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Project	<b>Financial Instruments: Phase 3 – Hedge Accounting</b>
Topic	<b>Applying cash flow hedge accounting mechanics to a fair value hedges</b>

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## Introduction

### *Background*

1. At the September 2008 main meeting, the Board tentatively decided to address hedge accounting by replacing fair value hedge accounting with a mechanism that permits recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (ie applying the *mechanics* of cash flow hedge accounting also to fair value hedges). This approach is referred to as the ‘**tentative approach**’ in this paper. The Board also tentatively decided to consider further simplifications to hedge accounting.
2. The staff notes that the main reason the Board decided to explore the tentative approach was because under this approach the carrying amount of the hedged item would not be affected.

### *Purpose of this paper*

3. The tentative approach replaces fair value hedge accounting mechanics with cash flow hedge accounting mechanics for fair value hedges. Applying cash flow hedge accounting mechanics to today’s fair value hedges has effects on the numbers reported in financial statements. The first being that the carrying amount of the hedged item would be unaffected (the main reason the Board agreed to this approach). The second relates to effects on equity and profit or loss. One consideration for the Board is whether it wishes to keep the same *profit*

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*or loss* effects that arise under today's fair value hedge accounting model under the tentative approach. If the Board wishes to keep the same effects, the Board would have to amend some aspects of cash flow hedge accounting mechanisms when applied to fair value hedges.

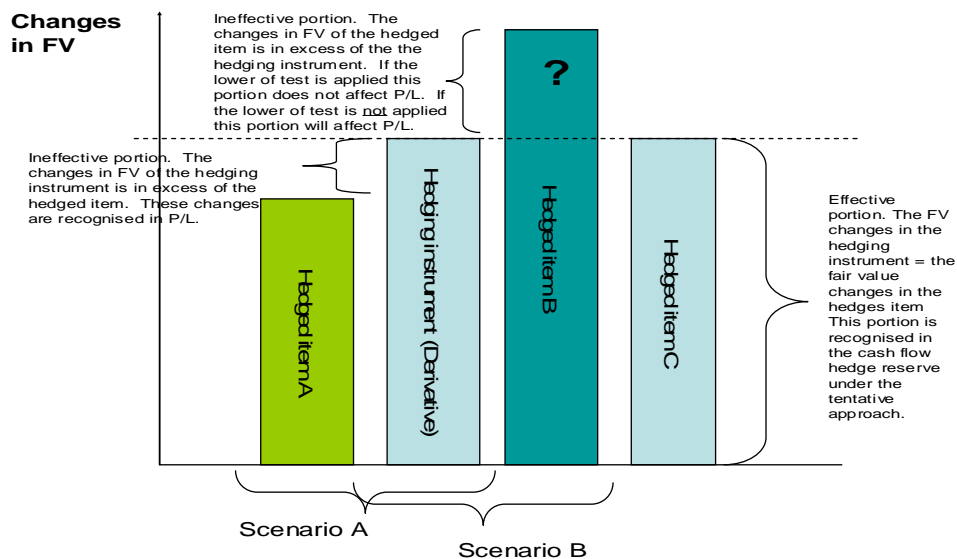
4. One of these aspects is the so-called 'lower of' test that today is required for cash flow hedges. This paper discusses the 'lower of' test in the context of the tentative approach for fair value hedges.
5. This paper does not discuss what items will be eligible for hedge accounting under the tentative model for fair value hedges. This paper focuses on the *mechanics* of the tentative approach.

**The issue**

6. Fair value hedge accounting relates to the offsetting of fair value changes in the hedging instrument and the hedged item. The table below illustrates the relationship between hedging instruments and hedged items. When a hedge accounting relationship is fully effective, the fair value changes in the hedging instrument perfectly offset the fair value changes in the hedged item (see hedged item C in the graph below). Ineffectiveness arises when fair value changes of the hedging instrument exceed that of the hedged item (see hedged item A in the graph below) or when the fair value changes of the hedging instrument are less than that of the hedged item (see hedged item B in the graph below).
7. Applying cash flow hedge accounting mechanics to a fair value hedge means that the effective portion (ie when fair value changes in the hedging instrument are the same as that of the hedged item) is recognised in equity. The issue is what to do in scenarios A and B. Under today's fair value hedge accounting requirements, ineffective portions in both A and B are recognised in profit or loss. However, under today's cash flow hedge accounting requirements, there is the 'lower of' test. The 'lower of' test ensures that *cumulative* fair value changes in hedged items that exceed *cumulative* fair value changes in the hedging instrument are not recognised in profit or loss. Thus, the ineffective portion is recognised in profit

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or loss only in scenario A. The issue is what the Board wants to do with the portion that arises in scenario B under the tentative approach.



8. In a cash flow hedge, reflecting gains and losses in profit or loss arising on the hedged item in excess of the hedging instrument is problematic because the hedged item, typically a highly probably forecast transaction, does not yet exist but is only expected to occur in the future. Recognising gains and losses on an asset or liability that does not yet exist might be considered conceptually incorrect and counter-intuitive.<sup>1</sup>
9. To avoid this result, the 'lower of' test ensures that only ineffectiveness due to *excess* cash flows on the hedging instrument (ie the derivative) is recognised in profit or loss.
10. The staff notes that the above rationale does not apply to fair value hedges. That type of hedge is the subject of the tentative approach. Unlike cash flow hedges, the hedged item in a fair value hedge is recognised, the tentative approach would not recognise changes in value of the hedged item as adjustments to assets or

<sup>1</sup> This rationale was provided in FASB Statement No. 133 BC379-380.

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liabilities but recognise the related profit or loss effect (by adjusting OCI rather than assets or liabilities).

11. The staff notes that in developing further the approach under consideration the Board needs to decide whether the ‘lower of’ test required under existing cash flow hedge accounting mechanics should be extended to the tentative approach.
12. The staff notes that applying cash flow hedge accounting mechanics to fair value hedges does not eliminate the economic differences in these type of hedges—one is concerned with fair *value* risk, the other with cash *flow* risk.

The appendices to this paper set out:

- (a) an illustrative example to which existing mechanics for a cash flow hedge, mechanics for a fair value hedge and the tentative approach are applied (Appendices B – D provide details of each alternative)
  - (b) an overview of the effect on financial statements is provided in Appendix A.
13. The examples illustrate how the financial statement effects differ when the ‘lower of’ test is applied and when the ‘lower of’ test is *not* applied (see table in paragraph 7 and Appendices A, B and D). **The illustrative example of the tentative approach for fair value hedges (Appendix D) does not apply the ‘lower of’ test as its purpose is to highlight the differences between applying the test and not applying the test**
  14. As the focus of this paper is to illustrate various hedge accounting mechanics, the staff suggests Board Members review the illustrative examples in the appendices before proceeding to the staff analysis.

**Staff analysis**

15. The staff has identified the following alternatives that could be applied to the tentative approach for fair value hedges:
  - (a) **Alternative 1:** extend the ‘lower of’ test to the tentative approach.

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- (b) **Alternative 2:** do not extend the 'lower of' test to the tentative approach for fair value hedges (as illustrated in Appendix D). Keep the lower of test for cash flow hedges *only*.
16. Another alternative is to change existing cash flow hedge accounting mechanics to align the accounting mechanics for cash flow hedges and fair value hedges. That is **Alternative 3**—eliminate the lower of test for cash flow hedges.
17. The arguments for and against each of these alternatives are outlined below.

**Alternative 1—Extend the 'lower of' test to the tentative approach**

18. Under Alternative 1, the 'lower of' test would also apply to fair value hedges. The financial statement effects for both cash flow hedges and fair value hedges would be the same under this alternative.
19. Arguments **for** Alternative 1 include:
- (a) this alternative accepts the carrying amounts that result from the normal recognition and measurement requirements that result from applying IFRSs. It does not create an exception to those normal requirements to change their outcomes simply because hedge accounting applies. By extending the 'lower of' test to fair value hedges it prevents that hedge ineffectiveness attributable to amounts that are not recognised under normal recognition and measurement requirements are recognised in profit or loss. In other words, it does not account for the hedged item in the 'shadow' as if it were a recognised asset or liability (as Alternative 2 does). Instead, this alternative focuses on effects *of the hedging instrument* on the income statement by allocating the gains and losses on the hedging instrument to OCI and profit or loss.
  - (b) this alternative reduces complexity because it applies the same accounting mechanics to both cash flow hedges and fair value hedges.
20. Arguments **against** Alternative 1 include:
- (a) cash flow hedges and fair value hedges are different in nature and should be treated differently. Cash flow hedges focus on *cash flow variability*

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arising from future transactions and fair value hedges focus on *fair value risk* on an item that (already) exists. Hence, any fair value exposure arising on a fair value hedge should be recognised.

- (b) in a fair value hedge the hedged item is also often recognised in the statement of financial position (before applying fair value hedge accounting). Hence, it is conceptually correct to recognise its fair value changes (albeit indirectly, via accounting for the hedged item in the ‘shadow’ is if it were a recognised asset or liability and balancing the entry against OCI) in profit or loss.
- (c) the ‘lower of’ test is complex (particularly for preparers) and should not be extended to fair value hedges (but rather be eliminated altogether).

**Alternative 2—Retain the ‘lower of’ test for cash flow hedges only**

- 21. Under Alternative 2, the ‘lower of’ test would apply to cash flow hedges only. For fair value hedges fair value changes arising on the hedged item in excess of fair value changes arising on the hedging instrument would also be recognised in profit or loss.
- 22. Arguments **for** Alternative 2 include:
  - (a) cash flow hedges and fair value hedges are different in nature. Cash flow hedges focus on cash flow variability arising from future transactions and fair value hedges focus on fair value exposures. Hence any fair value exposure arising on a fair value hedge should be recognised.
  - (b) as cash flow hedges and fair value hedges are different in nature, applying the same accounting mechanics to them impairs comparability as only hedges of the same nature should be accounted for in the same way.
  - (c) the purpose of the ‘lower of’ test is to avoid recognition of gains or losses on transactions that do not yet exist (highly probable forecast transactions). This rationale does not apply to fair value hedges as in

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that case the hedged item (already) exists. For example, while a firm commitment may not be recognised under IFRSs the *transaction* already *exists* whereas a forecast transaction does not yet exist but will (probably) only occur in the future.

23. Arguments **against** Alternative 2 include:
- (a) this alternative results in complexity as there are still different treatments of cash flow and fair value hedges (despite using only cash flow hedge mechanics).
  - (b) while the hedged item is no longer (partially or fully) adjusted in the statement of financial position there is still an indirect effect because hedge ineffectiveness attributable to amounts that are not recognised under normal recognition and measurement requirements are still recognised in profit or loss (see paragraph 19(a) above).
  - (c) the complexity of applying the ‘lower of’ test to cash flow hedges is not eliminated in its entirety.

***Alternative 3—Eliminate the ‘lower of’ test for cash flow hedge accounting***

24. Under Alternative 3, the ‘lower of’ test would be eliminated all together. Fair value changes arising on the hedged item in excess of fair value changes arising on the hedging instrument would be recognised in profit or loss for both cash flow and fair value hedges.
25. Arguments **for** Alternative 3 include:
- (a) the ‘lower of’ test is complex. As one of the objectives of phase 3 of the project to replace IAS 39 is to reduce complexity, this test should be eliminated in its entirety.
  - (b) although this alternative results in the recognition of gains and losses on transactions that do not yet exist, for a forecast transaction to qualify for hedge accounting, an entity must assert that the transaction is highly probable. Since the entity already accounts for the risks associated with the future transaction through applying hedge accounting, recognising

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the gains and losses associated with the forecast transaction would be supported by the same level of probability of occurring that justifies the change in the accounting for the hedging derivative.

- (c) this alternative results in reducing complexity as there is only one treatment for both cash flow hedges and fair value hedges.

26. Arguments **against** Alternative 3 include:

- (a) the purpose of the 'lower of' test is to ensure that gains and losses on transactions that do not yet exist are not recognised. Allowing the recognition of such gains and losses is conceptually incorrect and counter-intuitive.
- (b) fair value hedges and cash flow hedges are treated in the same way even though they are different (see paragraph 20(a) above).

**Staff recommendation**

27. While Alternative 3 would arguably achieve the greatest reduction in complexity it involves recognising gains and losses on transactions that do not yet exist. The staff believes that this conceptual disadvantage outweighs the benefit of reducing complexity. Therefore, the staff does *not* support Alternative 3.<sup>2</sup>

28. The choice between Alternatives 1 and 2 is a trade-off between

- (a) reducing complexity by eliminating the variety of mechanisms and focusing the effect of hedge accounting on the income statement (without indirect effects of hypothetical changes to the hedged item that are based on departures from the normal measurement and recognition requirements). This implies choosing **Alternative 1**.
- (b) reducing complexity by confining the difficult 'lower of' test to cash flow hedges and retaining a distinction between (i) transactions that exist

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<sup>2</sup> However, some members of staff would support Alternative 3 based on arguments set out in paragraph 25 of this paper.



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but are not (or not fully—ie at fair value) reflected in the financial statements and (ii) transactions that do not yet exist. The hedge ineffectiveness regarding the transactions that exist also exists and thus should be recognised as part of hedge accounting. This implies choosing **Alternative 2**.

29. On balance, the staff recommends Alternative 1 because:
- (a) if the primary consideration was to avoid the complexity of the ‘lower of’ test then—consequently—Alternative 3 should be chosen (which the staff discarded due to the conceptual problem it involves);
  - (b) if the primary consideration was to retain the effects of the hedged item where it is an existing transaction then—consequently—the fair value hedge accounting mechanism should be retained; the impact of changing from fair value hedge to cash flow hedge mechanics is far greater<sup>3</sup> than the aspect this paper deals with (which only relates to hedge ineffectiveness);
  - (c) Alternative 1 is the consequent extension of the tentative decision to avoid overriding the normal measurement basis<sup>4</sup> of items solely because they are hedged. The staff also notes that in most cases the fair value option is available to entities for whom it is pivotal to recognise fair value changes in the statement of financial position regarding what would be the hedged item in a fair value hedge. That is the more consequent alternative if departure from the normal measurement requirements is desired.

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<sup>3</sup> That is volatility of equity that amounts to the effective portion of the hedge (rather than just the ineffective portion).

<sup>4</sup> Or recognition criteria (in case of firm commitments).

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**Hedge accounting mechanism: application of the 'lower of' test**

Does the Board agree with the staff recommendation to extend the 'lower of' test to fair value hedges as part of applying cash flow hedge mechanics to all fair value and cash flow hedges (ie Alternative 1)?

If the Board does not agree, which Alternative does the Board prefer instead, and why?

**Alternative hedge accounting mechanics—illustrative example**

30. The following example is used to illustrate the mechanics of:
- (a) cash flow hedge accounting (Appendix B).
  - (b) fair value hedge accounting (Appendix C).
  - (c) the tentative approach to fair value hedges (tentative approach)<sup>5</sup> (Appendix D). The tentative approach is illustrated on the basis of *not* applying the 'lower of' test (if the 'lower of' test is applied the result is the same as for cash flow hedge accounting as illustrated in Appendix B).
31. For each illustration the appendices set out:
- (a) the journal entries.
  - (b) the effects on the statement of financial position on each reporting date.
  - (c) the effects on the income statement on each reporting date.
32. Note: The illustrative example of the tentative approach for fair value hedges (Appendix D) does not apply the 'lower of' test as its purpose is to highlight the differences between applying the test and not applying the test.
33. The fact pattern of the example is as follows:

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<sup>5</sup> The tentative approach refers to the application of existing cash flow hedge accounting mechanics to a fair value hedge. That is, permitting recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments.

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**Example:**

Entity A is a European widget retailer with Euro (EUR) as its functional currency. Entity A's reporting dates are 30 June and 31 December. Entity A enters into a contract to buy widgets to be delivered in December using a contract denominated in Swiss francs (CHF).<sup>6</sup> Payment is due on delivery.

To hedge against foreign currency risk arising from the firm commitment, Entity A uses an existing forward contract to buy CHF and sell EUR that it entered into in a previous period.<sup>7</sup> The hedging relationship is designated and documented on 1 January 20x0.

**Hedged risk:** foreign currency risk

**Hedging instrument:** derivative (FX forward contract)

**Hedged item:** firm commitment (unrecognised item)

IAS 39.87 permits a hedge of the foreign currency risk of a firm commitment to be accounted for as fair value hedge or as a cash flow hedge. The example illustrates the mechanics of cash flow hedge accounting, fair value hedge accounting and the tentative approach.

The fair value changes in the hedging instrument and hedged item are shown below.

This example does not demonstrate how the fair values of the hedging instrument are derived. Its purpose is to illustrate the mechanics of hedge accounting.

34. The following table provides an overview of the value changes of the derivative and the hedged item over time:

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<sup>6</sup> This example assumes the functional currency of the seller is CHF.

<sup>7</sup> Hedge ineffectiveness in the example results from using a forward contract that is in-the-money at inception of the hedging relationship.

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Date	Fair value of hedging instrument (derivative)			Fair value of hedged item (firm commitment)			'Lower of' test	
	Fair value	Period change	Cumulative change	Fair value	Period change	Cumulative change	Lesser of two cumulative changes	Adjustment to OCI
01 Jan 20x0	100			0				
30 June 20x0	300	200	200	(190)	(190)	(190)	190	(190)
31 Dec 20x0	50	(250)	(50)	55	245	55	50	240

35. The table shows that at:

- (a) 30 June 20x0, the period (and cumulative) gain from the derivative of +200 more than offsets the period (and cumulative) loss on the firm commitment of -190 by 10. Cumulatively the position is over-hedged.
- (b) 31 December 20x0, the period loss on the derivative of -250 more than offsets the period gain on the firm commitment of +245. Cumulatively, the change (loss) on the derivative of -50 less than offsets the cumulative change (gain) of +55 on the firm commitment. Cumulatively, the position is under-hedged. Essentially, *it is this scenario that this paper addresses.*

**Financial statement implications**

36. The financial statement effects of applying the three different mechanisms on equity and net profit<sup>8</sup> are as follows:

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<sup>8</sup> For an overview of the entire statement of financial position and income statement see Appendix A.

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Overview of effect on equity and net profit

	Appendix B			Appendix C			Appendix D		
	CFH			FVH			Tentative		
	1 Jan	30 Jun	31 Dec	1 Jan	30 Jun	31 Dec	1 Jan	30 Jun	31 Dec
<b>Equity</b>									
Retained earnings	(100)	(110)	(100)	(100)	(110)	(105)	(100)	(110)	(105)
CFH reserve		(190)	50					(190)	55
	<u>(100)</u>	<u>(300)</u>	<u>(50)</u>	<u>(100)</u>	<u>(110)</u>	<u>(105)</u>	<u>(100)</u>	<u>(300)</u>	<u>(50)</u>
<b>Income statement</b>									
Other gain/loss		(10)	10		(10)	5		(10)	5

37. Key observations about the effects of the different mechanisms are as follows:

(a) *Total equity:*

- (i) For cash flow hedging and the tentative approach *total equity is the same*. It is also the same as in a scenario without hedge accounting because these hedge accounting mechanisms solely affect the allocation of gains and losses to other comprehensive income (OCI) versus profit or loss.
- (ii) For fair value hedging total equity is different than for the other alternatives. The reason is that this mechanism involves recognising<sup>9</sup> an asset or liability for the hedged item. Hence the effect of hedge accounting on equity results solely from hedge ineffectiveness.

(b) *Composition of equity:*

- (i) The retained earnings are the same for fair value hedging and the tentative approach.
- (ii) The cash flow hedge reserve for cash flow hedging and the tentative approach is only the same when the value change of the hedging instrument exceeds that of the hedged item (over-hedge) *but is different if the value change of the hedging instrument is smaller than that of the hedged item (under-hedge)*. That difference arises because of the treatment of under-hedges in cash flow hedges that limits

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<sup>9</sup> Or measuring a part of a hedged item to fair value that otherwise would not be measured at fair value—the effect on the statement of financial position is the same.

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the amount that can be recognised in the hedging reserve to the derivative's fair value change.

- (c) Profit or loss:
- (i) Profit or loss is the same for fair value hedging and the tentative approach.
  - (ii) For cash flow hedging and the tentative approach differences in profit or loss result from under-hedge scenarios (that cause differences in the cash flow hedge reserve, as set out above).
38. In summary, the differences in the profit or loss amounts and the cash flow hedge reserve amounts result from applying the 'lower of' test for cash flow hedges (see table in paragraph 34) that is required by IAS 39 *Financial Instruments: Recognition and Measurement*<sup>10</sup>.
39. IAS 39.96(a) requires that the separate component of equity associated with the hedged item is adjusted to the lower of (in absolute amounts):
- (i) the *cumulative gain or loss* on the *hedging instrument* from inception of the hedge; and
  - (ii) the *cumulative change in fair value* (present value) of the expected future cash flows on the *hedged item* from inception of the hedge;
40. In the context of cash flow hedge accounting, the 'lower of' test *prevents* recognition of gains and losses in profit or loss when the cumulative fair value change in the hedged item exceeds that of the hedging instrument. In the example above, the under-hedged position at 31 December 20x0 when the cumulative change (loss) on the derivative of -50 less than offsets the cumulative change (gain) of +55 on the firm commitment.
41. Likewise, the test *requires* recognition of some of the derivative gains and losses in profit or loss when the cumulative fair value change in the hedged item is lower than that of the hedging instrument. In the example above, the over-

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<sup>10</sup> See IAS 39.96(a).

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hedged position at 30 June 20x0 when the period (and cumulative) gain from the derivative of +200 more than offsets the period (and cumulative) loss on the firm commitment of -190.

## Appendix A - Overviews

A1. This appendix provides an overview of the effect on financial statements that the different hedge accounting alternatives have. The first overview is by type of hedge accounting approach:

Overview <u>by type</u>	Appendix B			Appendix C			Appendix D		
	CFH			FVH			Tentative		
	1 Jan	30 Jun	31 Dec	1 Jan	30 Jun	31 Dec	1 Jan	30 Jun	31 Dec
<b>Assets</b>									
Inventory			3,500			3,555			3,500
FX forward	100	300		100	300		100	300	
Firm commitment				0					
	<u>100</u>	<u>300</u>	<u>3,500</u>	<u>100</u>	<u>300</u>	<u>3,555</u>	<u>100</u>	<u>300</u>	<u>3,500</u>
<b>Liabilities</b>									
Bank overdraft			(3,450)			(3,450)			(3,450)
Firm commitment				(190)					
	<u>0</u>	<u>0</u>	<u>(3,450)</u>	<u>0</u>	<u>(190)</u>	<u>(3,450)</u>	<u>0</u>	<u>0</u>	<u>(3,450)</u>
<b>Equity</b>									
Retained earnings	(100)	(110)	(100)	(100)	(110)	(105)	(100)	(110)	(105)
CFH reserve		(190)	50				(190)		55
	<u>(100)</u>	<u>(300)</u>	<u>(50)</u>	<u>(100)</u>	<u>(110)</u>	<u>(105)</u>	<u>(100)</u>	<u>(300)</u>	<u>(50)</u>
<b>Income statement</b>									
Other gain/loss		(10)	10		(10)	5		(10)	5

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A2. The second overview is for the same examples but by time (rather than by type of hedge accounting approach):

Overview by time

	1 Jan			30 Jun			31 Dec		
	CFH	FVH	Tentative	CFH	FVH	Tentative	CFH	FVH	Tentative
<b>Assets</b>									
Inventory							3,500	3,555	3,500
FX forward	100	100	100	300	300	300			
Firm commitment		0							
	<u>100</u>	<u>100</u>	<u>100</u>	<u>300</u>	<u>300</u>	<u>300</u>	<u>3,500</u>	<u>3,555</u>	<u>3,500</u>
<b>Liabilities</b>									
Bank overdraft							(3,450)	(3,450)	(3,450)
Firm commitment					(190)				
	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(190)</u>	<u>0</u>	<u>(3,450)</u>	<u>(3,450)</u>	<u>(3,450)</u>
<b>Equity</b>									
Retained earnings	(100)	(100)	(100)	(110)	(110)	(110)	(100)	(105)	(105)
CFH reserve				(190)		(190)	50		55
	<u>(100)</u>	<u>(100)</u>	<u>(100)</u>	<u>(300)</u>	<u>(110)</u>	<u>(300)</u>	<u>(50)</u>	<u>(105)</u>	<u>(50)</u>
<b>Income statement</b>									
Other gain/loss				(10)	(10)	(10)	10	5	5

## Appendix B – Applying cash flow hedge accounting mechanics

Dr/(Cr)

	Fair value of hedging instrument (derivative)			Fair value of hedged item (firm commitment)			'Lower of' test	
	A	B		C	D		E	F
Date	Fair value	Period change	Cumulative change	Fair value	Period change	Cumulative change	Lesser of two cumulative changes	Adjustment to OCI
01 Jan 20x0	100			-				
30 June 20x0	300	200	200	(190)	(190)	(190)	190	(190)
31 Dec 20x0	50	(250)	(50)	55	245	55	50	240

**Table B**

The above table sets out the data used in this example. It also illustrates the 'lower of' test required in IAS 39.96(a). The following steps are used to determine the amount to be recognised in OCI.

- **Step 1:** Determine the change in fair value of the derivative and the change in the present value of the cash flows on the hedged item. (columns A and C)
- **Step 2:** Determine the cumulative changes in the fair value of the derivative and the cumulative changes in the present value of the cash flows on the hedged item. (columns B and D)
- **Step 3:** Determine the lesser of the absolute amounts in Step 2. (column E)
- **Step 4:** Determine the change during the period in the amount that is the lesser of the absolute values. (column F)
- **Step 5:** Adjust the derivative to reflect the change in fair value and adjust OCI by the amount determined in Step 4. Adjust profit or loss to balance the entry.

## Appendix B – Applying cash flow hedge accounting mechanics

### 1 January 20x0

The fair value of the hedging instrument ie the forward contract at inception of the hedging relationship was 100 and hence results in ineffectiveness.

The opening statement of financial position is as follows:

Dr Derivative 100

Cr Retained earnings 100

### 30 June 20x0

Dr Derivative	200	To record the fair value changes of derivative.
Cr Cash flow hedge reserve	190	To record the effective portion in cash flow hedge reserve.
Cr Other gains and losses	10	To record ineffectiveness in profit or loss (ineffectiveness was a result of using an existing derivative as a hedging instrument).

## Appendix B – Applying cash flow hedge accounting mechanics

### Statement of financial position 30 June 20x0

<b>Assets</b>		
Inventory	0	
Derivative	300	Forward contract measured at fair value.
<b>Total assets</b>	<u>300</u>	
<b>Liabilities</b>		
Bank overdraft	<u>0</u>	
<b>Total liabilities</b>	<u>0</u>	
<b>Net assets</b>	<u>300</u>	
<b>Equity</b>		
Cash flow hedge reserve	(190)	Effective portion of hedge recognised in equity.
Retained earnings	<u>(110)</u>	
<b>Total Equity</b>	<u>(300)</u>	

### Income statement 30 June 20x0

<b>Expenses</b>		
Other gains and losses	(10)	Ineffective portion of cash flow hedge.
<b>Profit or (loss) for the period</b>	<u>(10)</u>	

## Appendix B – Applying cash flow hedge accounting mechanics

31 Dec 20x0

Cr Derivative	250	To record the fair value changes of forward contract.
<hr/>		
Dr Cash flow hedge reserve	240	Effective portion of hedge recognised in equity. The amount recognised is determined by the ‘lower of’ test in <b>Table B</b> above.
<hr/>		
Dr Other gains and losses	10	Adjustment to profit or loss.
<hr/>		

Dr Inventory	3500
<hr/>	
Cr Bank overdraft	3500
<hr/>	

To record receipt of and payment for widgets.

Dr Bank overdraft	50
<hr/>	
Cr Derivative	50
<hr/>	

To settle the derivative forward contract.

## Appendix B – Applying cash flow hedge accounting mechanics

### Statement of financial position 31 Dec 20x0

<b>Assets</b>		
Inventory	3500	Carrying amount of inventory.
Derivative	<u>0</u>	Derivative is settled.
<b>Total assets</b>	<u>3500</u>	
<b>Liabilities</b>		
Bank overdraft	<u>(3450)</u>	
<b>Total liabilities</b>	<u>(3450)</u>	
<b>Net assets</b>	<u>50</u>	
<b>Equity</b>		
Cash flow hedge reserve	50	Amount in cash flow hedge reserve to be recycled when hedged transaction affects profit or loss ie on sales of inventory.
Retained earnings	<u>(100)</u>	
<b>Total Equity</b>	<u>(50)</u>	

### Income statement 31 Dec 20x0

<b>Expenses</b>		
Other gains and losses	<u>0</u>	
<b>Profit or (loss) for the period</b>	<u>0</u>	No profit or loss effect (under-hedge scenario).

## Appendix C – Applying fair value hedge accounting mechanics

	Fair value of hedging instrument (derivative)			Fair value of hedged item (firm commitment)		
	A	B		C	D	
Date	Fair value	Period change	Cumulative change	Fair value	Period change	Cumulative change
01 Jan 20x0	100			-		
30 June 20x0	300	200	200	(190)	(190)	(190)
31 Dec 20x0	50	(250)	(50)	55	245	55

**Table C**

The above table sets out the data used in this example. It is the same as that used in Appendix B above. However, as this illustration applies fair value hedge accounting, the ‘lower of’ test does not apply.

## Appendix C – Applying fair value hedge accounting mechanics

### 1 January 20x0

The fair value of the hedging instrument ie the forward contract at inception of the hedging relationship was 100 and hence results in ineffectiveness.

The opening statement of financial position is as follows:

Dr Derivative 100

Cr Retained earnings 100

### 30 June 20x0

Dr Derivative	200
	<hr/>

Cr Other gains and losses	200
	<hr/>

To record changes in fair value of the derivative

Dr Other gains and losses	190
	<hr/>

Cr Firm commitment	190
	<hr/>

To record the fair value changes of the firm commitment. In a fair value hedge of a firm commitment, the fair value changes of the hedged item (an unrecognised item) is recognised in the statement of financial position.



## Appendix C – Applying fair value hedge accounting mechanics

### Statement of financial position 30 June 20x0

<b>Assets</b>	
Inventory	0
Derivative	300
	Forward contract is measured at fair value.
<b>Total assets</b>	<u>300</u>
<b>Liabilities</b>	
Firm commitment	(190)
	Changes in the fair value of the firm commitment are recognised.
Bank overdraft	<u>0</u>
<b>Total liabilities</b>	<u>(190)</u>
<b>Net assets</b>	<u>110</u>
<b>Equity</b>	
Retained earnings	<u>(110)</u>
<b>Total Equity</b>	<u><u>(110)</u></u>

### Income statement 30 June 20x0

<b>Expenses</b>	
Other gains and losses	(10)
	Ineffective portion ie difference in fair value changes of the hedging instrument and hedged item are recognised in profit or loss for the period.
<b>Profit or (loss) for the period</b>	<u><u>(10)</u></u>

## Appendix C – Applying fair value hedge accounting mechanics

**31 Dec 20x0**

Cr Derivative	<u>250</u>
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Dr Other gains an losses	<u>250</u>
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To record fair value changes of the derivative

Dr Firm commitment	<u>245</u>
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Cr Other gains and losses	<u>245</u>
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To record fair value changes of the firm commitment.

Dr Inventory	<u>3500</u>
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Cr Bank overdraft	<u>3500</u>
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To record receipt of and payment for widgets.

Dr Inventory	<u>55</u>
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Cr Firm commitment	<u>55</u>
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Adjusting carrying amount of inventory to reflect the effective portion of the hedge.

Cr Derivative	<u>50</u>
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Dr Bank overdraft	<u>50</u>
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To settle the derivative forward contract.

## Appendix C – Applying fair value hedge accounting mechanics

### Statement of financial position 31 Dec 20x0

<b>Assets</b>		
Inventory	3555	Inventory amount adjusted for hedge effectiveness.
Derivative	0	The forward contract is settled.
<b>Total assets</b>	<u>3555</u>	
<b>Liabilities</b>		
Firm commitment	0	
Bank overdraft	<u>(3450)</u>	
<b>Total liabilities</b>	<u>(3450)</u>	
<b>Net assets</b>	<u>105</u>	
<b>Equity</b>		
Retained earnings	<u>(105)</u>	
<b>Total Equity</b>	<u><u>(105)</u></u>	

### Income statement 31 Dec 20x0

<b>Expenses</b>		
Other gains and losses	<u>(5)</u>	Hedge ineffectiveness.
<b>Profit or (loss) for the period</b>	<u><u>(5)</u></u>	

## Appendix D – Applying tentative approach for fair value hedges

Date	Fair value of hedging instrument (derivative)			Fair value of hedged item (firm commitment)		
	A	B		C	D	
	Fair value	Period change	Cumulative change	Fair value	Period change	Cumulative change
01 Jan 20x0	100			-		
30 June 20x0	300	200	200	(190)	(190)	(190)
31 Dec 20x0	50	(250)	(50)	55	245	55

**Table D**

The above table sets out the data used in this example. It is the same as that used in Appendix B and Appendix C above.

## Appendix D – Applying tentative approach for fair value hedges

### 1 January 20x0

The fair value of the hedging instrument ie the forward contract at inception of the hedging relationship was 100 and hence results in ineffectiveness.

The opening statement of financial position is as follows:

Dr Derivative 100

Cr Retained earnings 100

### 30 June 20x0

Dr Derivative	200	To record fair value changes of derivative.
Cr Cash flow hedge reserve	190	To record the effective portion in cash flow hedge reserve.
Cr Other gains and losses	10	To record ineffectiveness in profit or loss (ineffectiveness was a result of using an existing derivative as a hedging instrument).

## Appendix D – Applying tentative approach for fair value hedges

### Statement of financial position 30 June 20x0

<b>Assets</b>		
Inventory	0	
Derivative	300	Forward contract measured at fair value.
	<hr/>	
<b>Total assets</b>	<b>300</b>	
	<hr/>	
<b>Liabilities</b>		
Bank overdraft	0	
	<hr/>	
<b>Total liabilities</b>	<b>0</b>	
	<hr/>	
<b>Net assets</b>	<b>300</b>	
	<hr/> <hr/>	
<b>Equity</b>		
Cash flow hedge reserve	(190)	Effective portion of hedge recognised in equity.
Retained earnings	(110)	
	<hr/>	
<b>Total Equity</b>	<b>(300)</b>	
	<hr/> <hr/>	

### Income statement 30 June 20x0

<b>Expenses</b>		
Other gains and losses	(10)	Ineffective portion of hedge.
	<hr/>	
<b>Profit or (loss) for the period</b>	<b>(10)</b>	
	<hr/> <hr/>	

## Appendix D – Applying tentative approach for fair value hedges

**31 Dec 20x0**

Cr Derivative	250	To record the fair value changes of forward contract.
Dr Cash flow hedge reserve	245	Effective portion of hedge recognised in equity. The 'lower of' test is not applied.
Dr Other gains and losses	5	Hedge ineffectiveness.

Dr Inventory	3500	

Cr Bank overdraft	3500	

To record receipt of and payment for widgets.

Cr Derivative	50	

Dr Bank overdraft	50	

To settle the derivative forward contract.

**Statement of financial position 31 Dec 20x0**

**Assets**

Inventory	3500	Carrying amount of inventory is not adjusted under the tentative approach for fair value hedges.
Derivative	0	The forward contract is settled.
<b>Total assets</b>	<u>3500</u>	

**Liabilities**

Bank overdraft	<u>(3450)</u>
<b>Total liabilities</b>	<u>(3450)</u>
<b>Net assets</b>	<u>50</u>

**Equity**

Cash flow hedge reserve	<u>55</u>	Amount in cash flow reserve to be recycled when hedged transaction affects profit or
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