

**THE ANALYSIS OF THE IFRS EXPERIENCE ON THE DERIVATIVES ACCOUNTING FOR APPLICATION IN THE ACCOUNTING PRACTICE IN THE REPUBLIC OF BELARUS**

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*The article considers the approaches to the accounting of derivatives based on the IFRS provisions. The accounting treatment of hedge relationship is presented in the article. The outcomes of applying of the hedge accounting on the profit or loss are compared with outcomes of ordinary accounting.*

**Introduction.** The current status of the derivatives accounting in the Republic of Belarus can be described as follows: in the banking system of Belarus there is a number of regulations based on international financial reporting standards (IFRS), while for the accountant of industrial or commercial enterprises it is quite difficult to make the accounting entries for forwards or other derivatives according to the standards of the Instruction approved by the Ministry of Finance of the Republic of Belarus № 164 dated 22.12.2006 [1]. That's why for the wide usage of derivatives by nonfinancial organizations in the Republic of Belarus it is necessary to develop transparent provisions for the accounting of transactions with derivatives. Therefore, we consider it appropriate to use the experience of IFRS. Moreover, IFRS will come into effect on the territory of the Republic of Belarus from 1 January 2017 as technical normative acts [2, 3]. In this article it will be considered what accounting treatments can be used for derivatives according to the provisions of IFRS.

According to IFRS a financial instrument is an agreement which causes a financial asset for one enterprise and a financial liability or equity instrument for another [4, p. 2]. And a derivative (alias derivative financial instrument or derivative instrument) is a financial instrument or some other contract with *all* of the following characteristics [5, p. 16]:

- a) Its value changes in response to changes in a set interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or some other variable, provided that in the case of a non-financial variable this variable is not specific to either party of the contract.
- b) It requires no initial investment, or an initial investment that is smaller than would be required for other types of the contracts which would be expected to have a similar response to changes in market factors.
- c) It is settled at a future date.

It is possible to distinguish between two types of derivatives according to the purpose they were entered into: purchased (entered into) to hedge unpredictable movement of prices and other variables, or entered into for speculation in order to profit from potential changes in market indicators. The main peculiarity of hedging is that it allows to guarantee a certain level of paid or received amount, but does not guarantee that these amounts will be more favorable than the amount received in a situation where hedging is not used. Hedging (from the English hedge – to protect, to insure yourself against possible losses) is a futures (forward) transaction for insurance against the possible fall in price when making long-term deals. And hedge, accordingly, is a position, which is used as a temporary replacement for a future position in another asset (obligation) or to protect the value of the current position of the asset (obligation), while this position may not be eliminated [6, p. 200].

In addition, an organization can buy or sell products using contracts with the deferral of the contract execution, which have similar trappings with the definition of derivatives in IFRS, but the goal of entering into such contracts is for the purpose of receipt or delivery of commodities in accordance with the entity's normal purchase or sale requirements (it is not expected that the organization will sell the contract; it is not planned for the received item to be sold shortly after delivery so as to profit from short term price changes; in the terms of the contract the physical delivery of goods is provided, while the net settlement isn't permitted). Commodity contracts that aren't considered as derivative contracts are called «own-use contracts» (or «normal purchase and normal sale» under US generally accepted accounting principles). These contracts also have the element of hedging relationship, because they fix the future sale or purchase price, but such method of accounting as «hedge accounting» in accordance with IFRS is not suitable for them. Own-use contracts are not fair valued, but accounted for using the accrual method.

There are several particular standards in IFRS that are relevant for hedging. The main standard connected with derivatives and hedging is IFRS 9 «Financial Instruments», which replaces IAS 39 «Financial Instruments: Recognition and Measurement» and establishes accounting principles for recognition, measurement and disclosure of financial assets and liabilities. Standard IFRS 9 «Financial Instruments» is a complex standard, remarkably wide in scope and interacts with other standards. IFRS 9 «Financial Instruments» in relation to derivatives allows the entity opportunity to defer financial results from derivatives in profit or loss. But it is possible only if all obligatory criteria established in IFRS 9 are met.

For hedging, in addition to standard IFRS 9, the following standards presented in Figure 1 will be relevant.

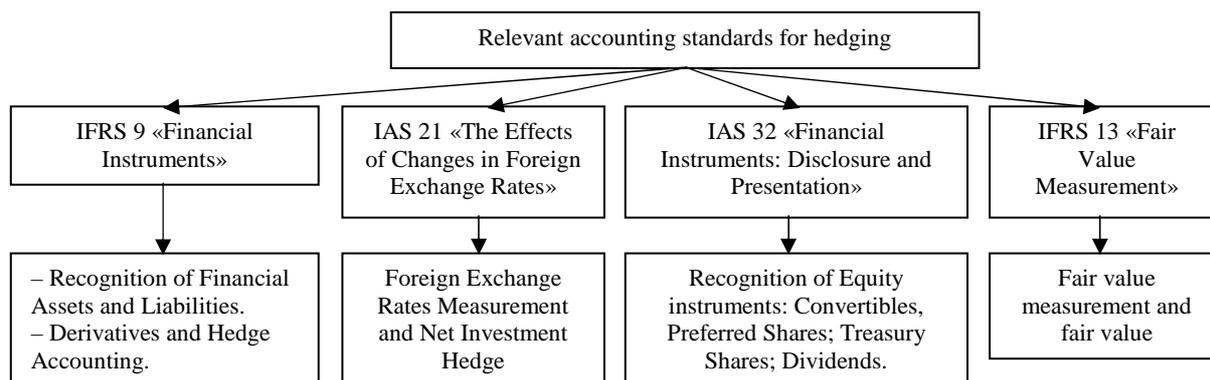


Fig. 1. The provisions of IFRS that are relevant for hedging

Source: [7, p. 1, fig. 1.1].

On the basis of the IFRS provisions it is possible to allocate the derivatives themselves, which are measured at fair value, and hedge accounting is applied for derivatives, the changes in fair value of derivatives are deferred until offsetting cash flows are obtained. It means that all derivatives are recognized in the balance sheet at fair value, no matter whether or not they are part of a hedge accounting relationship. There are two types of derivatives: undesignated for hedge accounting or speculative derivatives, which require the revaluation of fair value at the reporting date, and those, for which the hedge accounting is implemented. Such implementation requires formal designation of hedging relationship for each specific derivative, as well as hedge effectiveness criteria should be met.

Fair value is a price that might be received while selling an asset or paid to transfer a liability when conducting operations on a voluntary basis in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or is estimated using another valuation technique [8, p. 3]. The best indicator of fair value for a financial instrument is a published quote price, which is set on relevant stock exchanges.

In addition, IFRS and US GAAP for distinguishing commodity derivatives, purchased for the purposes of hedging or speculation, from simple contracts with future delivery establish specific terms such as «own-use contracts» (in IFRS) or «normal sale and normal purchase» (in US GAAP). These contracts don't require fair valuation like derivatives and are recorded on an accrual basis (the results of transactions and other events that are recognized when they occur (not when the receipt or payment of cash or cash equivalents takes place), are reflected in the accounting entries and are included in the financial statements of the periods which they relate to). The terms of settlement can be a reliable criterion for determining whether a particular contract is a derivative or own-use one: for own-use contracts physical delivery must be provided, but the organization must actually use the product for its current activities, and there shouldn't be the practice of selling the product soon after obtaining to profit from short term price changes.

Such concept as hedge accounting mentioned above is one of the key provisions of IFRS 9. Hedge accounting – is a method of accounting that changes the normal basis of recognition gains and losses associated with the hedging instrument and the hedged item to enable such gains and losses to be recognized in profit or loss in the same period when the offsetting cash flows occur. It should be noted that in the hedging relationship there are two elements [7, p. 24].

1. The hedged item – is the item that exposes the entity to a market risk. It is the element that is designated as being hedged.

2. The hedging instrument – is the element that hedges the risk to which the hedged item is exposed. Frequently, the hedging instrument is a derivative.

There are three types of hedge relationship [3, par. 6.5.2].

A. Fair value hedge: a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

B. Cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognized asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

C. Hedge of a net investment in a foreign operation as defined in IAS 21.

But in fact the hedge accounting can be divided into two forms [7, p. 24].

1. Fair value hedge – recognizing gains or losses in respect of both the hedging instrument and hedged item in earnings in the same accounting period.

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2. Cash flow hedge or net investment hedge – deferring recognized gains and losses in respect of the hedging instrument on the balance sheet until the hedged item affects earnings.

For example, suppose that an entity enters in 20X0 into a derivative to hedge risk exposure of an item that is already recognized in the balance sheet. The derivative matures in 20X1 and the hedged item settles in 20X2. The comparison of the impacts of cash flows in hedge relationship on profit or loss when applying, or not applying, hedge accounting is given in Table 1.

Table 1 – The comparison of applying or not applying hedge accounting

	20X1	20X2	Total
<b>Without hedge accounting:</b>			
Hedging instrument	1,000		1,000
Hedged item (realized gain)		<1,000>	<1,000>
Net profit / (loss)	1,000	<1,000>	-0-
<b>With fair value hedge:</b>			
Hedging instrument	1,000		1,000
Hedged item (unrealized gain)	<1,000>		<1,000>
Net profit / (loss)	-0-	-0-	-0-
<b>With cash flow hedge:</b>			
Hedging instrument (after deferral in equity)		1,000	1,000
Hedged item (realized gain)		<1,000>	<1,000>
Net profit / (loss)	-0-	-0-	-0-

Source: [7, p. 25].

It should be noted that for the application of hedge accounting in the beginning and throughout the period of the hedging relationship the hedge must meet very strict requirements. In general, these requirements are the following: in the relationship there should be only a qualified hedged item and hedging instrument (additional requirements); by the beginning of the hedge relationship the entity should develop formal documentation on this issue; the hedge relationship should meet the requirements of hedge effectiveness.

**Conclusion** Thus, in connection with the adoption of IFRS as the technical normative acts in the Republic of Belarus, the analysis of these provisions in accounting for derivatives is important for applying IFRS in practice, especially for organizations that report under IFRS. Such analysis will also help to improve the national legislation. In this paper general approaches to the accounting of derivatives according to IFRS have been described, and as the result the following aspects can be noticed: IFRS 9 requires all derivatives (but for some commodity own-use contracts) to be measured in the balance sheet at fair value. It is possible to distinguish between two types of derivatives: undesignated for hedge accounting or speculative derivatives which require the revaluation of fair value at the reporting date and those, for which the hedge accounting is implemented. Such implementation requires formal designation of hedging relationship for each specific derivative, and hedge effectiveness criteria should be met. Depending on the type of hedge relationship changes in fair value of derivatives can be recognized in different ways.

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