

MEMORANDUM

To: Technical Representatives

From: Simon Kettlewell

Date: 11 November 2015

Ref: TM 11/15

HEDGING AND HEDGE ACCOUNTING



INTRODUCTION

Under 'old' UK GAAP, hedge accounting was rarely an issue. This was for two reasons: firstly, there was no requirement for most UK companies to fair value financial instruments (such as interest rate swaps and forward exchange contracts); and secondly, SSAP 20 'Foreign Currency Translation' allowed the use of forward exchange rates to translate related outstanding balances where companies had entered into hedging arrangements.

Please note that this Memo refers to companies but its contents are equally applicable to other entities that may follow FRS 102 or FRS 102 Section 1A. It should also be noted that the requirements of FRS 102 regarding hedging were revised and simplified in July 2014, thus when referring to FRS 102, this Memo is referring to the amended version of the Standard. All examples in this Memo ignore the impact of current and deferred taxation.

THE REQUIREMENTS OF NEW UK GAAP

FRS 102 (which is mandatory for large and medium-sized companies with accounting periods commencing on or after 1 January 2015) and FRS 102, Section 1A (which is mandatory for

small companies with accounting periods commencing on or after 1 January 2016) require that non-basic financial instruments, such as interest rate swaps and forward exchange contracts, are recognised at fair value (FV) at each reporting date as either a financial asset or financial liability on the Statement of Financial Position (the Balance Sheet). Additionally it is not possible to adopt the SSAP 20 treatment of using forward rates to translate outstanding debtors or creditors. Movement in FV will be recognised in profit or loss as they occur unless an entity **opts to use** hedge accounting (i.e. the use of Hedge accounting is voluntary).

It should be noted that FRS 105, which can be adopted for micro companies, requires much simpler accounting which is more akin to 'old' UK GAAP. Non-basic financial instruments must be carried at historic cost, and where the company has entered into hedging transactions using forward currency transactions, then the forward rate must be used. Additionally provision must be made for any non-basic financial instruments which are deemed to represent onerous contracts.

TAXATION

The default position is that gains or losses that pass through profit or loss are taxable. However, regarding financial instruments it is possible to elect to tax them when the gains or losses physically crystallise.

For example; A company shows a gain on a financial instrument at its reporting date of £3m, however, when it crystallises the gain is only £2m. With no election in place, in the first year a gain of £3m would be subject to tax, and in the next year a loss of £1m would receive tax relief. However, if an election was made, then in the first year no tax would be payable; in the second year, tax would be payable on £2m.

It must be noted that where gains or losses are recognised (either in profit or loss or OCI) and are not taxable in the current period, but will be taxable in future periods, a deferred tax asset or liability will have to be recognised.

Where hedge accounting occurs then no election can be made - the gains or losses are taxed as they hit the profit or loss account.

HAT does not have expertise in corporation taxation and the above notes are only an introductory guide; the key issue is that if you have any clients who enter into non-basic financial instruments, you seek guidance from a corporation tax expert about whether elections need to be made and also the tax implications of hedge accounting.

EARNINGS MANAGEMENT

Fair value movements on financial instruments will be recognised in profit or loss in both the period in which the instruments are recognised on the balance sheet and in the period in which the instruments are settled. This will result in fair value movements being recognised in more than one accounting period, resulting in the volatility.

Ultimately, whether hedge accounting is undertaken or not, in the long-term the same gains or losses will be recognised. Where the short-term results of the company are not critical, i.e. there is no significant impact on banking covenants, illegality of dividends or profit related

contracts, then management may decide that there is no commercial reason why they should adopt hedge accounting.

However some companies will be very concerned about "earnings volatility". This volatility can be reduced through the **voluntary** use of hedge accounting. However, it is important to reiterate that "**hedging**" and "**hedge accounting**" are 2 different things!

"**Hedging**" involves the use of a compensating financial instrument to mitigate the impact of risks that the company faces. Using a forward exchange contract to mitigate the risk of receiving settlement of an invoice in a foreign currency as a result of volatility in that currency is an example of hedging activity that is commonly undertaken, as is the use of an interest rate swap to mitigate the risk of being subject to a variable interest rate.

"**Hedge accounting**" is an optional accounting policy decision, and can only be applied where certain qualifying criteria have been met. The purpose of hedge accounting is to minimise the earnings volatility arising when a financial instrument is used, and can more accurately reflect the substance of an entity's risk management strategy. Section 12 of FRS 102 (and FRS 102, Section 1A) permits entities to voluntarily apply hedge accounting conditional upon the qualifying criteria being met.

THE QUALIFYING CRITERIA

In order for hedge accounting to be a possibility, **all** of the qualifying conditions need to be met. These are as follows:

- The hedging relationship only consists of the **hedged item** and the **hedging instrument**;
- The hedging relationship is consistent with the entity's risk management objectives;
- There is an **economic relationship** between the hedged item and the hedging instrument;
- There is documentation of the **hedging relationship**;
- The entity has determined and documented the causes of hedge ineffectiveness (hedge ineffectiveness is discussed later in this Memo).

These criteria introduce some new terminology, so it is worthwhile considering these in more detail:

A **hedged item** can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation, or a component of any such item, provided the item is reliably measurable.

A hedged item is something that exposes the entity to risks in changes of fair value or future cash flows. Examples include a loan with variable interest rates (risks in changes of future cash flows), or a purchase of an asset from an overseas supplier (risks in changes of fair value and/or future cash flows).

An instrument may be a **hedging instrument** provided all of the following conditions are met:

- a) it is a financial instrument measured at fair value through profit or loss;
- b) it is a contract with a party external to the reporting entity (i.e. external to the group or individual entity that is being reported on); and
- c) it is not a written option, except as described in paragraph FRS 102 para 12.17C.

A hedging instrument is typically a derivative, which is taken out to minimise the risks arising from the hedged item. Examples include a floating to fixed interest rate swap or a forward currency contract.

An *economic relationship* between a hedged item and hedging instrument exists when the entity expects that the values of the hedged item and hedging instrument will typically move in opposite directions in response to movements in the same risk, which is the hedged risk.

The documentation of the *hedging relationship* does not need to be extensive (unlike the requirements of IAS 39) – however, it needs to be sufficient such that the following have been clearly identified:

- The risk being hedged;
- The hedged item;
- The hedging instrument;
- Causes of hedge ineffectiveness.

NB: Hedging documentation would need to specifically cover each individual hedging arrangement; a generic document **would not** be sufficient.

There are 3 different types of hedging relationships set out in Section 12 of FRS 102, and these are:

- Fair Value hedge;
- Cash Flow hedge; and
- Hedge of a net investment in a foreign operation.

A *Fair Value hedge* is “a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that are attributable to a particular risk and could affect profit or loss”. For example – a contract to purchase stock from an overseas supplier, hedged by a compensating forward exchange contract.

A *Cash Flow hedge* is “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 recognised 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”. For example, an interest rate swap.

We will consider here the first 2 possible relationships. The third is largely the same as the second option. Please refer to Section 12 of FRS 102 for further guidance.

THE THEORY OF HEDGE ACCOUNTING

As noted above, the purpose of applying hedge accounting is to minimise the earnings volatility arising from the use of financial instruments, where fair value movements in those instruments would be recognised in different accounting periods. Gains or losses arising on hedged items are offset by being recognised in the same period as the gains or losses on the hedging instrument.

THE REALITY

Whilst most interest rate swaps would usually qualify as hedging transactions, many companies enter into forward exchange contracts which are purely speculative or are based on vague budgets as opposed to being designed to hedge specific transactions - those would not qualify for hedge accounting.

Even where hedge accounting is an option, the application of hedge accounting is expected to be rare rather than the norm, due to the possible costs involved in applying this and the possibility of companies not being concerned about short-term earnings volatility. Companies need to carefully consider whether they wish to apply hedge accounting or not. The implications are purely from an accounting and taxation point of view; carrying out hedging activities will mitigate the risks faced by the company, and may well be in line with the company's risk management objectives, but the application of hedge accounting is simply an accounting and taxation treatment issue. The application of hedge accounting does not alter the commerciality of the transaction.

The application of hedge accounting would result in additional cost (although irrespective of whether hedge accounting is undertaken or not, non-basic financial instruments will still have to be valued), additional disclosures in the financial statements, and an increase in the amount of audit work to be carried out. But this could be offset by the reduction in the volatility in profit or loss.

Under FRS 102 and IFRS 102, Section 1A, there will be a number of items passing through profit or loss which would not have done so under old UK GAAP, such as investment property valuation gains and movements in the value of listed investments. These new treatments will inevitably lead to more fluctuations in the "bottom line". It is not clear that using hedge accounting to reduce the impact of only one such movement will yield much benefit.

It has been suggested that it would be possible to "disclose out" the requirements of hedge accounting – the entity may choose not to use hedge accounting, but may use hedging "techniques" to reduce its risks. The company could choose to include detailed disclosure about the nature of the financial instruments being used, the compensating derivative contract being used, the open positions at the reporting date, the expected close out date, the values intrinsic in the contracts, the anticipated exposure to be recognised on settlement etc., such that even if hedge accounting is not adopted, there is sufficient information in the financial statements to illustrate what the impact of the settlement of the instruments will be going forwards.

As noted above, the purpose of using hedging is to mitigate the impact on the company arising from the use of financial instruments. The decision to apply hedge accounting is aimed at reducing the earnings volatility, with the gains and losses arising on the hedged item and the hedging instrument being matched in profit or loss in the same accounting period. However, in reality hedging is rarely perfect – when the hedging instrument doesn't fully cover the gains / losses arising on the hedged item, this is known as "hedge ineffectiveness". There are a number of causes of such ineffectiveness, including the following (as identified by the ICAEW webinar "FRS 102 & financial instruments –hedging"):

- hedging instrument pre-existing on date of designation;
- timing differences;
- quantity or notional amount differences;
- credit risk;

- prepayment and termination features; and
- time value component of options

If the hedge is ineffective, the element of ineffectiveness always goes immediately to profit or loss.

THE ACCOUNTING TREATMENT

The impact of hedge accounting is best illustrated by way of examples, and comparing the accounting impact to old GAAP and new GAAP with no hedging.

The following appendix includes such examples – these assume that client has taken the choice to use the provisions of sections 11 and 12 of FRS 102 (as opposed to taking the option to use the measurement and recognition principals of IAS 39 ‘Financial Instruments: Recognition and Measurement’ or IFRS 9 ‘Financial Instruments’).

If you have any further questions on hedging please do not hesitate to contact our technical helpline.

APPENDIX - PRACTICAL EXAMPLES

The examples provided cover a forward purchase contract and an interest rate swap.

(Please note – all numbers have been rounded for ease of use)

FORWARD PURCHASE CONTRACT

We will deal with a UK company that has placed an order to purchase 100,000 items from a supplier in France. The items cost, at the point of order, €720,000. The Exchange rate at point of order is €1.20: £1, meaning the order is worth £600,000. These items will be due for delivery and payment in 6 months' time. The company is concerned about the fluctuation in the Euro / Sterling rate due to the political instability in certain Eurozone countries, so takes out a forward contract on the same day to purchase €720,000 at a fixed rate of €1.18:£1. This means that the company is looking to fix their cash outflow at (€720,000/€1.18 =) £610,000.

The entity's year end is 31 December 20X5. The contract was signed on 30 September 20X5, and is due for settlement on 31 March 20X6.

The spot rates and forward rates at the relevant dates are as follows:

	30/09/20X5	31/12/20X5	31/03/20X6
Spot rate	€1.20: £1	€1.15: £1	€1.12: £1
Forward rate	€1.18: £1	€1.14: £1 (*)	-

(*) - This is the rate for a contract to buy €720,000 of Euros that ends on the same day as the original contract.

Accounting Treatment under “Old” UK GAAP:

Unless FRS 25/26/29 were followed, the forward exchange contract would not be fair valued, and the purchase would be recognised based on the forward rate, thus being recognised at £610,000.

Accounting Treatment under FRS 102 WITHOUT the use of Hedge Accounting:

On 30/09/20X5 (Inception):

No accounting entries required. The financial instrument has a fair value of zero.

At 31/12/20X5 (Year end):

Recognise the financial instrument (the forward contract) at its fair value at year end. This would be based on the market rate at the reporting date for a forward contract to purchase the same amount of Euros which would settle on the same day as the original contract. E.g. a 3 month contract at the year end to purchase €720,000 would be at a rate of €1.14: £1. So the company would need to compare the value of the contract as follows:

At 30/09/X5: €720,000 / €1.18 = £610,000

At 31/12/X5: €720,000 / €1.14 = £631,500

As at the year end, it would cost more for the company to obtain the same forward contract (£631,500) than it did when the original contract was taken out (£610,000). Therefore the company has benefitted from the forward contract, resulting in a fair value gain of £21,500. This would be recognised as follows:

<i>Dr Financial Instrument (B/S)</i>	<i>£21,500</i>	
<i>Cr Financial Income (Profit or loss)</i>		<i>£21,500</i>

At 31/03/20X6 (Settlement):

On settling the transaction, the financial instrument would be revalued again, using the spot rate at settlement, and compared to the position recognised at the last reporting date.

At 31/12/X5: €720,000 / €1.14 = £631,500

At 31/03/X6: €720,000 / €1.12 = £642,850

<i>Dr Financial Instrument (B/S)</i>	<i>£11,350</i>	
<i>Cr Financial Income (Profit or loss)</i>		<i>£11,350</i>

On receiving the order (and invoice), the payment of €720,000 is made, where the entry would be (ignoring trade creditors);

<i>Dr Stock</i>	<i>(€720k/€1.12)</i>	<i>£642,850</i>	
<i>Cr Cash</i>			<i>£642,850</i>
<i>Dr Cash</i>	<i>(£21,500 + £11,350)</i>	<i>£32,850</i>	
<i>Cr Financial Instrument</i>			<i>£32,850</i>

This nets to £610,000 being the cash outflow that the company wanted to fix at (as noted in the introduction)

This example demonstrates how earnings are recognised in separate accounting periods (with £21,500 being recognised in 20X5, and £11,350 being recognised in 20X6), which can result in earnings volatility.

FRS 102 with Hedge Accounting

A hedge of the foreign currency risk of an unrecognised firm commitment may be accounted for as a fair value hedge or as a cash flow hedge. We shall consider both scenarios in turn.

Scenario 1 - Fair Value Hedge

This is perceived to be the less popular form of hedging. The fair value movements on the hedging instrument are recognised in profit or loss to offset against the movements on the hedged item.

At 30/09/20X5 (Inception):

No entries recorded. The forward contract has a value of nil at inception.

At 31/12/20X5 (Year end):

Offset the gain / loss on the hedged item against the gain / loss on the hedging instrument.

Hedged Item (Unrecognised Purchase Commitment):

Compare cost of purchase at spot rate on date of order against cost of purchase at spot rate at year end date:

$$€720,000/€1.20 = £600,000$$

$$€720,000/€1.15 = £626,000$$

The purchase is more expensive as at the year end, therefore a loss is recognised on the hedged item:

<i>Dr Financial Income (Profit or loss)</i>	<i>£26,000</i>	
<i>Cr Financial Liability ~ Commitment (B/S)</i>		<i>£26,000</i>

Hedging instrument (forward contract) – recognise this at fair value (as with no hedging):

$$\text{At 30/09/X5: } €720,000 / €1.18 = £610,000$$

$$\text{At 31/12/X5: } €720,000 / €1.14 = £631,500$$

<i>Dr Financial Asset (B/S)</i>	<i>£21,500</i>	
<i>Cr Financial Income (Profit or loss)</i>		<i>£21,500</i>

So the application of hedge accounting has reduced the impact through profit or loss to a net loss at the year-end of (£26,000 - £21,500) = £4,500. The hedge is ineffective as it has not fully covered the loss arising on the hedged item.

At 31/03/20X6 (Settlement):

Hedged Item (Unrecognised Purchase Commitment):

Compare cost of purchase at spot rate at year end date to cost using spot rate at date of settlement:

€720,000/€1.15 = £626,000
€720,000/€1.12 = £642,850

<i>Dr Financial Expense (Profit or loss)</i>	£16,850	
<i>Cr Financial liability (B/S)</i>		£16,850

[Cumulative position = £26,000 + £16,850 = £42,850]

Hedging Instrument (Forward Contract) – as with no Hedging:

At 31/12/X5: €720,000 / €1.14 = £631,500
At 31/03/X6: €720,000 / €1.12 = £642,850

<i>Dr Financial asset (B/S)</i>	£11,350	
<i>Cr Financial Expense (Profit or loss)</i>		£11,350

[Cumulative position = £21,500 + £11,350 = £32,850]

Again, the impact through profit or loss is reduced, being a net loss of (£16,850 – £11,350) = £5,500.

On receiving the order, the payment of €720,000 is made, where the entry would be (ignoring trade creditors):

<i>Dr Stock</i>	<i>(€720,000/€1.12)</i>	£642,850	
<i>Cr Cash</i>			£642,850
<i>Dr Cash</i>	<i>(£21,500 + £11,350)</i>	£32,850	
<i>Cr Financial asset (forward contract)</i>			£32,850
<i>Dr Financial liability (commitment)</i>		£42,850	
<i>Cr Stock</i>			£42,850

This nets to £610,000 being the cash outflow that the company wanted to fix at (as noted in the introduction)

When the hedged item is an unrecognised firm commitment to purchase a non-financial asset or liability, on settlement the cumulative hedging gain or loss is offset against the initial carrying amount of the asset or liability. In the example above, the cumulative hedging gain (£42,850) is offset against the stock (being the asset) such that the stock is recognised at £600,000 (the original value of the order).

This example demonstrates how hedge accounting reduces the volatility in profit or loss. The total impact through profit or loss is £4,500 + £5,500 = £10,000 which equates to the difference between the price of the order using the spot rate at the date of order (£600,000) and the contracted forward purchase amount (of £610,000). This is the hedge ineffectiveness, which arose because the forward contract was not at the same value as the order.

Scenario 2 - Cash Flow Hedge

This is perceived to be the more popular form of hedging. In simple terms the fair value movements on the hedging instrument are initially ‘parked’ in a cash flow hedge reserve (shown within equity as a non-distributable reserve) and then later released to profit or loss to offset the movements on the hedged item.

At 30/09/20X5 (Inception):

No entries recorded. The forward contract has a value of nil at inception.

At 31/12/20X5 (Year end):

Bring in a cash flow hedge reserve for the difference between the cumulative gain / loss on the hedging instrument and the cumulative change in the fair value of the hedged item:

Hedged Item (Unrecognised Purchase Commitment):

Compare cost of purchase at spot rate on date of order against cost of purchase at spot rate at year end date:

$$€720,000/€1.20 = £600,000$$

$$€720,000/€1.15 = £626,000$$

The purchase is more expensive as at the year end, therefore affecting the entity’s cash flows.

The cumulative loss is £26,000.

Hedging Instrument (Forward Contract) – Recognise this at Fair Value (as with no Hedging):

$$\text{At 30/09/X5: } €720,000 / €1.18 = £610,000$$

$$\text{At 31/12/X5: } €720,000 / €1.14 = £631,500$$

The cumulative gain here is £21,500.

FRS 102, Paragraph 12.23 (a) requires a cash flow hedge reserve, via Other Comprehensive Income (OCI), to be recognised at the lower (in absolute amounts) of: the cumulative gain / loss on the hedging instrument (£21,500); and the cumulative change on the hedged item (£26,000).

Furthermore, the same paragraph goes on to say:

“b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e. the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income;

(c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)), is hedge ineffectiveness that shall be recognised in profit or loss.”

<i>Dr Financial asset</i>	<i>£21,500</i>	
<i>Cr Other comprehensive income</i>		<i>£21,500</i>

At 31/03/20X6 (Settlement):

Hedged Item (Unrecognised Purchase Commitment):

Compare cost of purchase at spot rate at year end date to cost using spot rate at date of settlement:

€720,000/€1.15 = £626,000
 €720,000/€1.12 = £642,850

Change in fair value = £16,850

[Cumulative position = £26,000 + £16,850 = £42,850]

Hedging Instrument (Forward Contract) – as with no Hedging:

At 31/12/X5: €720,000 / €1.14 = £631,500
 At 31/03/X6: €720,000 / €1.12 = £642,850

Change in fair value = £11,350

[Cumulative position = £21,500 + £11,350 = £32,850]

£32,850 is the lower value, so the cash flow hedge reserve should be adjusted to this figure:

<i>Dr Financial asset</i>	<i>£11,350</i>	
<i>Cr Other comprehensive income</i>		<i>£11,350</i>

“If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability” (FRS 102, 12.23 (d) (i)).

On receiving the order, the payment of €720,000 is made, where the entry would be (ignoring trade creditors)

<i>Dr Stock</i>	<i>(€720,000/€1.12)</i>	<i>£642,850</i>	
<i>Cr Cash</i>			<i>£642,850</i>
<i>Dr Cash</i>	<i>(£21,500 + £11,350)</i>	<i>£32,850</i>	
<i>Cr Financial asset</i>			<i>£32,850</i>
<i>Dr OCI</i>		<i>£32,850</i>	
<i>Cr Stock</i>			<i>£32,850</i>

This nets to £610,000 being the cash outflow that the company wanted to fix at (as noted in the introduction)

The residual value in the cash flow hedge reserve has been removed (through OCI) and is offset against the initial carrying amount of the asset or liability. In the example above, the cumulative cash flow hedge reserve balance (£32,850) is offset against the stock (being the asset) such that the stock is recognised at £610,000 (the contracted cash outflow).

INTEREST RATE SWAP

A more common example of a Cash flow hedge is an interest rate swap. Consider the following simple scenario:

A company issues an 18 month debenture worth £1m (i.e. creates a creditor). The issue date is 30 September 20X5, and redemption date is 31 March 20X7. The company's year-end is 31 December.

The debenture is issued with interest based on LIBOR. In order to mitigate the risks arising from interest rate fluctuations (which affect the company's cash flows), an interest rate swap is taken out by the company, which requires the company to pay a fixed rate of 3.5% and receive LIBOR.

As at the year end, the LIBOR rate is 2.5%, and dealer quotes place a fair value on the swap of negative £15,000 at the year end. Interest is paid quarterly.

At 30/09/20X5 (Inception):

Recognise the issue of the debenture:

<i>Dr Cash</i>	<i>£1,000,000</i>	
<i>Cr Debenture Liability</i>		<i>£1,000,000</i>

At 31/12/20X5 (First Year end):

Recognise the change in the fair value of the hedging instrument (the interest swap):

<i>Dr Other Comprehensive Income</i>	<i>£15,000</i>	
<i>Cr Financial Liability</i>		<i>£15,000</i>

Interest paid based on LIBOR rate: £1m x 2.5%, pro-rated for 3 months:

<i>Dr Interest Expense</i>	<i>£6,250</i>	
<i>Cr Cash</i>		<i>£6,250</i>

Cash position on settling of the swap: £1m x (3.5% - 2.5%), pro-rated for 3 months (this is the net position of what the entity would pay to the swap issuer and receive back, as the agreement is to pay 3.5% but receive LIBOR):

<i>Dr Interest Expense</i>	<i>£2,500</i>	
<i>Cr Cash</i>		<i>£2,500</i>

[this means the net cash outflow is £8,750, which can be "reconciled" by £1m x 3.5% x 3/12].

This means that:

Cash outflow is	£8,750
Interest charge is	£8,750
Financial liability is	£15,000

Cash flow hedge reserve is £15,000

At 31/12/20X6 (Second Year end):

As at the year end, the LIBOR rate is unchanged at 2.5%, and dealer quotes place a fair value on the swap of negative £4,000 at the year end:

<i>Dr Financial Liability</i>	<i>£11,000</i>	
<i>Cr Other Comprehensive Income</i>		<i>£11,000</i>

Interest paid based on LIBOR rate: £1m x 2.5%:

<i>Dr Interest Expense</i>	<i>£25,000</i>	
<i>Cr Cash</i>		<i>£25,000</i>

Cash position on settling of the swap: £1m x (3.5% - 2.5%), (this is the net position of what the entity would pay to the swap issuer and receive back, as the agreement is to pay 3.5% but receive LIBOR):

<i>Dr Interest Expense</i>	<i>£10,000</i>	
<i>Cr Cash</i>		<i>£10,000</i>

This means that:

Cash outflow is	£35,000
Interest charge is	£35,000
Financial liability is	£4,000
Cash flow hedge reserve is	£4,000

At 31/3/20X7 (Settlement):

As at the settlement date the fair value on the swap is £nil:

<i>Dr Financial Liability</i>	<i>£4,000</i>	
<i>Cr Other Comprehensive Income</i>		<i>£4,000</i>

Interest paid based on LIBOR rate: £1m x 2.5%, pro-rated for 3 months:

<i>Dr Interest Expense</i>	<i>£6,250</i>	
<i>Cr Cash</i>		<i>£6,250</i>

Cash position on settling of the swap: £1m x (3.5% - 2.5%), pro-rated for 3 months (this is the net position of what the entity would pay to the swap issuer and receive back, as the agreement is to pay 3.5% but receive LIBOR):

<i>Dr Interest Expense</i>	<i>£2,500</i>	
<i>Cr Cash</i>		<i>£2,500</i>

This means that:

Cash outflow is	£8,750
Interest charge is	£8,750
Financial liability is	£nil
Cash flow hedge reserve is	£nil