

A86045 Accounting and Financial Reporting (2017/2018)

Session 19

Financial Instruments 2 – Risk Management

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SESSION 19 OVERVIEW AND OBJECTIVES

Course Objectives

At the end of this course students will be able to:

- ***Read and perform a high level interpretation*** of the financial statements of companies applying international accounting standards
- ***Identify and evaluate*** the impact on a companies accounts of alternative accounting methods
- ***Carry out a high level assessment*** of the the economic- financial position of a company reporting under IAS/IFRS.

Course Overview

1. Financial reporting under IFRS	14. Construction contracts	
2. Financial analysis: Ratio analysis	15. Other Non-financial liabilities	
3. Financial analysis: Segments and EPS	16. Review session	
4. Review session	17. Mid term test (Mon April 16)	PGS
5. Revenues	18. Financial Instruments 1	
6. Costs and expenses	19. Financial Instruments 2	PGS
7. Taxation - Direct and Indirect	20. Review session	
8. Non-current assets - Intangible assets	21. Cash Flow Statement	
9. Non-current assets - Tangible assets	22. Group accounts/Business comb	
10. Financial leases	23. Review session	PT
11. Impairment of assets	24. Review session	
12. Review session	25. Final test	PGS
13. Inventories		PT

Session 19 Overview

	Mins
Session overview and objectives	5
Review of pre-work and session 18 recap	5
Financial Instruments - Standards and definitions recap	5
Risk Management	5
Hedging and examples	25
Options and examples	15
Net investment	10
Disclosures and Unilever example	10
Overview of session 20, required reading and assignment for next session	5
Summary and validation	<u>5</u>

Objectives of Session 19

At the end of this session session students will be able to:

Understand the market risks to which a company is exposed and the financial instruments used by companies to mitigate these risks.

Understand the three types of hedging allowed under IFRS 9 (IAS 39) the conditions which need to be met to account for these as hedges, and the disclosures required by IFRS 7

SESSION 18 RECAP AND PRE-WORK

SESSION 19

Recap Session 18

- Financial Instruments
- Fair Value
- Accounts receivable

Overview of Session 18 – Financial Instruments

- Definitions and standards
- Classification and measurement (initial and subsequent)
- Financial assets
- Financial liabilities
- Equity instruments and compound financial instruments
- Disclosures

Overview of Session 18 – Fair Value

- Objective of IFRS 13
- IASs and IFRSs impacted
- Definition of Fair Value
- Fair Value Framework
- Valuation techniques - Fair Value hierarchy
- Disclosures

Overview of Session 18 – Accounts Receivable

- Accounts receivable
 - Discounting
 - Foreign currencies
- Valuation/allowances
 - Financial discounts
 - Returns
 - Bad debts
- Factoring/sale of receivables (with/without recourse)
- Credit Risk Disclosures

Session 19 Pre-work

- Reading
 - Melville International Financial Reporting – A Practical Guide :
 - Chapter 11 – Financial Instruments
 - IASB Technical Summaries
 - IAS 32 Financial Instruments: Presentation
 - IAS 39 Financial Instruments: Recognition and Measurement
 - IFRS 7 Financial Instruments: Disclosures
 - IFRS 9 Financial Instruments
- Exercises
 - Melville Chapter 11.1 – 11.6
 - Melville multiple choice Chapter 11
 - EX 19 Financial Instruments
- Research Assignment
 - RA 13 Financial Instruments

FINANCIAL INSTRUMENTS

Financial Instruments

- A business creates financial assets and liabilities through:
 - Buying and selling on credit
 - Borrowing to finance itself
 - Investing or trading in equity and other instruments
 - Raising additional cash from shareholders
 - Risk management activities
- Businesses are exposed to the following risks:
 - Credit risk (Counterparty can't meet its obligations)
 - Liquidity risk (Company can't meet its own obligations)
 - Market risk (Fair value or future cash flows of a financial instrument will fluctuate due to changes in market prices)
 - Price
 - Interest rate
 - Exchange rate

Financial Instruments

Primary financial instruments

Cash and contractual rights to receive or obligations to pay cash in future where one party's right to receive cash is matched by the other party's obligation to deliver cash

Receivables, Payables and equity instruments

Derivative financial instruments

A Financial instrument with all of the following three characteristics:

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

Financial options, futures and forwards, interest rate swaps and currency swaps

Financial Instruments

Non-derivatives

Financial assets

Cash, Short-Term Investments, Accounts Receivable

Financial liabilities

Bank overdrafts, Short-term Loans, Accounts Payable

Compound Financial Instruments

Current

Non-current

Equity

Investments, Loans and Receivables

Long-term Loans, Borrowings

Debt

Equity

Derivatives

Interest rate

Swaps, foreign currency swaps

Foreign currency

Options, forward contracts, collars, swaps

Commodity

Forward contracts, futures, options

Equity investments

Equity based derivatives

Risk management tools

Financial instruments – Recognition and measurement

*A financial asset or liability is only recognized in the balance sheet when, **and only when**, the entity becomes a party to the contractual provisions of the instrument. Prior to this there are no contractual rights or obligations.*

Examples	Recognition criteria met
Accounts Receivable and Accounts payable	Yes – legal right to receive or obligation to pay cash.
Firm commitments to purchase or sell goods and services	No – not until one of the parties has performed under the agreement
Forward contracts	Yes – It is a contract and recognized at the commitment date. It is recognized at the fair value of the right and obligation.
Option contracts	Yes - Right to buy “call” or sell “put”. “Bought” by the purchaser or “written” by the party with the obligation. Can be “in the money” or “out of the money”
Planned future contracts (forecast transactions)	No – the entity is not party to a contract. But could be if a hedge and highly probable

Initial Recognition

Both IAS 39 and IFRS 9 require that financial assets and liabilities be measured initially at their *Fair Value*.

This is normally the amount of the consideration given or received when the asset was acquired or the liability incurred.

Fair Value – IFRS 13

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

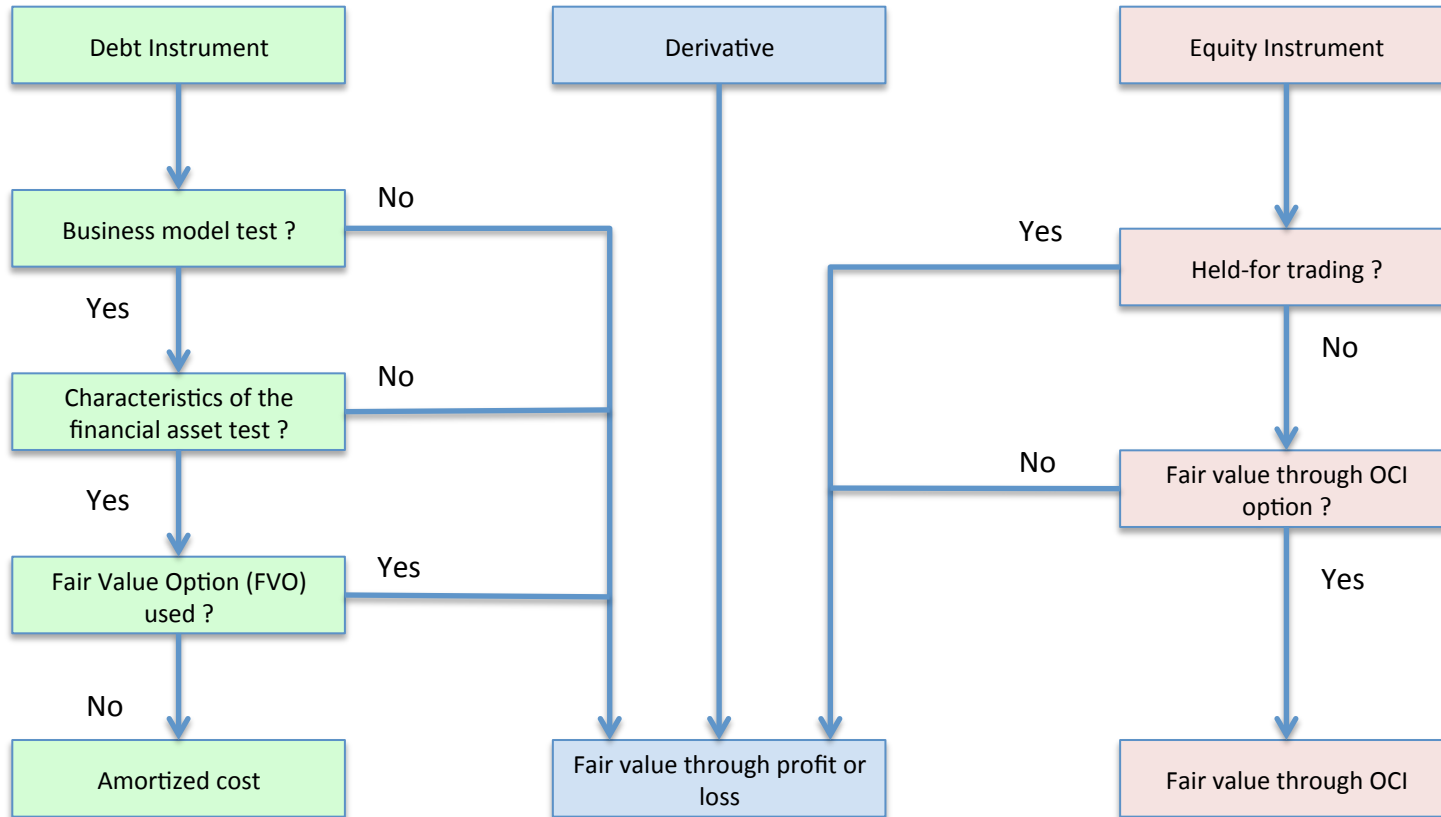
Fair value hierarchy:

Level 1 inputs: **quoted prices** in active markets for identical assets or liabilities

Level 2 inputs: inputs other than quoted prices included within level 1 **that are observable** for the asset or liability, either directly or indirectly e.g. quoted prices for similar assets or liabilities

Level 3 inputs: are **unobservable inputs** for the asset or liability. These should reflect assumptions that market participants would use when pricing an asset or liability, including assumptions about risk.

Classification - IFRS 9



RISK MANAGEMENT

Risk Management

- **Credit risk**
 - The risk that one party to a financial instrument will cause a loss for the other party by failing to discharge an obligation
- **Liquidity risk**
 - The risk that an entity will encounter difficulty in meeting obligations associated with that are settled by delivering or another
- **Market risk**
 - The risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk:
 - **Currency risk** - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates
 - **Interest rate risk** – the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates
 - **Other price risk** – The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than interest rate risk or currency risk), e.g. commodity prices or equity instruments, whether those changes are caused by factors specific to the individual financial instrument or its issuer or by factors affecting all similar financial instruments traded in the market.

What market risks ?

Type of transaction	Risks
Fixed interest loans	Interest rate changes impact future cash flows (interest income/expense) and the fair value of the loan (increase/decrease)
Purchases or sales in foreign currencies	Changes in exchange rates increase or decrease budgeted revenues and expenses
Fixed interest loans in foreign currencies	The combined effects of the risk of changes in interest rates and exchange rates
Investments in subsidiaries in foreign countries	Changes in exchange rates impact the value of the investment recorded in the financial statements

HEDGING

What is a Hedge ?

What is a hedge?

If you've ever packed an umbrella so you aren't caught out by the weather, you've adopted a hedge position. Chances are you have also taken out a financial hedge in the form of health or life insurance. You pay the premiums to cover yourself if something bad happens - it's a hedge on your health.

Businesses do the same thing. They will take steps to try to offset the possible losses that may be incurred by investments or by changes to financial markets.

Why do companies hedge?

Hedging is an important part of doing business. When investing in a company you expose your money to risks of fluctuations in many financial prices - foreign exchange rates, interest rates, commodity prices (oil and so on) and equity prices.

"They want to protect their financial results and/or financial position- for example cash or profits."

What can be hedged?

- A recognised asset or liability
 - E.g. receivable or payable or loan
- An unrecognised firm commitment
 - E.g. forward contract to buy materials or foreign currency
- A highly probable forecast transaction
 - E.g. Intragroup charges
- A net investment in a foreign operation
 - E.g. A subsidiary company

Hedging

- Fair value hedges

Gain or loss on re-measuring to FV recorded in P&L to offset change in value of hedged item

- Cash flow hedges

Portion determined to be an effective hedge recorded in OCI and the ineffective portion in P&L. Transfer to P&L in the period the hedged transaction impacts net income

- Net investment hedges

Similar to cash flow hedges. Reclassified to P&L on disposal

- Change in value of specific assets or liabilities or firm commitment e.g. risk of change in interest rates for a fixed rate bond.
- Future forecast cash flows e.g. future interest payments or exchange risk for a future transaction
- Currency risk on investments in foreign subsidiaries

N.B. In order to apply hedge accounting all the hedge accounting conditions must be met

Hedge accounting conditions

IAS 39

- Formal designation at inception fully **documented**
- Expected to be **highly effective**
- For cash flow hedges a forecast transaction must be **highly probable**
- The effectiveness can be **reliably measured**
- The hedge is **assessed** on an on-going basis

Hedging Criteria IFRS 9

A hedging relationship qualifies for hedge accounting only if **all of the following criteria are met**:

A352

- (a) the hedging relationship consists only of **eligible hedging instruments** and **eligible hedged items**.
- (b) at the inception of the hedging relationship there is **formal designation and documentation** of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).
- (c) the hedging relationship meets **all of the following hedge effectiveness requirements**:
 - (i) there is an **economic relationship** between the hedged item and the hedging instrument;
 - (ii) the effect of **credit risk does not dominate the value changes** that result from that economic relationship; and
 - (iii) the **hedge ratio** of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting

COMMON HEDGING INSTRUMENTS

Derivatives - examples

Type of contract

- **Swaps**: Interest rate, Currency, Commodity, Equity, Credit, Total return
- **Options**: (Purchased or written) bonds, currency, stock options
- **Futures**: Interest rate, currency, commodity
- **Forwards**: Interest rate, currency, commodity, equity

Main pricing-settlement underlying variable

- Interest rates, currency rates, commodity prices, equity prices, credit rating, Total fair value of the reference asset and interest rates



Derivative

A derivative is a **financial instrument** or other **contract** with all of the following characteristics:

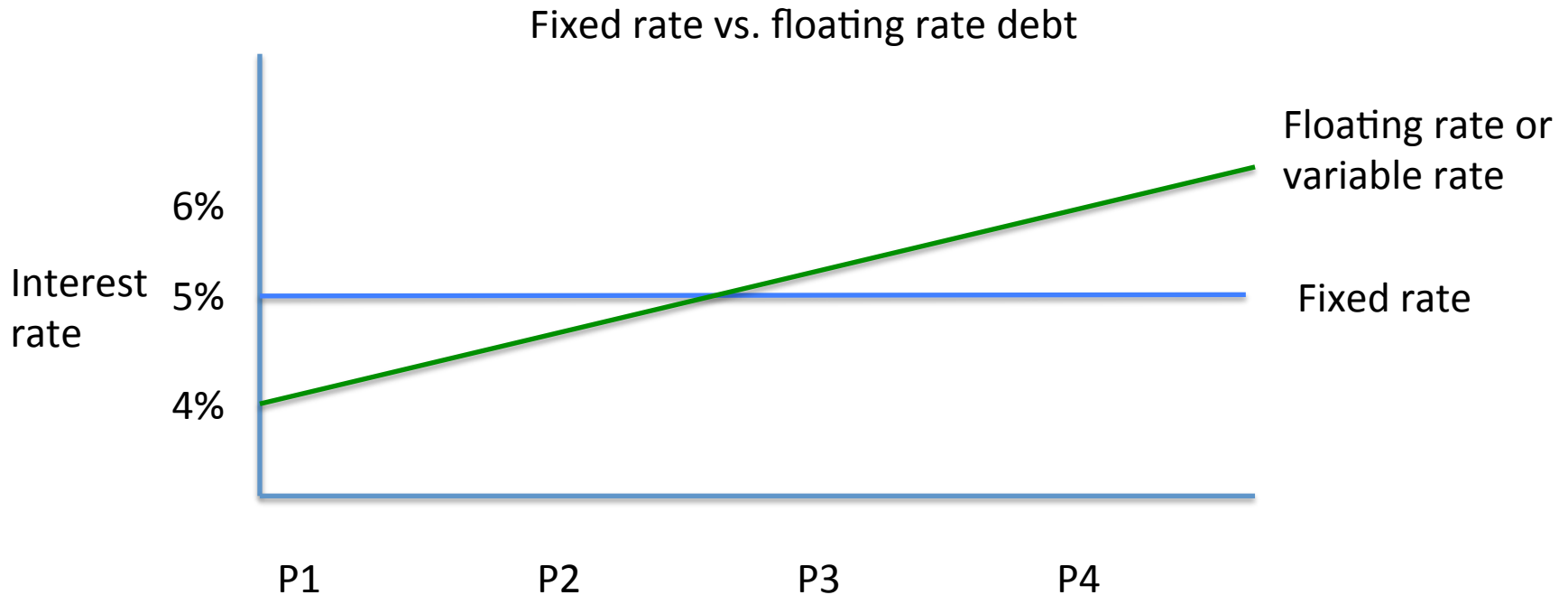
- a) Its **value changes in response** to the change in a specified interest rate (e.g. LIBOR), financial instrument price (e.g. share price), commodity price (e.g. price of a barrel of oil), foreign exchange rate (e.g. £/\$ spot rate), index of prices or rates (e.g. CPI), a credit rating (e.g. Fitch) or credit index (e.g. AAA rated corporate bond index), or other variable, provided in the case of a non-financial variable (e.g. index of earthquake losses or temperatures) that the variable is not specific to a party to the contract (sometimes called the underlying)
- b) It requires **no initial net investment**, or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors (e.g. an option, currency swap); and
- c) It is **settled at a future date**

EXAMPLES

Hedging Examples

- Interest rate risk
- Fair value hedge
- Currency (exchange rate) risk
- Cash flow hedge
- Futures/forward contracts
- Futures trading
- Options
- Purchase and sales transactions in foreign currencies
- Net investment hedges

Example – interest rate risk



How can we hedge the risks?

What are the implications for the debt instrument?

Risks

Cash flow: Increase/decrease in interest expense

Fair value: Increase/decrease in FV of debt instrument

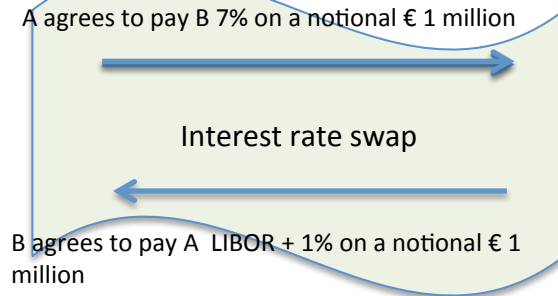
Interest Rate Swap

A
Variable

B
Fixed

A Borrows
€ 1 million
LIBOR + 2%

B Borrows
€ 1 million
Fixed 8%



SWAP

Pays	70,000	P1 5+2%	70,000
Receives	5+1% <u>60,000</u>		<u>10,000</u>
Net	10,000		80,000
→			
Pays	70,000	P2 4+2%	60,000
Receives	4+1% <u>50,000</u>		<u>20,000</u>
	20,000		80,000
→			
Pays	70,000	P3 6+2%	80,000
Receives	6+1% <u>70,000</u>		<u>0</u>
	0		80,000
→			
Pays	70,000	P4 8+2%	100,000
Receives	8+1% <u>90,000</u>		<u>(20,000)</u>
	(20,000)		80,000
→			

A is concerned interest rates will rise and wants to swap variable for fixed

LIBOR 5%
LIBOR 4%
LIBOR 6%
LIBOR 8%

SWAP

P1	80,000	Receives	70,000
	<u>(10,000)</u>	Pays	5+1% <u>60,000</u>
	70,000	Net	10,000
←			
P2	80,000	Receives	70,000
	<u>(20,000)</u>	Pays	4+1% <u>50,000</u>
	60,000		20,000
←			
P3	80,000	Receives	70,000
	<u>0</u>	Pays	6+1% <u>70,000</u>
	80,000		0
←			
P4	80,000	Receives	70,000
	<u>20,000</u>	Pays	8+1% <u>90,000</u>
	100,000		(20,000)
←			

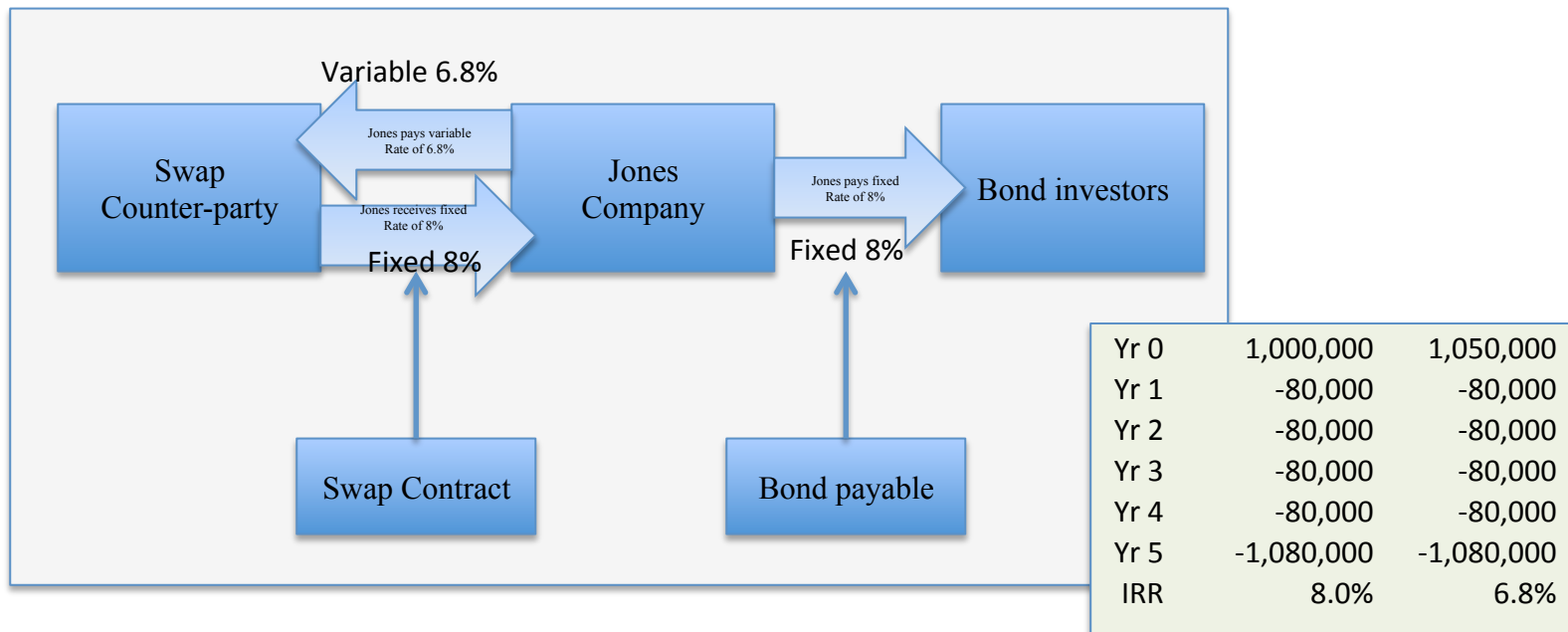
B is convinced interest rates will fall and wants to swap fixed for variable

Fair Value Hedge

Jones Company issues \$1,000,000 5 Year 8% fixed rate bonds on 2 January 2001. Jones is concerned that if market interest rates decline, the fair value of the liability to the company will increase. To protect against this Jones decides to hedge the risk entering into a 5 Year Interest Rate Swap contract. The Terms of the swap contract are:

1. Jones will receive fixed payments of 8%
2. Jones will pay variable rates based on market rates (currently 6.8%)

Jones has therefore changed the fixed rate loan to variable



Risk is also that if interest rates fall the fair value of the liability will increase

FV Hedge Accounting

January 2 2001	Dr Cash	1,000,000	
	Cr Bonds payable		1,000,000
January 2 2001			

Memorandum that swap contract is signed – No value so no entry

December 31	Dr interest expense	80,000	
	Cr Cash		80,000

Interest due on the bond (1,000,000 x 8%)

Net interest expense is 68,000 i.e. variable

December 31	Dr Cash	12,000	
	Cr Interest expense		12,000

(Proceeds from swap contract Net 1,000,000 @ 8% = 80,000 received less 1,000,000 @ 6.8% = 68,000 paid)

Interest rates have declined so the value of the swap contract has increased to 40,000

December 31	Dr Swap contract (B/S)	40,000	
	Cr Financial income		40,000

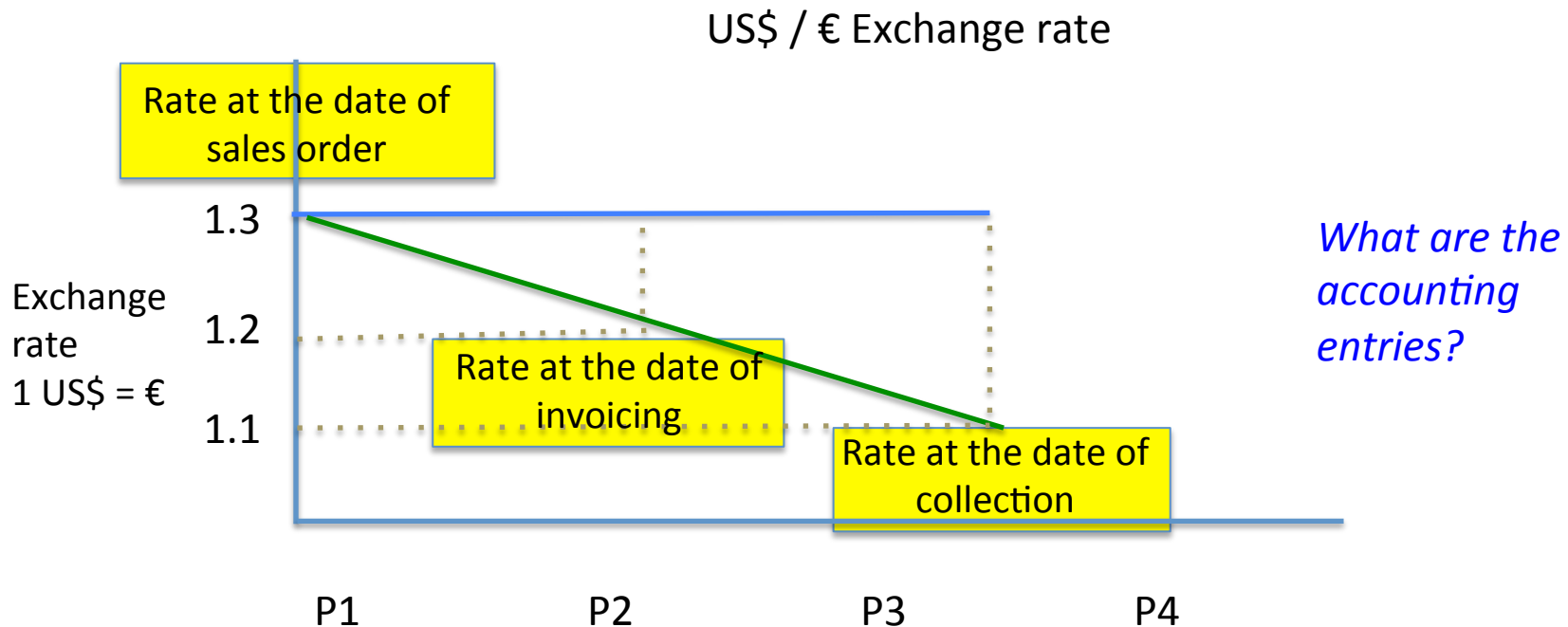
To record the value of the swap contract

Increase in FV of bond is exactly offset by the increase in value of the swap contract

December 31	Dr Financial expense	40,000	
	Cr Bonds Payable		40,000

To record the increase in the FV of the bond

Example – currency risk



Transaction

Sale of 100,000 unit at €10 each.

At date of order € 1,000,000 @ 1.3 = \$ 1,300,000 Anticipated sales proceeds

At date of invoicing € 1,000,000 @ 1.2 = \$ 1,200,000 Difference of €100,000 is a business loss

At date of collection € 1,000,000 @ 1.1 = \$ 1,100,000 Difference of €100,000 is a business loss and an accounting loss.

Cash Flow Hedge

In September 2000 Allied Can Co. anticipates purchasing 1,000 metric tons of aluminum in January 2001. It is concerned that prices will rise so to hedge that risk it enters into an aluminum futures contract to purchase 1,000 metric tons for \$1,550 a metric ton in January 2001. At the date of the contract if the value of the contract equals the spot price the option has no value. At December 31, 2000 the price of aluminum for delivery in January has increased to \$1,575 per metric ton.

December 31, 2000

Dr Futures contract	25,000	
Cr OCI		25,000
((\$1,575 - \$ 1550) x 1,000 tons)		

January 2001

Dr Aluminum Inventory	1,575,000	
Cr Cash		1,575,000
(\$1,575 x 1,000 tons)		

January 2001

Dr Cash	25,000	
Cr Futures contract		25,000
(\$1,575,000 – 1,550,000)		

When sold

Dr OCI	25,000	
Cr Cost of goods sold		25,000

<p><i>Anticipated Cash Flows</i></p> <p>Wish to fix cash paid for inventory at \$1,550,000</p>	=	<p><i>Actual Cash Flows</i></p> <table> <tr> <td>Actual cash paid</td> <td style="text-align: right;">\$1,575,000</td> </tr> <tr> <td>Less: Cash received On futures contract</td> <td style="text-align: right;"><u>(25,000)</u></td> </tr> <tr> <td>Final cash paid</td> <td style="text-align: right;"><u>\$1,550,000</u></td> </tr> </table>	Actual cash paid	\$1,575,000	Less: Cash received On futures contract	<u>(25,000)</u>	Final cash paid	<u>\$1,550,000</u>
Actual cash paid	\$1,575,000							
Less: Cash received On futures contract	<u>(25,000)</u>							
Final cash paid	<u>\$1,550,000</u>							

Futures/Forwards

Concerned prices will fall

Aluminium Producer (1)

Both want to hedge their exposure to price changes

Concerned prices will rise

Car Manufacturer

Futures Contract

Producer agrees to sell 1 ton of aluminium in 3 months time for \$ 2,500 a ton

Contract date
Market price \$ 2,500

One month later
Market price \$ 3,000

Loss \$500

If both parties decide they want to get out of the contract they can't tear up the contract, but they can **Novate** i.e. **replace the contract with another**

Profit \$500

Concerned this may just be a price spike and wants to lock in his profit

Aluminium Producer (2)

Car Manufacturer

Manufacturer agrees to sell 1 ton of aluminium in 2 months time for \$ 3,000 a ton

Trader 1

Trader 2

Three months later
Market price \$ 3,000

Contract 1. Producer buys at \$3,000 and sells at \$2,500 incurring a loss of \$500

Contract 2. Manufacturer sells to Producer 2 at \$3,000 who sells to Producer 1 at \$3,000

Futures Trading

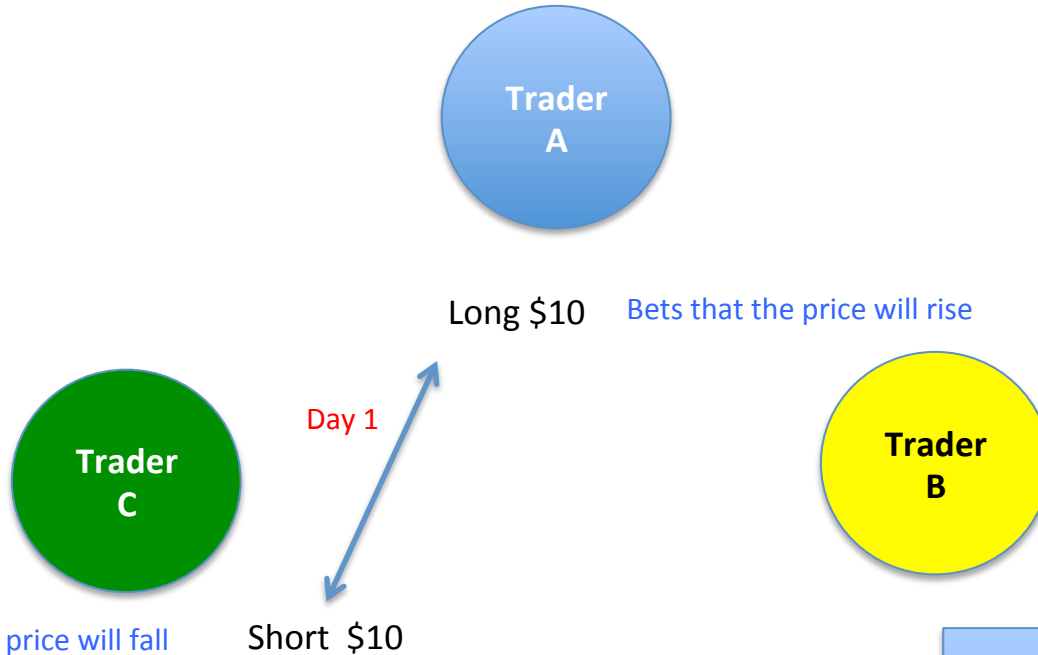
Traders do not want to take delivery. No product or goods change hands. Value of trades can far exceed the value of commodities available

Market Price

Day 1 \$10

Day 2

Day 3



Trade date vs. settlement date of markets

Long = Buys but doesn't take delivery
Short = Sells something he doesn't yet have

Futures Trading

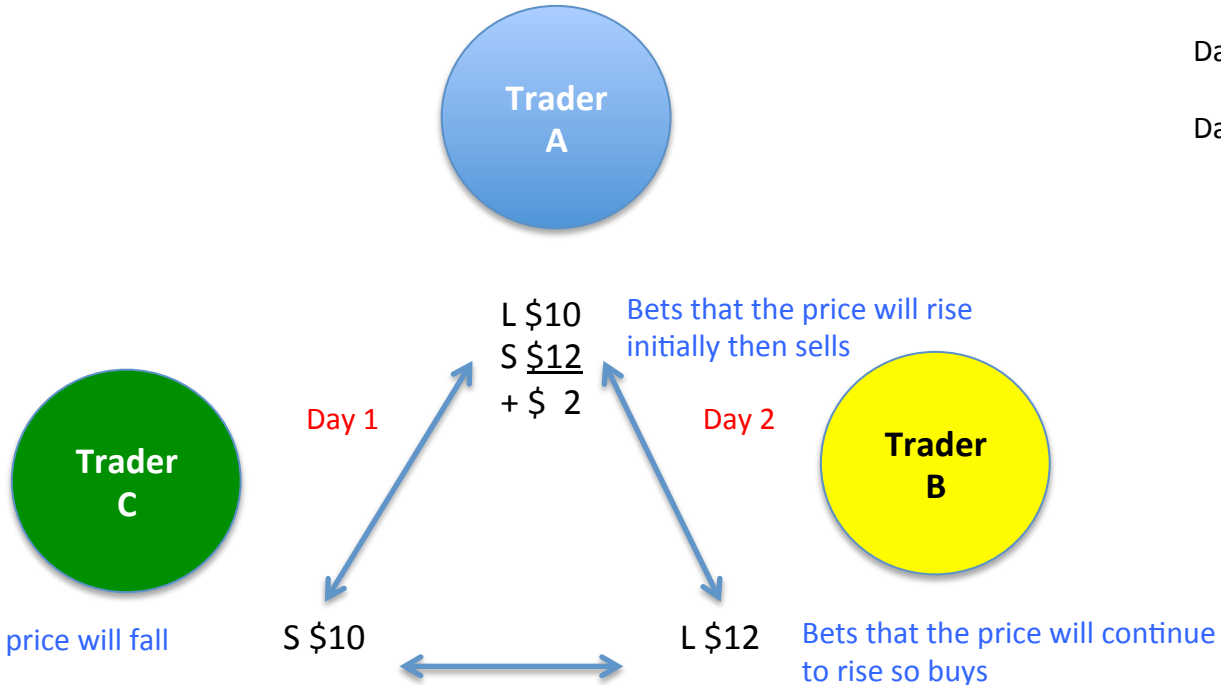
Traders do not want to take delivery. No product or goods change hands. Value of trades can far exceed the value of commodities available

Market Price

Day 1 \$10

Day 2 \$12

Day 3



Long = Buys
Short = Sells

Futures Trading

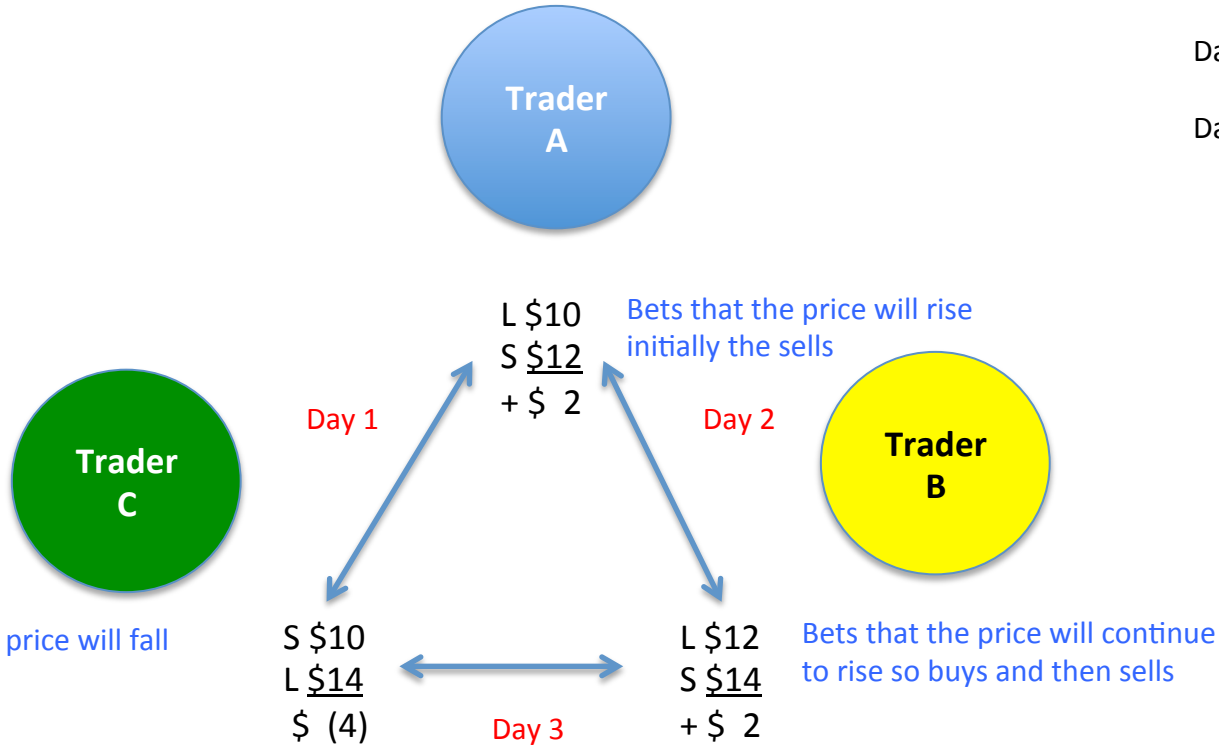
Traders do not want to take delivery. No product or goods change hands. Value of trades can far exceed the value of commodities available

Market Price

Day 1 \$10

Day 2 \$12

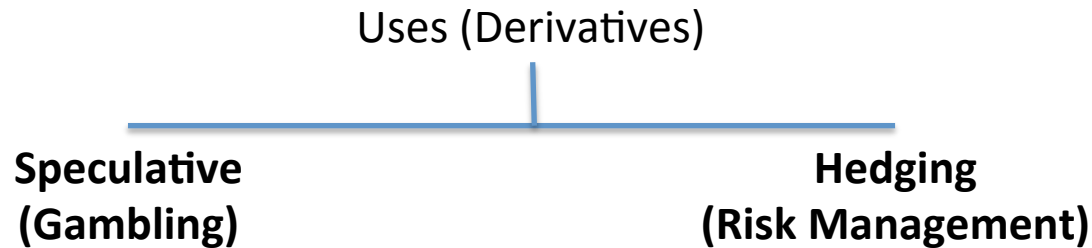
Day 3 \$14



Long = Buys
Short = Sells

On the settlement date all contracts need to be closed and Trader C is obliged to buy at \$14 to meet his contract to sell to Trader A at \$10

Options



The *Writer* of the option sets the price.



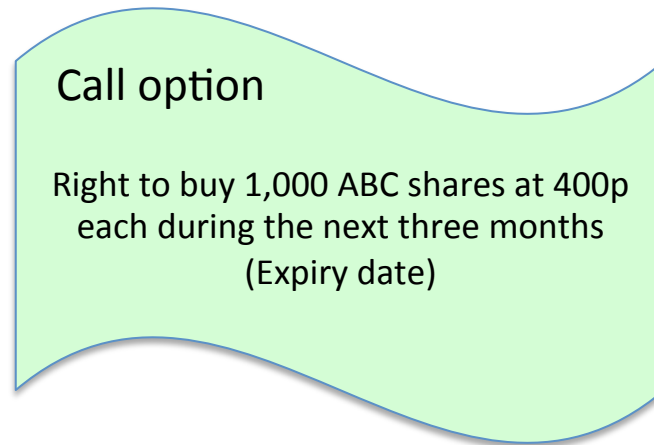
Strike price

Options are normally sold for a Premium

Call option: call to the writer i.e. to buy

Put option: put to the writer i.e. sell

Call Option - example



Premium paid = 30 p per share i.e. £300
(Similarities to an insurance premium)

Option holder calls the option 1,000 shares £400
Seller has to buy 4,000 share £450 and incurs a loss of $450 - 400 - 30 = 20$

Holder then sells the shares for £450	
Strike price	(400)
Premium paid	<u>(30)</u>
Profit for option holder	20

Market price 370p

Two weeks later

Market price 450p

If the market price had fallen to £300 the option would not have been exercised. Call options make money if price rises (bullish), put options if prices fall (bearish) Options can be traded and prices fluctuate with changes in the underlying

Purchases of goods in foreign currency

1.
 - a) On September 30, 20X0 a company buys 10,000 units of product X @ \$2 each i.e. \$20,000.
 - b) It records this transaction in € at the exchange rate at the time of the transaction i.e. 1.2 = €16,666.67.
 - c) At year end, December 31, the balance is still outstanding therefore the company restates the liability at the year end rate i.e. 1.3 = €15,384.62.
 - d) The difference of €1,282.05 is credited to income.

Inventory	Accounts Payable
16.666,67	1.282,05 16.666,67
	Exchange Differences (I/S)
	1.282,05

Exchange rates

September 30 20X0 €1 = \$1.2

December 31 20X0 €1 = \$1.3

	\$		€
Sept 30	20.000,00	1,20	16.666,67
Dec 31	20.000,00	1,30	15.384,62
			1.282,05

Sale of goods in foreign currency

2.

- a) On September 30, 20X0 the company sells 50,000 units of product X to a customer in the USA at \$10 each i.e. \$500,000.
- b) It records this transaction in € at the exchange rate at the time of the transaction i.e. 1.2 or €416,666.67.
- c) At year end, December 31, the balance is still outstanding therefore the company restates the receivable at the year end rate i.e. 1.3 or €384,615.38.
- d) The loss of €32,051.28 is debited to the income statement.

Accounts receivable	Sales
416.666,67	416,666.67
32.051,38	

Exchange Differences (I/S)
32.051,38

	\$		€
Sept 30	500.000,00	1,20	416.666,67
Dec 31	500.000,00	1,30	384.615,38
			32.051,28

Net Investment

Parent Company
Italy €

	Subsidiary A	Subsidiary B	Subsidiary C
Country/ Currency	USA \$	Switzerland CHF	Italy €
Assets	10,000,000	5,000,000	2,500,000
Liabilities	<u>(7,000,000)</u>	<u>(3,000,000)</u>	<u>(2,000,000)</u>
Net Assets	3,000,000	2,000,000	1,500,000
Exchange Rate 01.01.X0	1€ = \$1.3	1 € = CHF 1.0	N/A
Exchange Rate 31.12.X0	1€ = \$1.2	1€ = CHF 1.3	N/A
Translation difference	Gain €192,308	Loss €461,539	N/A

Net Investment Hedge

Parent Company
Italy €

	Subsidiary A	Subsidiary B	Subsidiary C
Country/ Currency	USA \$	Switzerland CHF	Italy €
Assets	10,000,000	5,000,000	2,500,000
Liabilities	<u>(7,000,000)</u>	<u>(3,000,000)</u>	<u>(2,000,000)</u>
Net Assets	\$ 3,000,000	CHF 2,000,000	1,500,000
Possible Hedges			N/A
Parent Company Bank Loan	\$ (3,000,000)	CHF (2,000,000)	N/A
Currency forwards	\$ (3,000,000)	CHF (2,000,000)	N/A

Loan to subsidiary in own currency

- 3.
- On September 30 20X0 a company makes a loan to its subsidiary in the USA of € 1,000,000
 - The subsidiary records this transaction in \$ at the exchange rate at the time of the transaction i.e. 1.2 or 1,200,000
 - At year end, December 31, the balance is still outstanding therefore the subsidiary company restates the liability at the year end rate i.e. 1.3 or \$1,300,000
 - The difference of \$100,000 is debited to income by the subsidiary.

Subsidiary

Loan payable \$	
	1.200.000,00
	100.000,00

Parent Co

Loan Receivable €	
	1.000.000,00

Exchange differences \$	
100.000,00	0,00

	\$		€
Sept 30	1.200.000,00	1,20	1.000.000,00
Dec 31	1.300.000,00	1,30	1.000.000,00
	-100.000,00		0,00

Translation of financial statements

5. a) Exchange differences arising on translation of a subsidiary's financial statements are taken to OCI.
b) Assuming a situation in which the subsidiary made neither profit or loss in the period.

	Sept 30 XO	Exchange		Dec 31 XO	Exchange	
	\$	Rate	€	\$	Rate	€
Assets	2.000.000,00	1,20	1.666.666,67	2.000.000,00	1,30	1.538.461,54
Liabilities	<u>1.000.000,00</u>	1,20	<u>833.333,33</u>	<u>1.000.000,00</u>	1,30	<u>769.230,77</u>
Net assets	1.000.000,00	1,20	833.333,33	1.000.000,00	1,30	769.230,77
				Loss on exchange to OCI on consolidation		64.102,56

DISCLOSURES RELATING TO FINANCIAL INSTRUMENTS

Disclosures relating to financial instruments

- IFRS 7 requires many detailed disclosures relating to financial instruments.
- The main purpose of these disclosures is to enable users to evaluate the significance of financial instruments for the entity's financial position and performance.
- Disclosures are also required which will enable users to evaluate the nature and extent of any risk related to financial instruments.

Disclosures - IFRS 7

- Carrying amounts
 - I. Financial assets at FVPL
 - II. Financial assets at FVOCI
 - III. Financial assets at amortized cost
 - IV. Financial liabilities at FVPL
 - V. Financial liabilities at amortized cost
- Allowance for credit losses
- Fair Value and FV hierarchy
- Items of income, expense, gain or loss
- Accounting Policies
- Hedge accounting
- Nature and extent of risks from financial instruments (Qualitative and quantitative) and sensitivity analysis: credit risk, liquidity risk, market risk

If IAS 39 is applied (ii) and (iii) are replaced by:

- Held To Maturity investments (HTM),
- Loans & Receivables (L&R) and
- Available for Sale (AFS) investments

Other Comprehensive Income

Consolidated statement of other comprehensive income

for the year ended 31 December 2014

	2014	2013	
Notes	€000	Restated* €000	
Profit for the year	8,230	6,459	IAS 1.49 IAS 1.51(c) IAS 1.81A IAS 1.10(b) IAS 8.28 IAS 1.51(d),(e) IAS 1.90 IAS 12.61A
Other comprehensive income			IAS 1.81A (a) IAS 1.82A
<i>Other comprehensive income to be reclassified to profit or loss in subsequent periods (net of tax):</i>			
Net gain on hedge of a net investment	195	—	IAS 39.102(a) IAS 21.32
Exchange differences on translation of foreign operations	(246)	(117)	IAS 21.52(b)
Net (loss)/gain on cash flow hedges	12.8 (512)	24 (512)	IFRS 7.23(c)
Net (loss)/gain on available-for-sale financial assets	12.8 (40)	2 (40)	IFRS 7.20(a)(ii)
Net other comprehensive loss to be reclassified to profit or loss in subsequent periods	(603)	(91)	IAS 1.82A
<i>Other comprehensive income not to be reclassified to profit or loss in subsequent periods (net of tax):</i>			
Remeasurement gains (losses) on defined benefit plans	29 257	(273)	IAS 19.120(c) IAS 19.122
Revaluation of land and buildings	16 592	—	IAS 16.39
Net other comprehensive income/(loss) not to be reclassified to profit or loss in subsequent periods	849	(273)	IAS 1.82A
Other comprehensive income/(loss) for the year, net of tax	246	(364)	IAS 1.81A(b)
Total comprehensive income for the year, net of tax	8,476	6,095	IAS 1.81A(c)
Attributable to:			
Equity holders of the parent	8,188	5,856	IAS 1.81B (b)(ii)
Non-controlling interests	288	239	IAS 1.81B (b)(i)
	8,476	6,095	

* Certain amounts shown here do not correspond to the 2013 financial statements and reflect adjustments made, refer to Note 2.5.

Unilever – an example (1/4)

Management of market risk

Unilever's size and operations result in it being exposed to the following market risks that arise from its use of financial instrument:

- Commodity price risk
- Currency risk
- Interest rate risk

The above risks may affect the Group's income and expenses, or the value of its financial instruments. The objective of the Group's management of market risk is to maintain this risk within acceptable parameters, while optimizing returns. Generally, the Group applies hedge accounting to manage the volatility in profit and loss arising from market risk.

Example – Unilever Group (2/4)

Potential impact of risk	Management policy and hedging strategy	Sensitivity to the risk
<p>i) Commodity price risk The group is exposed to the risk of changes in commodity prices in relation to its purchase of certain raw materials.</p> <p>At 31.12.2014 the Group has hedged its exposure to future commodity purchases for €197 million with commodity derivatives.</p>	<p>The group uses commodity forward contracts to hedge against this risk. All commodity forward contracts hedge future purchases of raw materials and the contracts are settled either in cash or by physical delivery.</p> <p>Commodity derivatives are generally designed as hedging instruments in cash flow hedge accounting relationships.</p>	<p>A 10 % increase in commodity prices as at 31.12.2014 would have led to a €18 million gain on the commodity derivatives in the cash flow hedge reserve. A decrease of 10 % in commodity prices on a full-year basis would have the equal opposite effect.</p>
<p>ii) Currency risk Currency risk on sales, purchase and borrowings</p> <p>Because of Unilever’s global reach, it is subject to the risk that changes in foreign currency values impact the group’s sales, purchases and borrowings</p>	<p>The Group manages currency exposures within prescribed limits, mainly through the use of forward currency exchange contracts.</p> <p>Operating companies manage foreign exchange exposures within prescribed limits. Local compliance is monitored centrally.</p>	<p>As an estimation of the approximate impact of the residual risk, with respect to financial instruments, the Group has calculated the impact of a 10% change in exchange rates</p>
<p>At 31.12.2104 the un-hedged exposure to the Group from companies holding financial assets and liabilities other than in their functional currency amounted to €76 million.</p>	<p>Exchange risks related to the principal amounts of the US\$ and Swiss Franc denominated debt either form part of hedging relationships themselves, or are hedged through forward contracts.</p> <p>The aim of the Group’s approach to management of currency risk is to leave the group with no material residual risk. This aim has been achieved.</p>	<p>A 10 % strengthening of the euro against key currencies to which the group is exposed would have led to approximately an additional €8 million gain in the income statement. A 10% weakening of the euro against these currencies would have led to an equal but opposite effect.</p>

Example – Unilever Group (3/4)

Potential impact of risk	Management policy and hedging strategy	Sensitivity to the risk
<p>Currency risk on the Group's net investments</p> <p>The Group is also subject to the exchange risk in relation to the translation of the net assets of its foreign operations into euros for inclusion in its consolidated financial statements.</p> <p>These net investments include Group financial loans which are monetary items that form part of our net investment in foreign operations, of €7.0 billion of which €4.0 billion is denominated in GBP. In accordance with IAS 21 the exchange differences on these financial loans are booked through reserves.</p> <p>Part of the currency exposure on the Group's investments is also managed using net investment hedges with a nominal value of €2.7 billion. Most of these hedges were US\$ contracts.</p> <p>At December 31, 2014 the net exposure of the net investments in foreign currencies amounts to € 10.4 billion.</p>	<p>Unilever aims to minimize this foreign investment exchange risk by borrowing in local currency in the operating companies themselves. In some locations, however, the Group's ability to do this is inhibited by local regulations, lack of local liquidity or by local market conditions.</p> <p>Where residual risk from these countries exceeds prescribed limits, Treasury may decide on a case-by-case basis to actively hedge the exposure. This is done either through additional borrowings in the related currency, or through the use of forward foreign exchange contracts.</p> <p>Where local currency borrowings, or forward contracts, are used to hedge the currency risk in relation to the Group's net investment in foreign subsidiaries, these relationships are designated as net investment hedges for accounting purposes.</p>	<p>A 10 % strengthening of the euro against all other currencies would have led to € 946 million negative translation effect. A 10 % weakening of the euro against these currencies would have had led to a €1,157 million positive retranslation effect.</p> <p>In line with accepted hedge accounting treatment and our accounting policy for financial loans, the retranslation differences would be recognized in equity.</p>

Example – Unilever Group (4/4)

Potential impact of risk	Management policy and hedging strategy	Sensitivity to the risk
<p>iii) Interest rate risk</p> <p>The Group is exposed to market interest rate fluctuations on its floating rate debt. Increases in benchmark interest rates could increase the interest cost of our floating-rate debt and increase the cost of future borrowings. The Group's ability to manage interest costs also has an impact on results.</p> <p>Taking into account the impact of interest rate swaps, at 31.12.2014, interest rates were fixed on approximately 70% of the expected net debt for 2015 and 67% for 2016.</p> <p>The average interest rate on short-term borrowings in 2014 was 1.2%.</p>	<p>Unilever's interest rate management approach aims for an optimal balance between fixed and floating-rate interest rate exposures on expected net debt. The objective of this is to minimize annual interest costs after tax and to reduce volatility.</p> <p>This is achieved either by issuing fixed or floating-rate long-term debt, or by modifying interest rate exposure through the use of interest rate swaps.</p> <p>Furthermore, Unilever has interest rate swaps for which cash flow hedge accounting is applied.</p>	<p>Assuming that all other variables remain the constant, 1.0 percentage point increase in floating interest rates on a full-year basis as at 31.12.2014 would have led to an additional €26 million of finance costs. A 1.0 percentage point decrease in floating interest rates on a full-year basis would have an equal but opposite effect.</p> <p>Assuming that all other variables remain constant, a 1.0 percentage point increase in floating interest rates on a full-year basis as at 31.12.2014 would have led to an additional €39 million credit in equity from derivatives in cash flow hedge relationships. A 1.0 percentage point decrease in floating interest rates on a full-year basis would have led to an additional €42 million debit in equity from derivatives in cash flow hedge relationships.</p>

REQUIRED READING AND ASSIGNMENT FOR NEXT SESSION

Overview of Session 20

- Review session

Session 20 Pre-work

- Reading
 - Melville International Financial Reporting A Practical Guide:
 - Chapter 11
 - IASB Technical summaries
 - IAS 32, 39
 - IFRS 7, 9,
- Exercises
 - Melville
 - Chapter 11,
 - On-line multiple choice questions for Chapter 11
 - EX 18 and 19

SUMMARY AND VALIDATION

Session 19 Recap

- Financial Instruments
- Non-derivative/Derivative
- Fair Value (P&L vs OCI), Amortized Cost
- Risk Management: Liquidity, Counterparty, Market (Price, interest rate, currency)
- Hedging (Fair Value, Cash Flow, Net Investment)
- Accounting

See also
SM 19.1 Derivatives and Hedging Primer
SM 19.2 Financial Instruments - Examples

Session 19 Validation

- What three market risks do financial instruments expose a company to?
- How should financial instruments be initially measured?
- How should they be subsequently measured?
- What are the three main types of hedge used by companies to manage risk?
- How are these accounted for?