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# SLFRS 9, LKAS 32
# Financial Instruments

## Chartered Accountancy
## Strategic Level

Advanced Business Reporting (ABR)

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# SLFRS 9 Financial Instruments

## Definitions
- Financial Instrument
- Financial Asset
- Financial Liability
- Equity instrument

## Financial Asset classification
- Business model test + Cash flow characteristics test
- Types of FA –
  - FVTPL
  - Amortized cost
  - FVTOCI -Equity
  - FVTOCI - Debt
- Designating items under FVTPL

## FA – Initial Recognition
- FVTPL - @ FV
- Others - @ FV + Txn cost
- Initial FV measurement

## FA – Subsequent measurement
- FVTPL - @ FV – Changes in FV to P&L
- Amortized cost = initial value + interest on effective rate – repayments - impairment
- FVTOCI - @ FV – Changes in FV to OCI

## Financial Liability classification
- Based on Intention of the FL
- FL held for trading at FVTPL
- Other FL at amortized cost
- Initial recognition and subsequent measurement



# SLFRS 9 Financial Instruments (Cont.)

## Derecognition of FA
- When to Derecognize
- Accounting for sale of FA

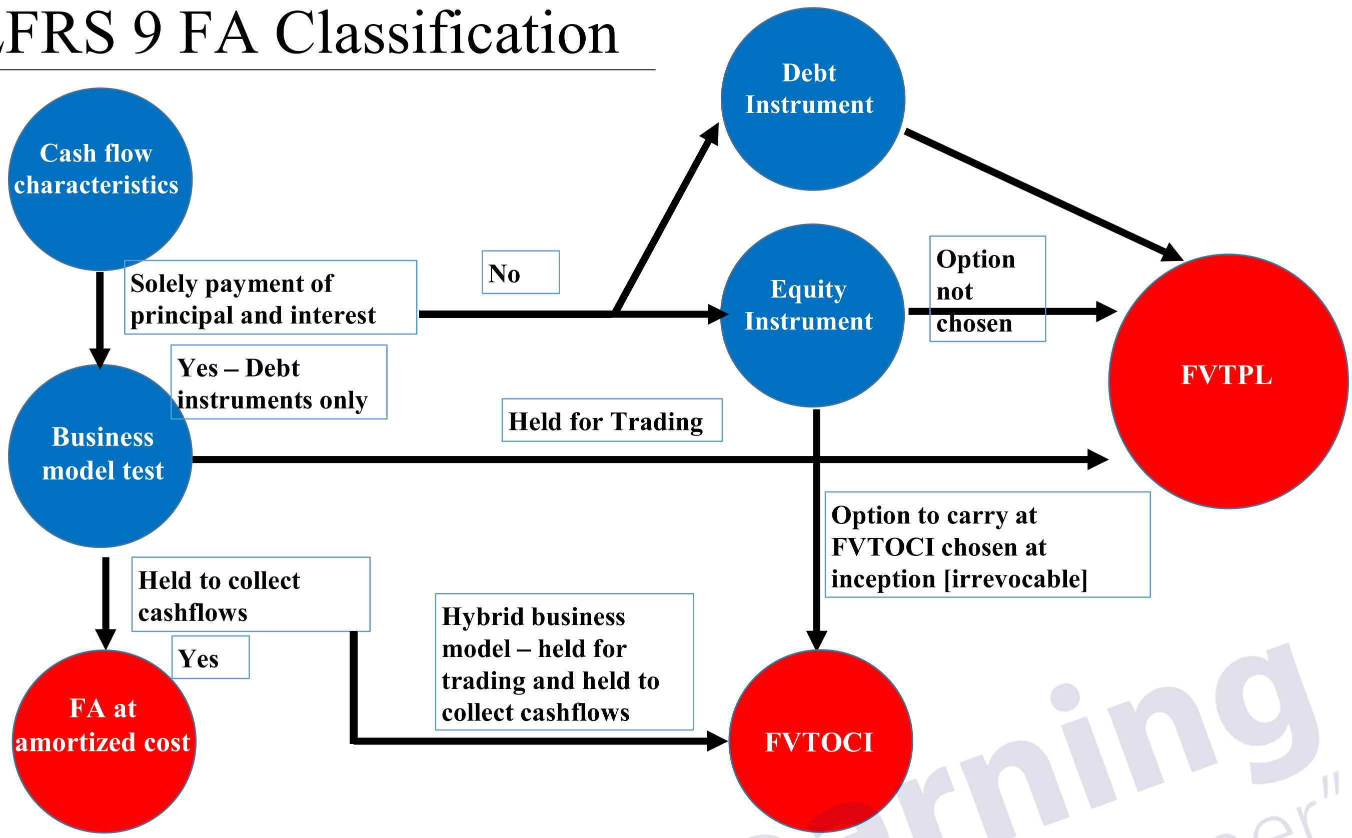
## Reclassification of FA
- Allowed only when business model changes which is considered to be rare
- Cannot reclassify
  - FVTOCI – Equity
  - Items designated as FVTPL
  - FL
- Accounting for reclassification

## Derivatives
- Definition
- Examples and accounting

## Classification of Equity and Liability
- Definition
- Examples
- Compound instruments

## Netting off FA and FL
- Allowed if legal and enforceable right to net and have an intention to settle net

# SLFRS 9 FA Classification






# SLFRS 9 FA - Reclassifications

| Existing classification | New classification | Accounting requirements |
|---|---|---|
| Amortized cost | FVTPL | On reclassification date measure at FV. Difference between CA and FV taken to P&L |
| Amortized cost | FVTOCI | On reclassification date measure at FV. Difference between CA and FV taken to OCI |
| FVTPL | Amortized cost | On reclassification date measure at FV. That FV is the initial amount to for amortized cost calculation |
| FVTPL | FVTOCI | No adjustment on reclassification. FV continues. Future FV changes taken to OCI |
| FVTOCI | FVTPL | On reclassification date cumulative FV adjustment in OCI is transferred to P&L. FV continues. Future FV changes taken to P&L |
| FVTOCI | Amortized cost | On reclassification date cumulative FV adjustment in OCI is netted off against CA. Results in the original amortized cost continuing |

# SLFRS 9 FA - Impairment

## Applies to

- FA at amortized cost –
  - ➢Loans granted
  - ➢Trade receivables
  - ➢Lease receivables etc
- FA at FVTOCI – Debt instruments - Debentures
- Not applicable to FVTPL and FVTOCI Equity instruments

## Requirements

Classify portfolio into stages for significant customers and others

1.) Performing – No overdues, no indication of impairment

2.) Underperforming – Significant increase in credit risk - existence of overdue payments

3.) Non Performing – Clear evidence of impairment

## Measuring impairment

| Category | Impairment allowance | Interest recognition |
|---|---|---|
| 1.) Performing portfolio | 12 month expected credit loss | On GROSS receivable (ie. On capital O/S <u>before</u> impairment) |
| 2.) Under Performing portfolio | Life time expected credit loss | On GROSS receivable (ie. On capital O/S <u>before</u> impairment) |
| 3.) Non Performing portfolio | Life time expected credit loss | On NET receivable (ie. On capital O/S <u>after</u> impairment) |



# SLFRS 9 FA - Impairment

## Significant Deterioration triggers

- Non-exhaustive list of factors or indicators to consider

Multifactor analysis

- Market indicators (Credit spread, CDS…)
- Operating results Of the borrower (revenues, margins etc.)
- Business, financial or economic conditions (Interest rate, unemployment..)
- External rating (current or expected downgrading)
- Regulatory, economic or technological environment
- Rate/ terms applicable to similar contracts
- Collateral, guarantee or financial support, if they impacts the PD
- Internal rating / score (current or expected downgrading)
- Payment status and behaviour
- Credit risk management approach / Close monitoring
- Delinquency (Negligence)
- Forbearance / Self Control (current or expected)
- Contagion (harmful contract)

# SLFRS 9 FA - Impairment

**Expected credit loss (ECL) measurement**

- Use best available information
  - About past events
  - About current conditions
  - Reasonable and supportable forecasts
- Use unbiased and probability weighted estimate
- Consider time value of money

**Calculation of ECL – using PD's**

ECL = EAD x PD x LGD x DF

EAD = Exposure at default ie. Amount outstanding at the time of default taking place

PD = Probability of Default ie. The chance of default taking place

LGD = Loss Given Default ie. When default takes place the actual loss that occurs

DF = Discounting Factor ie. To bring the loss to present value

**Illustration 1**

Debtors owes a total of Rs. 100,000 to A Ltd and is due for payment in 1 year from now. Based on historical experience A Ltd estimates 15% of debtors will go bankrupt and by selling the assets they have A Ltd can recover 80% of the balance outstanding. Applicable discount rate is 10%

ECL = 100,000 x 15% x 20% x [1/(1+10%)^1]
= 2,727



# SLFRS 9 FA - Impairment

**Illustration 2 – Impairment of loan carried at amortized cost**

Scenario – A Ltd granted loans totaling to 1,000 to customers which is to be repaid in annual installments of 230 each over 6 years. The effective interest rate is 10%p.a.

| | Description | Amount (Rs') |
|---|---|---|
| Year 1 | Opening balance | 1000 |
| | Interest at 10% | 100 |
| | Repayments | (230) |
| | **Closing balance** | **870** |

End of Year 1 – A Ltd concludes that there's NO significant increase in credit risk and categorizes the loan as Stage 1 – Performing. Therefore it measures expected credit losses based on 12 month ECL.
The 12 month PD is estimated at 2% while the lifetime PD is 5% and LGD is estimated at 90%.
At end of Year 1 A Ltd grants new loans at a rate of 12%p.a and the Treasury bill rate is 8%p.a.

ECL = (870 x 1.1) x 2% x 90% x [1/1.1]
= 15.66

**Discount using Original Effective Rate (O/E/R)**

Gross carrying amount loan = 870
Impairment provision = (15.66)
Net carrying amount of loan = 854.34

# SLFRS 9 FA - Impairment

**Illustration 2 – Impairment of loan carried at amortized cost**

| | Description | Amount (Rs') |
|---|---|---|
| Year 2 | Opening balance | 870 |
| | Interest at 10% | 87 |
| | Repayments | (230) |
| | **Closing balance** | **727** |

**Interest calculated on gross carrying amount**

**End of Year 2 – A Ltd concludes that there IS a significant increase in credit risk and categorizes the loan as Stage 2 – Under Performing. Therefore it measures expected credit losses based on life time ECL.**
**The PD is estimated at 6% and LGD is estimated at 90%.**

**ECL = 727 x 6% x 90%**
**= 39.26**

**Gross carrying amount loan = 727**
**Impairment provision = (39.26)**
**Net carrying amount of loan = 687.74**



# SLFRS 9 FA - Impairment

**Illustration 2 – Impairment of loan carried at amortized cost**

| | Description | Amount (Rs') |
|---|---|---|
| Year 3 | Opening balance | 727 |
| | Interest at 10% | 72.7 |
| | Repayments | (150) |
| | **Closing balance** | **649.7** |

**Interest calculated on gross carrying amount**

**End of Year 3 – A Ltd concludes that there IS a significant increase in credit risk and there is objective evidence of impairment and categorizes the loan as Stage 3 – Non Performing. Therefore it measures expected credit losses based on life time ECL.**
**The PD is estimated at 70% and LGD is estimated at 90%.**

**ECL = 649.7 x 70% x 90%**
**= 409.31**

**Gross carrying amount loan = 649.7**
**Impairment provision = (409.31)**
**Net carrying amount of loan = 240.39**

# SLFRS 9 FA - Impairment

**Illustration 2 – Impairment of loan carried at amortized cost**

| | Description | Amount (Rs') |
|---|---|---|
| Year 4 | Opening balance | 240.39 |
| | Interest at 10% | 24.04 |
| | Repayments | (50) |
| | **Closing balance** | **214.43** |

**Interest calculated on NET carrying amount**

**End of Year 4 – A Ltd concludes that there still IS a significant increase in credit risk and there is objective evidence of impairment and continues to categorize the loan as Stage 3 – Non Performing. Therefore it measures expected credit losses based on life time ECL.**
**The PD is estimated at 70% and LGD is estimated at 90%.**

**Gross carrying amount = 649.7 + 24.04 + (50) = 623.74**
**ECL = 623.74 x 70% x 90%**
**= 392.96**

**Gross carrying amount loan = 623.74**
**Impairment provision = (392.96)**
**Net carrying amount of loan = 230.78**



# SLFRS 9 FA - Impairment

**Illustration 2 – Impairment of loan carried at amortized cost**

**Summary of Financial statements**

| S/F/P Item | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|---|
| Gross amount | 1000 | 870 | 727 | 649.70 | 623.74 |
| Impairment provision | - | (15.66) | (39.26) | (409.31) | (392.96) |
| Net carrying amount | 1,000 | 854.34 | 687.74 | 240.39 | 230.78 |

| S/P&L Item | | Year 1 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|---|---|
| Interest income | | 100 | 87 | 72.70 | 24.04 |
| Impairment (provision) / reversal | | (15.66) | (23.60) | (370.05) | 16.36 |
| Net effect to Profit | | 84.34 | 63.40 | (297.35) | 40.39 |

# SLFRS 9 FA - Impairment

**Illustration 3 – Impairment of Debt instrument carried at FVTOCI**

**Scenario – X Ltd purchased debentures DEF PLC at a price of 5,000. the coupon rate was 10% and the effective rate was 13%. The face value was 6,000**

| | Description | Amount (Rs') |
|---|---|---|
| **Year 1** | Opening balance | 5,000 |
| | Interest at 13% | 650 |
| | Coupon interest | (600) |
| | **Closing balance** | **5,050** |

**End of Year 1 –**
**The fair value of the debenture was 4,800 due to market circumstances.**
**X Ltd concludes that there's NO significant increase in credit risk and categorizes the debenture as Stage 1 – Performing financial asset. Therefore it measures expected credit losses based on 12 month ECL.**
**The 12 month PD is estimated at 4% and life time PD is estimated at 12% LGD is estimated at 80%.**

**ECL = 5,050 x 4% x 80% = 161.6**

**Amortized cost = 5,050**
**Impairment provision = (161.6)**
**Amortized cost after impairment = 4,888.4**

**Amortized cost after Impairment = 4,888.4**
**Fair value = 4,800**
**FV adjustment (loss) in OCI = (88.4)**



# SLFRS 9 FA - Impairment

**Illustration 3 – Impairment of Debt instrument carried at FVTOCI**

| | Description | Amount (Rs') |
|---|---|---|
| **Year 2** | Opening balance | 5,050 |
| | Interest at 13% | 657 |
| | Coupon interest | (600) |
| | **Closing balance** | **5,107** |

**End of Year 2 –**
**The fair value of the debenture was 4,850 due to market circumstances.**
**X Ltd concludes that there's NO significant increase in credit risk and categorizes the debenture as Stage 1 – Performing. Therefore it measures expected credit losses based on 12 month ECL.**
**The PD is estimated at 5% and LGD is estimated at 80%.**

**ECL = 5,107 x 5% x 80% = 204.26**

**Amortized cost = 5,107**
**Impairment provision = (204.6)**
**Carrying amount after impairment = 4,902.24**

**Carrying amount after Impairment = 4,902.24**
**Fair value = 4,850**
**FV adjustment (loss) in OCI = (52.24)**

# SLFRS 9 FA - Impairment

**Illustration 3 – Impairment of Debt instrument carried at FVTOCI**

**Summary of Financial statements**

| **S/F/P Item** | **Year 0** | **Year 1** | **Year 2** |
|---|---|---|---|
| Gross amount | 5000 | 5,050 | 5,107 |
| Impairment provision | - | (161.60) | (204.26) |
| Amortized cost | 5,000 | 4,888.40 | 4,902.24 |
| FV adjustments | - | (88.40) | (52.24) |
| FV / Carrying amount | 5,000 | 4,800 | 4,850 |

| **S/P&L Item** | | **Year 1** | **Year 2** |
|---|---|---|---|
| Interest income | | 650 | 657 |
| Impairment (provision) / reversal | | (161.60) | (42.66) |
| **Net effect to Profit for the period** | | **488.40** | **613.84** |
| OCI | | | |
| FV change in FA carried at FVTOCI | | (88.40) | 36.16 |



# LKAS 32 FI - Presentation

**Equity or Liability?**

**Contractual obligation to pay cash (either Principal or Interest / return) ?**

- Yes → **Financial Liability**
- No → **Contract to be settled in fixed number of equity instruments**
  - No → **Financial Liability**
  - Yes → **Equity instrument**

**Exceptions – certain puttable instruments**

**Puttable instruments requires the issuer to redeem the instrument on the exercise of the put**

**These instruments are classified as equity if,**

- **Entitles holder to net assets on liquidation**
- **Ranks below all other instruments**
- **Returns are based on profit or losses**

**Compound Instruments**

**Such as Convertible Debentures**

**Split the initial value between liability component & equity component**

**Liability component = PV of CF discounted using interest rate of a similar instrument without the conversion option**

**Equity Component = Balance amount = Issue value less liability component**

# LKAS 32 FI - Presentation

**Illustration**

**GEF Ltd on 1st Jan 2020 issued a debentures worth 10,000 at a coupon interest of 7% p.a. These debentures carry a conversion option where on the maturity date these can be converted to 100 shares or be settled in cash. The maturity date is 31st Dec 2023.**

**A debenture of a similar company without the conversion option would have a coupon interest of 10% p.a.**

**GEF incurred transaction cost of 100 on the issue of these debentures**

**<u>Step 1 - Calculation of liability component</u>**
**PV of CF discounted using interest rate of a similar instrument without the conversion option**

| Year | CF | DF @10% | PV |
|---|---|---|---|
| 1 | 700 | 0.909 | 636 |
| 2 | 700 | 0.826 | 579 |
| 3 | 10,700 | 0.751 | 8,039 |
| | | | **9,254** |

**<u>Step 2 - Calculation of equity component</u>**
**The balance amount**
**10,000 – 9,254 = 746**

**<u>Step 3 – Allocation of transaction cost between equity and liability components</u>**

**To liability component = 100 x (9,254/10,000) = 92.54**
**To equity component = 100 x (746/10,000) = 7.46**

**<u>Step 4 – Recalculate effective interest rate on liability component</u>**

**Initial value of liability component = 9,254 – 92.54 = 9,161.46**

**Effective rate that makes PV of CF equal to 9,161.46 = 10.40%**

**<u>Step 5 – Accounting for the instrument on the issue date</u>**

| | | |
|---|---|---|
| **Cash** | **Dr** | **10,000 – 100 = 9,900** |
| **Liability – Debenture** | **Cr** | **= 9,161.46** |
| **Equity option** | **Cr** | **= 746** |
| **Retained earnings** | **Dr** | **= 7.46** |



# LKAS 32 FI - Presentation

**Illustration continued**

**<u>Step 6 – Subsequent accounting for liability component</u>**

| Date | Description | Amount |
|---|---|---|
| 1.1.2020 | Opening balance | 9,161.46 |
| 2020 | Interest at 10.40% | 952.37 |
| 31.12.2020 | Coupon interest payment | (700) |
| **31.12.2020** | **Balance** | **9,413.83** |
| 2021 | Interest at 10.40% | 978.60 |
| 31.12.2021 | Coupon interest payment | (700) |
| **31.12.2021** | **Balance** | **9,692.43** |
| 2022 | Interest at 10.40% | 1,007.57 |
| 31.12.2022 | Coupon interest payment | (700) |
| **31.12.2022** | **Balance** | **10,000.00** |

**<u>Step 7 – Financial statements extract</u>**

| **S/F/P as at** | **1.1.2020** | **31.12.2020** | **31.12.2021** | **Before settlement 31.12.2022** | **Option 1 - Settlement - by Cash** | **Option 2 - Settlement - by shares** |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Cash | + 9,900 | | | | (-) 10,000 | - |
| | | | | | | |
| **Equity** | | | | | | |
| Share capital | XXX | | | | | XXX + 10,000 + 746 |
| Retained earnings | XXX - 7.46 | | | | XXX + 746 | XXX |
| Equity option | 746 | 746 | 746 | 746 | - | - |
| | | | | | | |
| **Liabilities** | | | | | | |
| Debentures | 9,161.46 | 9,413.83 | 9,692.43 | 10,000 | - | - |

| **S/P&L for the year ended** | | **31.12.2020** | **31.12.2021** | **31.12.2020** | **Total** |
|---|---|---|---|---|---|
| | | | | | |
| **Finance cost** | | | | | |
| Interest on debentures | | (952.37) | (978.60) | (1,007.57) | **(2,938.54)** |
| | | | | | |
| **Profit before tax** | | **XXX** | **XXX** | **XXX** | **XXX** |

# SLFRS 9 FI - Derivatives

### Definition

- Requires little or no initial investment
- Value changes based on an underlying variable such as interest rate / exchange rate
- To be settled at a future date

### Examples

- Forward exchange contracts
- Interest rate swaps

### Accounting

- At fair value in the SFP
- Changes in fair value recognized in P&L



# SLFRS 9 FI - Derivatives

**Illustration 1 – Forward Exchange Contract**

On 1 Jan 2020

ABC Ltd ← Obtains a loan of USD 1 Repayable on 31 Dec 2020 — Bank of America

**Exchange rate 1 USD : 100 LKR**

**ABC is not certain of the exchange rate on 31 Dec 2020 Therefore enters into a contract with HSBC Sri Lanka to buy 1 USD on 31 Dec 2020 at 124**

**This safeguards ABC from any unexpected movement in exchange rates**
**Regardless of the exchange rate on 31st Dec 2020, ABC has the right / commitment to purchase 1 USD at 124 from HSBC**

**On 31 Mar 2020 exchange rate increases to 1 USD : 130 LKR**

**On this date if a 3rd party requests a quote from HSBC to buy 1 USD on 31st Dec 2020, HSBC will quote a rate of 1 USD : 148 LKR**

**This results in an advantageous position to ABC and their contract to purchase 1 USD on 31 Dec 2020 will have a value**

**This happens due to change in exchange rates. At the start of the contract ABC did not incur any expenses and the contract is to be settled in the future.**

**Therefore this forward exchange contract satisfies the conditions to be a derivative**

# SLFRS 9 FI - Derivatives

**Illustration 1 – Forward Exchange Contract**

**Summary of Financial statements**

| **Description** | **Calculation reference** | **As at 1 Jan 2020** | **As at 31 Mar 2020** | **As at 30 June 2020** | **As at 30 Sep 2020** | **As at 31 Dec 2020** |
|---|---|---|---|---|---|---|
| Exchange rate 1 USD : LKR | A | 100 | 130 | 140 | 132 | 150 |
| Forward exchange rate to buy 1 USD on 31 Dec 2020 | B | 124 | 148 | 152 | 138 | 150 |
| Contracted rate by ABC Ltd | C | 124 | 124 | 124 | 124 | 124 |
| Value of the forward exchange contract | D = B - C | - | 24 | 28 | 14 | 26 |
| Amount of USD contracted to purchase | E | 1 | 1 | 1 | 1 | 1 |
| Total value of the contract | F = D x E | - | 24 | 28 | 14 | 26 |
| Change in fair value | G = Change in value of F | | 24 | 4 | (14) | 12 |



# SLFRS 9 FI - Derivatives

**Illustration 1 – Forward Exchange Contract**

**Summary of Financial statements**

| **S/F/P as at** | | **As at 1 Jan 2020** | **As at 31 Mar 2020** | **As at 30 June 2020** | **As at 30 Sep 2020** | **As at 31 Dec 2020** |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Derivative Asset | F | - | 24 | 28 | 14 | 26 |
| | | | | | | |
| **Liabilities** | | | | | | |
| FCY Loan | H = A x Loan amount | 100 | 130 | 140 | 132 | 150 |

| **S/P&L for the quarter ended** | | | **31 Mar 2020** | **30 June 2020** | **30 Sep 2020** | **31 Dec 2020** | **Total for 2020** |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| **Other income and expenses** | | | | | | | |
| FV change in derivative | I = G | | 24 | 4 | (14) | 12 | 26 |
| Exchange gain / (loss) on FCY loan | J = Change in value of FCY loan | | (30) | (10) | 8 | (18) | (50) |
| **Net effect to profit for the period** | **K = I + J** | | **(6)** | **(6)** | **(6)** | **(6)** | **(24)** |

# SLFRS 9 FI - Derivatives

**Illustration 2 – Interest rate swap**

**Com Bank** → **XYZ Ltd** → **Investment**

**Obtains a loan of 1,000 at fixed interest rate of 10% p.a.**

**Makes an investment which gives a return of AWPLR + 2%**

**The period of the loan and investment is 5 years**

**Current AWPLR = 9%**

**XYZ is not certain of the interest rate in the future and if the interest rate (AWPLR) drops below 8% they will incur losses.**

**To safeguard them from this risk they enter into the following contract**

**XYZ Ltd**

**Notional capital = 1,000**

**HNB**

**Pays HNB AWPLR + 1%**

**Receives from HNB 10% fixed interest**

**This results in XYZ being safeguarded from the changes in the AWPLR**

**Whatever the AWPLR is XYZ will always have a 1% margin over it**

**Through this arrangement XYZ has SWAPPED its fixed interest loan from Com Bank to a variable interest loan. This is called an Interest Rate Swap (IRS)**



# SLFRS 9 FI - Derivatives

**Illustration 2 – Interest rate swap**

**Cashflows arising from the Interest Rate SWAP**

| **Description** | **Calculation reference** | **2020** | **2021** | **2022** | **2023** | **2024** |
|---|---|---|---|---|---|---|
| AWPLR (at the beginning) | A | 9% | 13% | 6% | 17% | 3% |
| **Income - Interest received** | | | | | | |
| From Investment - AWPLR + 2% | B = 1,000 x (AWPLR + 2%) | 110 | 150 | 80 | 190 | 50 |
| From HNB - Fixed at 10% | C = 1,000 x 10% | 100 | 100 | 100 | 100 | 100 |
| | | | | | | |
| **Expense - Interest paid** | | | | | | |
| To Com Bank - Fixed at 10% | D = 1,000 x 10% | (100) | (100) | (100) | (100) | (100) |
| To HNB - AWPLR + 1% | E = 1,000 x (AWPLR + 1%) | (100) | (140) | (70) | (180) | (40) |
| | | | | | | |
| **Net effect to Profit for the period** | **F = B + C + D + E** | **10** | **10** | **10** | **10** | **10** |

# SLFRS 9 FI - Derivatives

**Illustration 2 – Interest rate swap**

**Measuring and accounting for the FV changes in the IRS**

| Description | 1.1.2020 | 31.12.2020 | 31.12.2021 | 31.12.2022 | 31.12.2023 | 31.12.2024 |
|---|---|---|---|---|---|---|
| FV or IRS - Asset / (Liability) | - | (120) | 75 | (150) | 60 | - |
| FV change to be recognized in P&L | | (120) | 195 | (225) | 210 | (60) |

**Generally measured at PV of expected cash flows from the IRS**

**Cashflows could either be positive or negative. If expected cash flows are positive the FV of the IRS is an Asset and if the expected cashflows are negative the FV of the IRS is a liability**



# Hedge Accounting

## Definition

- **Hedge – Action of managing a risk**

- **Hedge item – item that is exposed to the risk the entity has chosen to Hedge**

- **Could be,**
- **Recognised asset or liability or**
- **Unrecognised firm commitment**
- **Highly probable forecast transaction**
- **Net investment in a foreign operation**

- **Hedge instrument – instrument used to minimize the risk – such as, Derivative with third parties**

## Types of hedges

- **Fair value hedge**

- **Hedge of exposure to changes in fair value of,**
  - ✓ **a recognised asset or liability / an unrecognised firm commitment**
  - ✓ **that is attributable to a particular risk**
  - ✓ **could affect profit or loss**

- **Cashflow hedge**

- **Hedge of exposure to variability in cash flows that is,**
  - ✓ **attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction**
  - ✓ **could affect profit or loss**

# Hedge Accounting

## Accounting

- **Hedge accounting is voluntary**

- **Fair value hedge –**
**e.g.-** FV hedge on bond prices
- **Change in FV of Hedge Item and Hedge Instrument accounted in P&L**
- **Except where the hedge item is an equity instrument where the entity has chosen the FVTOCI option – in this case the FV changes are reflected in OCI**
- **No segregation as effective and ineffective**

- **Cashflow hedge –**
E.g.
- using an interest rate swap to hedge the interest rate risk of a floating rate interest-bearing asset or liability
- using a forward contract to hedge the foreign currency risk of foreign currency denominated future operating lease or payroll payments;
- using a forward contract to hedge the commodity price risk of highly probable forecast purchase or sale transactions.

- **Change in FV of Hedge Item and Hedge Instrument accounted in OCI – if EFFECTIVE**
- **If INEFFECTIVE – the ineffective portion is transferred to P&L**
- **A CashFlow Hedge Reserve (CFHR) is created in equity which will be the lower of (in absolute amounts)**
  - ✓ **Cumulative gain/loss on the hedge INSTRUMENT from inception of the hedging relationship**
  - ✓ **Cumulative change in FV of the Hedge ITEM from inception of the hedging relationship**
- **The remaining component of FV change after adjusting the CFHR as above is recognized in P&L – this is the INEFFECTIVE portion**



# Hedge Accounting

## Hedge accounting criteria

- **Only on eligible Hedge ITEMs and Hedge INSTRUMENTS**
- **At the inception of the hedge formal designation and documentation is required. Documentation should include,**
- **Hedge relationship and the entity's risk management objective and strategy**
- **Identification of the hedged ITEM and INSTRUMENT**

- **The nature of the risk being hedged and how the entity will measure the hedge effectiveness**

## Flexibility in determining the type of hedge

- **A hedge of the foreign currency risk of a firm commitment may be designated as a fair value hedge or as a cash flow hedge**
- **A forward contract to buy foreign currency may be designated as the hedging instrument in a fair value hedge of a foreign currency financial liability, or alternatively in a cash flow hedge of the forecast settlement of that liability**
- **A receive-fixed - pay-floating interest rate swap may be designated as a fair value hedge of a fixed interest liability or as a cash flow hedge of a variable interest asset.**