ACCOUNTING & REPORTING OF DERIVATIVES

The derivatives are special class of financial instrument (Assets/Liability) and are defined as transaction or contract, which take its origin (derived) from another asset such as stock, bond, mortgage, market index or foreign currency. The value and financial implication of these transaction or contract depends on the assets from which it has been derived. Thus derivative needs a special accounting policy & reporting practice even though it is a special class of financial instrument.

Objectives

- To standardize accounting and reporting procedure.
- To lay down principles for preparation and presentation.
- To eliminate the extent possible the non-comparability of financial statement.
- To ensure the users of financial statements gets reliable financial statement prepared by the enterprises.
- To attain international levels in the related areas.

— Palash Goswami

Features of derivatives

- The derivatives are those financial instrument whose value changes in response to the change in the value of variable from which it is derived.
- The variable from which it is derived should be objectively observable.
- The basic elements of definition are risk, futurity and origination.
- The futurity element of derivatives (settlement of contract or transaction at some future date) makes it more risky as its value changes with the future change in the value of variable from which it is derived.
- Transactions such as insurance contract, bank guarantees etc are having the element of risk and futurity but are excluded from the definition of derivatives because it originates from the past events.
- Generally derivatives require very little initial investment as compared to the other kind of financial instruments.
- The classification of a financial instrument as derivatives should be according to the nature and intention of the transaction or contract not by their name or specific class. For example convertible warrants issued with shares or bond. The conversion of warrant will take place at some future date and conversion ratio will depend on the market value of shares or bonds on conversion date. The convertible warrant issued with shares and bonds are derivatives as it possess all elements of derivatives.
- Like other financial instrument some derivatives are traded on the organized market while other is on over the counter (OTC). The organized market traded derivatives has standardized features whereas OTC traded derivatives are non-standardized and customized to meet specific requirements.
- The value of derivatives, which are traded in the organized market can be measured accurately on particular day by its quotation in free and active market on that particular day.
- The values of derivative, which are not traded in the organized market are measured by adopting

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some model of valuation. The model of valuation will contain certain factors by which value of derivatives can be measured reliably. The value of those factors can be gathered from the organized, free and active markets.

- The derivatives can be divided into two categories viz. Derivative held for trading/speculation and Derivative held for hedging.
- The point of difference between investment in financial instrument and investment in derivatives are listed below

Particulars	Financial Instruments	Derivatives
Intention	Financial Instruments are held for earning income by way of interest, dividend, and capital appreciation or for other benefits.	Derivatives are held for trading/speculation or hedging.
Period	Short or Long term	Trading/Speculation purpose derivatives are generally short-term but for hedging may be for short-term or long-term.
Initial Investment	Acquisition cost plus cost of financial instruments.	Acquisition cost plus margin money if any.
Origin and Valuation	Independent	It takes it origin from other objectively observable variables. Its valuation is dependent on such variables.

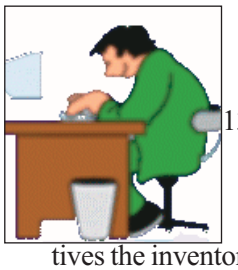
Suggested Accounting and Financial Reporting

1. Accounting and financial reporting of derivatives should be consistent from one period to another.
2. Revenue and cost of derivatives are to be recognized as they are earned or incurred and recorded in the financial statement of the period to which it relates.
3. Accounting and financial reporting should disclose all items and facts, which are considered for making estimates under the condition of uncertainty and transactions are accounted for in accordance with actual happening and economic reality of the transactions not by its legal forms.
4. Initial valuation of the derivatives should be done at the cost, which is the fair value of amount paid or received for such acquisitions. The transaction cost should be charged to the P&L account of those periods as the same is excluded from the definition of the fair value. The fair value of a financial instrument is defined as an amount at which it will be exchanged or settled between knowledgeable, willing parties in an arm's length transaction. This amount could be the market price and computed price or present value of future cash flows of derivatives in organized market and OTC respectively.
5. Initial premium or discount paid or received for derivatives of trading/speculation purpose

should be recognized as transaction cost and charged to P&L account of that period.
6. Subsequent valuation of the derivatives of trading/speculation purpose should be done at the fair value and all gain and loss should be charged to current income statement because economic benefit of holding a position in such derivatives is truly related to the period in which the derivative was held rather than to the period in which the contract is finally closed out. The guidance notes on accounting for equity index, equity stock futures and options issued by ICAI suggests that losses on equity index futures to be charged to earning of current year and profit to be deferred till maturity of contract, losses on equity index/stock options to be charged to earning of the current year and net gain or marked- to-market premium on it to be deferred till maturity of the contract. This guidance note is not in line with international standard. The ICAI is committed to adopt international standard in absence of any specific accounting standard for derivatives in India. In India, accounting standard and their interpretation issued by ICAI overrides the guidance notes issued by ICAI for the purpose of Indian GAAP therefore all losses and gain should be charged to current income statement in line with international standard as the same is

adopted by ICAI in absence of any specific accounting standard for derivatives in India.

7. Investment in derivatives for hedging may be for long-term or short-term.
8. The hedging means creating a position in a derivative (hedging instrument) such that it offsets any unfavorable change in the value of another asset or liability (hedged item) and accounting thereof is called hedge accounting. The process of hedge accounting involves. (i) The identification of item, which is exposed to various significant risk affecting the profit. However item so identified should not be a normal business commitment, transaction or held to maturity security. (ii) The identification of derivatives (hedging instrument) which can offset any unfavorable change in the above identified items (hedged item). (iii) Formulation of risk management policy by the apex management i.e. risk management objectives and hedging strategies. (iv) Formulation of strategies for continuous monitoring and measurement of hedging. This involves pre-statement of method of assessing the effectiveness for a particular hedge and strategies for compliance of A.P.(DIR Series) Circular no.19 dated 24-01-2002 issued by RBI. The continuous monitoring and measurement is needed to determine the following, whether (A) the derivative cease to offset any unfavorable changes in the value of hedged item (B) the hedged item is no longer expected to occur. (C) the expected gain is less than the loss. (D) designation of hedge is removed.
9. The method assessing hedge should be consistent during the currency of hedge and if changed than hedge has to be discontinued and reestablished as it relates to the determination of the effectiveness of hedge.
10. The change in the value of hedging instrument shall offset any unfavorable change in the value of hedged item. Hence, for accounting purpose they should be treated together.
11. AS-11 inconformity to above also consider the foreign currency forward and corresponding commitment together by requiring only the amortization of the premium over the life of the forward.
12. The disallowance of hedge accounting through guidance notes on equity index future and option and equity stock option issued by ICAI could be made allowable on the basis of explanation given at S.N.-6 above.



13. For accounting of commodities derivatives the inventories (commodities) marked or segregated as hedging inventory and hedged inventory should be treated together and measured at fair market value for accounting at subsequent date and not at cost or fair market value whichever is less as prescribed by **AS-2**.
14. The financial instrument defined as derivative should be measured at fair market value as explained earlier and not as per **AS-13.**
15. The initial premium/discount paid /received for acquiring derivative for hedging to be amortized during the hedge period.
16. For the purpose of accounting hedge transaction can be classified into three categories viz. Fair value hedge, Cash flow hedge and, Foreign currency hedge
17. The fair value hedge is done with an intention to safeguard changes in the value of an asset or liability or an unrecognized firm commitment in a given period in which the contract is finally closed out. The gain or loss in hedged item and hedging instrument is due to re-measuring of its value at subsequent date. As such if the fair value hedge is fully effective the gain or loss of hedged item would be compensated by the loss or gain of hedging instruments. Any variation than expected are truly due to the managerial perception of future risk as regard their valuation during particular period and hence any gain or loss in the re-measured value of hedged item and hedging instrument should be charged to that period. Thus resultant gain or loss in respective value considering the hedged item and hedging instrument together should be charged to the income statement of that period.
18. The cash flow hedge is done with an intention to safeguard variation in a forecasted cash flow in a given period in which the derivatives was held. In case of cash flow hedge shortfall in expected cash flow of hedged item is compensated by the extra cash flow generated by the hedging instrument in a fully effective cash flow hedge. As these are meant to offset the unfavorable change in the value of hedged item at a later date but in reality it acts differently and the gain or loss of a business entity due to excess or less cash flow of hedged item and hedging instrument is precisely determinable at end of

the hedge period in which hedging transaction/contract is finally closed out. Considering the real situation we can distinguish three component of cash flow hedging instrument namely effective, ineffective and excluded portion. The effective portion generates necessary compensating cash flow during the hedge period, the ineffective portion are those portion which is unable to generate desired compensating cash flow during that particular period and excluded portion of cash flow hedge are unrelated to the hedged item. Thus gain or loss on ineffective and excluded portion is to be written off as the income or loss of the current period. The gain or loss of a business entity at the end of hedge period due to the effective portion of cash flow hedging instrument which is accumulated as reserve may be divided into two part. Firstly, the gain or loss in the financial year in which the hedge period ends. Secondly gain or loss of the remaining prior period. The gain or loss of the financial period in which the hedge period ends should be charged to income statement of that year and gain or loss the second portion should be shown as prior period item in current year income statement in which hedge period ends.

19. Foreign currency hedge safeguards exposure of an asset, liability and forecasted transaction to foreign rate fluctuations. It could be net investment in foreign operation, unrecognized firm commitment involving foreign currency exposure, foreign currency dominated forecasted transactions and available for sale securities with foreign exchange exposure. The accounting of above referred kind of foreign currency hedge should be done similar to those as indicated in table

S. No.	FOEIGN CURRENCY HEDGE	PRESCRIBED ACCOUNTING
1.	Net investment in foreign operation,	Cash flow hedge
2.	Unrecognized firm commitment involving foreign currency exposure,	Cash flow hedge
3.	Foreign currency dominated forecasted transactions,	Cash flow hedge
4.	Available for sale securities with foreign exchange exposure.	Fair value hedge

20. Prior designation of hedging instrument and hedged item is essential to curb the scope for use of discretion for divergent interpretation and accounting treatment. This can be explained with the help of following illustration. Suppose a business entity is holding an investment and debt. The investment is earning fixed interest and interest on debt is payable in Libor. To achieve asset liability match the business entity enter in swap to designate either the fixed interest earning investment as hedging instrument and interest tied to Libor debt as hedged item or the fixed interest earning investment as hedged item and interest tied to Libor debt as hedging instrument. The former is fair value hedge and later is cash flow hedge. The accounting treatment for fair value hedge is different from cash flow hedge and should not be left to the discretion of business entity for designation at later date.

21. Following disclosure should be made.

- Classification of derivatives done according to the nature and intention.
- Underlying variable from which derivatives have been derived is objectively observable.
- For accounting purpose hedged item and hedging instrument are treated together.
- Insurance contract and bank guarantee etc. entered in regular way according to common convention and trade practice are excluded through futurity and risk is involved.
- Fair value accounting for derivatives is accepted as default treatment unless they are used as hedge.
- Intention for holding a derivative i.e. for trading/ speculation or hedging purpose.
- Method used for assessing the effectiveness of hedge not changed and if changed than hedge was discontinued and re-established during the period under reporting
- Hedge will discontinue automatically if hedged item is no longer expected to occur, derivatives ceases to offset any unfavorable change in the value of hedged item, hedging instrument ceases to exist and designation of hedge is removed hence continuous monitoring and measuring of hedge was effected during the period under reporting in term of RBI directives.
- Hedged item and hedging instrument are designated at the inception stage. ■