APPROVED

by Order No. VAS-6 of 17 September 2007 of the Director of the Public Establishment the Institute of Accounting of the Republic of Lithuania

26 BUSINESS ACCOUNTING STANDARD "DERIVATIVE FINANCIAL INSTRUMENTS"

Version effective as from 21 September 2007 ("Valstybės žinios" (Official Gazette), 2007, No. 99-4045)

I. GENERAL PROVISIONS

1. This Standard set out how financial assets and financial liabilities arising from derivative financial instruments shall be recognised, measured, accounted for and presented in financial statements.

2. All entities which keep accounting records and present financial statements in accordance with Business Accounting Standards shall apply this Standard in accounting for financial assets and financial liabilities arising from derivative financial instruments.

3. This Standard is not applicable to:

3.1. financial assets and financial liabilities arising from primary financial instruments;

3.2. insurance and reinsurance contracts under which the insurer accepts significant insurance risk from another party (the policyholder) by agreeing to compensate (cover insurance claim) the policyholder if a specified insured event occurs;

3.3. sale-purchase agreements made in order to purchase inventories or other assets necessary for the entity's operating activities;

3.4. financial leases, except for those with embedded derivative financial instruments;

3.5. financial guarantee contracts, except for cases when in accordance with the terms of a financial guarantee the creditor has a right to require that the guarantor settles the obligation in response to changes in a specified interest rate, price of securities, commodity price, credit rating, foreign exchange rate, index of prices or other variable.

3.6. equity instruments issued by the entity.

II. KEY DEFINITIONS

Hedged item – an asset, liability, firm commitment, made or forecast transaction, which exposes an entity to risk of changes in its fair value or future cash flows.

Hedge effectiveness – the percentage degree to which changes in the fair value or cash flows of the hedged item are offset by changes in the fair value of the derivative financial instrument designated for a hedge against the risk.

Hedging instrument – a derivative financial instrument whose fair value or cash flows are expected to offset all or most of changes in the fair value or cash flows of a hedged item.

Swap – a transaction whereas two parties agree to swap periodic payments. Generally this transaction involves a payment of a specified cash amount on a specified future date by one party, and a cash amount depending on a variable not specific to the entity‘s operations by another party.

Future – a standardised forward that is traded on an exchange.

Carrying amount – the amount at which an asset or liability is presented in the balance sheet.

Financial liability – an obligation to deliver cash or another financial asset.

Financial instrument – any transaction which gives rise to a financial asset of one party to the transaction and a financial liability or equity instrument of another.

Financial risk – interest rate, foreign currency, credit, liquidity or other risk arising from the entity's financial assets or financial liabilities.

Financial asset - any asset that is cash, a contractual right to receive cash or another financial asset from another party, or an equity instrument issued by another entity.

Purchased option – a transaction of assuming for a certain consideration a right rather than an obligation to acquire or sell goods or financial assets at a specified price.

Forward – a transaction whereas the parties agree to sell or buy goods or financial services at a specified price on a specified future date.

Derivative financial instrument – a financial instrument:

1) which gives rise to a financial asset or a financial liability;
2) the value of which changes in response to the change in a commodity price, interest rate, price of securities, index of prices or interest rates, credit rating, credit index or other similar variable not specific to the entity's operations;
3) which requires little or no initial investment compared to other types of transactions;
4) which will be settled on a future date.

Net value of derivative financial instrument – a difference in the values of financial assets and financial liabilities arising from a derivative financial instrument.

Derivative financial instrument item – an asset, liability, firm commitment, made or forecast transaction.

Embedded derivative financial instrument – a derivative financial instrument embedded into another financial instrument.

Credit risk – a risk that one party to a transaction will fail to discharge its obligations, thus causing the other party to incur losses.

Liquidity risk – a risk to incur losses if assets cannot be quickly realised, and liabilities easily settled.

Combined financial instrument – a financial instrument comprising several financial instruments, of which at least one is derivative.

Interest rate risk – a risk of potential losses due to fluctuations in interest rates.

Written option – a transaction of assuming for a certain consideration an obligation to acquire or sell goods or financial assets at a specified price if another party so requires.

Option – a transaction of assuming for a certain consideration a right or obligation to acquire or sell goods or financial assets at a specified price whereas the parties can determine the time of exercising the contract.

Forecast transaction – a highly probable anticipated future transaction related to ordinary activities of an entity.

Fair value - the amount for which an asset or a service could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Firm commitment – a binding agreement for the exchange of a specified asset or liability at a specified price on a specified future date.

Foreign currency risk – a risk that the value of financial assets or financial liabilities will fluctuate due to changes in foreign exchange rates.

III. NATURE OF FINANCIAL INSTRUMENTS

4. Rights and obligations arising from a transaction that gives rise to a financial asset of one party to the contract and a financial liability or equity instrument of another are treated as financial instruments.
5. By nature financial instruments are primary and derivative.
6. Examples of financial assets, financial liabilities and equity instruments arising from primary financial instruments include:

6.1. financial assets – amounts receivable, purchased debts or equity instruments of other entities;

6.2. financial liabilities – amounts payable, issued debt securities;

6.3. equity instruments – new issue of shares.

7. Financial assets and financial liabilities arising from primary financial instruments are accounted for in accordance with the requirements of 18 Business Accounting Standard “Financial Assets And Financial Liabilities”, equity instruments – in accordance with 8 Business Accounting Standard “Equity”.

8. The value of financial assets and financial liabilities arising from derivative financial instruments changes due to a variable not specific to the entity's operations.

9. Financial assets and financial liabilities arising from derivative financial instruments are recorded in accounting and presented in financial statements in accordance with the requirements of this Standard.

IV. DERIVATIVE FINANCIAL INSTRUMENTS

10. At initial recognition of financial assets and financial liabilities arising from derivative financial instruments in accounting both the presentation form and economic substance of the transaction shall be considered.

11. Derivative financial instruments are used to hedge against risks or for trading purposes.

12. Derivative financial instruments are generally related to sale-purchase transactions of shares, bonds, foreign currencies, raw materials and energy.

13. Examples of derivative financial instruments include:

13.1. forwards;

13.2. futures;

13.3. swaps;

13.4. options.

14. Derivative financial instruments can be embedded into other financial instruments. An embedded derivative financial instrument is a component of a combined financial instrument, therefore cash flows of the embedded financial instrument and the combined financial instrument vary in a similar way.

15. An embedded derivative financial instrument can be closely related or unrelated to the host contract.

16. An embedded derivative financial instrument shall be separated from the host contract and accounted for as a separate derivative financial instrument if all the following conditions are met:

16.1. the economic characteristics and risks of the embedded derivative financial instrument are not closely related to the economic characteristics and risks of the host contract;

16.2. a separate financial instrument would meet the definition of a derivative financial instrument;

16.3. a combined financial instrument is not measured at fair value.

17. If an embedded derivative financial instrument is separated, the result of the host contract is registered in accounting in accordance with the accounting requirements for such transaction, while financial assets and financial liabilities arising from the embedded derivative financial instrument are accounted for in accordance with the requirements of this Standard.

18. If an entity is unable to measure reliably the value of an embedded derivative financial instrument either at acquisition or at the balance sheet date, the entire combined financial instrument shall be treated as a derivative financial instrument, and financial assets and financial liabilities arising from it shall be registered in accounting in accordance with the requirements of this Standard.

V. HEDGING INSTRUMENTS

19. A derivative financial instrument used to hedge against risks affecting a financial asset or financial liability or their group is designated as a hedging instrument.

20. A derivative financial instrument used to hedge against risks can be designated as a hedging instrument if all of the following conditions are met:

20.1. If the derivative financial instrument is related to a specific risk documented in the entity's prepared risk management policy and affecting the entity’s profit or loss, rather than to the entity’s general business risk. Before the inception of a contract involving a derivative financial instrument, in accordance with the set procedure the entity prepares a document specifying the risk being hedged, risk management objective and strategy, hedged item and procedure for assessing hedge effectiveness.

20.2. The derivative financial instrument used for hedging against the risk is expected to be highly effective, i.e. it will offset the risk of changes in the fair value or cash flows of the hedged item consistently with the prepared document.

20.3. A forecast transaction that is subject to the hedge must be highly probable and related to changes in cash flows that could affect the entity’s profit or loss.

20.4. Hedge effectiveness of the derivative financial instrument can be measured reliably.

21. Hedging instruments may be used to hedge against the following risks:

21.1. exposure to changes in fair value of an asset, liability, portion of an asset or liability or a group of assets or liabilities;

21.2. exposure to changes in cash flows;

21.3. exposure to changes in foreign exchange rates of a net investment in a foreign operation.

22. Only those derivative financial instruments whose fair value can be measured reliably can be used for hedging against risk.

23. Written options cannot be used to hedge against risks, except for cases when they are used to offset the purchased options.

24. In some cases primary financial instruments can be used for hedging.

25. The following items can be designated as hedged items:

25.1. a separate asset or liability;

25.2. a firm commitment;

25.3. a forecast transaction;

25.4. groups of assets, liabilities, firm commitments or forecast transactions.

26. Financial assets or financial liabilities can be hedged against entire or partial risk of changes in fair value or cash flows.

27. If a hedged item is a non-financial asset or non-financial liability, it can be hedged only against foreign currency risk or in its entirety for all risks without splitting the item into separate portions.

28. A single derivative financial instrument may be designated as a hedge of more than one type of risk provided that the risks can be identified clearly and it is possible to prove that the derivative financial instrument can be used to hedge against several types of risk.

29. If similar assets or liabilities are aggregated and hedged as a group, the change in the fair value of each asset or liability in the group is determined in proportion to the change in the fair value of the hedged group.

30. The change in the fair value of a financial asset or financial liability arising from a derivative financial instrument used to hedge against risk is recorded in accounting at net value which partly or fully offsets the change in the fair value of cash flows of the hedged item.

VI. RECOGNITION OF AND ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS

31. An entity shall record in accounting a financial asset or financial liability arising from a derivative financial instrument when it assumes a contractual right to receive the asset or an obligation to settle the liability.

32. At initial recognition a financial asset or financial liability arising from a derivative financial instrument shall be recorded at its acquisition cost.

33. Direct transaction costs related to a financial asset arising from a derivative financial instrument shall be included into expenses for financing activities of the reporting period.

34. Direct transaction costs related to a financial liability arising from a derivative financial instrument shall be included into expenses for financing activities of the reporting period.

35. After initial recognition and at each balance sheet date financial assets and financial liabilities arising from derivative financial instruments shall be measured and presented in financial statements at their fair values, except for the cases when their fair value cannot be measured reliably. Possible transaction costs are not deducted for the purpose of estimating fair value.

36. A gain or loss arising from a change in the estimated fair value of a financial asset or financial liability arising from a derivative financial instrument, except for a hedging instrument, shall be presented in the income statement of the period when it appears.

37. If a fair value of a derivative financial instrument cannot be measured reliably, a financial asset or financial liability arising from such instrument is stated at acquisition cost less impairment.

38. In the financial statements derivative financial instruments can be presented at acquisition value only if:

38.1. they do not have a quoted market price in an active market, therefore their fair value cannot be measured reliably;

38.2. they are related to equity instruments with no quoted market price, the fair value of which cannot be measured reliably;

38.3. they have to be settled by presenting equity instruments with no quoted market price the fair value of which cannot be measured reliably.

39. If a reliable measure of fair value becomes available for a derivative financial instrument for which such a measure was previously not available and which was registered at acquisition value, it shall be remeasured at fair value, and the difference between its acquisition cost and fair value shall be presented in the income statement of the period when the fair value is measured.

VII. FAIR VALUE MEASUREMENT OF DERIVATIVE FINANCIAL INSTRUMENTS

40. Fair value of derivative financial instruments is measured periodically, as often as chosen by an entity but at least at each balance sheet date.

41. A fair value of a derivative financial instrument can be determined in two ways:

41.1. on the basis of a quoted market price in an active market;

41.2. using fair value measurement models that estimate fair value on the basis of prices in an active market.

42. If a fair value of a derivative financial instrument is determined on the basis of a quoted market price in an active market, the closing price in an active market at the end of the reporting period shall be used for the purpose.

43. If a market price is unavailable, a price of the most recent transaction of an entity can be used to determine the fair value as long as there has not been a significant change in economic circumstances since the time of the transaction to the balance sheet date.

VIII. ASSESSING HEDGE EFFECTIVENESS

44. A hedging instrument is considered as effective if its hedge effectiveness for the whole period of its validity is in a range from 80 to 125 percent.

45. For the purpose of assessing hedge effectiveness, changes in the fair value of the hedged item rather than changes in its carrying amount shall be measured and compared.

46. An entity adopts a method for assessing hedge effectiveness at its own discretion and describes it in a respective document.

47. Hedge effectiveness shall be assessed each time an entity prepares its financial statements.

IX. ACCOUNTING FOR HEDGING INSTRUMENTS DESIGNATED FOR A FAIR VALUE HEDGE

48. A hedging instrument designated for a fair value hedge and a hedged item shall be valued at fair value. A gain or loss arising from changes in fair value is presented in the income statement.

49. An entity shall write off a financial asset or financial liability arising from a hedging instrument if:

49.1. the hedging instrument expires, for example is exercised, sold, terminated, etc.;

49.2. the hedge no longer meets the recognition criteria specified in this Standard.

X. ACCOUNTING FOR HEDGING INSTRUMENTS DESIGNATED FOR A CASH FLOW HEDGE

50. A hedging instrument designated for a cash flow hedge and a hedged item shall be valued at fair value.

51. After determining the fair value, hedge effectiveness shall be assessed.

52. A portion of gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised directly in equity, in the revaluation reserve (results) item.

53. A portion of gain or loss on the hedging instrument that is determined to be an ineffective hedge shall be recognised in the income statement.

54. An entity shall write off a financial asset or financial liability arising from a hedging instrument if:

54.1. the hedging instrument designated for a cash flow hedge expires, or made or forecast transaction is completed;

54.2. the hedge no longer meets the recognition criteria specified in this Standard;

54.3. the forecast transaction is no longer expected to occur.

55. When a financial asset or financial liability arising from a hedging instrument is written off, all accumulated gain or loss related to it that remains recognised in revaluation reserve (results) item shall be included into profit or loss of the reporting period.

XI. ACCOUNTING FOR HEDGING INSTRUMENTS DESIGNATED FOR A HEDGE OF FOREIGN CURRENCY RISK OF A NET INVESTMENT IN A FOREIGN OPERATION

56. A hedging instrument designated for a hedge of foreign currency risk of a net investment in a foreign operation and a hedged item shall be valued at fair value.

57. After determining the fair value of a hedging instrument, hedge effectiveness shall be assessed.

58. A portion of gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised directly in equity, in the revaluation reserve (results) item.

59. A portion of gain or loss on the hedging instrument that is determined to be an ineffective hedge shall be recognised in the income statement.

60. An entity shall write off a financial asset or financial liability arising from a hedging instrument if:

60.1. the hedging instrument designated for a hedge of foreign currency risk of a net investment in a foreign operation expires, for example is exercised, sold, terminated, etc.;

60.2. the hedge no longer meets the recognition criteria specified in this Standard.

61. If a net investment in a foreign operation hedged against foreign currency risk is disposed of, an accumulated amount relating to the hedging instrument and remaining in revaluation reserve (results) shall be included into the profit or loss of the reporting period. If only a portion of a net investment into a foreign operation is disposed of, only a portion of the accumulated account is transferred into the profit or loss in proportion to the transferred portion of the investment.

XII. IMPAIRMENT OF FINANCIAL ASSETS ARISING FROM DERIVATIVE FINANCIAL INSTRUMENTS

62. If a financial asset arising from a derivative financial instrument is accounted for at acquisition cost, when preparing its financial statements an entity shall determine whether the carrying amount of the asset does not exceed its expected recoverable amount.

63. If a carrying amount of a financial asset arising from a derivative financial instrument is significantly greater than its expected recoverable amount, the carrying amount of the asset shall be reduced to that expected recoverable amount.

XIII. DERECOGNITION OF FINANCIAL ASSETS OR FINANCIAL LIABILITIES

64. Financial assets or financial liabilities arising from a derivative financial instrument shall be derecognised in the balance sheet when rights and obligations created by the derivative financial instrument expire.

65. When rights and obligations created by the derivative financial instrument expire, a received (receivable) or paid (payable) consideration is recorded in accounting.

XIV. DISCLOSING INFORMATION IN COMPLETE EXPLANATORY NOTES

66. In complete explanatory notes to financial statements, the following information shall be disclosed about the entity‘s derivative financial instruments:

66.1. A short description of a derivative financial instrument or group of instruments including the disclosure of significant terms and conditions that may affect the amount of future cash flows.

66.2. The fair value of a derivative financial instrument or group of instruments at the balance sheet date.

66.3. Changes in the fair value during the reporting period.

66.4. The methods used to measure derivative financial instruments and assumptions applied in determining which method to use if the fair value could not be measured reliably. The reasons why the fair value is neither determined nor presented is also disclosed.

67. In complete explanatory notes, the following information shall be disclosed about the hedging instruments:

67.1. A short description of financial risk management objectives and policies for each significant hedged item.

67.2. A description of hedging instruments.

67.3. A description of hedged items and their fair value at the balance sheet date.

67.4. The nature of risks being hedged.

67.5. For hedging instruments of forecast transactions the following information shall be presented:

67.5.1. Maturity dates when forecast transactions are expected to be exercised.

67.5.2. A description of forecast transactions that are hedged but are not expected to be exercised.

67.6. For hedging instruments designated for a cash flow hedge and a hedge of foreign currency risk of a net investment in a foreign operation the following information shall be presented:

67.6.1. The amount included into the income statement of the reporting period.

67.6.2. The changes in revaluation reserve (results) during the reporting period (data is presented in tabular form).

XV. FINAL PROVISIONS

68. This Standard shall be effective for financial statements covering periods beginning on or after 1 January 2008. The Standard can be applied in preparing financial statements for 2007.