revoke the designation prospectively, but without closing out the swap.**

At 31 December 20X3 the swap has a fair value of CU600 (liability) and LIBOR was 4.5 per cent.

The journal entries on 31 December 20X3 are as follows:

31 December 20X3

Loan—amortised cost (see table at the end of this Example)

Dr	Expense: profit or loss— finance costs	CU2,815	
	Cr Asset: financial asset—cash		CU2,500
	Cr Liability: financial liability—loan		CU315

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Liability: financial liability—swap	CU150[(a)]	
Cr	Income: profit or loss—change in fair value of swap		CU150

To record the change in fair value of interest rate swap

[(a)] Change in fair value of swap = CU(600) less CU(1,000) less CU250 = CU150.

Swap—periodic net cash settlement (LIBOR is 4.5 per cent)

Dr	Liability: financial liability—swap	CU250	
	Cr Asset: financial asset—cash		CU250

To record the cash flow under the swap agreement (CU50 000 x (4% (fixed rate) – 4.5% (LIBOR))

The loan is no longer adjusted for changes in fair value attributable to interest rate risk, because hedge accounting has been discontinued.

At 31 December 20X3 the carrying amount of the loan is CU49,315 and the swap is a liability of CU600.

The calculation of the revised effective interest rate is below:

Year	Carrying amount at 1 January	Interest at 5.7447%(a)	Cash inflow	Carrying amount at 31 December
20X3	49,000	2,815	(2,500)	49,315
20X4	49,315	2,833	(2,500)	49,648
20X5	49,648	2,852	(52,500)	-

(a) The effective interest rate of 5.7447 per cent is the rate that discounts the expected cash flows on the loan to the carrying amount, CU49,000, on 31 December 20X2.

Hedge of variable interest rate risk of a recognised financial instrument, foreign exchange risk or commodity price risk in a firm commitment or highly probable forecast transaction, or a net investment in a foreign operation

12.23 If the conditions in paragraph 12.16 are met and the hedged risk is

(a) the variable interest rate risk in a debt instrument measured at amortised cost,

(b) the foreign exchange risk in a **firm commitment** or a highly probable forecast transaction,

(c) the commodity price risk in a firm commitment or highly probable forecast transaction, or

(d) the foreign exchange risk in a net investment in a foreign operation,

the entity shall recognise in other comprehensive income the portion of the change in the fair value of the hedging instrument that was effective in offsetting the change in the fair value or expected cash flows of the hedged item. The entity shall recognise in profit or loss any excess of the fair value of the hedging instrument over the change in the fair value of the expected cash flows (sometimes called hedge ineffectiveness). The hedging gain or loss recognised in other comprehensive income shall be reclassified to profit or loss when the hedged item is recognised in profit or loss or when the hedging relationship ends.

12.24 If the hedged risk is the variable interest rate risk in a debt instrument measured at amortised cost, the entity shall subsequently recognise in profit or loss the periodic net cash settlements from the interest rate swap that is the hedging instrument in the period in which the net settlements accrue.

Notes

Examples of hedging transactions covered by paragraph 12.23 include the following:

- An entity has a recognised variable-rate debt instrument measured at amortised cost and enters into an interest rate swap, which hedges the risk of changes in the cash flows of the debt instrument due to changes in interest rates.

  If the variable-rate debt instrument is a financial liability (eg a variable-rate loan from a bank, in which the interest rate is based on a quoted interest rate such as LIBOR), variable-rate interest will be paid. Consequently, the entity would enter into a pay-fixed, receive-variable interest rate swap, with the swap having reference to the same quoted observable rate as the loan (ie LIBOR). The outcome of this will be that the entity pays interest at a fixed rate.

  If the variable-rate debt instrument is a financial asset (eg an investment in variable-rate bonds in which the interest rate is based on a quoted interest rate such as EURIBOR), variable-rate interest will be received. Consequently, the entity would enter into a pay-variable, receive-fixed interest rate swap, with the variable interest rate having reference to the same quoted interest rate as the bonds (ie EURIBOR). The outcome of this will be that the entity receives interest income at a fixed rate.
- An entity has a firm commitment or highly probable forecast transaction to purchase (or sell) goods in a foreign currency in the future. The entity may wish to enter into a foreign currency swap or foreign currency forward exchange contract that will have the effect of locking in a particular exchange rate between its functional currency and the foreign currency, instead of simply making the purchase (or sale) at the spot exchange rate on the date of the transaction. In other words, the entity knows in advance what amount it will pay (or will receive) in its own functional currency on that future date.
- An entity has a firm commitment or highly probable forecast transaction to purchase (or sell) a commodity. An entity may wish to enter into a commodity forward contract with another party, which, by net settling, will have the effect of locking in a particular price for the purchase (or sale) of the commodity when combined with making the purchase (or sale) at the spot price of the commodity on the date of the transaction. In other words, the entity knows in advance what net amount it will pay (or will receive) on that future date.

For the examples of hedges above, the accounting is as follows:

Accounting for the hedged item

Hedge accounting in accordance with paragraph 12.23 has no impact on the 'normal'[7] accounting for the hedged item. Paragraph 12.23 affects only the accounting for the hedging instrument. Consequently, the hedged item will be accounted for in the same way, regardless of whether it is included in a designated hedging relationship or not.

Accounting for the hedging instrument

The hedging instruments permitted to be used in Section 12 are all derivatives. For that reason, Section 12 would normally require them to be accounted for at fair value, with gains or losses recognised in profit or loss of the period in which the change in fair value occurs. When applying hedge accounting in accordance with paragraph 12.23, they are still accounted for at fair value but the gain or loss on the hedging instrument is divided into two: (i) the amount that was effective (see below) in hedging the hedged risk is recognised in other comprehensive income (OCI); and (ii) the balance is recognised in profit or loss.

Hedge effectiveness

If an entity applies hedge accounting in accordance with paragraph 12.23 to a hedging relationship, the portion of the change in the fair value of the hedging instrument that is determined to be an effective hedge is recognised in other comprehensive income. The portion of the hedging instrument that is considered to be ineffective, and is therefore recognised in profit or loss, is the excess of:

- the fair value of the hedging instrument; over
- the change in the fair value of the expected cash flows on the hedged item, attributable to the hedged risk.

Reclassification of the hedging gain or loss

In accordance with paragraph 12.23, the gain or loss on the hedging instrument that was recognised in other comprehensive income is reclassified to profit or loss when:

- the hedged item is recognised in profit or loss (eg when the highly probable forecast transaction, or transaction under a firm commitment, affects profit or loss), or
- the hedging relationship ends.

Note: a forecast transaction or transaction under a firm commitment does not always affect profit or loss on the transaction date. For example, if the transaction involves the purchase of an item of property, plant or equipment, it will affect profit or loss as the item is depreciated and/or on resale of the item. If the transaction is the sale of inventory, the transaction will affect profit or loss on the date the sale meets the conditions to be recognised under Section 23 *Revenue* (see conditions for sale of goods—paragraph 23.10).

---

[7] The accounting that would apply in accordance with the *IFRS for SMEs* without the existence of paragraph 12.23.

If the hedged risk is the variable interest rate risk in a debt instrument measured at amortised cost, the amount of the gain or loss on the interest rate swap that was recognised in other comprehensive income that should be reclassified to profit or loss in an accounting period will equate to the accrual of the net cash settlement for that accounting period. Paragraph 12.24 explicitly requires this to be recognised in profit or loss.

Net investment in a foreign operation

A hedge of a net investment in a foreign operation is slightly different to the other hedges listed in paragraph 12.23. The hedges in paragraphs 12.23 (a)–(c) are hedges of the variability in the cash flows from a hedged item that are due to a particular risk. A hedge of a net investment (paragraph 12.23(d)) is not a hedge of cash flows, but is instead a hedge of the changes in the reporting entity's share of the net assets of a foreign operation that are due to foreign exchange risk arising on translation of those net assets into the parent's functional currency in order to incorporate the net assets into the parent's financial statements. However, a hedge of a net investment in a foreign operation is dealt with in the same paragraphs as the hedges in paragraph 12.23 (a)–(c) because of the similarity in accounting treatment. Consequently, for a hedge of a net investment, paragraph 12.23 is applied as follows:

- the entity recognises in other comprehensive income the portion of the change in the fair value of the hedging instrument, foreign currency swap or foreign currency forward exchange contract, that was effective in offsetting the change in the reporting entity's net investment in a foreign operation due to foreign exchange risk; and
- the entity recognises in profit or loss any excess of the fair value of the hedging instrument over the change in the reporting entity's net investment in the foreign operation due to foreign exchange risk.

In accordance with paragraph 12.23, even if the hedging relationship ends, any cumulative hedging gain or loss that has been recognised in other comprehensive income is not reclassified to profit or loss, even when the entity disposes of the foreign operation—see paragraph 9.18 and see the SME Implementation Group (SME IG) non-mandatory guidance issued, in April 2012, on the meaning of the word 'excluding' in paragraph 9.18 (see http://www.ifrs.org/NR/rdonlyres/C3E33711-FBC8-4FA9-91F9-C27F3EC7F373/0/IFRSforSMEsFinal_Recyclingofcumulativeexchangedifferencesondisposalofasubsidiary.pdf).

Examples—hedge risks covered by paragraph 12.23

Ex 32 **On 1 January 20X0 an entity took out a three-year variable-rate loan from a bank for CU50,000. In order to maintain regular cash outflows, the entity decided to enter into an interest rate swap with an external party on the same date, to effectively convert the loan from a variable rate to a fixed rate so that interest is payable at the same amount each year. In addition to the above:**

- **The variable rate on the loan is LIBOR plus 100 basis points and this is reset on an annual basis. The loan is at the market rate of interest for a loan to the entity. Interest is paid annually on 31 December based on LIBOR at the start of the year. Initial LIBOR is 3.25 per cent.**

- The swap is a three-year pay 3.25 per cent fixed, receive LIBOR interest rate swap with a nominal value of CU50,000. The floating leg of the swap is reset on an annual basis. Interest is payable at the end of the year based on LIBOR at the start of the year. The interest rate swap is on-market at inception and has a fair value of zero. There are no prepayment, early termination or extension features. The credit rating of the entity and of the external party remain the same throughout the three-year period and hence the changes in the fair value of the swap are due only to changes in interest risk, that is, the change in the fair value of the swap is fully effective in offsetting the change in the expected cash flows of the hedged item that is due to interest rate risk.

	1 January 20X0	*31 December 20X0*	*31 December 20X1*
	CU	*CU*	*CU*
Fair value (asset/(liability)) of interest rate swap[8]	0	250	(75)

The entity does not wish to apply hedge accounting to this transaction. Consequently, the entity neither designates nor documents the hedging relationship.

Assume LIBOR is 3.5 per cent on 1 January 20X1 and 3.1 per cent on 1 January 20X2.

1 January 20X0

The journal entries on initial recognition are as follows:

Dr	Asset: financial asset—cash	CU50,000	
	Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash

The loan is measured initially at CU50,000, its transaction price.

Because the swap has a fair value of zero on 1 January 20X0, no entries are required on initial recognition.

31 December 20X0

The journal entries on 31 December 20X0 are as follows (LIBOR = 3.25 per cent on 1 January 20X0):

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,125[(a)]	
	Cr Asset: financial asset—cash		CU2,125

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Asset: financial asset—swap	CU250	
	Cr Income: profit or loss—change in fair value of swap		CU250

To record the change in fair value of interest rate swap

(8) The figures in the table have not been calculated accurately and are for illustration purposes only. The effects of the time value of money have been ignored.

Swap—periodic net cash settlement

Dr	Asset: financial asset—swap	CU0[(b)]	
	Cr Asset: financial asset—cash		CU0

To record the cash flow under the swap agreement

[(a)] CU50,000 × (LIBOR + 1%) = CU50,000 × (3.25% + 1%) = CU2,125.

[(b)] Net payment under swap = CU50,000 × (3.25% less LIBOR) = CU50,000 × (3.25% less 3.25%) = CU0. In accordance with the terms of the swap, payments are calculated and paid at the end of each year but based on LIBOR at the start of the year; the payment at 31 December 20X0 will therefore always be zero regardless of the level of LIBOR at 31 December 20X0.

At 31 December 20X0 the carrying amount of the loan is a liability of CU50,000 and the swap is an asset of CU250. The loan continues to be recorded at CU50,000 in accordance with the amortised cost method (see Module 11 for more explanation).

31 December 20X1

The journal entries on 31 December 20X1 are as follows (LIBOR = 3.5 per cent on 1 January 20X1):

Loan—interest

Dr	Expense: profit or loss— finance costs	CU2,250[(a)]	
	Cr Asset: financial asset—cash		CU2,250

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Expense: profit or loss—change in fair value of swap	CU200	
	Cr Asset: financial asset—swap		CU200[(b)]

To record the change in fair value of interest rate swap

Swap—periodic net cash settlement

Dr	Asset: financial asset—cash	CU125[(c)]	
	Cr Asset/Liability: financial asset/liability—swap		CU125

To record the cash flow under the swap agreement

[(a)] CU50,000 × (LIBOR + 1%) = CU50,000 × (3.5% + 1%) = CU2,250.

[(b)] Change in fair value of swap = CU(75) less (CU250 less CU125) = CU200.

[(c)] Net receipt under swap = CU50,000 × (LIBOR less 3.25%) = CU50,000 × (3.5% less 3.25%) = CU125.

At 31 December 20X1 the carrying amount of the loan is a liability of CU50,000 and the swap is a liability of CU75.

31 December 20X2

The journal entries on 31 December 20X2 are as follows (LIBOR = 3.1 per cent on 1 January 20X2):

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,050[(a)]	
	Cr Asset: financial asset—cash		CU2,050

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Expense: profit or loss—change in fair value of swap	CU0[(b)]	
	Cr Liability: financial liability—swap		CU0

To record the change in fair value of interest rate swap

Swap—periodic net cash settlement

Dr	Liability: financial liability—swap	CU75[(c)]	
	Cr Asset: financial asset—cash		CU75

To record the cash flow under the swap agreement

Loan—settlement

Dr	Liability: financial liability—loan	CU50,000	
	Cr Asset: financial asset—cash		CU50,000

To record the repayment of principal under loan agreement

(a) CU50,000 × (LIBOR + 1%) = CU50,000 × (3.1% + 1%) = CU2,050.

(b) Change in fair value of swap = CU0 less (CU(75) add CU75) = CU0.

(c) Net payment under swap = CU50,000 × (3.25% less LIBOR) = CU50,000 × (3.25% less 3.1%) = CU75.

At 31 December 20X2 the loan and the swap have both reached maturity and hence, after settlement of the loan, both have a carrying amount of nil.

This example shows the result of the entity taking out an interest rate swap as an economic hedge of the variable interest rate risk of its loan, but not applying hedge accounting.

The journal entries above show that the swap has the effect of transforming the loan into a fixed-rate loan. Each year the entity effectively pays annual interest of CU2,125, ie it effectively pays interest at the fixed rate of 4.25 per cent of the principal amount—the total of the interest payable on the loan plus (or minus) the cash payment (or receipt) under the swap. The entity pays interest at the rate of LIBOR plus 1 per cent on the loan, pays interest at the rate of 3.25 per cent under the swap, and receives interest at the rate of LIBOR under the swap (= LIBOR + 1% + 3.25% less LIBOR = 4.25%).

Summary: entries recognised in profit or loss when not applying hedge accounting

	20X0	20X1	20X2	Total
Loan interest payable	(2,125)	(2,250)	(2,050)	(6,425)
Swap—payment	0	125	(75)	50
Swap—residual change in fair value	250	(325)	75	-
	(1,875)	(2,450)	(2,050)	(6,375)

The overall effect on profit or loss of the swap is a gain of CU50, which is equal to the sum of the net cash settlements in each of the three years. However, the swap causes volatility in profits during each individual year because of fluctuations in its fair value during the three-year period.

Ex 33 **The facts are the same as in Example 32. However, in this example, the entity wishes to designate a hedging relationship between the interest rate swap and the LIBOR interest rate risk of the loan in such a way as to qualify for hedge accounting. Consequently, on 1 January 20X0 the entity designates and documents the hedging relationship in accordance with paragraph 12.16(a).**

The interest rate swap is expected to be highly effective, because the principal terms of the loan and the swap match. The entity may therefore designate a hedging relationship between the interest rate swap and the LIBOR interest rate risk of the loan and, because the entity complies with all the conditions in paragraph 12.16, apply hedge accounting.

1 January 20X0

The journal entries on initial recognition are as follows:

Dr	Asset: financial asset—cash	CU50,000	
	Cr Liability: financial liability—loan		CU50,000

To recognise the loan and the receipt of cash

The loan is measured initially at CU50,000, its transaction price. Because the swap has a fair value of zero on 1 January 20X0, no entries are required on initial recognition.

31 December 20X0

The journal entries on 31 December 20X0 are as follows (LIBOR = 3.25 per cent on 1 January 20X0):

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,125[(a)]	
	Cr Asset: financial asset—cash		CU2,125

To record the finance costs for the period and the payment of coupon interest

Dr	Asset: financial asset—swap	CU250	
	Cr Income: OCI-change in fair value (hedging instrument)		CU250

To record the change in fair value of interest rate swap

Swap—accrual of periodic net cash settlement

Dr	Income: OCI-change in fair value (hedging instrument)	CU0[(b)]	
	Cr Income: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)		CU0

To record the accrued net cash settlement of interest rate swap

Swap—periodic net cash settlement

Dr	Asset: financial asset— cash	CU0[(b)]	
	Cr Asset: financial asset— swap		CU0

To record the cash flow under the swap agreement

(a) CU50,000 × (LIBOR + 1%) = CU50,000 × (3.25% + 1%) = CU2,125.

(b) Net payment under swap = CU50,000 × (3.25% less LIBOR) = CU50,000 × (3.25% less 3.25%) = CU0. In accordance with the terms of the swap, payments are calculated and paid at the end of each year but based on LIBOR at the start of the year; the payment at 31 December 20X0 will therefore always be zero regardless of the level of LIBOR at 31 December 20X0.

At 31 December 20X0 the carrying amount of the loan is a liability of CU50,000 and the swap is an asset of CU250.

31 December 20X1

The journal entries on 31 December 20X1 are as follows (LIBOR = 3.5 per cent on 1 January 20X1):

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,250[(a)]	
	Cr Asset: financial asset—cash		CU2,250

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Expense: OCI-change in fair value (hedging instrument)	CU200	
	Cr Asset: financial asset—swap		CU200[(b)]

To record the change in fair value of interest rate swap

Swap—accrual of periodic net cash settlement

Dr	Expense: OCI-change in fair value (hedging instrument)	CU125[(c)]	
	Cr Income: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)		CU125

To record the accrued net cash settlement of interest rate swap

Swap—periodic net cash settlement

Dr	Asset: financial asset—cash	CU125[(c)]	
	Cr Asset/Liability: financial asset/liability—swap		CU125

To record the cash flow under the swap agreement

(a) CU50,000 × (LIBOR + 1%) = CU50,000 × (3.5% + 1%) = CU2,250.

(b) Change in fair value of swap = CU(75) less (CU250 less CU125) = CU200.

(c) Net receipt under swap = CU50,000 × (LIBOR less 3.25%) = CU50,000 × (3.5% less 3.25%) = CU125.

At 31 December 20X1 the carrying amount of the loan is a liability of CU50,000 and the swap is a liability of CU75.

31 December 20X2

The journal entries on 31 December 20X2 are as follows (LIBOR = 3.1 per cent on 1 January 20X2):

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,050[(a)]	
	Cr Asset: financial asset—cash		CU2,050

To record the finance costs for the period and the payment of coupon interest

Swap—change in fair value

Dr	Liability: financial liability—swap	CU0[(b)]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU0

To record the change in fair value of interest rate swap

Swap—accrual of periodic net cash settlement

Dr	Expense: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)	CU75[(c)]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU75

To record the accrued net cash settlement of interest rate swap

Swap—periodic net cash settlement

Dr	Liability: financial liability—swap	CU75[(c)]	
	Cr Asset: financial asset—cash		CU75

To record the cash flow under the swap agreement

Loan—settlement

Dr	Liability: financial liability—loan	CU50,000	
	Cr Asset: financial asset—cash		CU50,000

To record the repayment of principal under loan agreement

(a) CU50,000 × (LIBOR + 1%) = CU50,000 × (3.1% + 1%) = CU2,050.

(b) Change in fair value of swap = CU0 less (CU(75) add CU75) = CU0.

(c) Net payment under swap = CU50,000 × (3.25% less LIBOR) = CU50,000 × (3.25% less 3.1%) = CU75.

At 31 December 20X2 the loan and the swap have both reached maturity and hence, after settlement of the loan, both have a carrying amount of nil.

This example shows the result of the entity taking out an interest rate swap as a hedge of the variable interest rate risk of its loan and applying hedge accounting.

As a result of entering into the interest rate swap, each year the entity effectively pays interest at 4.25 per cent of the principal amount.

Summary: entries recognised in profit or loss when applying hedge accounting

	20X0	20X1	20X2	Total
Loan interest payable	(2,125)	(2,250)	(2,050)	(6,425)
Swap—reclassification*	-	125	(75)	50
	(2,125)	(2,125)	(2,125)	6,375

* Equals the accrual for the net cash (payment)/receipt.

Instead of recognising the changes in the fair value of the swap in profit or loss as they occur, hedge accounting in accordance with paragraphs 12.23 and 12.24 results in the changes in fair value being recognised in other comprehensive income. The effect of hedge accounting is therefore a reduction in the volatility of annual profit or loss during a hedging relationship. Over the three-year period of the loan, the fair value of the swap could fluctuate significantly if LIBOR is volatile, changing from an asset in one period to a liability in another period. In this case, recognising the change in fair value in other comprehensive income avoids significant debits and reversing credits from being recognised in profit or loss during the three-year period. Instead, the volatility only affects the total comprehensive income figure. Because the interest rate swap has a fair value of nil on initial recognition and maturity, the overall effect on other comprehensive income is nil.

Summary: entries recognised in other comprehensive income when applying hedge accounting

	20X0	20X1	20X2	Total
Swap—Change in fair value	(250)	200	-	(50)
Swap—reclassification*	-	125	(75)	50
	(250)	325	(75)	-

In effect, a part of the hedging gain has been reclassified from other comprehensive income to profit or loss each year to match with when the effect of the risk being hedged was recognised in profit or loss.

If the annual payments under the swap had been made one day later, that is, on 1 January rather than on 31 December, the fair value of the swap would be as follows:

	1 January 20X0	31 December 20X0	31 December 20X1	31 December 20X2
	CU	CU	CU	CU
Fair value of interest rate swap (dirty value)	0	250	50	(75)

The journal entries at 31 December 20X1 and on 1 January 20X2, assuming that the annual payments under the swap and the annual interest payments and capital repayment under the loan had been made on 1 January rather than on 31 December, would be as follows:

31 December 20X1 (LIBOR = 3.5 per cent on 1 January 20X1)

Loan—interest

Dr	Expense: profit or loss—finance costs	CU2,250[(a)]	
	Cr Liability: financial liability—loan		CU2,250

To record the finance costs for the period

Swap—change in fair value

Dr	Expense: OCI-change in fair value (hedging instrument)	CU200	
	Cr Asset: financial asset—swap		CU200[(b)]

To record the change in fair value of interest rate swap

Swap— accrual of periodic net cash settlement

Dr	Expense: OCI-change in fair value (hedging instrument)	CU125	
	Cr Income: profit or loss—change in fair value: accrued net cash settlement (hedging instrument)		CU125[(c)]

To record the accrued net cash settlement of interest rate swap

(a) CU50,000 × (LIBOR + 1%) = CU50,000 × (3.5% + 1%) = CU2,250.

(b) Change in fair value of swap = CU50 less CU250 = CU(200).

(c) Accrual for net receipt under swap = CU50,000 × (LIBOR less 3.25%) = CU50,000 × (3.5% less 3.25%) = CU125.

At 31 December 20X1 the carrying amount of the loan is a liability of CU52,250 and the swap is an asset of CU50.

1 January 20X2

Loan—interest cash payment

Dr	Liability: financial liability—loan	CU2,250	
	Cr Asset: financial asset—cash		CU2,250

To record the payment of coupon interest

Swap—periodic net cash settlement

Dr	Asset: financial asset—cash	CU125	
	Cr Asset/Liability: financial asset/liability—swap		CU125

To record the cash flow under the swap agreement

Ex 34 On 1 November 20X0 a tin mining entity, whose functional currency is the CU, forecasts that it will sell 500 tonnes of tin to its biggest customer in early February 20X1 at the spot price at the date that the transaction occurs. The sale is considered to be highly probable.

The entity's management expects the price of tin to fall between 1 November 20X0 and early February 20X1. Consequently, to hedge the tin price risk in the highly probable forecast sale, the entity enters into a forward contract with an external party to sell 500 tonnes of tin on 1 February 20X1 for CU11,440,000. The forward contract permits the company to net settle in cash based on the price specified in the contract and the fair value of the tin, calculated using the spot price, at the end of the contract. The entity intends to net settle the forward contract.

Because the contract is to be net settled, the contract is within the scope of Section 12. The forward contract has no prepayment, early termination or extension features. The entity has a 31 December year-end.

At inception of the hedge, the forward contract is transacted at current market rates and its initial fair value is nil. The entity expects the forward contract to be highly effective in offsetting changes in the spot price of tin.

The following information relates to the fair value of tin and the forward contract:

	1 November 20X0	*31 December 20X0*	*1 February 20X1*
	CU	*CU*	*CU*
Market value of tin per tonne	22,500	21,000	20,000
Fair value of the 500 tonnes of tin	11,250,000	10,500,000	10,000,000
Change in fair value of expected cash flows from the sale assuming the spot price remains unaltered for the remainder of the contract (ignoring time value of money)	-	(750,000)	(500,000)
Price in forward contract (or notional forward contract) if taken out on 31 December 20X0 for delivery of 500 tonnes of tin on 1 February 20X1		10,558,000	n/a
Fair value of forward contract (ignoring time value of money)	-	882,000	1,440,000
Change in fair value of forward contract		882,000	558,000

The entity sells 500 tonnes of tin to the customer for CU10,000,000 on 1 February 20X1.

Management does not wish to apply hedge accounting to this transaction. Consequently, management neither designates nor documents the hedging relationship.

The journal entries are as follows:

1 November 20X0

Because the forward contract has a fair value of zero on 1 November 20X0, no entries are required on initial recognition.

31 December 20X0

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU882,000	
	Cr Income: profit or loss—change in fair value of forward contract		CU882,000

To record the change in fair value of forward contract

1 February 20X1

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU558,000	
	Cr Income: profit or loss—change in fair value of forward contract		CU558,000

To record the change in fair value of forward contract

Forward contract—net settlement

Dr	Asset: financial asset—cash	CU1,440,000[(a)]	
	Cr Asset: financial asset—forward contract		CU1,440,000

To record the cash flow on termination of the forward contract

Sale of tin

Dr	Asset: financial asset—cash	CU10,000,000	
	Cr Income: profit or loss—revenue		CU10,000,000

To record the sale of tin to customer and receipt of cash

(a) The cash payment of CU1,440,000 equals CU11,440,000, as specified in the forward exchange contract, less CU10,000,000, the fair value of the tin at the end of the forward contract.

Ex 35 **The facts are the same as in Example 34. However, in this example, the entity wishes to designate a hedging relationship between the commodity-based forward contract and the price risk of the tin in the highly probable forecast sale in such a way so as to qualify for hedge accounting. Consequently, on 1 November 20X0**

Entity A designates and documents the hedging relationship in accordance with paragraph 12.16(a).

The hedging relationship is expected to be highly effective, because the principal terms of the highly probable forecast transaction and the forward contract match. The entity may therefore designate a hedging relationship between the forward contract and the tin price risk in the highly probable forecast transaction and can apply hedge accounting, because the entity complies with all the conditions in paragraph 12.16.

The journal entries are as follows:

1 November 20X0

Because the forward contract has a fair value of zero on 1 November 20X0, no entries are required on initial recognition.

31 December 20X0

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU882,000	
	Cr Income: OCI-change in fair value (hedging instrument) [9]		CU750,000
	Cr Income: profit or loss—ineffective portion of hedging instrument[a]		CU132,000

To record the change in fair value of forward contract

1 February 20X1

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU558,000	
	Cr Income: OCI-change in fair value (hedging instrument)		CU500,000
	Cr Income: profit or loss—ineffective portion of hedging instrument[a]		CU58,000

To record the change in fair value of forward contract

Forward contract—net settlement

Dr	Asset: financial asset—cash	CU1,440,000[b]	
	Cr Asset: financial asset—forward contract		CU1,440,000

To record the cash flow on termination of the forward contract

Sale of tin

Dr	Asset: financial asset—cash	CU10,000,000	
	Cr Income: profit or loss—revenue		CU10,000,000

To record the sale of tin to customer and receipt of cash

[9] This hedge is a hedge of commodity price risk in a highly probable forecast sale, and is not a hedge of commodity price risk of inventory. Accordingly, the accounting is in accordance with paragraph 12.23, not paragraph 12.19.

Reclassification from other comprehensive income to profit or loss[10]

Dr	Income: OCI-change in fair value (hedging instrument)	CU1,250,000	
	Cr Income: Profit or loss— fair value income (hedging instrument – re sale of tin)		CU1,250,000

To record the reclassification of hedging gain from OCI to profit or loss

(a) In accordance with paragraph 12.23, the ineffective portion of the hedging instrument is the excess of the fair value of the hedging instrument (CU882,000 at 31 December 20X0) over the change in the fair value of the expected cash flows of the hedged item (CU750,000 at 31 December 20X0).

(b) The cash payment of CU1,440,000 equals CU11,440,000, as specified in the forward exchange contract, less CU10,000,000, the fair value of the tin at the end of the forward contract.

The income attributable to the hedging instrument recognised in other comprehensive income must be reclassified from other comprehensive income to profit or loss on 1 February 20X1 (ie when the hedged item is recognised in profit or loss or when the hedging relationship ends—in this case both events are on the same date).

The effect of hedge accounting does not change total profits over time, but it reduces volatility of reported annual profits during a hedging relationship. If the price risk was hedged over a longer period, say 10 years, and during this period tin prices were volatile, the fair value of the forward contract would fluctuate significantly, possibly even changing from an asset in one period to a liability in another period. Recognising the effective portion of the gains and losses in other comprehensive income, in accordance with hedge accounting, avoids reflecting volatility in profit or loss until the conclusion of the hedging relationship.

12.25 The entity shall discontinue the hedge accounting specified in paragraph 12.23 if:

(a) the hedging instrument expires or is sold or terminated;

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 12.16;

(c) in a hedge of a forecast transaction, the forecast transaction is no longer highly probable; or

(d) the entity revokes the designation.

If the forecast transaction is no longer expected to take place or if the hedged debt instrument measured at amortised cost is derecognised, any gain or loss on the hedging instrument that was recognised in other comprehensive income shall be reclassified from other comprehensive income to profit or loss.

[10] Conceptually, there is neither income nor expense because there has been no change in the entity’s assets or liabilities (see paragraph 2.23). This journal entry is moving, from OCI to profit or loss, income that was recognised previously.

Examples—discontinued hedge accounting

Ex 36 **The facts are the same as in Example 35 (ie the facts from Example 34 but the entity applies hedge accounting). However, in this example, because of damage to inventory due to a fire in the storage facility on 8 January 20X1, the forecast sale to the customer does not take place. The entity is not sure when the tin will be in a condition to be suitable for sale.**

On 8 January 20X1 the fair value of the forward contract is CU985,000 and the fair value of 500 tonnes of tin is CU10,400,000.

On 1 January 20X1 the forecast transaction is considered highly probable. However, because of the fire (a change in circumstances), this assessment must be reassessed on 8 January 20X1. Upon reassessment, the forecast transaction is no longer considered to be highly probable, even though a sale of part of the cleaned-up tin is possible later in the year.

Consequently, on 8 January 20X1 hedge accounting must be discontinued as illustrated in the following journal entries.

31 December 20X0 (same as Example 35)

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU882,000	
	Cr Income: OCI-change in fair value (hedging instrument)		CU750,000
	Cr Income: profit or loss—ineffective portion of hedging instrument		CU132,000

To record the change in fair value of forward contract

8 January 20X1

Forward contract—change in fair value during period hedge is effective (ie from 1 January 20X1 to 8 January 20X1)

Dr	Asset: financial asset—forward contract	CU103,000[(a)]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU100,000[(b)]
	Cr Income: profit or loss—ineffective portion of hedging instrument		CU3,000

To record the change in fair value of forward contract

Transfer from other comprehensive income to profit or loss on 8 January 20X1

Dr	Income: OCI-change in fair value (hedging instrument)	CU850,000	
	Cr Profit or loss— fair value income (hedging instrument – re expected sale of tin)		CU850,000

To record the reclassification of hedging gain from OCI to profit or loss on termination of the hedging relationship

1 February 20X1

Forward contract—change in fair value

Dr	Asset: financial asset—forward contract	CU455,000[c]	
	Cr Income: profit or loss—change in fair value of forward contract		CU455,000

To record the change in fair value of forward contract

Forward contract—net settlement

Dr	Asset: financial asset—cash	CU1,440,000	
	Cr Asset: financial asset—forward contract		CU1,440,000

To record the cash flow on termination of the forward contract

(a) CU985,000 less CU882,000 = CU103,000.

(b) CU10,500,000 less CU10,400,000 = CU100,000.

(c) CU558,000 change in fair value from 1 January to 1 February less CU103,000 change in fair value from 1 January to 8 January, recognised on 8 January = CU455,000 change in fair value from 9 January to 1 February. Because hedge accounting has been discontinued from 8 January 20X1, all of the change in fair value is recognised directly in profit or loss.

Disclosures

12.26 An entity applying this section shall make all of the disclosures required in Section 11 incorporating in those disclosures financial instruments that are within the scope of this section as well as those within the scope of Section 11. In addition, if the entity uses hedge accounting, it shall make the additional disclosures in paragraphs 12.27–12.29.

Notes

Module 11 illustrates and discusses the disclosures required under Section 11. The examples and notes in Module 11 focus on financial instruments within the scope of Section 11. Paragraph 12.26 requires the Section 11 disclosure requirements additionally to be applied to financial instruments within the scope of Section 12. Example 37 and Example 38 illustrate paragraph 11.40 (summary of significant accounting policies for financial instruments) and paragraph 11.43 (disclosure of the basis for determining fair value) disclosures for two of the more common financial instruments within the scope of Section 12. In addition to illustrating some of the disclosures required by Section 11, Example 38 illustrates some of the disclosures required by Section 12.

Example 37 is for reference only and should not be used by entities as a template. Entities should explain their own specific facts and circumstances and provide information that is relevant to users. In particular, if an entity uses a valuation technique in the measurement of any financial instrument, it must disclose which valuation technique has been used and the significant assumptions applied (paragraph 11.43). Such disclosures will be specific to the entity and the type of financial instrument being valued; they will make users of the financial statements aware of the extent to which judgement was exercised in performing the valuation. Disclosures provided should be sufficient for users to assess the level of subjectivity involved and assess whether the assumptions used by the entity's management are appropriate.

Example—general disclosures

Ex 37 **Extract from notes to Entity A's financial statements for the year ended 31 December 20X2**

Note 2: Accounting policies (extract)

Forward contracts and interest rate swaps

Foreign currency forward exchange contracts and interest rate swaps are used to manage exposure to foreign exchange and interest rate risk. The forward contracts and interest rate swaps are initially recognised at fair value, which is zero if the contract is entered into at market prices or rates. Any transaction costs are recognised in profit or loss immediately. Such contracts are subsequently measured at fair value, with changes in fair value recognised in profit or loss during the period, unless the instrument is designated as, and is expected to be effective as, a hedging instrument, in which case the policy for hedge accounting is applied (see below).

The fair value of foreign currency forward contracts is calculated by comparing the contracted rates with the current forward exchange rates for contracts with similar maturity profiles and discounting the difference in expected cash flows to reflect the time value of money. The fair value of interest rate swaps is determined by reference to market values for similar instruments and specific valuations performed by counterparties at the balance sheet date.

(Notes—management should tailor disclosures for an entity's own particular facts and circumstances to enhance this disclosure.

Entity A's policy for hedge accounting is illustrated in Example 38.)

Note 20: Derivative financial instruments (extract)

Foreign currency forward exchange contracts

The fair value of foreign currency forward contracts is calculated by comparing the contracted rates with the current forward exchange rates for contracts with similar maturity profiles and discounting, by using LIBOR, the difference in expected cash flows to reflect the time value of money.

Interest rate swaps

The fair value of interest rate swaps is determined by reference to market values for similar instruments and specific valuations performed by counterparties at the balance sheet date.

(Notes—management should tailor disclosures for an entity's own particular facts and circumstances to enhance this disclosure, eg regarding any major assumptions made.)

12.27 An entity shall disclose the following separately for hedges of each of the four types of risks described in paragraph 12.17:

(a) a description of the hedge.

(b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date.

(c) the nature of the risks being hedged, including a description of the hedged item.

Notes

In the absence of hedge accounting for the risks that the *IFRS for SMEs* permits to be accounted for using hedge accounting, gains and losses on hedging instruments or hedged items would be recognised in different accounting periods.

Hedge accounting disclosures are necessary for the user to understand the nature of an entity's hedging relationships and the effect that those hedging relationships have had on the performance of the entity during the current and prior period, and that they are expected to have in future periods.

Example—disclosures for hedge accounting

Ex 38 Extract from notes to Entity A's financial statements for the year ended 31 December 20X2

Note 2: Accounting policies (extract)

Hedge accounting

Forward contracts and interest rate swaps are used to reduce currency risk and interest rate risk. When the contracts or swaps are expected to be highly effective in offsetting the designated risk, hedge accounting is applied to the transaction. Hedge accounting overrides other reporting requirements to permit the gain or loss on the hedging instrument or on the hedged item, as appropriate, to be recognised in profit or loss at the same time, as set out below.

The entity uses the following types of hedging instruments:

- Interest rate swaps. The swaps are used to offset variable interest rate risk in bank loans by exchanging variable-rate interest for fixed-rate interest. When the swap and the loan qualify for hedge accounting, the portion of the change in the fair value of the swap that is effective in offsetting the changes in interest payments due to changes in market interest rates, is recognised in other comprehensive income. The balance, if any, of the change in fair value of the swap is recognised in profit or loss. An amount equal to the periodic net cash settlements accruing under the swap for the financial period is reclassified to profit or loss in that financial period. The variable rate interest payable on the loan being hedged is also recognised in profit or loss. The resulting effect is that fixed-rate interest is recognised in profit or loss in each period in which the hedge is effective. When the loan is derecognised, for example on early settlement, any cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income is reclassified to profit or loss.

- Foreign currency forward exchange contracts. These forward contracts are used to offset foreign exchange risk in firm commitments to purchase specialised point-of-sale computer systems and computer equipment from overseas suppliers when the purchase price is denominated in a foreign currency. Such a forward contract is measured at fair value at each reporting date. The portion of the change in the fair value of the forward contract that is effective in offsetting the change in the purchase price due to movements in exchange rates, is recognised in other comprehensive income. Any excess of the change in the fair value of the forward contract over the change in the purchase price due to movements in exchange rates is recognised in profit or loss. The cumulative hedging gain or loss that has been recognised in other comprehensive income is reclassified to profit or loss when the computer system is recognised as an expense, usually as it is depreciated.

Note 20: Derivative financial instruments (extract)

	20X2 CU	20X1 CU
Fair values of derivative instruments held, and designated as, hedging instruments:		
Interest rate swaps	9,500	(5,000)
Foreign currency forward exchange contracts	7,050	3,200

12.28 If an entity uses hedge accounting for a hedge of fixed interest rate risk or commodity price risk of a commodity held (paragraphs 12.19–12.22) it shall disclose the following:

(a) the amount of the change in fair value of the hedging instrument recognised in profit or loss.

(b) the amount of the change in fair value of the hedged item recognised in profit or loss.

Example—disclosures using hedge accounting (fixed interest rate risk or commodity price risk)

Ex 39 **Extract from notes to Entity A's financial statements for the year ended 31 December 20X2**

Note 10: Profit for the year (extract)

	20X2 CU	20X1 CU
Profit for the year is stated after recognising the following:		
Losses/(gains) arising on forward contracts for wheat in a designated hedge accounting relationship	35,000	(28,000)
(Gains)/losses arising on adjustment to inventory of wheat in a designated hedge accounting relationship	(36,000)	28,000

12.29 If an entity uses hedge accounting for a hedge of variable interest rate risk, foreign exchange risk, commodity price risk in a firm commitment or highly probable forecast transaction, or a net investment in a foreign operation (paragraphs 12.23–12.25) it shall disclose the following:

(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss.

(b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur.

(c) the amount of the change in fair value of the hedging instrument that was recognised in other comprehensive income during the period (paragraph 12.23).

(d) the amount that was reclassified from other comprehensive income to profit or loss for the period (paragraphs 12.23 and 12.25).

(e) the amount of any excess of the fair value of the hedging instrument over the change in the fair value of the expected cash flows that was recognised in profit or loss (paragraph 12.24).

Notes

These disclosures are required in respect of hedge accounting in accordance with paragraphs 12.23 to 12.25 inclusive, that is, they are in respect of what might be termed cash flow hedges.

In Example 40, the disclosures required by paragraph 12.29(c)–(e) have been shown in the statement of comprehensive income rather than in note 20. Actuarial gains and losses are shown in shading because they are not specifically required to be disclosed in accordance with Section 12. They are included to show what else may appear in other comprehensive income together with the hedging entries (see Section 28 *Employee Benefits*).

Example—disclosures where hedge accounting is used for hedges of variable interest rate risk, foreign exchange risk and/or commodity price risk in a highly probable forecast transaction

Ex 40 **Extract from Entity A's statement of comprehensive income for the year ended 31 December 20X2**

	Notes	*20X2 CU*	*20X1 CU*
Profit for the year		**1,121,250**	**865,500**
Other comprehensive income:			
Gains/(losses) on hedging instruments recognised in other comprehensive income		251	(4,510)
Transfers to profit or loss of (gains)/losses on hedges previously recognised in other comprehensive income		(1,840)	3,004
Transfer to profit or loss of gains on a forward exchange contract that is no longer used as a hedge	20	(730)	–
Actuarial gains (losses) on defined benefit pension plans		(67)	13
Total comprehensive income for the year		**1,121,123**	**8,645,007**

Extract from notes to Entity A's financial statements for the year ended 31 December 20X2

Note 20: Derivative financial instruments (extract)

The entity has entered into a number of interest rate swaps to swap its variable-rate interest exposure, arising from bank loans, to fixed-rate interest. One of the swaps has three years still to run while all the other swaps have two years to run.

The entity has a number of foreign currency forward contracts to hedge changes in the price, as a result of foreign exchange rate movements, of specialised point-of-sale computer systems and computer equipment, which it is highly probable that it will purchase in July 20X3 from overseas suppliers. The point-of-sale computer systems and computer equipment will be depreciated over their useful lives of five years.

In 20X2 the entity abandoned a highly probable forecast purchase of yet-to-be-manufactured computer equipment following the liquidation of the supplier when its plant was destroyed by a tsunami. Consequently, the purchase transaction never took place and all accumulated hedging gains on the forward contract were reclassified to profit or loss in 20X2.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty are useful in assessing the financial position, performance and cash flows of an entity. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties. Significant estimates and other judgements in accounting for financial instruments in accordance with Section 12 are set out below.

Scope of Section 12

Judgement may need to be applied in interpreting 'unrelated', as used in paragraphs 12.3(d), 12.3(f) and 12.4. In particular, assessing whether some contracts to buy, sell, lease or insure non-financial items are within the scope of Section 12 may require judgement if they contain risks that are partially but not completely related to standard risks such as foreign exchange risk or price risk. For example, a contract to buy, sell, lease or insure a non-financial item may include a risk that is related to the price risk of a different non-financial item, but judgement is required if the price of that non-financial item nevertheless shows some correlation with the price of the non-financial item in the contract.

Initial measurement

Assessing whether a transaction has taken place at arm's length may require judgement if the transaction does not take place in an active market or the parties to the transaction are related. If the transaction does not take place at arm's length, judgement will need to be applied in determining fair value at initial recognition, for example when using valuation techniques to determine fair value.

Subsequent measurement

Judgement is required in determining the fair value of financial instruments when there is no active market for such instruments. In particular, choosing and applying valuation techniques often involves a significant amount of judgement. Often the inputs into the valuation model and other assumptions used when applying the model involve subjectivity. For example, for present value calculations, judgement is required in determining which cash flows to use (for example if there is significant uncertainly of the cash flows or there are early repayment features), what adjustments to make for the risk premium required by investors and what is an appropriate discount factor. If an external valuer is used, management must assess the external valuation provided for reasonableness and check that it was performed using valuation techniques usually applied to such instruments by market participants and in accordance with the *IFRS for SMEs*. The fact that a range of estimates of fair value may exist reflects the fact that different entities might make different judgements in particular situations. However, a single entity must apply judgements consistently (across time and by type of instrument) when measuring fair value.

Judgement may also be required in assessing whether or not a market is active (if transactions are not occurring frequently) and also in assessing whether the transactions taking place are forced transactions. An active market is one in which transactions are taking place regularly on an arm's length basis. The determination of what is 'regularly' is a matter of judgement and depends upon the facts and circumstances of the market for the instrument being measured at fair value.

Recent transactions for similar instruments might provide evidence of fair value. What constitutes a 'similar instrument' is a matter of judgement and requires a clear understanding of the terms of the instruments. Further judgement is then required to determine what adjustments are required to be made to the fair value of the similar instrument in order to estimate the fair value of the instrument held by the entity.

Judgement needs to be applied before concluding that the fair value of some equity instruments cannot be measured reliably. Such instruments are measured at cost less impairment.

Performing an impairment test for equity instruments measured at cost requires significant judgement. In order to be measured at cost, the fair value cannot be measured reliably; consequently, in most cases the best estimate of the amount that the entity would receive for the asset if it were to be sold at the reporting date will also be difficult to determine.
The Standard does not permit the impairment to be ignored on the grounds that the measurement is difficult; consequently, the entity must use judgement to estimate the impairment.

Hedging

Management must apply judgement when assessing whether it expects a particular hedging instrument to be highly effective in offsetting a specific designated risk, particularly if the principal terms of the hedging instrument and the hedged item relating to the particular risk are not perfectly matched.
Section 12 permits hedge accounting to be applied for forecast transactions if they are considered to be highly probable to occur. Judgement needs to be applied in determining how likely it is that a transaction will occur.

Derecognition

Judgement is sometimes required in assessing whether substantially all the risks and rewards are transferred to another party and thus whether to derecognise a financial asset or financial liability.

COMPARISON WITH FULL IFRSs

When the *IFRS for SMEs* was issued in July 2009, Section 12 was based on IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*. At that time IFRS 9 *Financial Instruments* had not been issued. The following comparison looks only at IAS 39 and does not look at IFRS 9; consequently references to 'full IFRSs' in this comparison assume that IFRS 9 is not being applied early.

Full IFRSs (IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*) and the *IFRS for SMEs* (see Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*) share some similar principles for the recognition, measurement, derecognition and disclosure of financial instruments. However, there are also a number of significant differences between full IFRSs and the *IFRS for SMEs*.

In the *IFRS for SMEs* the accounting for basic financial instruments is addressed separately from the accounting for more complex financial instrument transactions and the requirements have been written in simplified language. In addition there are a number of differences in the detail (outlined below).

In accordance with the *IFRS for SMEs* an entity chooses to account for all of its financial instruments either:

(a) by applying the provisions of both Section 11 and Section 12 in full; or

(b) by applying the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* and the disclosure requirements of Section 11 and Section 12.

If an entity chooses to apply (b)

The difference between applying (b) and applying full IFRSs is the applicable disclosure requirements. IFRS 7's disclosures are divided into three main categories: significance; risk; and transfers. Section 11 includes many of the 'significance' disclosures that are in IFRS 7. However, the *IFRS for SMEs* includes none of the 'risk' disclosures that are in IFRS 7. The only disclosure from IFRS 7 relating to 'transfers' that is included in the *IFRS for SMEs* relates to transfers of financial assets that do not qualify for derecognition.

The reasons that the *IFRS for SMEs* omits so many of the IFRS 7 disclosures include:

- many of the IFRS 7 disclosures are designed for financial institutions (which are not eligible to use the *IFRS for SMEs*);
- many of the IFRS 7 disclosures are designed for entities whose securities trade in public capital markets (which are also ineligible to use the *IFRS for SMEs*); or
- in the case of disclosure of fair values for all financial instruments measured at amortised cost, requiring such disclosures would be burdensome for small or medium-sized entities and contrary to the objective of Section 11, which is an amortised cost section for basic financial instruments.

The only disclosures required by Section 12 that are in addition to those required by Section 11 are disclosures for entities applying hedge accounting. The only difference from the hedge accounting disclosures in IFRS 7 (which are part of the 'significance' disclosures) is that Section 12 does not require separate disclosure of the amount of the gain or loss on a hedging instrument that has been included in the cost of a non-financial asset or liability; the *IFRS for*

SMEs does not permit this accounting treatment and hence the disclosure requirement is not applicable.

If an entity chooses to apply (a)

There are a number of differences between the recognition and measurement requirements of Section 11 and full IFRSs and these are covered in Module 11. The disclosure differences between Sections 11 and 12 and full IFRSs are mentioned under 'If an entity chooses to apply (b)' above. The other key differences between Section 12 and full IFRSs, assuming IFRS 9 is not being applied early, are as follows:

- *Classification and measurement:* if a financial instrument is within the scope of Section 12, it is automatically required to be measured at fair value through profit or loss, with the exception of equity instruments whose fair value is not reliably measurable. In contrast, IAS 39 requires entities to classify financial instruments into categories that will then determine the measurement requirements. In accordance with IAS 39, only financial instruments that are held for trading are automatically classified and measured at fair value through profit or loss. Section 12 therefore avoids the requirement in IAS 39 to assess management's intentions regarding financial instruments in order to classify them, and it does this without bringing in significant additional fair value measurements because the majority of an entity's financial instruments will be measured at amortised cost under Section 11.
- *Derivative financial instruments:* unlike IAS 39, Section 12 does not require separate accounting for 'embedded derivatives'. However, in general, non-financial contracts that include a risk component with economic characteristics not closely related to the host contract will be included within the scope of Section 12 and will be accounted for in their entirety at fair value. This means that for some contracts Section 12 will require the entire contract to be at fair value, whereas IAS 39 would only require the embedded contract with the risk component to be recognised at fair value.
- *Hedge accounting:* Section 12 focuses on the types of hedging that SMEs are likely to use and only allows hedge accounting for the following:
    - interest rate risk of a debt instrument measured at amortised cost;
    - foreign exchange risk or interest rate risk in a firm commitment or a highly probable forecast transaction;
    - price risk of a commodity that the entity holds or in a firm commitment or a highly probable forecast transaction to purchase or sell a commodity; and
    - foreign exchange risk in a net investment in a foreign operation.

  IAS 39 is not as restrictive.

  Section 12 requires periodic recognition and measurement of hedge ineffectiveness, but under less strict conditions than those in IAS 39.

  Section 12 permits hedge accounting only if the hedging instrument is one of four instruments listed in paragraph 12.18. IAS 39 is less restrictive. Consequently, hedge accounting cannot be achieved under Section 12 by using debt instruments, such as a foreign currency loan, as hedging instruments, whereas IAS 39 permits this for a hedge of a foreign currency risk. Similarly, hedge accounting is not permitted under Section 12 for an option-based hedging strategy.

Hedge accounting for portfolios is not permitted under Section 12.

- *Derecognition:* differences are explained in Module 11. Additionally, however, Section 11's rules on derecognition only apply to financial assets whereas those in Section 12 apply to financial assets and financial liabilities.

Module 12 – Other Financial Instruments Issues

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for the accounting and reporting of financial instruments, other than those covered by Section 11, in accordance with the *IFRS for SMEs* by answering the questions below.

Once you have completed the test, check your answers against those set out below this test.

Assume all amounts are material.

Question 1

Which one of the following financial instruments held by an entity is within the scope of Section 12?

(a) A loan from a bank with a rate of interest equal to a single referenced quoted interest rate.

(b) A financial instrument that qualifies and is designated as a hedging instrument in accordance with the *IFRS for SMEs*.

(c) A quoted fixed-interest bond.

(d) An obligation to pay employees who serve throughout the year a specified proportion of profit earned by the entity for that year. The payment will be made nine months after year-end.

(e) An obligation under a finance lease to pay a stream of payments to a lessor. The lease does not contain any unusual embedded risks.

Question 2

Which one of the following financial instruments held by an entity is within the scope of Section 12?

(a) Trade receivables.

(b) A 5 per cent holding in the non-puttable ordinary shares of another entity (investee).

(c) A 30 per cent holding in the non-puttable ordinary shares of another entity (investee) where the investee is classified as an associate of the entity.

(d) A contract to purchase FCU500 for CU10,000 in four months' time.

Question 3

Which one of the following contracts is within the scope of Section 12?

(a) A contract to purchase a property in six months’ time that could result in an additional payment of 10 per cent of the purchase price if the CPI in the jurisdiction of the property increases by 1 per cent during the six-month period.

(b) A contract to purchase a property in six months’ time that could result in an additional payment of 1 per cent of the purchase price if the CPI in the jurisdiction of the property increases by 1 per cent during the six-month period.

(c) A contract to sell a property in six months’ time that could result in a loss to the seller if the buyer defaults because of financial difficulties.

(d) A contract to sell a property in six months’ time to an overseas buyer for CU1,000,000 that could result in a loss to the buyer if the currency in the buyer's jurisdiction depreciates against CU during the six-month period.

Question 4

An entity enters into a futures contract to purchase 20,000 bushels of wheat in 6 months’ time at a fixed price in accordance with its expected usage requirements (a fixed price future). The contract permits the entity to take physical delivery of the wheat at the end of six months or to pay or receive a net settlement in cash at the end of six months.

Which of the following statements is true?

(a) The contract is within the scope of Section 12 because it can be net settled in cash.

(b) The contract is outside the scope of Section 12 because it is a contract for the purchase of a non-financial asset.

(c) The contract is only outside the scope of Section 12 if the entity intends to accept delivery of the wheat.

(d) The contract is within the scope of Section 12 because it is a hedging instrument.

Question 5

On 1 January 20X0 an entity purchased 100 share options from a bank for cash of CU2,000 in an arm's length transaction. The share options permit the entity to purchase shares in a listed entity, XYZ, for CU50 per share at any time during the next two years. XYZ's share price is currently quoted at CU44 per share.

On 1 January 20X0 the entity incurred (and paid to the bank) transaction fees of CU20 for the purchase of the options.

At what amount should the entity measure the 100 share options purchased on initial recognition?

(a) CU1,380.
(b) CU1,980.
(c) CU2,000.
(d) CU2,020.
(e) CU4,040.

Question 6

The facts are the same as in Question 5. On 31 December 20X0 the option has not yet been exercised and the shares are trading at CU47 per share. The fair value of the option has increased to CU2,500.

At what amount should the entity measure the 100 share options held on subsequent recognition?

(a) CU1,980.
(b) CU2,000.
(c) CU2,020.
(d) CU2,500.
(e) CU4,700.

Question 7

Which of the following statements is true for an entity that does not apply hedge accounting?

(a) At the end of each reporting period, an entity must measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss.

(b) At the end of each reporting period, an entity must measure all publicly traded financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss. Financial instruments that are not publicly traded are measured at cost less impairment.

(c) At the end of each reporting period, an entity must measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss, except equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably (and contracts linked to such instruments that, if exercised, will result in delivery of such instruments), which are measured at cost less impairment.

(d) At the end of each reporting period, an entity must measure all financial instruments within the scope of Section 12 at cost less impairment.

Question 8

Section 12 permits hedge accounting for selected risks. Which of the following risks is *not* one of those permitted for hedge accounting under Section 12?

(a) Interest rate risk of a debt instrument measured at amortised cost.

(b) Foreign exchange risk of a debt instrument measured at amortised cost.

(c) Foreign exchange risk in a firm commitment.

(d) Foreign exchange risk in a net investment in a foreign operation.

Question 9

A jeweller holds an inventory of miniature gold ingots for use in a range that will be ready for sale in roughly three months' time. The entity is worried that the price of gold may decline in the next three months and so the entity enters into a commodity forward contract, which can be net settled, to hedge the commodity price risk of the commodity that it holds. This relationship meets the conditions for hedge accounting and the entity documents the hedge and chooses to apply hedge accounting. Which of the following is the appropriate accounting treatment?

(a) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in profit or loss. Recognise the change in the fair value of the gold inventory in profit or loss and as an adjustment to the carrying amount of the gold inventory.

(b) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in profit or loss. Recognise the change in the fair value of the gold inventory attributable to the hedged risk in profit or loss and as an adjustment to the carrying amount of the gold inventory.

(c) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in other comprehensive income. Recognise the change in the fair value of the gold inventory that is attributable to the hedged risk in other comprehensive income and as an adjustment to the carrying amount of the gold inventory.

(d) Recognise the commodity forward contract as an asset or liability at fair value and the change in the fair value of the forward contract in other comprehensive income. Do not recognise any change in the fair value of the gold inventory because inventory is measured at cost.

Question 10

Under what circumstances must an entity discontinue hedge accounting for a hedging relationship that previously met the requirements to qualify for hedge accounting as set out in paragraph 12.16?

(a) The hedging instrument expires or is sold or terminated.

(b) The hedge no longer meets the conditions for hedge accounting specified in paragraph 12.16.

(c) The entity revokes the designation.

(d) In a hedge of a forecast transaction, the forecast transaction is no longer highly probable.

(e) Any of (a) to (d) above.

Module 12 – Other Financial Instruments Issues

Answers

Q1	(b) see paragraphs 12.3, 11.8 and 11.9
Q2	(d) see paragraphs 12.3 and 11.8
Q3	(a) see paragraph 12.4
Q4	(c) see paragraph 12.5
Q5	(c) see paragraphs 12.7 and 12.12
Q6	(d) see paragraph 12.8
Q7	(c) see paragraph 12.8
Q8	(b) see paragraph 12.17
Q9	(b) see paragraph 12.19
Q10	(e) see paragraphs 12.21 and 12.25

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements for the accounting and reporting of financial instruments, other than those covered by Section 11, in accordance with the *IFRS for SMEs* by solving the case studies below.

Once you have completed each case study check your answers against those set out at the end of the case study.

Case study 1

On 1 November 20X0 SME A, whose functional currency is CU, enters into a firm commitment with SME B, whose functional currency is FCU, to purchase an item of specialised equipment for FCU750,000 for use within the sales function of SME A's business. Both delivery and payment are scheduled to take place on 1 July 20X1.

Also on 1 November 20X0, SME A enters into a foreign currency forward exchange contract (forward contract) with an external party to buy FCU750,000 and sell CU500,000 on 1 July 20X1. SME A enters into the forward contract to hedge its future exposure to FCU arising from the firm commitment with SME B. As a result of the contract, SME A will receive and pay FCU750,000 on the same date and hence, when viewed from a net position, it has no exposure to change in the FCU/CU exchange rate. The forward contract effectively 'locks in' the exchange rate at FCU1.5/CU1 for FCU750,000. The fair value of the forward contract at inception (on 1 November 20X0) is zero. The forward contract has no prepayment, early termination or extension features.

The spot rate at:

- 1 November 20X0 = FCU1.55/CU1
- 31 December 20X0 = FCU1.47/CU1
- 1 July 20X1 = FCU1.2/CU1.

All changes in fair value of the currency forward are due to changes in the spot and forward FCU/CU exchange rates.

The fair value of the currency forward at various dates is shown in the table below:

	1 November 20X0	*31 December 20X0*	*1 July 20X1*
Fair value of forward contract	CU0	CU24,475	CU125,000

From 1 July 20X1 SME A will, in accordance with Section 17, depreciate the equipment on the straight-line method over its estimated useful life of 15 years to a residual value of CU25,000 (estimated net proceeds that would be obtained on 1 July 20X1 from disposal of the equipment if the equipment were already 15 years old and in the condition expected at the end of its useful life).

SME A has a 31 December financial year-end.

SME A does not recognise executory contracts[11] unless explicitly required to do so by the *IFRS for SMEs* (eg when executory contracts are onerous a provision must be recognised in accordance with Section 21). On 1 July 20X1 the recoverable amount of the specialised equipment is expected to be at least CU625,000.

Part A:
SME A chooses not to use hedge accounting under Section 12.

Prepare the journal entries necessary to record the transactions described above for the year ended 31 December 20X0 and for the year ended 31 December 20X1.

Part B:
SME A wishes to designate a hedging relationship between the forward contract and the foreign exchange risk in the firm commitment in such a way as to qualify for hedge accounting.

Can SME A use hedge accounting for the hedging relationship between the forward contract and the foreign exchange risk in the firm commitment? If so, what actions must management take in order to use hedge accounting?

Part C:
Unlike in Part A, in this part (Part C) SME A does use hedge accounting in accordance with Section 12.

Prepare journal entries to record the transactions described above for the year ended 31 December 20X0 and for the year ended 31 December 20X1. Ignore the time value of money.

Part D:
The facts are the same as in Part C. On 31 December 20X2 the equipment has a recoverable amount of CU400,000 because of damage from bad weather conditions experienced towards the end of 20X2.

Prepare journal entries to record the transactions described above for the year ended 31 December 20X2.

Part E:
The facts are the same as in Part D. On 1 January 20X3 management estimates that the equipment has a residual value of CU20,000. Estimated useful life remains 15 years from the original date of acquisition. On 31 May 20X3 the equipment is sold for CU390,500 because of changes in business plans.

Prepare journal entries to record the transactions described above for the year ended 31 December 20X3.

---

[11] contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (see paragraph 21.2 of the *IFRS for SMEs*)

Module 12 – Other Financial Instruments Issues

Answer to Case study 1

Part A:

1 November 20X0

Because the forward contract has a fair value of zero on 1 November 20X0, no entries are required on initial recognition.

The firm commitment entered into on 1 November 20X0 to buy the equipment is outside the scope of Section 12, because contracts that were entered into, and continue to be held, for the purpose of the receipt of a non-financial item in accordance with the entity's expected usage requirements are not financial instruments for the purposes of Section 12, even if the contract can be net settled; see paragraph 12.5. Because the contract is not onerous, in accordance with SME A's accounting policies, no entries are made for the commitment entered into on 1 November 20X0 to buy the equipment.

31 December 20X0

Dr	Asset: financial asset—forward contract	CU24,475	
	Cr Income: profit or loss—change in fair value of forward contract		CU24,475

To recognise the change in the fair value of the forward contract between 1 November 20X0 and 31 December 20X0.

Note: changes in fair value are recognised in profit or loss because the forward contract is not designated as a hedging instrument.

No entries are required at 31 December 20X0 for the firm commitment entered into on 1 November 20X0 to buy the equipment (for the same reasons as at 1 November 20X0).

1 July 20X1

Dr	Asset: financial asset—forward contract	CU100,525[(a)]	
	Cr Income: profit or loss—change in fair value of forward contract		CU100,525

To recognise the change in the fair value of the forward contract between 1 January 20X1 and 1 July 20X1.

Note: changes in fair value are recognised in profit or loss because the forward contract is not designated as a hedging instrument.

Dr	Asset: financial asset—cash	CU125,000	
	Cr Asset: financial asset—forward contract		CU125,000

To recognise the settlement under the forward contract on expiry (pay CU500,000 to receive FCU750,000 (= CU625,000)).

Dr	Asset: property, plant and equipment—equipment cost	CU625,000[(b)]	
	Cr Asset: financial asset—cash		CU625,000

To recognise the purchase of the equipment on 1 July 20X1 in exchange for FCU750,000 (= CU625,000).

31 December 20X1

Dr	Expense: profit or loss—depreciation	CU20,000[(c)]	
	Cr Asset: property, plant and equipment—equipment accumulated depreciation		CU20,000

To recognise depreciation on the equipment for the six months between 1 July 20X1 and 31 December 20X1.

Note: on 31 December 20X1, the carrying amount of the equipment is an asset of CU605,000[(c)].

Part B:

SME A may designate a hedging relationship between the forward contract and the foreign exchange risk in the firm commitment and apply hedge accounting in accordance with paragraph 12.23, provided that SME A designates and documents the hedging relationship appropriately; the other conditions in paragraph 12.16 appear to be satisfied, as follows:

- The hedged risk—foreign exchange risk in a firm commitment—is one of the risks specified in paragraph 12.17.
- A foreign currency forward exchange contract is one of the four hedging instruments specified in paragraph 12.18. The contract also meets all the other conditions in paragraph 12.18: the forward contract is entered into with a party external to SME A; the foreign currency amount in the forward contract is equal to the purchase price of FCU750,000; the maturity date of the forward contract is the same as the date of the firm commitment; and the forward contract has no prepayment, early termination or extension features.
- The principal terms of the forward contract and of the firm commitment, which relate to foreign exchange risk, match, so the changes in the fair value of the forward contract are expected to be, both at inception and subsequently, highly effective in offsetting the changes in the expected cash flow from the firm commitment that is attributable to foreign exchange risk. The principal terms include the maturities of the commitment and the forward exchange contract (in eight months' time), the foreign currency (FCU), and the amount of each (FCU750,000)). In addition, the fair value of the forward contract at inception is zero.

However, potential sources of ineffectiveness include subsequently agreed changes in the date of sale of the equipment, termination of the contract by both parties and changes in the creditworthiness of the counterparty to the forward contract.

Part C:

1 November 20X0

Because the forward contract has a fair value of zero on 1 November 20X0, no entries are required on initial recognition.

The firm commitment entered into on 1 November 20X0 to buy the equipment is outside the scope of Section 12, because contracts that were entered into, and continue to be held, for the purpose of the receipt of a non-financial item in accordance with the entity's expected usage requirements are not financial instruments for the purposes of Section 12, even if the contract can be net settled; see paragraph 12.5. Because the contract is not onerous, in accordance with SME A's accounting policies, no entries are made for the commitment entered into on 1 November 20X0 to buy the equipment.

31 December 20X0

Dr	Asset: financial asset—forward contract	CU24,475	
	Cr Income: OCI-change in fair value (hedging instrument)		CU24,475[d]

To recognise the change in the fair value of the forward contract between 1 November 20X0 and 31 December 20X0 in accordance with paragraph 12.23.

No entries are required at 31 December 20X0 for the firm commitment entered into on 1 November 20X0 to buy the equipment (for the same reasons as at 1 November 20X0).

1 July 20X1

Dr	Asset: financial asset—forward contract	CU100,525[a]	
	Cr Income: OCI-change in fair value (hedging instrument)		CU100,525[e]

To recognise the change in the fair value of the forward contract between 1 January 20X1 and 1 July 20X1 in accordance with paragraph 12.23.

Dr	Asset: financial asset—cash	CU125,000	
	Cr Asset: financial asset—forward contract		CU125,000

To recognise the settlement under the forward contract on expiry (ie on 1 July 20X1).

Dr	Asset: property, plant and equipment—equipment	CU625,000[b]	
	Cr Asset: financial asset—cash		CU625,000

To recognise the purchase of the equipment on 1 July 20X1.

31 December 20X1

Dr	Expense: profit or loss—depreciation	CU20,000[c]	
	Cr Asset: property, plant and equipment—equipment accumulated depreciation		CU20,000

To recognise depreciation on the equipment for the six months between 1 July 20X1 and 31 December 20X1.

Dr	Income: OCI-change in fair value (hedging instrument)	CU4,167[f]	
	Cr Income: profit or loss—reclassification of hedging gain		CU4,167

To reclassify an appropriate portion of the cumulative hedging gain from other comprehensive income to profit or loss as the equipment is depreciated.

On 31 December 20X1 the carrying amount of the equipment is an asset of CU605,000[c] and there are CU120,833[f] of cumulative hedging gains in other comprehensive income that are still to be reclassified in relation to that asset.

Part D:

31 December 20X2

Dr	Expense: profit or loss—depreciation	CU40,000[c]	
	Cr Asset: property, plant and equipment—equipment accumulated depreciation		CU40,000

To recognise depreciation on the equipment for the year ended 31 December 20X2.

Dr	Expense: profit or loss—impairment	CU165,000[g]	
	Cr Asset: property, plant and equipment—equipment (accumulated impairment and accumulated depreciation)		CU165,000

To recognise the impairment of the equipment at 31 December 20X2.

Dr	Income: OCI-change in fair value (hedging instrument)	CU42,703[h]	
	Cr Income: profit or loss—reclassification of hedging gain		CU42,703

To reclassify an appropriate portion of the cumulative hedging gain from other comprehensive income to profit or loss as the equipment is depreciated and as it is written down for impairment.

On 31 December 20X2 the carrying amount of the equipment is an asset of CU400,000 and there are CU78,130[i] of cumulative hedging gains in other comprehensive income that are still to be reclassified in relation to that asset.

Part E:

31 May 20X3

Dr	Expense: profit or loss—depreciation	CU11,728[j]	
	Asset: property, plant and equipment—equipment (accumulated depreciation and accumulated impairment)		CU11,728

To recognise depreciation on the equipment for the five months between 1 January 20X3 and 31 May 20X3.

Dr	Asset: financial asset—cash	CU390,500	
Dr	Asset: property, plant and equipment—equipment (accumulated depreciation and impairment)	CU236,728[k]	
	Cr Asset: property, plant and equipment—equipment (cost)		CU625,000
	Cr Income: profit or loss: gain on disposal of equipment		CU2,228(k)

To recognise the sale of the equipment on 31 May 20X3.

Dr	Income: OCI-change in fair value (hedging instrument)	CU78,130[i]	
	Cr Income: profit or loss		CU78,130

To reclassify the cumulative hedging gain from other comprehensive income to profit or loss as the equipment is depreciated and to reclassify the remaining balance in the account on the sale of the equipment.

Calculations and explanatory notes:

(a) Change in fair value between 1 January 20X0 and 1 July 20X1: CU125,000 less CU24,475 = CU100,525.

(b) Cost of equipment: CU750,000 ÷ 1.2 (spot rate on 1 July 20X1) = CU625,000.

(c) Depreciable amount: CU625,000 less CU25,000 = CU600,000.
Annual depreciation charge: CU600,000 ÷ 15 = CU40,000.
Depreciation charge for the six months from 1 July to 31 December 20X1: CU20,000.
Carrying amount of equipment at 31 December 20X1: CU625,000 less CU20,000 = CU605,000.

(d) Change in fair value of the expected cash flows = present value of (FCU750,000/1.55 less FCU750,000/1.47) = present value of (CU483,871 less CU510,204) = present value of CU(26,333).
The instructions say to ignore discounting, so for this purpose the change in the fair value of the expected cash flows = CU(26,333).
Because the change in the fair value of the expected cash flows is greater than the change in the fair value of the hedging instrument, there is no hedge ineffectiveness.

(e) Change in fair value of the expected cash flows, ignoring discounting = FCU750,000/1.47 less FCU750,000/1.20
= CU510,204 less CU625,000
= CU(114,796).
Because the change in the fair value of the expected cash flows is greater than the change in the fair value of the hedging instrument, there is no hedge ineffectiveness.

(f) Cumulative exchange gain recognised in other comprehensive income = CU24,47 + CU100,525 = CU125,000.
Reclassification of cumulative exchange gain to match with annual depreciation = CU125,000 ÷ 15 = CU8,333.
Reclassification of cumulative exchange gain to match with six months' depreciation = CU8,333 ÷ 2 = CU4,167.
Because the total depreciable amount of the equipment is CU600,000, an alternative method of calculation is (CU20,000 ÷ CU600,000) × CU125,000 = CU4,167.
Amount still to be reclassified at 31 December 20X1 = CU125,000 less CU4,167 = CU120,833.

(g) Additional impairment charge = CU605,000 less CU40,000 less CU400,000 = CU165,000.

(h) Appropriate reclassification of cumulative exchange gain for annual depreciation charge and impairment charge = (CU165,000 + CU40,000) ÷ CU600,000 × CU125,000 = CU42,703.

(i) Amount of cumulative exchange gains in other comprehensive income still to be reclassified at 31 December 20X2 = CU120,833(f) less CU42,703(h) = CU78,130.

(j) Depreciable amount at 1 January 20X3 = CU400,000 less CU20,000 = CU380,000. Depreciation for the five months ended 31 March 20X3 = CU380,000 ÷ 13.5 × 5 ÷ 12 = CU11,728.

(k) Carrying amount of the equipment on 31 May 20X3 = CU400,000 less CU11,728 = CU388,272.
Profit on sale = CU390,500 less CU388,272 = CU2,228.
Total accumulated depreciation and impairment at 31 May 20X3 = CU20,000 + CU40,000 + CU165,000 + CU11,728 = CU236,728.

Case study 2

The facts are the same as in Case study 1. As in Part C of that case study, assume that SME A designates a hedging relationship between the forward contract and the foreign exchange risk in the firm commitment in such a way as to qualify for hedge accounting.

Prepare disclosures sufficient to satisfy the requirements in Section 12 both for the year ended 31 December 20X0 and the year ended 31 December 20X1.

Answer to Case study 2

Extract from SME A's statement of comprehensive income for the year ended 31 December 20X0

	Note	20X0 CU	20W9 CU
Profit for the year (a)		XXX,XXX	XXX,XXX
Other comprehensive income			
…			
Gains on hedges of foreign exchange	18	24,475 [(b)]	-
Total comprehensive income for the year		**XXX,XXX**	**XXX,XXX**

Extract from SME A's notes to financial statements for the year ended 31 December 20X0

Note 2 Accounting policies

Foreign exchange forward contracts

Foreign exchange forward contracts are occasionally entered into to manage exposure to foreign exchange rate risk on firm commitments or highly probable forecast transactions to purchase specialised imported equipment.

Forward contracts are initially recognised at fair value at the date the contract is entered into and are subsequently remeasured to their fair value at the end of each reporting period. The resulting gain or loss is recognised in profit or loss immediately, unless the forward contract is designated and effective as a hedging instrument, in which case the effective portion of the gain or loss is recognised in other comprehensive income and the ineffective portion, if any, is recognised in profit or loss.

Amounts previously recognised in other comprehensive income are reclassified to profit or loss in the periods when the cost of the specialised equipment is recognised in profit or loss in the form of depreciation/impairment, or on sale.

Hedge accounting is discontinued if the hedging relationship is revoked, if the forward contract expires, is sold, terminated, or exercised, or when the relationship no longer qualifies for hedge accounting. Provided the forecast transaction is still highly probable, any cumulative gain or loss recognised up to that date continues to be deferred in other comprehensive income and will be recognised in profit or loss when the specialised equipment is depreciated, impaired or sold. If a hedged forecast transaction or firm commitment is no longer expected to occur, the cumulative gain or loss recognised in other comprehensive income is recognised immediately in profit or loss.

The fair value of the foreign exchange forward contracts is determined by reference to forward exchange rates for contracts which, at the end of the reporting period, have the same maturities as those held by the entity, and discounting the difference between the cash flows specified in the contract held by the entity and those that would occur using the forward rate relevant at the end of the reporting period, using a risk free rate, usually EURIBOR, to reflect the time value of money.

Note 18 Hedge reserve

On 1 November 20X0, the company entered into a firm commitment to purchase an item of specialised equipment for FCU750,000 with cash payment to be made on the delivery date of 1 July 20X1. On 1 November 20X0, the company also entered into an eight-month foreign currency forward contract and designated it as a hedge of the foreign exchange risk under the firm commitment.

On 31 December 20X0, the fair value of the forward contract was CU24,475, the entire amount of which represents a gain. The entire gain of CU24,475 was recognised in other comprehensive income. The net gain or loss at 1 July 20X1 will be reclassified to profit or loss in the same periods during which the specialised equipment affects profit or loss. This will be in the periods following 1 July 20X1 when the equipment is depreciated or any impairment expense is recognised. The item of equipment will be depreciated from 1 July 20X1 over its 15-year life to its scrap value.

In 20X0 (and 20W9) the company had no other hedging relationships.

Extract from SME A's statement of comprehensive income for the year ended 31 December 20X1

	Note	**20X1** **CU**	**20X0** **CU**
Profit for the year		XXX,XXX	XXX,XXX
Other comprehensive income			
…			
Gains on hedges of foreign exchange net of gains reclassified to profit or loss	20	96,358[c]	24,475
Total comprehensive income for the year		**XXX,XXX**	**XXX,XXX**

Extract from SME A's notes to financial statements for the year ended 31 December 20X1

Note 2 Accounting policies

Same as in extracts from financial statements for the year ended 31 December 20X0 above.

Note 20 Hedge reserve

On 1 July 20X1 the company purchased an item of equipment for FCU750,000 (CU625,000); the contract for the purchase was entered into on 1 November 20X0. On 1 November 20X0, the company also entered into an eight-month foreign currency forward contract, to receive FCU750,000 and pay CU500,000, and designated it as a hedge of the foreign exchange risk under the firm commitment. The hedge was effective in offsetting the changes in the expected cash flows under the firm commitment that were due to foreign exchange risk.

	20X1 CU		20X0 CU
Accumulated gains on hedging instruments in effective hedges of forecast transactions recognised in other comprehensive income at the beginning of the year	24,475		–
Gains arising in the year on hedging instruments recognised in other comprehensive income in the year	100,525	(d)	24,475
	125,000		24,475
Reclassified from other comprehensive income to profit or loss in the year	(4,167)	(e)	-
Accumulated gains on hedging instruments in effective hedges of forecast transactions recognised in other comprehensive income at the end of the year	**120,833**		**24,475**

On 31 December 20X0, the fair value of the foreign currency forward contract was CU24,475.

At 1 July 20X1, when the forward contract matured, CU125,000 in gains on the forward contract had been recognised in other comprehensive income. These gains are being reclassified to profit or loss in the same periods in which the specialised equipment affects profit or loss through depreciation and, if relevant, impairment. Depreciation of the equipment commenced on 1 July 20X1 and will continue over the equipment's 15-year estimated useful life. At 31 December 20X1 the amount of gains still to be reclassified to profit or loss totals CU120,833.

In 20X1 and 20X0 the company had no other hedging relationships.

Gains and reclassifications from hedge accounting

The calculations and explanatory notes below do not form part of the proposed disclosures:

(a) Had there been any hedge ineffectiveness, it would have been included in the “Profit for the year”. However, in this example there was no hedge ineffectiveness (see Case study 1).

(b) Change in fair value of the forward contract from 1 November 20X0 to 31 December 20X0 less hedge ineffectiveness = CU24,475 (see case study 1).

(c) CU96,358 = the change in fair value between 1 January 20X1 and 1 July 20X1 (CU100,5252—see note (d)) less the amount reclassified to profit or loss to match with six months’ depreciation (CU4,167—see note (e)).

(d) Change in fair value between 1 January 20X1 and 1 July 20X1 = CU100,525 (see Case study 1, note (a)).

(e) Reclassification of cumulative exchange gain to match with six months’ depreciation = CU4,167 (see Case study 1, note (f)).