Accounting for Foreign Currency Forwards

Being a developing country, arguably India has a long way to go before it can make other countries accede to transacting with it in the Indian Rupee. This exposes Indian entrepreneurs to the vagaries of foreign exchange rates. On such occasions they would be better placed if they could freeze their cash flows and enhance their efficiency in other crucial activities such as financing and budgeting. One of the most common means resorted to under such circumstances is to sign up a forward contract with a banker. Thus, accounting for forward contracts assume a lot of significance in a country like India, where hedging is becoming almost indispensable to survive competition. Besides, it is imperative for every corporate to carefully weigh the accounting policies, and adopt the one that best suits it and provides greater advantages. This article discusses some of the practical aspects of accounting for forward contracts in the light of recent pronouncements and developments.

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Forward Contract

In common parlance, a forward currency contract refers to a contract that fixes the quantity of two currencies to be exchanged on a specified future date. The exchange ratio at which the contract is executed is called the forward rate. The difference between the forward rate and the spot rate on the date of the contract is called a forward premium or discount.

What Does AS11 Say?

The Accounting Standard 11 on '*The effect of changes in foreign exchange rates*' specifically covers accounting for a forward contract or a financial instrument, which in substance is a forward contract and one that is not entered into for the purpose of trade or speculation.

As per AS11, the aforesaid forwards will have to be originally accounted at the transaction date spot rate and restated at the spot rate on the balance sheet date, while the forward discount or premium paid or accrued will have to be deferred and amortised over the unexpired period of the contract. The result is that once the upfront forward premium or discount portion is removed and separately accounted, the foreign currency payable or receivable under the forward contract becomes a normal monetary item, which will get restated at the closing rate at every balance sheet date. This also establishes an offsetting relationship with the original receivable or payable monetary item for which the contract is entered into.

If a forward contract has been intended for trade or speculation, then the standard requires that we mark the contract to market on each reporting date. 'Mark to market' means that the carrying amount of the contract will be restated using a forward rate applicable for the remaining unexpired period of the contract. For example, if a contract fixes the forward rate on 1-12-2011 as 1 $=₹50 as the rate for a transaction to be done after six months, i.e., 31-5-2012, then as on 31-3-2012, which is the balance sheet date, we will have to check the forward rate available in the market for the remaining two months (1-4-2012 to 31-5-2012), which may be, say, 1 $=₹52, and use this rate for restating the forward contract.

Some Practical Insight

Forward contract with a banker nowadays are of two types: 1) Underlying and 2) Past performance-based forward deals. In the banking parlance, a forward deal based on Underlying means that the forward deal has been taken based on either one or more (a) Commercial Invoices (Import/Export), or (b) Purchase Orders from customers. A forward deal based on past performance means that as per RBI regulations, the company will be allowed to sign up forward contracts for a specified amount in the entire financial year. This specific amount is fixed based on an average computation of past foreign currency exposure to imports and exports of the company.

Indian GAAP recognises three types of foreign currency exposures of an entity (import or export). To this a forward contract may be generally related to, namely:

1. A recognised monetary asset or liability (e.g. debtors or creditors in foreign currency as per books)
2. An unrecognised firm commitment, and
3. Highly probable forecast transaction

An unrecognised firm commitment is a binding agreement to purchase or sell a specified quantity of a resource at a specified price at a future date. A highly probably forecast transaction is an anticipated, uncommitted future transaction. 'highly probable' means 'more likely than not'.

With this background, we can map these currency exposures to the types of forward contract mentioned at the inception para for the purpose of accounting under Indian GAAP as below:

1. Recognised Asset or Liability	:	Commercial Invoice-based forwards (Underlying)
2. Unrecognised Firm Commitment	:	Purchase Order-based forwards (Underlying)
3. Highly Probable forecast transaction	:	Past performance-based forwards

Current Accounting Scenario

Few years ago, ICAI issued an announcement clarifying that AS11 does not apply to forward contracts, which are meant to hedge an unrecognised firm commitment or a highly probable forecast transaction. But later on it withdrew the announcement citing that AS30 relating to '*Financial instruments – Measurement and Recognition*' will become mandatory from 1-4-2011 to all entities except SMEs, and will regulate the accounting for all derivative transactions. But the Ministry of Corporate Affairs (MCA) has not yet notified AS30 for the purpose of Section 211 (3C), which means that AS30 will still not be applicable for companies, but applicable for non-companies, which are not described as SMEs. Should there be confusion that with the withdrawal of the aforesaid announcement whether AS11 will now become applicable to the rest of the categories of forward contracts? No. This is due to following:

The reason for withdrawal of the announcement was the introduction of another standard, which has not yet been made applicable and not any change in fundamentals or amendment to AS11 per se. Thus, the essence of AS11 has not diluted.

> Para 36 of AS11 talks about forward contracts, which are non-speculative, and are entered into to establish the amount of foreign currency available (export) or required (import) *as on the settlement date of transaction.* But the settlement date of a transaction will not be known correctly for a transaction, which is only at the PO stage or a mere forecasted transaction, though highly probable.

Thus, AS11 will be still be applicable only to forward contracts, which are entered into in respect of a recognised asset or liability (i.e., Underlying Invoice).

As far as other forward contracts (i.e., relating to unrecognised firm commitment or highly probable forecast transaction) are concerned, there is no mandatory applicable standard as of now. But again, ICAI had issued an announcement on 29-3-2008 as a guideline for foreign currency derivatives other than forwards covered under AS11. This announcement clarifies that the company has to mark all such derivatives to market. Any gain or loss due to such marking to market will be taken to P&L, because of the concept of 'prudence' as advocated in AS1 on the disclosure of accounting policies. It may be

recalled that the same accounting principle has been laid down in AS11 for forwards meant for trading or speculation.

Popular Accounting Practices

In fact, what is being followed by many major Indian companies in respect of foreign currency derivatives is a combination of AS11, and either AS30 or Mark to Market (MTM). More appropriately, if such mark to market is a gain, then most companies prefer not to take the credit to their Profit and Loss account on principles of conservatism. The table below shows the derivative accounting policies adopted by some of the popular Indian companies as per their annual reports for the FY2010-11.

Once this is done, all fair value changes will go to add or deduct the carrying amount of the forward contract, which is already accounted under AS30 principles. Treatment of the corresponding gain or loss account will depend on the type of hedge designated as below,

- If it is a fair value hedge, the gain or loss in fair value is taken to P&L
- If it is a cash flow hedge, the gain or loss in fair value will be accumulated in a separate equity reserve (corporate uses the popular name 'Hedging Reserve')

Cash flow hedge is predominantly used for highly probable forecast transaction for one important reason

		Forward Contracts Relating To		
S.No	**Name of Company**	**Recognised Asset/Liability**	**Firm Commitment**	**Highly probable Forecast transaction**
1	Tata Motors	AS11	Not specified	AS30 - Cash flow Hedge
2.	Infosys	AS30 adopted to the extent it is not contradicting other AS, and other authoritative pronouncements of Company Law and other regulatory requirements		
3.	Reliance Communications	AS11	Any loss arising out of marking of a class of derivative contracts to market price is recognised in the Profit and Loss Account. Income, if any, arising out of marking a class of derivative contracts to market price is not recognised in the Profit and Loss Account	
4.	Tech Mahindra	AS11	Not specified	AS30 - Cash Flow Hedge
5.	Bajaj Auto	The Company has adopted the accounting treatment and disclosures in accordance with the principles laid down in AS30 and AS32 on foreign currency derivative contracts.		
6.	Essar Oil and Gas	AS11	Mark to Market	
7.	Tata Consultancy Services	AS11	Ind AS39 adopted. These are accounted as Cash Flow Hedges. (Ind AS39 is the IFRS Converged version with fundamentally the same principles as of AS30)	

What is AS30 All About?

AS30 requires the following:

- If Hedge accounting is not followed, then mark all forward contracts to market, and dispose of the resultant changes being gain or loss to P&L.
- If Hedge accounting is followed, then the company has to do two important things, namely:
  a. Designate the hedged item (risk carrying instrument) and hedging instrument (i.e. exchange risk offsetting instrument)
  b. Decide whether to follow a fair value hedge or a cash flow hedge

that it avoids unnecessary hit to P&L when the forecast transaction is yet to happen and the fair value changes have nothing to offset in P&L. All these accounting treatments are possible if there is a proper hedging documentation as required by AS30, and in case of cash flow hedge, the hedge is effective as defined and set out in the standard. If the auditor does not approve the hedge documentation, all derivatives will have to be separately accounted at their fair value on each reporting date. In other words, AS30 will not be helpful if the company does not establish the hedging purpose of its derivatives outstanding as on the Balance sheet

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by means of an efficient hedging accounting and documentation.

It may also be noted that ICAI issued another announcement with regard to application of AS30 while reasoning that MCA had not yet notified AS30, and laid that with effect from 1-4-2011, Ind AS39 will be applicable with respect to derivative accounting to all companies, which fall in the Phase-1 of converged GAAP (IFRS) compliance. For others, AS30 will be applicable. But until now, IFRS has not set in and, therefore, AS30 is still recommendatory.

Usefulness of ERP Software for Hedge Accounting

As mentioned above, hedge accounting requires that a Cash Flow hedge should be effective, and only then hedging documentation will be required. The Hedge effectiveness needs to be tested prospectively at the time of inception of the hedging relationship, and retrospectively at the end of each reporting period to determine the expensing portion of the fair value change (i.e., ineffective portion)

Testing of hedge effectiveness requires maintenance of proper records. In case of an underlying-based forward contract, the company has to keep a track of all invoices or purchase orders, which are marked for hedging and mark them off as 'utilised' as and when they are received or paid and the related forwards are utilised. It calls for care when there are also bookings based on past performance, so that when an invoice, which is already marked as underlying for another forward contract, does not again get knocked-off while utilising a past performance-based forward deal or vice versa. If this blunder is committed, there will be difficulty in obtaining the quarterly certifications as mandated by RBI regulations.

The above issues can be encountered by implementing an ERP such as SAP, with a 'Treasury' module. This module basically operates a Hedge management, system which captures/tracks all forward deal details in a single screen. It categorises them as those on an underlying and past performance basis. It also interacts with another system called 'Exposure Management System,' from where it links all the related invoices or purchase orders. Thus, at any time one call put out a report showing the amount of outstanding forwards and the related outstanding invoices due to be utilised. It can also show a transaction log how various deals were utilised in the period, which forms the basis for testing the effectiveness as required by the AS. Considering that this will involve a significant manual exercise, an ERP in this regard could be the best bet, subject, of course, to passing the cost-benefit tests.

Conclusion

To summarise the status of compliance with accounting standards with respect to foreign currency forward contracts:

	Forward Contracts Relating To	
Type of Entity	**Recognised Monetary item**	**Firm Commitment/Highly probable Forecast transaction**
Companies incorporated under Companies Act 1956	AS11 till date	Up to 31-03-2009 : MTM From 01-4-2009 TILL DATE : MTM or AS-30 (either fully or to the extent AS-11 is not applicable)
Other cases	From 1-4-2011 AS-30 will be applicable.	Up to 31-3-2009 : MTM 01-04-2009 to 31-3-2011 : MTM or AS-30 (either fully or to the extent AS11 is not applicable) 01-04-2011 onwards : AS-30 in full

Thus, prudent entities will be leveraged accordingly by opting either Mark to Market or Hedge accounting policy, which will stabilise the charge to Profit & Loss account. ■