Financial Markets Books

Treasury Services

IN COMPLIANCE WITH THE ESMA GUIDELINES

Derivatives Accounting

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Introduction

When the first major derivatives failures came to light in the 1980s, it suddenly became apparent that derivatives were not recognised in the financial statements; they were off-balance sheet instruments. Today, things are different. Companies are expected, in principle, to disclose derivatives in their balance sheet and statement of profit or loss (p&l). IFRS (International Financial Reporting Standards), US GAAP (Generally Accepted Accounting Principles) and Dutch GAAP (Dutch Accounting Standard (RJ 290), for instance, all have rules for how to account for derivatives.

1 Standard reporting rules

Under IFRS, US GAAP and RJ 290, financial instruments must be recognised at fair value when the company becomes party to the contract. However, with the exception of options, the cost of derivatives at contract inception usually corresponds to zero[3]. For this reason, most derivatives are not recognised at inception. The clean market value is always used for accounting purposes.

The cost price of an option is the premium and a purchased option must be recognised as an asset and a sold option as a liability. The value corresponds to the option premium in both cases.

[3] Not including the client margin.

Example 1

A company purchases an interest rate option for 50,000. The entries in the financial accounts are as follows:

Derivatives (balance sheet)	50,000 dt
To Bank (balance sheet)	50,000 cr

Under US GAAP and IFRS, derivatives must be recognised at fair value during the term of the contract, irrespective of whether this value is positive or negative. A positive fair value must be reported on the asset side of the balance sheet and a negative fair value must be reported on the liabilities side. In addition, all changes in the fair value between two reporting dates must be recognised through profit or loss.

Under RJ 290, derivatives must in principle be recognised at the lower of cost or fair value over the term of the contract. This means that non-option derivatives can only be disclosed on the liabilities side of the balance sheet (i.e. they are only recognised if the fair value is negative). Changes in negative fair value must be recognised through profit or loss.

Example 2

A company has calculated that, after inception, a commodity swap had a negative value of 35,000 on the first reporting date. As the initial fair value of the derivative corresponded to zero, it makes the following entries in the financial statements (under IFRS, US GAAP and RJ 290):

Result on financial instruments (statement of p&l)	35,000 dt
To Derivatives Credit (balance sheet)	35,000 cr

If, in the next year, the value of the commodity swap rises to € 10,000 negative (i.e. becomes less negative), the organisation must make the following entries (under IFRS, US GAAP and RJ 290):

Derivatives Credit (balance sheet)	25,000 dt
To Result on financial instruments (statement of p&l)	25,000 cr

If, in the next year, the value of the commodity swap rises from 10,000 negative to 12,500 positive, the organisation must make the following entries under RJ 290:

Derivatives Credit (balance sheet)	10,000 dt
To Result on financial instruments (statement of p&l)	10,000 cr

However, under IFRS and US GAAP, the entries should be as follows:

Derivatives Credit (balance sheet)	10,000 dt
|Derivatives Debit (balance sheet)	12,500 dt
To Result on financial instruments (statement of p&l)	22,500 cr

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If the value of a purchased option falls below the cost price, the debit item (Option) must be reduced in the balance sheet (credited). At the same time, the item 'Result on financial instruments' in the statement of profit or loss must be debited for the negative change in value.

If the option's value rises again in the next reporting period, the loss recognised in earlier financial statements must be offset against a profit. Under RJ 290, the option's value is never to exceed its cost, the reason being that, under this regime, options are recognised at the lower of cost or fair value.

Example 3

A company purchases an interest rate option for 50,000. If, the next year, the option's value has fallen to 20,000, the organisation must make the following entries:

Result on financial instruments (statement of p&l)	30,000 dt
To Derivatives (balance sheet)	30,000 cr

If, in the next year, the option's value has risen from 20,000 to 60,000, the organisation must make the following entry under IFRS or US GAAP:

Derivatives (balance sheet)	40,000 dt
To Result on financial instruments (statement of p&l)	40,000 cr

However, if the company reports under RJ 290, it must make the following entries:

Derivatives (balance sheet)	30,000 dt
To Result on financial instruments (statement of p&l)	30,000 cr

If the option's value rises above 50,000, RJ 290 stipulates that it is to be recognised at its initial cost of 50,000 in accordance with the 'cost or lower fair value' accounting principle.

At the end of the term of a derivatives contract or in the event of early termination, the contract must be eliminated from the balance sheet and the difference between this contract's fair value at the end date and the last-measured value is to be recognised through profit or loss. This applies to both gains and losses.

The fair value of an interest rate swap is zero at the end of the term. Any cash flows arising at the end of the term are payments from accrued interest, which is why they do not represent fair value. If the fair value in the preceding report was positive, it would not have been reported under RJ 290. In this case, no entry is required on the end date. If the fair value in the preceding report was negative, a contra entry must be reported for this negative value.

Example 4

An interest rate swap matures on 15 May. On 31 December of the preceding year, the negative fair value of this swap was 45,000. Upon termination of the swap, the following entries must be made:

Derivatives (balance sheet)	45,000 dt
To Result on financial instruments (statement of p&l)	45,000 cr

If the interest rate swap had had a positive value of 45,000 on 31 December, no entry would have been required under RJ 290, given that the swap would then not have been recognised in the previous year. Under US GAAP and IFRS, however, the interest rate swap would have been recognised as a debit item of € 45,000 in the balance sheet and the following entries would have been required:

Result on financial instruments (statement of p&l)	45,000 dt
To Derivatives (balance sheet)	45,000 cr