Query No. 34

Subject: ***Restatement of foreign currency monetary liabilities covered (hedged) by plain vanilla call option.***[1]

A. Facts of the Case

1. A company (hereinafter referred to as the 'company') operates in the entire value chain of generation, transmission and distribution of electricity. The company has majority of its operations in India and consequently, majority of its revenue is generated from its domestic operation. The company has funded its various projects through domestic and foreign currency debt. Furthermore, the company is also importing coal, oil and project related capital goods on a regular basis. The company hedges the risk of foreign currency exposure (i.e., long-term and short-term) through hedging instruments such as forward contract and plain vanilla call option contract.

2. *Accounting practices followed by the company:*

The accounting practices followed by the company relating to treatment of exchange differences and accounting for forward contracts and plain call option contracts are as articulated hereunder:

- *Treatment of exchange differences:*

  Exchange differences arising on settlement/restatement of short-term foreign currency monetary assets and liabilities of the company and its integral foreign operations are recognised as income or expense in the statement of profit and loss. The exchange differences on restatement/settlement of loans to non-integral foreign operations that are considered as net investment in such operations are accumulated in a 'foreign exchange translation reserve' until disposal/recovery of the net investment. The exchange differences arising on revaluation of long-term foreign currency monetary items are capitalised as part of the depreciable fixed assets to which the monetary items relate and depreciated over the remaining balance life of such assets and in other cases amortised over the balance period of such long-term foreign currency monetary items. The unamortised balance is carried in the balance sheet as 'foreign currency monetary item translation account' net of the tax effect thereon.

- *Accounting for forward contracts:*

[1] Opinion finalised by the Committee on 1.5.2014.

Premium/discount on forward exchange contracts, which are not intended for trading or speculation purposes, are amortised over the period of the contracts if such contracts relate to monetary items as at the balance sheet date.

The exchange differences (i.e., difference in exchange rate prevailing at time of contract taken and at reporting period or on cancellation/settlement date) on forward contracts, which are not intended for trading or speculation purposes and taken to hedge the foreign currency risk of existing assets and liabilities are recognised in the statement of profit and loss at each reporting period or on settlement.

- *Plain Call Option Contracts:*

Premium/discount on plain call option contracts, which are not intended for trading or speculation purposes, are amortised over the period of the contracts if such contracts relate to monetary items as at the balance sheet date.

Marked to market (MTM) losses are recognised in the statement of profit and loss while gains arising on the same are not recognised until realised on the ground of prudence.

3. The querist has stated that the company hedges its monetary foreign currency exposures by taking suitable hedging products which can be broadly classified into forward exchange contracts and plain vanilla call option contracts. Paragraph 11 of Accounting Standard (AS) 11, 'The Effects of Changes in Foreign Exchange Rates', provides that all foreign currency monetary items as on the balance sheet date are required to be reported using the closing rate or at exchange rate which, according to the querist, more likely reflects the reasonably accurate amount to be paid or to be received. Further, AS 11, while expressly covers the accounting treatment to be given in respect of forward exchange contracts in paragraph 36, is silent on treatment to be given in case of plain call option contracts. Paragraph 36 of AS 11 is reproduced below:

> ***"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."***

In view of the above, the accounting practice followed in respect of forward contract and plain vanilla option is summarised as below:

Particulars	***Forward Contract***	***Plain Call Option***	***Impact***

Premium/Cost of hedges	*Amortised over the period of contract*	*Amortised over the period of contact*	*Accounting treatment is same for both the instruments*
Restatement of liabilities and hedges at each reporting period	*The MTM gain/loss at each reporting period is recorded in the statement of profit and loss.*	*The gain in MTM is ignored but the loss is recognised in the statement of profit and loss.*	*Due to this different accounting practice, the liabilities covered by plain call will always show the loss though it is known that maximum liability will be to the extent of strike rate of the call option.*

4. According to the querist, while the above treatment in respect of forward contracts reflects the *true and fair* state of affairs, in the case of liabilities covered by plain call options, it is reflecting an incorrect picture. The following example will demonstrate the impact:

- Assume the company has a forex loan outstanding of USD 1 million and it has been recognised at exchange rate as on transaction date which is say Rs. 51/ $. The company has hedged this exposure with following products.
  Case 1 - Forward contact to buy USD at Rs. 51 by paying premium say Rs. 2 per $ or
  Case 2 - Currency call option on USD at strike rate of Rs. 51 by paying premium say Rs. 2 per $

The accounting treatment as at the end of each reporting period would be as under:

(a) Premium/ cost of hedges – Rs. 2/per $ (say) will get amortised over the period of hedges in both the scenarios.

(b) Impact of restatement of liabilities at each reporting period:

Each Rate at each reporting date at which liability gets re-stated	***Gain/(loss) in forward contract rate of* Rs. *51 per $ (Rs. /$)***	***Effective Each rate if hedged through forward***	***Gain in Plain Call Option with strike of Rs. 51 / $***	***Effective exchange rate if hedged through plain call***
48.00	(3.00)	51.00	0.00	48.00
49.00	(2.00)	51.00	0.00	49.00
50.00	(1.00)	51.00	0.00	50.00
52.00	1.00	51.00	1.00	51.00

53.00	2.00	51.00	2.00	51.00
54.00	3.00	51.00	3.00	51.00
55.00	4.00	51.00	4.00	51.00

It can be seen from the above example that:

(a) the *maximum rate* at which liability will get paid off is *at Rs.51 in both the cases.*

(b) a plain vanilla call contract, in effect, has the same effect of a forward contract in terms of mitigating the potential risk. Further, it allows the flexibility of enjoying the benefit of favourable movement by charging a small premium, which forward contracts do not provide (i.e., below Rs. 51 in given case).

(c) by not recognising the MTM/restated gain in the statement of profit and loss for plain vanilla call option contract, the very purpose of hedging gets defeated and it also goes against the principle of using reasonable accurate exchange rate as mentioned in *paragraph 11* of AS 11.

(Emphasis supplied by the querist.)

Impact of current accounting practice on profit and loss account:

5. The querist has stated that in the above example, the MTM gain/ (loss) of the underlying liability as well as corresponding plain vanilla call option in spirit is supposed to offset each other at each accounting period. By not allowing the accounting for gain on plain vanilla call in the profit and loss account, the whole purpose of the hedge for that particular accounting period is getting defeated as illustrated below:

MTM rate (Rs.)	**Loss in Underlying liability (Rs.)**	**Notional gain in MTM of plain call option (Rs.)**	**Charge in the statement of profit and loss for accounting period if gain in plain call option is not recognised (Rs.)**	**Charge in the statement of profit and loss for accounting period if gain in option is recognised (Rs.)**
52.00	(1.00)	1.00	Amortised premium+1.00	Amortised Premium
53.00	(2.00)	2.00	Amortised premium+2.00	Amortised Premium
54.00	(3.00)	3.00	Amortised	Amortised Premium

			premium+3.00	
55.00	(4.00)	4.00	Amortised premium+4.00	Amortised Premium

B. Query

6. Considering the above facts, the querist has sought the opinion of the Expert Advisory Committee as to whether the liabilities covered by plain vanilla call options can be restated at the lower of strike rate or spot price as at the reporting date, which, as per the querist, will reflect the true and fair view of such transactions and also be in consonance with paragraph 11 of AS 11.

C. Points considered by the Committee

7. The Committee notes that the basic issues raised by the querist relate to treatment of foreign currency liabilities covered by plain vanilla call option contracts and MTM gains/losses on plain vanilla call options contracts undertaken to hedge against the losses on such liabilities. 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 accounting for forward contracts, accounting for exchange differences on foreign currency liabilities other than those covered by plain vanilla call options, accounting for integral/non-integral foreign operations, accounting policy of the company in respect of exchange differences, etc.

8. The Committee notes that a call option is a type of derivative instrument whereby a person gets the right to buy at an agreed amount an underlying asset (foreign currency in the extant case) on or before the specified future date, although he is not under an obligation to do so. Thus, the buyer of an option contract can make a loss of no more than the option premium paid to the seller but the possible gain is unlimited. Accordingly, the Committee is of the view that an option contract cannot be considered in substance as a forward contract as in case of a forward contract, both the parties are under an obligation to complete the contract on the specified date and accordingly, the gain/loss on the settlement of a forward contract is also unlimited. In this regard, the Committee also notes the definition of forward exchange contract as per AS 11, notified under the Companies (Accounting Standards) Rules, 2006 as follows:

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

9. The Committee notes that the foreign currency liability is denominated in a foreign currency and is also repayable in the same currency. The fact that the company has mitigated its foreign currency risk on the foreign currency liability to the maximum of strike price of the call option contract does not alter this fact that the company has incurred INR liability to the lender. Under the call option agreement, if the strike price is less than the spot rate, the company gives INR to the counterparty of the option and that party actually remits foreign currency to the

company at the strike price. Further, the company uses the foreign currency, so received, to settle its foreign currency liability. Thus, the foreign currency loss risk is mitigated by undertaking an option contract. However, it does not alter the fact that the company has the obligation to repay the liability in foreign currency to the lender.

Further, the Committee notes that AS 11 requires separate accounting for forward exchange transactions considering it as a transaction separate from the underlying transaction. Accordingly, the Committee is of the view that the foreign currency liability, which is an underlying transaction and the call option contract to hedge against any loss arising on the aforesaid liability should be treated as two separate transactions.

10. Accordingly, the Committee is of the view that the foreign currency liability should be accounted for in accordance with AS 11. In this regard, the Committee notes paragraph 13 of AS 11, notified under the Companies (Accounting Standards) Rules, 2006, which provides as follows:

> ***"13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15."***

From the above, the Committee is of the view that at each reporting date, foreign currency liability should be restated at the exchange rate prevailing on that date and exchange differences should be charged to the statement of profit and loss. Accordingly, the foreign currency liabilities covered by plain vanilla call options cannot be restated at the lower of strike rate or spot price as at the reporting date, as being suggested by the querist.

11. As regards accounting treatment of call option contract, the Committee notes that paragraph 36 of AS 11 deals with accounting for 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. Thus, AS 11 covers forward exchange contracts and other financial instruments of similar nature. However, as discussed in paragraph 8 above, the call option contract cannot be considered in substance as a forward contract. Accordingly, call option is not within the scope of AS 11.

12. With regard to the contention of the querist regarding incorrect picture of state of affairs by recognising only losses and not recognising MTM gains on plain call option contract, as stated above, the Committee notes that the Announcement issued by the Institute of Chartered Accountants of India on 'Application of AS 30, *Financial Instruments: Recognition and Measurement*' clarifies, inter alia, that to the extent of accounting treatments covered by any of

the existing notified accounting standards, such as AS 11, the existing accounting standards would continue to prevail over AS 30. Accordingly, the Committee is of the view that while AS 30, 'Financial Instruments: Recognition and Measurement', issued by the Institute of Chartered Accountants of India, is not yet notified under the 'Rules', the company should follow the requirements of AS 30 to the extent that it does not contradict the requirements of existing notified accounting standards.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that as per the requirements of AS 11, the foreign currency liability, which is an underlying transaction and the call option contract to hedge against any loss arising on the aforesaid liability should be treated as two separate transactions, as discussed in paragraph 9 above and that at each reporting date, foreign currency liability should be restated at the exchange rate prevailing on that date as per the requirements of paragraph 13 of AS 11, as discussed in paragraph 10 above. Accordingly, the foreign currency liabilities covered by plain vanilla call options cannot be restated at the lower of strike rate or spot price as at the reporting date.