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V.S. Ambarchian, PhD in Economics, Associate Professor
Kyiv National Economic University named after Vadym Hetman

Cash flow hedges using interest rate swaps: accounting under IFRS

The paper discloses the accounting treatment for cash flow hedge of exposure to risks arising from the changes in cash flows of financial instruments, in which interest rate swaps are used as hedging instruments. The author considers the economic meaning of hedge relationship as an instrument of reducing financial risks being inherent to financial assets and financial liabilities of the bank. The paper represents the purpose of the cash flow hedge as well as the mechanics of the interest rate swap as the most efficient instrument of the cash flow hedge relationship. The author analyzes the statements of IFRS 9 on the cash flow hedge accounting: recognizing the cash flow hedge reserve, assessing the portion of gain or loss on the swap that is either effective or ineffective hedge. The paper explains the procedures of the cash flow hedge accounting to reduce interest rate risks that arises from the changes in the cash flows of floating-rate financial liabilities. In particular, the paper covers the procedures of the fair value measurement of a hedging instrument as the present value of the difference between cash inflows and outflows discounted at spot rates for each period. The author discloses the accounting for the cash flow hedge: the accrual of interests on the financial liability, the change in the fair value of swap, the net settlement of the interest on swap, the reclassification of the interest on swap and settlement of interests on the financial liability. The article suggests the accounting procedures comply with the requirements of IFRS 9 on the cash flow hedge accounting and recommends the implementation to Ukrainian banks.

Keywords: *accounting; hedge; interest rate swap; cash flow hedge; IFRS 9.*

Relevance of the article. Banks, performing operations with financial assets and liabilities, face different risks that influence assets, liabilities, revenues and expenses: interest rate risk – the risk of reducing revenue or increasing the expenses, caused by unfavorable fluctuations of the interest rate; foreign exchange risk – the risk of reducing the value for assets and liabilities denominated in currency other than the basic currency of the business entity; market risk – the risk of dimension of revenue or increasing the expenses caused by adverse fluctuations in trading portfolio of a bank; credit risk – the risk of default on the debt arising from the failure to fulfill financial liabilities by a borrower.

In order to reduce the risks on financial instruments, banks use financial derivatives. Hedging procedures refer to the application of the derivatives (swaps, options, forward and futures) as the instruments of compensation of fluctuations in the fair value or cash flows of financial instruments.

Some requirements on hedge accounting and financial reporting are set in IFRS (International Financial Reporting Standard) 9 «Financial Instruments». Under the Law of Ukraine «On Accounting and Financial Reporting in Ukraine», domestic banks are required to account for business transactions in compliance with domestic statements and instructions, and apply IFRS recommendations to prepare financial reports [1]. Before 2018, Ukrainian banks applied the Instruction on Accounting for Derivative Transactions in Ukrainian Banks, developed according to IAS (International Accounting Standard) 39 «Financial Instruments: Recognition and Measurement». After IAS 39 was replaced by IFRS 9, banking regulatory authorities faced the necessity to develop a new regulatory document. Therefore, in 2018, the National Bank of Ukraine has approved the Instruction on Accounting for Derivatives in Ukrainian Banks [2].

The above-mentioned legal document provides the detailed explanation of hedge accounting. Nevertheless, it does not give any suggestions on calculating assets, liabilities, revenues and expenses recognized in the hedge relationship. The absence of any information creates a strict demand for considering hedge accounting on the stages of assessing and journal entries recording.

It is worth mentioning that in her previous paper «Fair Value Hedges with Swaps: Accounting Practices under IFRS», the author has disclosed the accounting procedures for the fair value hedge on financial liabilities, applying interest rate swaps and currency swaps. In turn, the current research is devoted to the disclosure of the cash flow hedge accounting with the use of interest rate swaps as the hedging instruments.

Literature review. Derivative transactions cover both trading and hedge relationships. They make a huge share of all the financial instrument transactions.

Following the Annual Statistical Report of the European Securities and Markets Authorities, in 2018 traders reported a total of 74 million open transactions amounting to a gross notional amount outstanding of around 660 trillion euros. Swaps are the most common contract type of derivatives on the European financial market, accounting for 50 % of the total amount outstanding. Interest rate swaps dominate in the financial markets [3].

According to the European Central Bank Economic Bulletin, «swaps are the most prominent contracts, covering about 54 % of the notional value of outstanding contracts… Swaps are used for a wide range of purposes, including the hedging of interest rate risks on banks and insurers' balance sheets» [4].

The analysis of the literature on hedge accounting enables to indicate two research areas: hedge accounting procedures under IFRS and modeling the effect of hedge accounting on the financial results of the business entities.

Controversial issues of hedge accounting were disclosed by J.P. Singh [5]. The author compares the core distinctions between IAS 39 and IFRS 9 on hedge accounting. Ju.A. Kuzminskyj considers the qualitative and quantitative features of the information on the fair value hedge accounting within financial reports of business entities [6].

The other research area refers to econometric analysis of hedging relationship and their influence on the financial position and financial performance. For instance, S.A. Hairston and M.R. Brooks have reviewed the economic literature on derivative accounting and the quality of financial reporting by institutions that trade derivatives and use them as the hedging instruments. In particular, the authors analyzed various Statements on Financial Accounting Standards, issued by the Financial Accounting Standard Board (FASB), which consider the purpose of derivative transactions, and examined scientific papers on earnings quality, which depends on derivative fair value adjustments included in other comprehensive income [7].

Rashad Abdel-khalik A. and Chen Po-Chang investigated that the use of cash flow hedge accounting helps to reduce earnings volatility / equity risk, and that firms to increase their use of non-trading derivatives when facing high level of earnings volatility / equity risk [8]. Ding T. and Seitz B. claim that hedge accounting has the intended effect of earnings smoothing, which works as a mechanism for the improved information environment. The findings of the study prove the importance of the application of hedge accounting under IFRS 9 [9].

Purpose of the article. The purpose of the article is to develop the accounting procedures for the cash flow hedge on financial liabilities under IFRS, which are as follows: the fair value measurement of both the hedging instrument and the hedged item at the date of initial and subsequent recognition, the calculation of changes in the fair values of the hedging instrument and the hedged item, accounting treatment of these transactions.

Results. Cash flow hedge is a method for minimization or total elimination of the risk of cash flow fluctuations on the floating-rate financial instrument. Under the cash flow hedge the floating-rate cash flows are converted into the fixed-rate cash flows. Floating-rate financial assets and financial liabilities are considered as hedged items in cash flow hedge relationship.

Interest rate swaps are considered as the most effective and the most convenient hedging instrument. An interest rate swap is an agreement that requires the exchange of contractual cash flows between two parties at fixed or floating interest rates. There are four types of interest rate swaps – a fixed-for-fixed swap, a fixed-for floating swap, a floating-for-floating swap and a floating-for-fixed swap. The fixed-for-fixed swap exchanges fixed cash flows and are suitable for counterparties that operate in different countries. For the counterparty with lower fixed swap rate, it is much more beneficial to enter the fixed-for-fixed swap and receive higher fixed-rate cash flows on the principal amount. The fixed-for-floating swap is used to reduce risks on fixed-rate financial liabilities. The cash outflow on the financial liability and the cash inflow on the interest rate swap are netted, while the party of swap pays interests at the floating rate plus / minus any spread, determined by market terms and counterparty's credit rating. The floating-for-floating swaps are used to convert floating-rate cash inflows on the financial liability to fixed-rate cash flows. The floating-rate legs of both the financial liability and the swap are netted, while the fixed-rate leg becomes the counterparty's borrowing rate. The floating-for-floating swap is used to transform the floating-rate interest of the financial liability into the fixed one.

Swaps are also used as hedging instruments in the cash flow hedges of financial assets and financial liabilities. The cash flow hedges are structured to eliminate or reduce exposure to variability in interest receipts or payments on financial assets and financial liabilities. Using the interest rate swaps banks compensate fluctuations in the floating interest rates from the cash flow hedge reserve. Following the recommendations of IFRS 9, accounting for the cash flow hedge relationships requires several explanations:

1) in order to compensate the fluctuations in the floating cash flows of the hedged item, the bank is required to build up cash flow hedge reserve that is the lower of the cumulative gain / loss on the hedging instrument from inception of the hedge and the cumulative change in fair value of the hedged item from inception of the hedge [10, p. 6, 5, 11]; when the gain / loss on the hedging instrument exceeds the gain / loss on the hedged item, the difference is classified as hedge ineffectiveness and recognized in profit or loss; in turn the excess of the gain / loss on the hedged item over the gain / loss on the hedging instrument is not classified as hedge ineffectiveness, and the gain / loss on the hedging instrument is fully recognized in other comprehensive income;
2) the cumulative gain or loss on the hedging instrument at the end of each accounting period is calculated as the difference between the fair value gain or loss during the period and the cash settlement;
3) the portion of gain or loss on swap (change in fair value) that is an effective hedge (equals the cash flow hedge reserve) is recognized in other comprehensive income;
4) any remaining, if exists, gain or loss on swap is hedge ineffectiveness and recognized in profit or loss;

5) the amount recognized in the cash flow hedge reserve that offsets the floating interest rate fluctuations will be reclassified to profit or loss [10].

The illustrative example on cash flow hedge accounting is provided below (Figure 1).

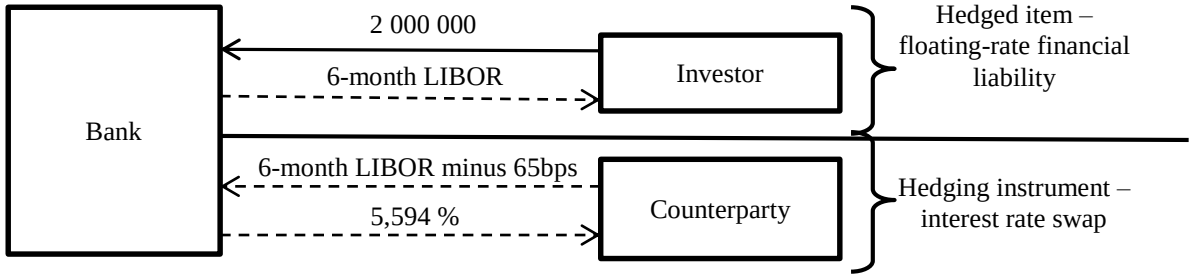

Figure 1. Cash flow hedge with the interest rate swap

01.03.20X1 the bank issued debt instruments that mature in 2,5 years. The principal – 2 000 000 cu., the interest rate is 6-month LIBOR. Interests are paid semiannually. The 6-month LIBOR at the settlement date is 2,648 %. In expectation of LIBOR fluctuation, the bank decides to hedge the interest rate risk with the interest rate swap. At the same date, the bank enters into the interest rate swap agreement that matures in 2,5 years. By the terms of agreement the bank receives interests at the 6-month LIBOR minus 65 bpt and pays fixed 5,594 % annually (LIBOR swap rate) on the principal amount of 2 000 000 cu. The benchmark LIBOR, calculated using spot-rates at the trade dates are as follows: the 12-month LIBOR – 3,237 %, the 18- month LIBOR – 4,34 %, the 24-month LIBOR – 5,43 %, and the 30- month LIBOR – 5,75 %.

At the inception of the hedge, the effectiveness requirements – the economic relationship, effect of credit risk and hedge ratio – are fulfilled.

Cash flows are hedged in order to transfer floating-rate cash flows into fixed-rate cash flows and thus protect the borrower from the interest rate fluctuations. In the given example, the interest rate swap enables to convert the floating-rate cash outflow (6-month LIBOR) into the fixed-rate outflow at 6,24 % (5,59 % + 0,65 bps).

The fair value of the interest rate swap is calculated as the present value of net cash flows (the difference between fixed- and floating-rate cash flows) discounted at the LIBOR spot rate at each date of exchange. The floating-rate interest is based on the LIBOR forward curve, which, in turn, is based on the LIBOR yield curve. Forward rates are calculated using the following equation:

$$f = \frac{(1+S_t)^t}{(1+S_{t-1})^{(t-1)}} - 1, \quad (1)$$

where f – forward LIBOR;

S – spot LIBOR;

t – period.

Forward rates are calculated using the equation (1) and information on spot LIBOR at each date of reassessment (Table 1).

Table 1

Spot and forward LIBOR at each date of remeasurement

Periods	**Dates of initial recognition and remeasurement**									
	01.03.20X1		**01.09.20X1**		**01.03.20X2**		**01.09.20X2**		**01.03.20X3**	
	spot rate	forward rate	spot rate	forward rate	spot rate	forward rate	spot rate	forward rate	spot rate	forward rate
01.09.20X1	2,65	2,65	–	–	–	–	–	–	–	–
01.03.20X2	3,24	3,92	4,14	4,14	–	–	–	–	–	–
01.09.20X2	4,34	7,48	4,76	5,45	6,46	6,46	–	–	–	–
01.03.20X3	5,43	10,23	4,75	4,74	4,45	2,98	7,68	7,68	–	–
01.09.20X3	5,75	7,20	4,68	4,61	5,50	6,75	5,45	3,79	6,51	6,51

Note: built and calculated by the author

The fair value of the interest rate swap is nil at inception. A deviation from zero point can be caused by either the credit risk (which requires discounting of the cash flows to zero point at risk-adjusted interest rates) or premium / discount recognition as a result of adopting the fixed swap rate that is higher / lower than the market one. In the given example, the fair value is 1,62 cu., therefore, in order to simplify the calculations, it will be considered as a nil (Table 2).

Table 2

Fair value of the interest rate swap at initial recognition

Period	Fixed-rate cash outflows	Forward rate, %	Floating-rate cash inflows	Net cash flows	Spot rate, %	Present value of net cash flows
01.09.20X1	55945,7	2,65	19980,00	-35965,70	2,65	-35729,95
01.03.20X2	55945,7	3,92	32710,99	-23234,71	3,24	-22864,65
01.09.20X2	55945,7	7,48	68321,67	12375,97	4,34	11983,79
01.03.20X3	55945,7	10,23	95758,73	39813,03	5,43	37736,14
01.09.20X3	2055945,7	7,20	2065473,78	9528,08	5,75	8876,28
Total						1,62

Note: built and calculated by the author

The frequency of remeasurement of the financial instruments is determined by internal documents of the bank. Financial instruments are remeasured when the fair value of the financial instrument exceeds the materiality threshold, determined in accounting policies. The fair value of the considered financial liability due to the fluctuation of spot LIBOR is remeasured at each date of the cash flows exchange.

In order to hedge cash flows of the hedged item, the bank is required to prepare the cash flow hedge reserve that is the lower of the cumulative gain / loss on the hedging instrument and the cumulative change in the fair value of the hedged item. Therefore, at each remeasurement date, two abovementioned figures should be compared. The fair value of both the hedging instrument and the hedged item are calculated as the present value of cash flows, discounted at the spot LIBOR at the remeasurement date (Table 3).

Table 3

Fair value of the hedging instrument and the hedged item at first remeasurement date of 01.09.20X1

Period	Interest rates		Financial liability		Interest rate swap			
	spot rates	forward rates	floating-rate cash flows	present value of cash flows	fixed-rate cash flows	floating-rate cash flows	net cash flows	present value of cash flows
01.09.20X1	2,65	2,65	26480,00	26480,0	55945,7	19980,00	-35965,40	-35965,40
01.03.20X2	3,68	5,00	50039,47	49585,4	55945,7	43539,47	-12406,23	-12293,64
01.09.20X2	3,71	3,74	37401,92	36720,8	55945,7	30901,92	-25043,78	-24587,68
01.03.20X3	4,22	4,79	47852,23	46376,7	55945,7	41352,23	-14593,47	-14143,48
01.09.20X3	4,75	5,33	2053338	1959172,3	2055945,7	2046838,12	-9107,58	-8689,91
Total	–	–	–	**2118335,2**	–	–	–	**-95680,4**

Note: built and calculated by the author

At the end of the first period the increase of the fair value of the hedged item is 118335,15 cu, while the cumulative loss on the hedging instrument is 95680,4 cu. Therefore, the bank does not consider the hedge relationship as ineffective one and all the gains on the swap are recognized in other comprehensive income.

The cash flow hedge relationship is accounted as follows:

1. The recognition of the financial liability (01.03.20X1):
   Dr Cash 2 000 000
   Cr Financial liability 2 000 000
2. Accrued interests on the debt at the end of the first period (01.09.20X1):
   Dr Interest Expense (Profit / Loss) 26480
   Cr Accrued interest on financial liability 26480
3. Change in the fair value of the swap (01.09.20X1):
   Dr Other comprehensive income (cash flow hedge reserve) 95680
   Cr Derivative 95680
4. Net settlement of interest on the swap
   Dr Derivative 35965
   Cr Cash 35965
5. Reclassification from Other comprehensive income to Profit / Loss (01.09.20X1):
   Dr Interest Expense (Profit / Loss) 35965
   Cr Other comprehensive income (cash flow hedge reserve) 35965
6. Settlement of interest on the financial liability (01.09.20X1):
   Dr Accrued interest on the financial liability 62445
   Cr Cash 62445

In the following three periods – 01.09.20X1, 01.03.20X2, 01.03.20X3 – hedge relationships are considered as effective ones so far as the gain / loss on the hedging instrument is less than the cumulative change in the fair value of the hedged item (Table 4).

Table 4

Fair value valuation of the hedged item and the hedging instrument

Period	Financial liability			Interest rate swap				
	at the beginning of the period	change during the period	at the end of the period	at the beginning of the period	change during the period	at the end of the period (before receipt / payment of the cash on the interest rate swap)	receipt / payment of the cash on the interest rate swap	at the end of the period (after receipt / payment of the cash on the interest rate swap)
01.03.20X1	0	0	2000000	0	0	0	0	0
01.09.20X1	2000000	118335	2118335	0	-95680	-95680	-35966	-59715
01.03.20X2	2118335	-390	2117946	-59715	387	-59328	-21046	-38282
01.09.20X2	2117946	-11668	2106277	-38282	13105	-25177	2154	-27332
01.03.20X3	2106277	-18760	2087517	-27332	17497	-9835	14354	-24189
01.09.20X3	2087517	-22417	2065100	-24189	26843	2654	2654	0

Note: built and calculated by the author

On opposite, in the end of the third and the fifth periods (01.09.20X2, 01.09.20X3), the cumulative gain on the hedging instrument exceeds the decrease of the fair value of the hedged item. The hedge relationship is considered as ineffective one. The effective portion of gain on the swap is recognized in other comprehensive income while the ineffective portion of gain is recognized in Profit / Loss.

The accounting entries to recognize the cumulative gain on the interest rate swap in terms of hedge ineffectiveness are as follows:

The change in the fair value of the swap (01.09.20X2):
   Dr Derivative 13105
   Cr Other comprehensive income (cash flow hedge reserve) 11668
   Cr Profit / Loss 1437

Information on the cash flow hedge of the financial liability is disclosed both in the Statement of Financial Position and the Income Statement (Table 5).

Table 5

Disclosure of the cash flow hedge relationships in the financial statements

Period	Transaction	Statement of financial position			Statement financial performance	
		cash flows	interest rate swap	financial liability	gains / losses	other comprehensive income
01.03.XX1X	Recognition of the financial liability	2000000		2000000		
01.09.XX1X	Interest accrual on the financial liability			26480	(26480)	
	Change in the fair value of the swap		(95680)			(95680)
	Net settlement of interest on the swap	(35966)	35966			
	Reclassification from OCI to Profit / Loss				(35966)	35966
	Settlement of interest on the financial liability	(26480)		(26480)		
01.03.XX2X	Interest accrual on the financial liability			41400	(41400)	
	Change in the fair value of the swap		387			387
	Net settlement of interest on the swap	(21046)	21046			
	Reclassification from OCI to Profit / Loss				(21046)	21046
	Settlement of interest on the financial liability	(41400)		(41400)		
01.09.XX2X	Interest accrual on the financial liability			64600	(64600)	
	Change in the fair value of the swap		13105		1437	11668
	Net settlement of interest on the swap	2154	(2154)			
	Reclassification from OCI to Profit / Loss				2154	(2154)
	Settlement of interest on the financial liability	(64600)		(64600)		
01.03.XX3X	Interest accrual on the financial liability			76800	(76800)	
	Change in the fair value of the swap		17497			17497
	Net settlement of interest on the swap	14354	(14354)			
	Reclassification from OCI to Profit / Loss				14354	(14354)
	Settlement of interest on the financial liability	(76800)		(76800)		
01.09.XX3X	Interest accrual on the financial liability			65100	(65100)	
	Change in the fair value of the swap		26843		4426	22417
	Net settlement of interest on the swap	2654	(2654)			
	Reclassification from OCI to Profit / Loss				2654	(2654)
	Settlement of interest on the financial liability	(65100)		(65100)		
	Derecognition of the financial liability	(2000000)		(2000000)		
	Final reclassification of the cash flow hedge reserve				5861	(5861)

Note: built and calculated by the author

Conclusions. The paper discloses the accounting procedures for the cash flow hedge of financial liabilities, using interest rate swaps as hedging instruments. The cash flow hedge reserve is built as the lower of the cumulative gain / loss on the hedging instrument and the cumulative change in fair value of the hedged item. The paper explains the criteria for recognition of the effective and ineffective hedge in other comprehensive income and gains / losses, respectively. The cash flow hedge accounting consists of 3 stages, which are as following: the calculation of the fair value of the interest rate swap at the date of initial recognition, the assessment of the fair values of both the debt instrument and the interest rate swap at each date of remeasurement, the accounting for the cash flow hedge. The current findings of the research are extremely relevant for domestic banks, as they work on implementing IFRS 9 in cash flow hedge accounting.

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Амбарчян Вікторія Самвелівна – кандидат економічних наук, доцент кафедри обліку в кредитних і бюджетних установах та економічного аналізу ДВНЗ «Київський національний економічний університет імені Вадима Гетьмана».

Наукові інтереси:

– облік фінансових інструментів.

http://orcid.org/0000-0003-3871-5135.

Стаття надійшла до редакції 12.03.2020.