



Guidance Note on Accounting for Derivative Contracts

Key Highlights

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Introduction

The Accounting Standards 30, 31 issued in 2007 and Accounting Standard 32 issued in 2008, which deal with financial instruments were made recommendatory from the date of their issue and to be made mandatory from specified dates. Owing to the Global situation and various issues raised in respect of the treatment of financial instruments, ICAI withdrew the recommendatory as well as mandatory status of AS 30, AS 31 and AS 32 in March 2011 on account of proposed revision of International Accounting Standard 39 by the IASB on whose principles the AS 30 was based on. Currently, the relevant regulation that concerns accounting for foreign currency transactions and foreign exchange forward contracts is AS 11. However, AS 11 does not cover contracts used to hedge highly probable forecast transactions and firm commitments. In order to bring the uniformity on accounting for derivative, the ICAI has issued the Guidance Note on accounting for derivative contracts. This Guidance Note provides the guidance on recognition, measurement, presentation and disclosure for derivative contracts so as to bring uniformity in their accounting and presentation in the financial statements. This Guidance Note however does not cover foreign exchange forward contracts which are within the scope of AS 11. This Guidance Note will apply to all entities that do not apply Indian Accounting Standards (IND AS).

Applicability

This Guidance Note becomes applicable for accounting periods beginning on or after 1st April, 2016; its earlier application, is encouraged. From the date this Guidance Note comes into effect the following Announcements issued by the Council of the ICAI stand withdrawn:

- i. Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction issued on the basis of the decision of the Council at its meeting held on June 24-26, 2004
- ii. Disclosures regarding Derivative Instruments published in 'The Chartered Accountant', December 2005 (pp 927).
- iii. Accounting for Derivatives published in 'The Chartered Accountant', May 2008 (pp.1945).
- iv. Application of AS 30, Financial Instruments: Recognition and Measurement published in 'The Chartered Accountant', April 2011 (pp.1575) to the extent of the guidance covered for accounting for derivatives within the scope of this Guidance Note.

Scope

This Guidance Note thus applies to the following derivative contracts:

- Foreign exchange forward contracts outside the scope of AS 11
- Other foreign currency derivative contracts such as cross currency interest rate swaps, foreign currency futures, options and swaps, not covered in scope of AS 11
- Other derivative contracts such as traded equity index futures, traded equity index options, traded stock futures and option contracts
- Commodity derivative contracts

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This Guidance Note is not applicable to:

- Foreign exchange forward contracts covered by AS 11
- Foreign exchange forward contracts or covered by regulations specific to a sector or specified set of entities.
- Macro hedging and accounting for non derivative financial assets/liabilities which are designated as hedging instruments since its objective is to provide guidance on accounting for derivative contracts only and not hedge accounting in its entirety.

Examples of contracts within the scope of AS 11 and thus not covered within the scope of this Guidance Note include:

- Foreign currency forward or future contract entered into to hedge the payment of a monetary asset or a monetary liability recognised on balance sheet, e.g., a debtor, creditor, loan, borrowing etc.
- A currency swap contract (principal only; no interest rate element) that hedges the repayment of the principal of a foreign currency loan.

Accounting of derivatives

The Guidance Note includes definitions of various terms such as derivative, firm commitment; forecast transaction, hedging instrument, hedged item, hedge effectiveness, hedge ratio.

The key principles, on which the accounting for derivatives are based, are as follows:

- i. All derivative contracts should be recognized on the balance sheet date and measured at fair value.
- ii. If any entity is not using hedge accounting as described in Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognized in the statement of Profit and Loss.
- iii. If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify
 - its risk management objective,
 - the risk that it is hedging,
 - how it will measure the derivative instrument if its risk management objective is being
- iv. An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.
- v. Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.

This Guidance Note requires that all derivatives are recognized on the balance sheet and measured at fair value since a derivative contract represents a contractual right or an obligation

Fair value in the context of derivative contracts represents the 'exit price' i.e. the price that would be paid to transfer a liability or the price that would be received when transferring an asset to a knowledgeable, willing

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counterparty. The fair value would also incorporate the effect of credit risk associated with the fulfillment of future obligations. The extent and availability of collateral should be factored in while arriving at the fair value of a derivative contract.

Synthetic Accounting not permitted

The Guidance Note does not permit synthetic accounting, i.e. accounting of combining a derivative and the underlying asset together as a single package. For instance, if any entity has a foreign currency borrowing that it has hedged by entering into a cross currency interest rate swap, it would require the entity to recognise the loan liability separately from the cross currency interest rate swap and not treat them as a package (synthetic accounting) as INR loan. Alternatively, if any entity has borrowed in terms of INR which it swaps with foreign currency borrowing it would not treat such a loan as a foreign currency borrowing.

Hedge Accounting

Designation of Derivative Contract as a Hedging Instrument

Designation of derivative contract as a hedging instrument is optional. Once designated, the entity needs to:

- Identify its risk management objective
- Demonstrate how the derivative contract helps meet that risk management objective
- specify how the entity plans to measure the fair value of the derivative instrument if the derivative contract is effective in meeting its risk management objective (including the relevant hedge ratio)
- Document risk management assessment at inception of the hedging relationship and subsequently at every reporting period
- demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring
- conclude that the risk that is being hedged could impact the statement of profit and loss
- adequately disclose its accounting policies, risk management objectives and hedging activities as required by this Guidance Note in its financial statements

If not classified as hedging instrument?

In case a derivative contract is not classified as a hedging instrument because it does not meet the required criteria or an entity decides against such designation, it will be measured at fair value and changes in fair value will be recognized immediately in the statement of profit and loss.

Designation for a partial term?

It is clarified that derivatives cannot be designated for a partial term of the derivative instrument. A derivative may be used in a hedging relationship relating to a portion of a non-financial item as long as the hedged portion is clearly identifiable and capable of being measured reliably.

Indian scenario

Large number of derivative contracts undertaken in the Over-the-counter (OTC) market and banks, are required by RBI to determine whether all or some of the above criteria are met before permitting an entity to enter into such a contract. Certain derivative instruments that are traded on stock exchanges such as foreign exchange futures contracts or equity options / equity futures do not have such requirements and in those cases, in particular, it will be important to demonstrate compliance with the above criteria before hedge accounting can be applied.

Why Hedge Accounting?

Hedge Accounting may be required due to accounting mismatches in:

- Measurement – Non-derivative financial instruments are NOT measured at fair value with changes being recognized in the statement of profit and loss whereas all derivatives, which commonly are used as hedging instruments, are measured at fair value.
- Recognition – unsettled or forecast transactions that may be hedged are not recognized in the balance sheet and are included in the profit and loss statement only in the future accounting period, whereas all derivatives are recognized at inception.

Some examples of such measurement mismatch include:

- Hedge of interest rate risk on fixed rate debt instruments that are not held with the intention of trading
- Derivative undertaken to hedge the price risk associated with recognised inventory.

Example of such recognition mismatch include hedge of a contracted or expected but not yet recognised sale, purchase or financing transaction in a foreign currency and future committed variable interest payments.

In order that the statement of profit and loss reflects the effect of the hedge properly, it is necessary to match the recognition of gains and losses on the hedging instrument and those on the hedged item. Matching can be achieved in principle by delaying the recording of certain gains and losses on the hedging instrument or by accelerating the recording of certain gains and losses on the hedged item in the statement of profit and loss. Both of these techniques are used while applying hedge accounting, depending on the nature of the hedging relationship.

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Types of Hedge Accounting

The Guidance Note Recognizes three types of hedges and lays down accounting and measurement principles relating to:

- Fair value hedge accounting model – applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised. When applying this method, the hedging instrument is measured at fair value with changes in fair value recognised in the statement of profit and loss.
- Cash flow hedge accounting model – applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency. Under this method, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognised in equity, e.g., cash flow hedge reserve.
- Hedge of a Net Investment in a foreign operation. The foreign exchange gains and losses on a net investment in a non-integral foreign operation are recognised directly in equity.

Documentation and Hedge effectiveness testing

The Guidance Note provides for elaborate documentation of hedge relationship at inception of a hedge which include entity's risk management objective and clear identification of the hedged item and the hedging instrument.

The entity should assess whether a hedging relationship meets the hedge effectiveness requirement. At a minimum, an entity should perform the ongoing assessment at each reporting date or when there is a significant change in the circumstances that affect hedge effectiveness requirement, whichever comes first. The Guidance note does not prescribe bright line tests for effectiveness assessment, instead requires disclosure of the entities risk management objectives and measures for assessing, if those objectives are met. This guidance note prohibits voluntary hedge de-designation if risk management objectives and hedging instruments are unchanged.

Hedge ineffectiveness

It also does not prescribe a single method of how ineffectiveness measurement should be conducted other than to require an entity to consider how ineffectiveness could affect a hedging relationship and require immediate recognition of such ineffectiveness. Hedge ineffectiveness is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.

Examples of situations where ineffectiveness is to be recognised are:

- in a cash flow hedge, when the forecasted hedged transaction is no longer probable of occurring
- in a fair value hedge, when the hedging instrument is no longer considered to be an effective hedge of the hedging instrument; and
- in any hedge relationship, if the risk management objective is changed or no longer expected to be met.

If recognition is ineffective, the Hedge Accounting need not be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.

Termination of Hedge Accounting / Reclassification of Hedge Reserve

Voluntary termination is prohibited unless the management objective of the entity, as was originally defined at the inception, is no longer met.

Hedge accounting is discontinued prospectively in the following cases:

- Termination a hedging instrument prior to its maturity / contractual term,
- In case of hedges of highly probable forecast transactions or commitments, if the forecasted transaction is no longer 'highly' probable of occurring, but still probable of occurring

The amount previously recognised in the hedge reserve is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings.

In case of hedges of forecast transactions, if the forecasted transaction is no longer probable of occurring, then hedge accounting is discontinued and all amounts recognised in the hedge reserve are recognised immediately in the statement of profit and loss.

Presentation in the financial statements

- Derivatives that are intended for trading or speculative purposes should be reflected as current assets and liabilities.
- Derivatives that are hedges of recognized assets or liabilities should be classified as current or non-current based on the classification of the hedged item.
- Derivatives that are hedges of forecasted transactions and firm commitments should be classified as current or non-current based on the settlement date / maturity dates of the derivative contracts.
- Derivatives that have periodic or multiple settlements such as interest rate swaps should not be bifurcated into current and non-current elements. Their classification should be based on when a predominant portion of their cash flows are due for settlement as per their contractual terms.
- Netting off of assets and liabilities is not permitted except where basis adjustment is applied under cash flow hedges.
- Amounts recognised in the statement of profit and loss for derivatives not designated as hedges may be presented on a net basis.

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Disclosures

Entities should disclose:

- Overall financial risk management objectives & policy
- Explanation on financial risks and approach towards managing financial risks
- Methodology used to arrive at the fair value of derivative contracts
- Extent of fair value gains/losses recognized in the statement of profit and loss and in equity
- Types of hedging instruments
- Extent of transactions that are hedged
- Description of the Hedge
- Description of the financial instruments designated as hedging instruments for the hedge and their fair values at the balance sheet date
- Nature of risks being hedged
- For hedges of forecast transactions, the periods in which the transactions are expected to occur, when they are expected to affect the statement of profit and loss, and a description of any forecast transactions that were originally hedged but now are no longer expected to occur
- Amount recognised as Hedge Reserve
- Amount recycled from the hedge reserve and reported in statement of profit and loss
- Amount recycled from hedge reserve and added to the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged forecast transaction
- Breakup of the balance in the hedge reserve between realised and unrealized components and a reconciliation of the opening balance to the closing balance for each reporting period

Transitional Provisions

This Guidance Note applies to all derivative contracts covered by it and are outstanding on the date this Guidance Note becomes effective. Any cumulative impact (net of taxes) should be recognized in reserves as a transition adjustment and disclosed separately. An entity is not permitted to follow hedge accounting as recommended in this Guidance Note retrospectively.

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