A Digital Learning Platform for Generation Z: Passport to IFRS®

IAS® Standard 39 Financial Instruments: Recognition and Measurement

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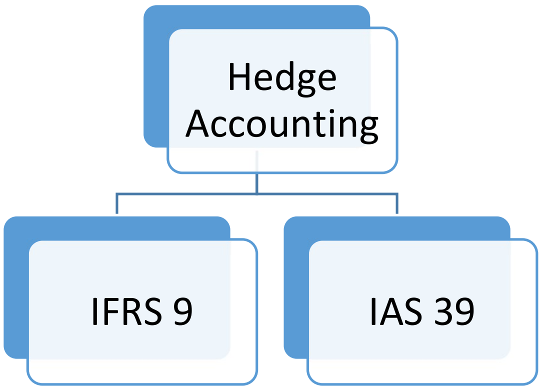
IAS® Standard 39: Financial Instruments: Recognition and Measurement

SCOPE AND OBJECTIVE

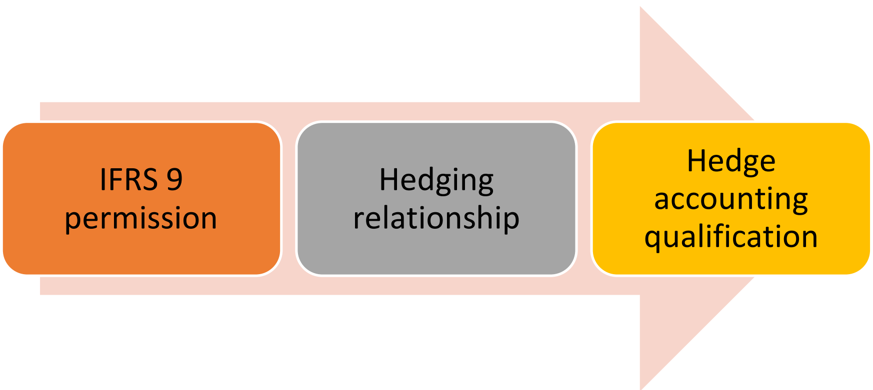
Before IFRS Standard 9 Financial Instruments, IAS Standard 39 Financial Instruments: Recognition and Measurement was the main standard for accounting for financial instruments. After IFRS 9 began to be implemented, IAS 39, which was intended to be repealed under normal circumstances, continued to be applied in a limited manner. IAS 39 contains hedge accounting regulations only, and for hedging accounting purposes, an entity can choose to apply IFRS 9 or IAS 39 requirements. Thus, as shown in figure 1 for hedge accounting purposes, there are two applicable standards. In terms of hedge accounting rules, IAS 39 is more complex than IFRS 9.

Figure 1: Application of Hedge Accounting



All entities can apply this standard to all financial instruments which are in the scope of IFRS 9 in accordance with the roadmap specified in Figure 2. However, first of all, there must be permission in IFRS 9 that the hedge accounting rules of IAS 39 can be applied. In addition, the relevant financial instrument should be part of the hedging relationship. And the relevant hedging relationship must have the hedge accounting qualification specified in IAS 39.

Figure 2: Usage of Hedge Accounting According to IAS 39



DEFINITIONS

The definitions used in IAS 39 are largely similar to those used in IFRS 9. Some basic definitions are presented below (IAS39.9):

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

A *hedging instrument* is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument

WHAT IS HEDGING?

Hedging is part of the risk management practices of entities. Hedging is the compensation of future adverse changes in the price or value of an asset with the income from financial instruments whose price changes in contrast to the asset value or price. Figure 3 shows the relationship between the hedging instrument and hedging item in a hedging transaction.

Figure 3: Hedging relationship between the hedged item and hedge instrument

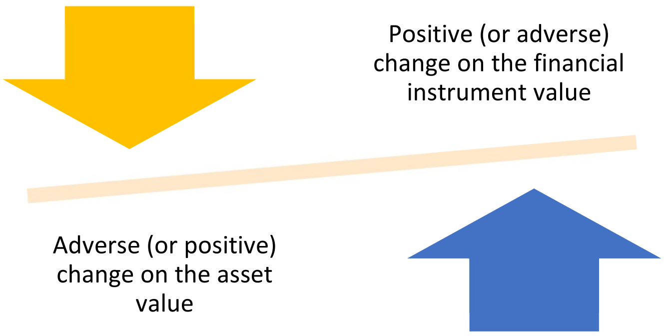
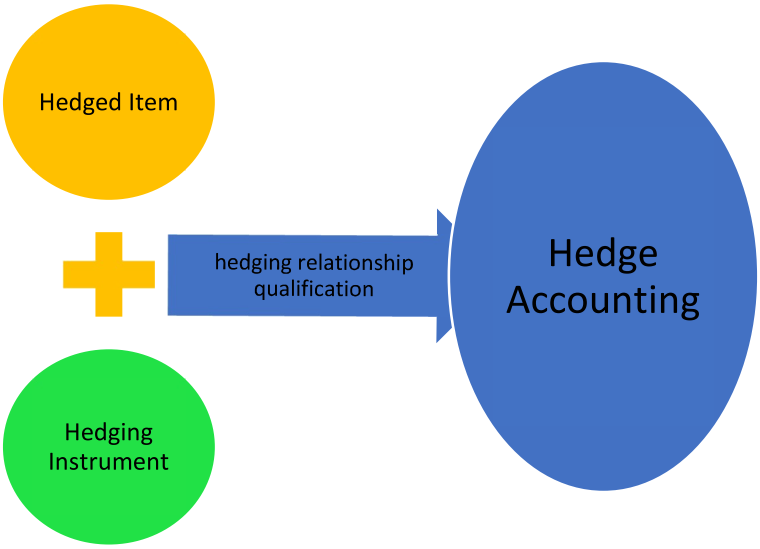


Figure 4 shows the hedging elements in a hedging transaction. In order to be able to make a hedging transaction, first of all, there must be an element that may adversely affect the future value due to various risks. This element can be an asset, liability, or potential cash flow. It is called hedged item. Then, there is a need for a financial instrument that can compensate for possible future losses that may arise from the hedged item. It is called hedging instrument. Hedging instrument can be a designated derivative or a non-derivative instrument.

Figure 4: Hedge Accounting Elements



Hedge accounting can be defined as reporting the results of various transactions made by entities in order to balance (manage, control) the decrease in value of their assets and/or additional cash outflows due to various risks they are exposed to. Entities can use IAS 39 or IFRS 9 for hedge accounting. The implementation of hedge accounting is optional in both standards.

Hedge Qualification

If the entity has a hedged item and can designate a hedging instrument, it can apply hedge accounting. However, in order to apply hedge accounting, the relationship established between the hedged item and the hedging instrument must meet all of the conditions stated in the standard. Those conditions are (IAS 39, 88):

a. Formal designation and documentation of the hedging relationship, entity's risk management strategy, and strategy for undertaking the hedge at its inception.
b. High hedge effectiveness
c. 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.
d. Reliable measurement of hedge effectiveness
e. 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.

When we examine the hedging criteria, we see that the first element is the documentation requirement. The second factor appears to be the effectiveness of the hedge. However, effectiveness is not considered as a single item, and its various dimensions are explained separately as conditions.

Hedge Documentation

In order to apply hedge accounting in terms of both IAS 39 and IFRS 9, hedge documentation must be made. The elements of the hedge must be documented at the beginning of the hedge. During documentation, first the hedging item and hedging instrument should be determined and explained.

The nature of the risk giving rise to the hedge should then be disclosed. In addition, the entity should document how it will evaluate the effectiveness of the hedge. This evaluation should include the procedures for effectiveness assessment.

If an entity frequently resets the hedging relationship due to the hedging instrument and hedging item, it must be consistent with the hedge documentation.

Hedge Effectiveness

In order to use hedge accounting, it is necessary to provide hedge qualification. Three of the conditions for hedge qualification are directly related to hedge effectiveness. Accordingly, hedge effectiveness must be high, and it must be able to be measured reliably. In addition, this high efficiency should continue throughout the financial reporting periods.

In a hedge effectiveness assessment, the hedge is considered to be highly effective when the following two conditions coexist.

- An expectation at the inception that changes in the values of hedged item and hedge instrument almost offset each other during the hedge period.
- Having an actual hedge effectiveness within a range of 80-125 per cent during the hedging period.

The entity should assess the hedge effectiveness at minimum during the annual or interim financial reporting periods.

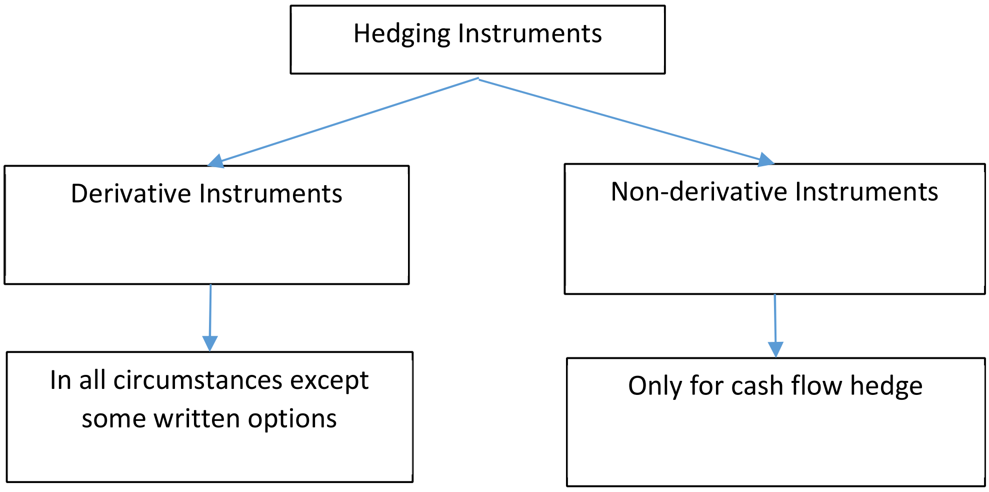
There is no specific method specified in IAS 39 for hedge effectiveness assessment. The assessment method applied for hedge effectiveness is related with the entity's risk management strategy. The assessment method determined should be defined in the hedge documentation at the inception. And this method should be applied consistently throughout the hedging relationship.

Hedging Instrument

As shown in Figure 5, derivative and non-derivative instruments can be designated as the hedging instrument. Derivative instruments can be designated as hedging instruments in all circumstances, except for some written options. A written option may end up with a potential loss that is significantly more than the potential gain of the hedged item. Due to this, written options are not designated as hedging instruments. IFRS 9 does not allow written options to be used as hedging instruments, either. A non-derivative financial asset or financial liability can only be designated as a hedging instrument for foreign currency risk hedging.

Hedging instrument must be made with an external party other than the reporting entity. If the party with which the reporting entity has a hedging instrument contract is included in the same group, the hedging transaction is eliminated in the consolidation. Therefore, such hedges are not covered by hedge accounting in the group's consolidated financial statements. However, for individual and separate financial statements those transactions may qualify for hedge accounting.

Figure 5: Designation of Hedging Instruments



The fair value of the hedging instrument is valid for the entirety of the instrument. For this reason, the entirety of hedging instrument is taken into account when establishing the hedging relationship. However, there are two exceptions to this (IAS 39.74):

a. separating the intrinsic value and time value of an option contract and designating only the change in intrinsic value of an option as the hedging instrument and excluding the change in its time value; and
b. separating the interest element and the spot price of a forward contract.

These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately. A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

A single hedging instrument may be designated as a hedge of more than one type of risk provided that

- the risks hedged can be identified clearly.
- the effectiveness of the hedge can be demonstrated.
- it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

In addition, two or more instruments can be designated as hedging instruments when necessary.

Hedged items

IAS 39 requires the identification and designation of the item that will be the subject of hedge accounting at inception. The hedge item can be one of the following:

- An asset
- A liability
- An unrecognised firm commitment
- A highly probable forecast transaction
- A net investment in a foreign operation

A hedged item can be a single item or a group of items. Also, in a portfolio, hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged could be a hedged item.

For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. The hedged item must be exposed to a risk that may affect the current or future profit or loss of the entity.

HEDGE ACCOUNTING

Hedge accounting recognises the offsetting effects of changes in the fair values of the hedging instrument and the hedged item on profit or loss. In order to use hedging accounting, a hedging relationship is initially required. Then, this hedging relationship should meet the necessary conditions.

Hedge Categories

Three different hedging relationships have been identified in IAS 39. These are:

a. fair value hedge.
b. cash flow hedge.
c. hedge of a net investment in a foreign operation.

The hedge relationships listed above are also valid for IFRS 9.

In a hedge classification assessment, hedge of a foreign currency risk of a firm commitment can be accounted for according to the fair value hedge or cash flow hedge. In order to be able to apply hedge accounting based on these hedging relationships, first of all, it is necessary to provide a hedge relationship qualification.

Fair Value Hedge

Fair value hedge is the hedge of exposures resulting from fair value changes of a recognized asset or liability or unrecognised firm commitment or an identified portion thereof.

If hedge qualifications are provided for fair value hedge, the hedge transaction is accounted for as follows.

- Gain or loss from hedging instrument remeasurement recognised in profit loss. If the hedging instrument is a derivative, then remeasurement is made through fair values of the instrument. For a non-derivative hedging instrument measurement made on the foreign currency component of its carrying amount in accordance with IAS 21 The Effects of Changes in Foreign Exchange Rates.
- The gain or loss on the hedged item attributable to the hedged risk adjusts the carrying amount of the hedged item and is recognized in profit or loss. This applies if the hedged item is otherwise measured at cost.

In a fair value hedge, gain or loss originating from both the hedging instrument and the hedged item is associated with the profit and loss statement.

Example

On October 1, 2021, entity ABC purchased goods on credit for CUX 10,000. ABC Co.'s functional currency is Y. ABC Co. considers that it is exposed to foreign exchange risk related to this four-month maturity liability. ABC Co. signed a four-month forward contract on October 1 to hedge this risk. On October 1, 2021, 1 CUX = 7.00 CUY. With the forward contract, ABC Co. has the right to receive CUX 10,000 at the rate of 1 CUX=8.00 CUY on February 1, 2022.

The X/Y rate was as follows on the relevant dates.

December 31, 2021 current rate 1 CUX=7.70 CUY

December 31, 2021 forward rate 1 CUX=8.50 CUY

February 1, 2022 current rate 1 CUX =9.00 CUY

In this hedge, the hedged item is accounts payable of CUX 10,000 in foreign currency (X). If the exchange rate increases, ABC Co. will have to pay more (in Y currency) due to the exchange rate difference. In order to manage this currency risk, ABC Co. bought a hedging instrument. The forward contract entitles ABC business to receive CUX 20,000 at the rate of 1 CUX=8 CUY on February 1, 2022.

Accounting for hedging item			Accounting for hedging instrument		
October 1, 2021			October 1, 2021		
Dr. Inventory	70,000		Dr. Forward Receivables	160,000	
Cr. Accounts Payable		70,000	Cr. Forward Payables		160,000
December 31, 2021			December 31, 2021		
Dr. Loss on Exchange Rate	7,000		Dr. Forward Receivables	10,000	
Cr. Accounts Payable		7,000	Cr. Gain on Forward		10,000
February 1, 2022			February 1, 2022		
Dr. Loss on Exchange Rate	13,000		Dr. Forward Receivables	10,000	
Cr. Accounts Payable		13,000	Cr. Gain on Forward		10,000
Dr. Accounts Payable	90,000		Dr. Forward Payables	160,000	
Cr. Cash		90,000	Dr. Cash	20,000	
			Cr. Forward Receivables		180,000

ABC Co paid CUY 20,000 more than the item's original book value of CUY 70,000, due to the negative exchange rate difference, as expected. However, entity ABC earned a total revenue of CUY 20,000 from the forward contract. This income compensates the entity's loss due to the exchange rate difference. Gains and losses concerning the hedging relationship are presented in Table 1 below.

Table 1: Gains and losses of the hedging relationship

	Gains and Losses as of December 31	Gains and Losses as of February 1	Total
Hedging item	(7,000)	(13,000)	(20,000)
Hedging instrument	10,000	10,000	20,000
Total	3,000	(3,000)	

The gains and losses of the hedging instrument and hedging item are equalized in this example. At the reporting date, the hedging instrument gained CU10,000, while the hedging item lost CU7,000.

Cash Flow Hedge

A cash flow hedge is made due to the variability of cash flows. These cash flows are:

- attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction
- could affect profit or loss

In cash flows hedging, there is hedging of variable elements that may affect future cash flows, such as price, cost, and interest.

Cash flow hedge is accounted as follows:

- the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income; and
- the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.

In cash flow hedge, changes in the value of the hedging instrument are not reported in profit and loss. These are deferred by reporting in other comprehensive income (OCI). Deferred gains and losses are transferred to profit and loss in the same period as gains and losses arising from the hedged item.

Example

ABC Co. manufactures lithium batteries. The entity anticipates that lithium costs will rise due to problems in lithium supply and increased demand. ABC Co. estimates that it will need 1,000 tons of lithium per month for 2020.

ABC Co. plans to make hedging transactions as being a party to futures contracts. Currently, lithium futures contracts are sold on a monthly basis. The details of the contracts are as follows.

Contract size: 300 tons
Initial Margin: CU 1,000
Maintenance Margin: CU 600
ABC company purchased 3 futures contracts on January 1, 2020. The spot price for 1 ton of lithium is CU 20. With the futures contract, ABC Co. acquired the right to purchase 1 ton of lithium for CU 20. At the end of January, the spot price of lithium increased to CU 25.

Let's account for the hedging for the first month of the year for ABC Co.

Accounting for hedging item	Accounting for hedging instrument
January 1, 2020 No Entries	January 1, 2020 Dr. Futures Contact 3,000 Cr. Cash 3,000 The purchase of 3 futures contract.
January 31, 2020 Dr. Inventory 25,000 Cr. Cash 25,000 Purchase of 1,000 tons of lithium. The entity paid CU 5,000 more compared to the lithium prices on January 1, 2020.	January 31, 2020 Dr. Futures Contract 4,500 Cr. Unrealized Gain (OCI) 4,500 (CU 25 – CU 20) x (3x300) =4,500 Fair value increase of 3 futures contract Dr. Cash 7,500 Cr. Futures Contract 7,500 Settlement of Futures Contract

Gains and losses concerning the hedging relationship are presented in Table 2 below.

Table 2: Gains and losses of the hedging relationship

	Gains and Losses as of January 31
Hedging item	(5,000)
Hedging instrument	4,500
Total	(500)

ABC Co. expected the lithium price to rise. As lithium prices rose in line with the entity's expectations, the entity had to pay an additional CU 5,000. However, the entity offset this CU5,000 extra cash outflow with CU4,500 earned from futures designated as hedging instrument. However, despite the purchase of lithium, the entity did not transfer the CU4,500 gain from hedging to the statement of profit and loss. The entity will transfer this amount to the profit and loss statement only when the hedging item is expensed.

Now suppose that all of the lithium purchased is used to make lithium batteries, and all of these batteries are sold.

Accounting for hedging item			Accounting for hedging instrument		
Sale of lithium batteries			January 1, 2020		
Dr. Cost of Goods Sold	XXX		Dr. Unrealized Gain (OCI)	4,500	
Cr. Inventories		XXX	Cr. Cost of Goods Sold		4,500
			.		

Net Investment Hedge

An entity may have a foreign operation such as a:

- subsidiary
- associate
- joint venture
- branch

The financial statements of these foreign operations should be translated into group's presentation currency. This may lead to a currency risk which the entity will want to hedge.

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, shall be accounted for in a manner that is similar to cash flow hedges:

- the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income; and
- the ineffective portion shall be recognised in profit or loss. The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment on the disposal or partial disposal of the foreign operation

Example

ABC Co. purchased 100% of an overseas subsidiary for CUX 500,000 (Assets CUX 700,000, liabilities CUX 200,000). ABC Co. financed this purchase by a loan of CUX 400,000. ABC Co. has the functional currency of Y.

Exchange rates of the currencies CUX and CUY are;

At the inception 1 CUX = 2 CUY

At the reporting date 1 CUX = 2.50 CUY

Accounting for hedging item			Accounting for hedging instrument		
At inception			At inception		
Dr. Subsidiary	1,000,000		Dr. Cash	800,000	
Cr. Cash		1,000,000	Cr. Loan		800,000
At the reporting date			At the reporting date		
Dr. Subsidiary	250,000		Dr. Loss (OCI)	200,000	
Cr. OCI		250,000	Cr. Loan		200,000

Table 3: Gains and losses of the hedging relationship

	Gains and Losses as of Reporting date
Hedging item	250,000
Hedging instrument	(200,000)
Total	50,000

Table 3 provides the gains and losses related to the hedging transaction. This gain (or loss) will be reclassified as profit or loss only when the ABC Co. disposes all or part of the foreign operation. Thus, it will be ensured that the profit or loss arising from the foreign operation and the profit or loss arising from the hedging instrument can be reported in the profit or loss statement of the same period.

Discontinuation of Hedge Accounting

Entities can stop applying the hedge accounting. The effects of this discontinuation should be accounted for prospectively. The entities stop the hedge accounting application in the following cases.

IAS 39 grants entities the right to revoke the designation. In this case, the entity can voluntarily stop applying hedge accounting at any time. Secondly, entities should stop the hedge accounting application when the hedging transaction does not meet the criteria set for hedge accounting.

Finally, stopping the application of hedge accounting may be related to the hedge instrument. If the hedging instrument expires, is sold, terminated or exercised, the entity must discontinue hedge accounting. However, the company can replace or rollover a hedging instrument with another hedging instrument in line with its hedging strategy. This situation is not considered a termination or expiration for the existing hedging instrument. In this case, the business will continue to apply hedge accounting.