Treatment of Mark to Market Losses on Principal only Currency Swap

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company, registered under the Companies Act, 1956 (hereinafter referred to as 'the company'), is engaged in providing port and related infrastructure services (including SEZ) to various port and SEZ users.
2. The querist has stated that when the company approaches banks for long-term loans to fund the capital expenditure for port project, it has the option of seeking a foreign currency loan (FCL) or a Rupee loan. In case FCL is not readily available, the company agrees to borrow Rupee loan. The sanction letter of bank could also provide the company the option to convert the undrawn portion of Rupee loan into FCL at a later date. Further, along with the sanction of Rupee loan, banks also sanction derivative limits so that the company could utilise the same for swapping drawn and outstanding Rupee loan amount into foreign currency facility. According to the querist, the company enters into derivative transaction by way of Principal only Swap (POS) to the extent of outstanding Rupee loan in its balance sheet. As per the querist, though the POS transaction is an off-balance sheet item, the same cannot be entered into unless there is an underlying outstanding loan in the balance sheet. Hence, it is clearly inter-linked to a balance sheet item.
3. The querist has further stated that POS transaction with bank involves notional swap of the company's Rupee loan with USD. As a result, the company has USD exposure through POS. The tenor of underlying Rupee loan of POS contract is same and notionally, the company swaps the Rupee loan with the USD loans. The bank which enters into the POS actually buys Rupee from the company and sells it USD. However, no cash flow takes place, no entries are passed in books and details of outstanding transaction are disclosed in the financial statements. Thus, effectively, what was a Rupee obligation of the company becomes a USD obligation with the POS.
4. According to the querist, all POSs are monitored on a regular basis and, periodically, the company has interest inflow on account of differential interest rate on Rupee and USD borrowings. As per RBI directives, POS contracts are cancellable but once cancelled, cannot be renewed during tenure of the term loan and, hence, it is possible to have POS till the maturity of Rupee loan.
5. The querist has also stated that for such transactions, bank pays Rupee interest rate of, say, 11% and the company pays USD interest rate of, say, 5%. The difference is called "carry". This means that if Rupee interest rate goes below 11%, the company gets benefited as "carry" remains same and vice versa but the company has exposure on account of variation in INR/USD exchange rate. (The interest rate "carry" and USD exposure are two different things which means, even if carry is more or less, the USD exposure remains). Effect of USD increase is still exchange rate difference and is still to be accounted for by way of mark to market (MTM) loss/gain. But, this is only again memorandum (notional), because, just as the exchange rate differences on External Commercial Borrowings (ECBs), this also does not actually materialise till the loan is actually paid off.
6. The question arises about accounting for MTM losses/gains on such POS transaction along with receipt of 'carry' income at regular intervals in accordance with the Ministry of Corporate Affairs (MCA) Notification dated 7th December, 2006 and subsequent extension vide Notifications dated 31st March, 2009 and 29th December, 2011.
7. The company believes that it is technically possible to take advantage of the MCA Notification where there are MTM losses on POS contracts. To explain its view, the company has stated that it takes foreign currency exposure against Rupee loan liability which is taken to fund capital asset.
8. The querist has given the following arguments:
   a) Similarities between foreign currency borrowings and POS are as under:
   (i) Both are USD exposures.
   (ii) Both are taken for reduction of rate of interest.
   (iii) Both lead to increase or decrease in cost of funding depending upon the USD / Rupee movement.

- Say, for example: A foreign currency loan taken at 5% when fully hedged = Rupee rate of interest 5% + Rupee-USD hedge, i.e., 6% = 11%.
- Similarly Rupee loan @ 11% with POS carry of 5% = 6% = USD rate of interest.
- Thus, whether the loan is a foreign currency loan or Rupee loan, once the foreign currency loan is hedged into equivalent Rupee and so also, if a Rupee loan and a POS are taken, it is equivalent to foreign currency loan. Therefore, both foreign currency loan and Rupee loan with POS are the same (in fact two sides of the same coin).
- Foreign currency loan gets affected by exchange rate changes and results into 'exchange rate difference'. Rupee loan with POS gets affected by exchange rate changes and results into MTM gain or loss.
- Both are governed by Rupee-USD exchange rate movement.
- Thus in all respects, they are the same.

b) *Some differences between foreign currency borrowings and POS are as under:-*
- Foreign currency loans are recorded in the books.
- POS is not recorded but can be entered into only if the company has outstanding Rupee loan, which in anyway stands recorded in the books.

c) *POS is not a speculative derivative*
- POS can be entered into only if there is an underlying Rupee loan and is not a speculative transaction which is entered into without any underlying asset / liability.
- POS is only relevant for the period of the loan and cannot be rebooked, once cancelled.
- POS is for hedging a Rupee to USD, and, thus is 'Swap', which means that it is effectively Rupee swapped to USD and, thus, is akin to a foreign currency loan.

d) *Why MCA Notification can be considered to be applicable on MTM loses on POS transaction*

(i) Spirit
- The Government Notification was given to take care of ill effects of the spikes in USD movement affecting the balance sheet. POS also leads to MTM losses which are a result of spike in USD movement.
- The Government Notification effectively sets aside the provisions of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', notified under the Companies (Accounting Standards) Rules, 2006 (the 'Rules') in respect of foreign exchange (forex) losses and allows them to be capitalised, if they arise on long term borrowings/ monetary items. POS also leads to forex losses and are of long-term nature and hence, provisions of AS 11 should be set aside in terms of the Government Notification.

(ii) Substance
- Both POS and foreign currency borrowings are, in substance, the same as explained earlier in terms of purposes.
- Both are, in substance, of long-term nature and for interest costs savings.
- Both lead to forex losses or gains of long-term nature and are notional.
- Paragraph 46 of AS 11 inserted by the MCA Notification (Notification No: GSR 225(E) dated 31st March 2009[1]), states as follows:

  "In respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011, at the option of the enterprise (such option to be irrevocable and to be exercised retrospectively for such accounting period, from the date this transitional provision comes in to force or the first date on which the concerned foreign currency monetary item is acquired, whichever is later, and applied to all such foreign currency monetary items), exchange differences arising on reporting of long- term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be

[1] *Paragraph 46 of AS 11 has been further amended by Companies (Accounting Standards) Amendment Rules, 2011 and Notification No. G.S.R. 913(E) dated 29.12.2011. Also, a new paragraph 46A has been inserted in AS 11 by Notification No. G.S.R. 914(E) dated 29.12.2011.*

added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/liability but not beyond 31st March, 2011 ...".

The transaction under discussion as described above is a 'Long Term Foreign Currency Monetary Item' in every way and hence would fall within the parameters of paragraph 46 of AS 11.

(iii) Specific Provisions

There is no specific reference to POS level of transaction in the Government Notifications but the purpose is same, i.e., to take care of forex fluctuations.

B. Query

9. The querist has sought the opinion of the Expert Advisory Committee as to whether the mark to market losses on POS can be treated as exchange rate difference and, accordingly, can be recognised as per paragraphs 46 and 46A of AS 11, notified by the Central Government.

C. Points considered by the Committee

10. The Committee notes that the basic issue raised by the querist relates to whether MTM gains/losses on POS transaction can be treated as exchange rate differences which can be recognised as per paragraphs 46 and 46A of AS 11, notified under the Rules. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, measurement of MTM gains/ losses on POS contracts, accounting for interest on Rupee loan and 'carry', accounting for POS transaction as per Accounting Standard (AS) 30, 'Financial Instruments : Recognition and Measurement', issued by the Institute of Chartered Accountants of India, as the querist has not raised the issue from the angle of AS 30, etc. It seems that in the Facts of the Case as furnished by the querist, the first two bullet points in paragraph 8(a)(iii) above should be read as below:
    - Say, for example: A foreign currency loan taken at 5% when fully hedged = USD rate of interest 5% + Rupee-USD hedge, i.e., 6% = 11%.= Rupee rate of interest"
    - Similarly Rupee loan @ 11% with POS carry of 6% = 5% = USD rate of interest."

    However, this does not affect the opinion of the Committee.
11. The Committee is of the view that the issue raised by the querist requires examination from two angles – firstly, whether the Rupee loan taken by the company becomes a foreign currency liability by the existence of POS transaction or whether it should, in substance, be treated as a foreign currency loan by the existence of POS transaction and, secondly, whether the POS transaction can be considered to be a foreign currency transaction within the scope of AS 11.
12. The Committee notes from the Facts of the Case that the company has taken Rupee loan which has been swapped into USD for getting the benefit of differential interest rate between Rupee loan and USD loan. The Committee also notes that the liability of the company, (viz., Rupee loan) is denominated in Rupee and is also repayable in the same currency. The fact that the company has swapped the Rupee loan exposure into USD currency exposure using the POS does not alter this position. The POS does not mean that the company has incurred USD liability to the lending bank. Thus, entering into the POS transaction does not alter the fact that the company has the obligation to repay the loan in Rupees to the lending bank. Further, the POS can be cancelled by the company (though it may not have the intention to cancel). Accordingly, the Committee is of the view that the Rupee loan does not become a foreign currency liability solely by the existence of POS transaction. The Committee is further of the view that the combination of the Rupee loan and the POS cannot be treated as a single transaction enabling treatment of the Rupee loan as a USD loan. This is because AS 11 does not recognise such 'synthetic accounting'. Further, the legal effect of the terms of the Rupee loan (which is denominated in Rupee) and POS (which is cancellable) cannot be ignored. Hence, Rupee loan and POS transactions should be treated as two separate transactions.
13. The Committee notes the following paragraphs of AS 11, notified under the Companies (Accounting Standards) Rules, 2006:

    "1. This Standard should be applied:
        (a) in accounting for transactions in foreign currencies; and
        (b) in translating the financial statements of foreign operations."

    "2. This Standard also deals with accounting for foreign currency transactions in the nature of forward exchange contracts."

"8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:
   (a) buys or sells goods or services whose price is denominated in a foreign currency;
   (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;
   (c) becomes a party to an unperformed forward exchange contract; or
   (d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency."

The Committee notes that POS does not result in borrowing of USD funds. It is simply a derivative which requires performance and settlement in future and is also cancellable. Hence, in the extant case, a foreign currency transaction within the scope of AS 11 may occur only if the POS transaction undertaken by the company can be considered to be an unperformed forward exchange contract, which is examined in paragraph 14 below.

14. The Committee notes the definition of forward exchange contract and forward rate given in paragraphs 7.8 and 7.9 respectively of AS 11, which are reproduced below:

"7.8 <u>Forward exchange contract</u> means an agreement to exchange different currencies at a forward rate.

7.9 <u>Forward rate</u> is the specified exchange rate for exchange of two currencies at a specified future date."

The Committee notes that the POS may be argued to be a forward exchange contract as per the definition reproduced above. However, as per footnote 1 appended to paragraph 2 of AS 11, not all forward exchange contracts fall within the scope of AS 11, which reads as below:

"This Standard is applicable to exchange differences on all forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities and is not applicable to the exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risks of future transactions in respect of which firm commitments are made or which are highly probable forecast transactions. A 'firm commitment' is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates and a 'forecast transaction' is an uncommitted but anticipated future transaction."

From the above, it might appear that with the exceptions mentioned in the above mentioned footnote, all forward exchange contracts are within the scope of AS 11. However, the Committee notes that accounting treatment of forward exchange contracts is prescribed in paragraphs 36-39 of AS 11 and is of the view that if a forward exchange contract is not of the nature dealt with in those paragraphs, it is outside the scope of AS 11, even though it does not fall within the exceptions mentioned in the above mentioned footnote. The Committee notes that paragraphs 36-39 of AS 11, notified under the 'Rules', provides the following principles for recognition of various nature of forward exchange contracts referred to in footnote 1 appended to paragraph 2 of AS 11:

"36. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled

during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.

38. ***A gain or loss on a forward exchange contract to which paragraph 36 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognised separately.***

39. In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised."

A combined reading of paragraphs 36-39 of AS 11 indicates that those paragraphs prescribe accounting treatment for *only* those forward exchange contracts which are entered into for hedging foreign currency risk where the underlying transaction is denominated in a foreign currency, or for trading or speculation purposes. The Committee notes from the Facts of the Case that the underlying transaction is a Rupee loan that does not give rise to any foreign currency risk. It is the POS transaction in the extant case that exposes the company to foreign currency risk rather than mitigating the same. Thus, the purpose of the POS is not hedging any foreign currency risk. The POS is not held for trading because the company is not a trader in foreign exchange (such as, for example, an authorised dealer in foreign exchange). There may be speculation, if there is no underling transaction or if there is an underlying transaction but the intention is to speculate the movement in foreign exchange rate and to cancel the POS for booking profit at the opportune time. In the extant case, the POS has an underlying transaction viz., Rupee loan. But, the company's intention is not to speculate the movement in foreign exchange rate and to cancel the POS at the opportune time for profit booking (with the attendant risk of incurring a loss), as also stated by the querist in paragraph 8 (c) above. The basic purpose of the POS transaction in the extant case is to take advantage of the difference between Rupee interest rate and USD interest rate. Its purpose is saving in interest cost though it exposes the company to foreign currency risk. The mere fact that the company might have considered likely foreign exchange loss in making the decision to enter into the POS transaction, in itself, does not make the POS as held for speculation purposes. Thus, the POS is not held for hedging any foreign currency risk or trading or speculation purposes. Hence, the POS is not a forward exchange contract within the scope of AS 11 and therefore, is not a foreign currency transaction within the scope of AS 11.

15. As regards applicability of paragraphs 46 and 46A of AS 11, the Committee notes that the said paragraphs are applicable on exchange differences arising on long-term foreign currency monetary items. However, from the above discussions, the Committee is of the view that the POS is not a foreign currency transaction within the scope of AS 11 and, accordingly, the said transaction is not covered under paragraphs 46 and 46A of AS 11.

D. Opinion

16. On the basis of the above, the Committee is of the opinion that mark to market losses on POS cannot be treated as exchange differences for the purposes of AS 11. The question of applying paragraphs 46 and 46A of AS 11, therefore, does not arise at all.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on December 26-27, 2012. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty one volumes. A CD of Compendium of Opinions containing thirty one volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in

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