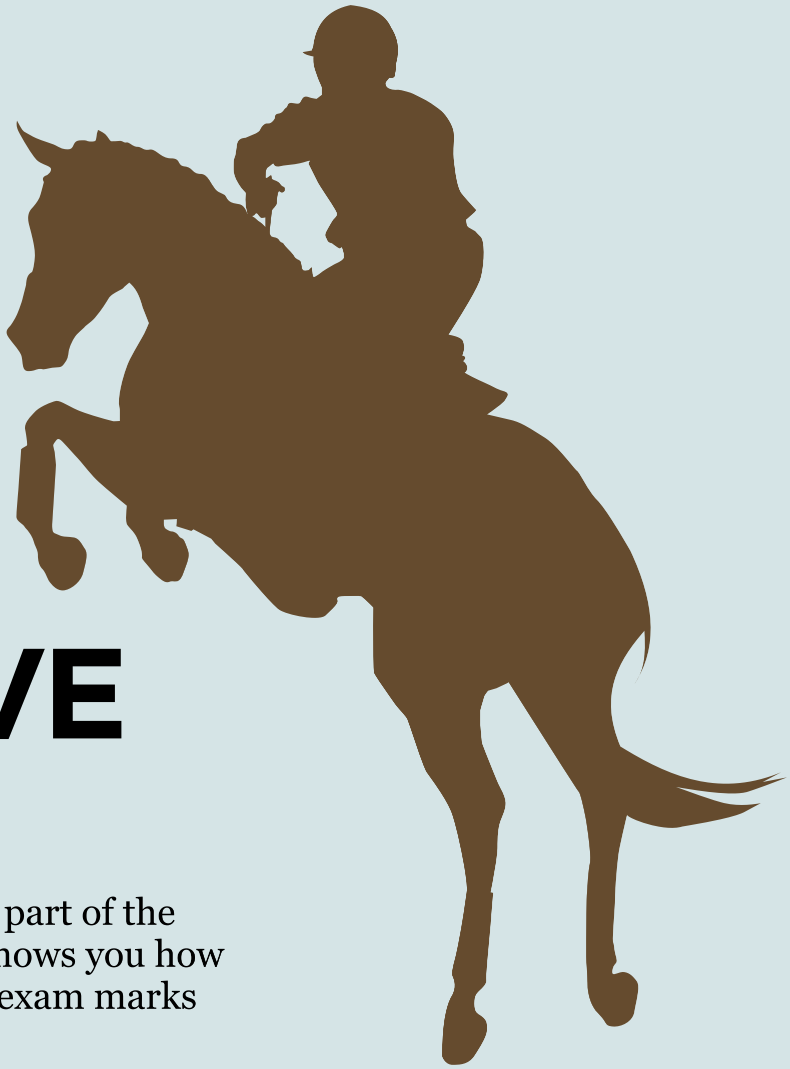


THE GRAND DERIVATIVE HURDLE

Accounting for derivatives is an essential part of the financial reporting race. Doug Williamson shows you how to jump each obstacle in turn to earn easy exam marks

Most financial disasters follow a period of misreporting, concealment or false accounting. A common source of treasury disasters has been speculative losses on derivatives, together with their misreporting. As a result, all of us now have to report our derivatives more often and in more detail than ever before.

They're off

Accounting for derivatives is often examined, so a firm grasp of the details is crucial to gain vital exam marks. The detailed steps follow a simple time order (see Winning Answer, on page 61).

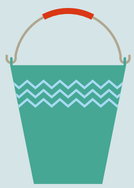
> **Challenging question**
>
> *A derivative can be used for speculative or hedging purposes. Accounting standards require alternative accounting treatments depending on the purpose for which the derivative is being used.*
>
> **Required:**
>
> Explain the accounting treatment required for:
>
> **a)** A non-hedge derivative. **(3 marks)**
>
> **b)** A derivative used in a cash-flow hedge. **(3 marks)**
>
> October 2013, Financial and Management Accounting (FMA)

First fence fallers

Looking at our Winning Answer (page 61) and the recent examiner's report Details, please (above right), some candidates tried to answer the harder revaluation steps (3) and (4) straight away, without jumping the first two easier hurdles about the initial valuation. Sadly, these candidates lost the easy marks available for writing about steps (1) and (2). A possible explanation may be that the initial value is often close to nil, so it might have appeared – wrongly – not to be worth writing about.

Other candidates, even more unfortunately, never got past the starting barrier on this question, inevitably scoring zero.

> **Details, please**
>
> *This question asked students to explain the accounting for a non-hedge derivative and a derivative used in a cash-flow hedge.*
>
> *Answers were insufficiently detailed. For example, it was quite commonly stated that a non-hedge derivative should be valued annually at fair value with changes in fair value taken to profit or loss – this is correct. However, there was no mention of how the item should be initially recorded.*
>
> *A significant number omitted this question.*
>
> *The average mark was 47%.*
>
> Examiner's report, FMA, October 2013



Mastering the details

The detailed accounting rules are easy to remember when we've understood:

1. What derivatives are;
2. What derivatives are for; and
3. Why the latest accounting rules were developed.

HELP FOR ACT STUDENTS

Download the previous articles from this series and other useful study information from the Exam tips and Study tips areas of the student site at **study.treasurers.org/examtips** and **study.treasurers.org/studytips**

WINNING ANSWER

Step	(a) Non-hedge derivative	(b) Derivative in a cash-flow hedge
1	Record initially at fair value.	
2	Charge any transaction costs to profit or loss.	
3	Remeasure to fair value at each period end.	
4	Take gains or losses directly to profit or loss.	Take gains or losses to reserves ('park in equity'). Report them in other comprehensive income.
5	Not applicable.	Release ('recycle') cumulative gains or losses to profit or loss in the same period(s) as the hedged cash flows affect profit or loss.

1. What is a derivative?
A financial derivative is a liability or an asset whose value is derived from a market price or rate.

2. What are derivatives for?
For a non-financial corporate, the primary use of derivatives is to hedge existing exposures to market prices. The derivative effectively insures us against adverse changes in the market price. When the market price goes against us, the value of the hedging derivative moves in our favour, reducing or eliminating the total change in our net hedged position.

For example, let's say we're due to receive and convert foreign currency at a future date. If the foreign currency exchange rate were to weaken, we would suffer a loss on the exchange rate.

We can insure ourselves against any unwelcome changes in exchange rates by entering into a forward FX contract. The table below illustrates an adverse change in the FX rate, and hedging of 100% of the FX receivable value.

	Domestic currency value
FX receivable value	Falls
Forward contract value	Improves
Net hedged value achieved	Unchanged

The value of our net hedged receipt has been protected by the hedge.

3. Why the accounting rules?
The reasons for the modern accounting rules are very important:

- Some naughty people are tempted to use company money and derivatives for speculation when they shouldn't.
- Their speculations often result in losses.
- It's attractive for people to under-report their speculative losses.
- If that were allowed by accounting rules, they'd be further tempted to carry on speculating, in the hope of recouping the losses before being found out.

Excessive speculation of this kind wipes out companies. Modern accounting rules are designed to ensure that any speculative losses are recognised and reported promptly. This helps to discourage and detect unauthorised or unwise speculations.

How the rules achieve their purpose
The accounting rules require:

- Recording of all derivatives at their fair value, and their periodic remeasurement to fair value (steps (1) to (3) in our Winning Answer, above).
- Identifying the purpose of the derivative, and proving the purpose and effectiveness of any hedging.
- The immediate reporting of non-hedging gains or losses in the profit and loss account, step (4).

This means that reporting any speculative losses cannot be deferred. The default accounting treatment is 'non-hedge', which includes speculation. If we can't positively prove we have an effective hedge, we have to account for it as a non-hedge. Indeed, if we fail the very strict 'hedge effectiveness' tests, we must always account under the non-hedge rules, regardless of our purpose or motivation.

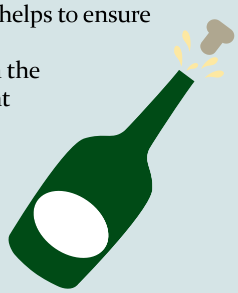
Starting order
The detail of our Winning Answer is easy to remember if you note:

- The simple time order of the steps.
- Initial recording at fair value, and periodic remeasurement to fair value (ie the first three steps) apply equally to all derivatives.
- The accounting treatment only diverges in steps (4) and (5).

First things first
Returning to the full exam question, Challenging question (see page 60), we now know where to begin.

Read the requirement carefully and break it down:

- A numbered timeline will help enormously.
- The question says alternative treatments are required, depending on the purpose of the derivative. But this doesn't mean the answer is different at every stage.
- Where the answer is the same, we will get credit for including it briefly in both relevant places.
- A well-structured table saves writing time and helps to ensure a complete answer.
- The table Winning Answer (above) would earn the full six marks in the Financial and Management Accounting exam.



Past the post
Congratulations, you've crossed the finishing line. Step into the winner's enclosure and claim the crowd's applause – and your champagne.

Which topics do you have problems with? Do you have any advice that you can share with other students?
Please email your ideas and suggestions to Sally Percy at **editor@treasurers.org**

Doug Williamson
FCT was an ACT chief examiner for five years. He now enjoys helping you to pass your exams as a tutor, author and coach