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IAS® Standard 39 Financial Instruments: Recognition and Measurement

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CASE STUDY - IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

Introduction

Entities face many different risks in the current economic system. It has been one of the duties of the managers to identify the possible negative effects of these risks on the financial performance of the entities and to control this effect. The effects of these risks on financial transactions and the control of the negative consequences of this effect with financial instruments are within the scope of IAS 39.

Certain conditions must be met for the application of hedge accounting. For hedge accounting, the characteristics of the hedged item and the related financial instrument must match within certain conditions. In this case, it is aimed to explain the relationship between hedged item and derivative instrument and to explain how hedge accounting is applied.

The Case Information

Babylon Company has been providing national and international transportation services. Although the entity has grown strongly since its foundation, it has always needed good management in a sector where there is a very strong competition. The transportation sector was one of the sectors that had significant operational risks and that these risks need to be managed continuously. However, despite all its risks, the transportation sector has been pleasing its investors as it transforms the successful financial performances of well-managed companies into high profitability figures.

At the beginning of 2022, the financial manager of the Babylon Company stated that they should pay attention to the rising risks in energy prices and that they should take precautions accordingly. However, upper management and executives in charge of operations stated that economic activity in the world is increasing slowly and that the increase in fuel prices will be limited in this environment. Top managers stated that the storage costs of the fuel to be purchased would be high. The finance manager then decided to buy an option to at least make money from the increase in fuel prices.

After short research, the finance manager decided that it would be appropriate to invest in crude oil futures contracts. Shortly after the finance manager bought the futures contract, the negative news that affected the whole world caused the fuel prices to rise rapidly. The finance manager has made a substantial profit by realizing his futures investment.

But the news from the operation side is not good at all. Rising fuel prices had negative consequences on costs. As a precaution against the increase in fuel prices, taking and storing fuel from the front caused a significant storage cost. However, before these extra fuels were used from the tanks, the world's fuel prices fell again and reached the old level, which increased the fuel and storage losses of the enterprise to significant levels. At the end of the year, the fuel cost of the Babylon Co. in 2022 was CU5,000,000, while the fuel cost in the warehouses was CU4,000,000. This change in fuel prices negatively affected the profitability trend of the enterprise. And next year would be even worse due to fuel purchased at a high price in 2022 and most of it not yet used.

While considering ways to reduce the possible impact of the increase in fuel costs on the financial statements, the finance manager thought of applying hedge accounting. In their meeting with the finance manager, accounting and operations managers, they calculated that they had purchased an additional CU6 million fuel due to the increase in fuel prices. The finance manager stated that he made

a profit of CU5.5 million with the futures contract. And he stated that profits from futures investment and cost increase can be hedged. The accounting manager also stated that this could happen. He added that 2.5 million CU's of the additional cost in fuel is transferred to the cost of service account and the remaining amount is kept in ending inventory.

Discussion Questions

a. Show how the financial statements of Babylon Company will be affected in case of using or not using hedge accounting.
b. Is it appropriate for the entity to use hedge accounting?

SOLUTION OF CASE STUDY- IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

a. If hedge accounting will be applied, this will be cash flow hedge. In this case, the hedge item is the fuel price. In case of cash flow hedge, gains and losses arising from hedged item and hedge instrument must be measured and recognized separately. In this case, Babel Co calculated that it had spent CU6 million more due to the increase in fuel prices. As CU2.5 million of this additional expenditure is used, it has been transferred to the cost of service. The remaining CU3.5 million are in the ending inventory and when used next year it will be transferred to the cost of service.

The profit from the futures transaction is CU5.5 million. For hedge accounting, this gain should not be directly transferred to profit and loss but should be recognized in other comprehensive income. Gains from the futures transactions should transferred to profit and loss in the same period as gains and losses arising from the fuel price. Then some portion of futures gain should be used to offset the cost of service in 2022. The remaining amount will be used to offset cost of service of 2023 due to the usage of the high-priced fuel. Calculations and 2022 cost of service offset record are as follows.

	Total	**2022**	**2023**
Fuel	(6,000,000)	%40 (2,400,000)	%60 (3,600,000)
Futures	5,500,000	2,200,000	3,300,000
Total	(500,000)	200,000	300,000

Dr. Unrealized Gain from Futures (OCI) 2,200,000

Cr. Cost of Service 2,200,000

With this entry, a portion of the increased cost of service due to the increase in the fuel price will be offset by a portion of the profit from the futures transaction determined as a hedge item.

b. Simply NO. To apply hedge accounting, the transaction must provide hedge qualification. For hedge qualifications there are some conditions:

1) Formal designation and documentation of the hedging relationship, entity's risk management strategy, and strategy for undertaking the hedge at its inception.
2) High hedge effectiveness
3) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
4) Reliable measurement of hedge effectiveness
5) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

In this case, we see that the hedging relationship at the initial stage is not documented. More importantly, it is understood that the risk of increase in fuel prices was not determined as a significant risk by the management at the very beginning. For this reason, the hedge accounting applied above has not been made in accordance with the rules specified in IAS 39.