

Accounting for Derivatives

Accounting for Derivatives – Study Notes

1. Overview

Derivatives are financial instruments whose value derives from an underlying asset, rate, or index. Because they can generate significant gains or losses, accounting standards require detailed recognition, measurement, and disclosure.

Aspect	Key Point
Definition	A contract that gives the right or obligation to buy/sell an underlying asset, receive/pay cash flows, or exchange financial instruments.
Common Types	• Forward contracts • Futures contracts • Options (calls & puts) • Swaps (interest rate, currency, credit)
Purpose of Accounting	Reflect economic substance, ensure comparability, and provide users with information on risk exposure, cash flow impact, and fair value.

2. Relevant Accounting Frameworks

Standard	Scope	Main Guidance
IFRS 9 – Financial Instruments	All entities reporting under IFRS.	Classification (amortised cost, FVOCI, FVTPL), hedge accounting, impairment.
IAS 12 – Income Taxes	Tax effects of derivative gains/losses.	Deferred tax assets/liabilities for temporary differences.
IAS 36 – Impairment of Assets	Impairment testing for assets that include embedded derivatives.	
IAS 38 – Intangible Assets	When a derivative is part of an intangible (e.g., a licensing agreement).	

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Standard	Scope	Main Guidance
ASC 815 (U.S. GAAP)	Similar to IFRS 9, with specific rules for “derivatives” and “embedded derivatives.”	
ASC 815-40 – Hedge Accounting	Criteria for qualifying hedges, effectiveness testing, and reclassification.	

3. Classification of Derivatives

Category	When to Use	Measurement
Held-to-Maturity (HTM) – amortised cost	Rare; only if the derivative is a non-derivative financial asset (e.g., a forward that meets the “solely for settlement of a non-derivative” test).	Amortised cost, using effective interest method.
Fair Value Through Other Comprehensive Income (FVOCI)	Only for equity-linked contracts that meet the FVOCI criteria (e.g., equity-linked put options that are not held for trading).	Fair value; unrealised gains/losses go to OCI, reclassified to profit or loss on disposal.
Fair Value Through Profit or Loss (FVTPL)	Default classification for all derivatives unless they qualify for the FVOCI or HTM exceptions.	Fair value; changes recorded directly in profit or loss (P&L).

In practice, nearly all derivatives are measured at FVTPL.

4. Initial Recognition

1. **Identify the contract** as a derivative (must meet the three-part test).
2. **Determine classification** (FVTPL is default).
3. **Record at fair value** on the date of acquisition/issuance.
 - **Debit** an asset (if fair value is positive) or **credit** a liability (if negative).
 - **Corresponding entry** is a credit to *Equity* (for issuance) or a debit to *Cash/Bank* (for purchase) plus the fair-value component.

Example – Entering a 1-year interest-rate swap (pay-fixed, receive-floating):

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Date Account Dr Cr