Decoding the Concept of Hedge Accounting

In the year 2007, the Institute of Chartered Accountants of India (ICAI) introduced accounting for financial instruments in India by issuing Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, Accounting Standard (AS) 31, Financial Instruments: Presentation and (AS) 32 Financial Instruments: Disclosures mandatory in respect of accounting periods commencing on or after 1st April, 2011. Owing to global financial crisis which raised issues regarding accounting treatment of financial instruments, various accounting standards setting bodies including the ICAI examined these aspects. Later, the ICAI withdrew the recommendatory as well as mandatory status of AS 30, AS 31 and AS 32 in March 2011. In order to provide recommendatory guidance on accounting for derivative contracts and hedging activities considering the lack of mandatory guidance in this regard and with a view to bring about uniformity of practice in accounting for derivative contracts by various entities, ICAI issued Guidance Note on Accounting for Derivative Contracts applicable for accounting periods beginning on or after 1st April, 2016


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1. Introduction

Under Ind AS regime, Ind AS 109 *Financial Instruments*, Ind AS 32 *Financial Instruments: Presentation* and Ind AS 107 Financial Instruments: Disclosures provides guidance on accounting for financial instruments which is largely in line with International Financial Reporting Standards with a few exceptions.

As per Ind AS 109, a derivative is a financial instrument with all three of the following characteristics –

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract ('underlying')
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- it is settled at a future date.

A few of the commonly used derivative financial instruments are forward contract, futures contract, options contract, swap contracts etc.

2. Accounting for derivatives in accordance with Ind AS 109 (without hedge accounting)

In accordance with Ind AS 109, a financial asset should be measured at fair value through profit or loss (FVTPL) unless it is measured at amortised cost (provided conditions specified in paragraph 4.1.2 of Ind AS 109 are met) or at fair value through other comprehensive income (FVOCI) (provided conditions specified in paragraph 4.1.2A of Ind AS 109 are met).

Derivative contracts (classified as financial assets) will not meet the condition specified in paragraph 4.1.2 (b) and the conditions specified in 4.1.2A (b) and hence derivatives that are financial assets should be measured at fair value through profit or loss. Further as per Ind AS 109, derivatives that are liabilities, should also be measured at fair value through profit or loss.

Illustration 1 (Example where entity does not follow hedge accounting and fair value change of derivatives is taken through profit and loss): Company A borrows loan amounting USD 1,000,000 on 1st April, 2017 which is repayable after two years on 31st March, 2019. The exchange rate on 1st April 2017 was ₹ 65 per USD. In order to mitigate the exchange rate risk, Company A enters into a forward contract with Bank B on 1st April, 2017 to buy USD 1,000,000 on 31st March, 2019 at ₹ 70 per USD (spot rate of ₹ 65 per USD and forward premium of ₹ 5 per USD) (For simplicity sake we have not considered the interest on borrowings).

The following are the exchange rate movements:

Spot rate on 31st March, 2018 – ₹ 68 per USD

Forward rate on 31st March, 2018 – ₹ 72 per USD

Spot rate on 31st March, 2019 – ₹ 73 per USD

Accounting entries	Year ended 31st March 2018	Year ended 31st March 2019
Loan taken		
Bank	65,000,000	NA
Borrowings	(65,000,000)	
At initial recognition the value of the derivative is nil and hence not accounted.		
Year-end restatement of borrowings		
Exchange loss	3,000,000	5,000,000
Borrowings	(3,000,000)	(5,000,000)
Valuation of derivatives		
Derivative assets	2,000,000	1,000,000
Gain on derivatives (PL)	(2,000,000)	(1,000,000)
Loan repayment		
Borrowings	NA	73,000,000
Derivative assets		(3,000,000)
Bank		(70,000,000)

3. Hedge accounting in accordance with Ind AS 109

3.1 Background

The accounting for derivative instruments at fair value, as enunciated above, creates accounting mismatch due to the fact that derivative instrument is measured at fair value, and the underlying exposure being hedged might be accounted for at cost or amortized cost basis which results in volatility in the financial statements.

The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income.

Ind AS 109 envisages the following three types of hedging relationships -

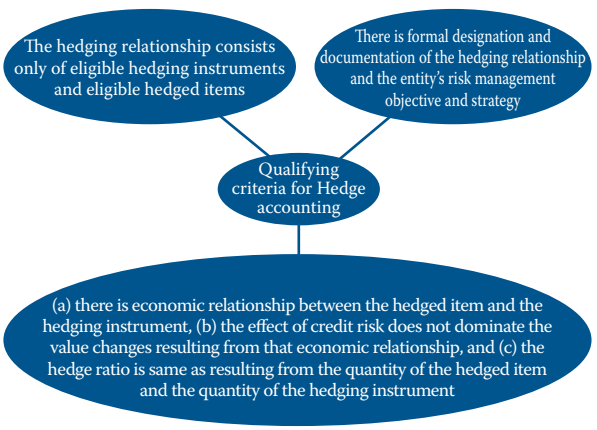
- Fair Value Hedge
- Cash Flow Hedge
- Net Investment Hedge

3.2 Qualifying criteria

Hedge accounting under Ind AS 109 is a policy choice available to a company. There are three basic requirements that must be satisfied for applying hedge accounting.

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a forecast transaction or a net investment in a foreign operation. The hedged item can be a single item; or a group of items. A hedged item can also be a component of such an item or group of items.

A derivative measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options. A non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.



3.3 Measurement of hedge effectiveness

An entity should assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity should perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

Methods for assessing hedge effectiveness

Ind AS 109 does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity should use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness.

- Qualitative assessment - For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging instrument and the hedged item have values that will generally move in the opposite direction because of the same risk and hence

that an economic relationship exists between the hedged item and the hedging instrument.

Taking the example in illustration 1, we can see that following critical terms of the hedging instrument (forward contract) are closely aligned to hedged item (borrowing) –

- ✓ Currency - The currency pair of the forward contract (USD/INR) match with the USD/INR exposure arising from the USD loan
- ✓ Term/ expiration date - Expiration date of the forward contract match with the timing of the corresponding hedged USD loan repayment
- ✓ Notional amount - The notional amount of the forward contract match with loan principal
- ■ Quantitative assessment - Conversely, if the critical terms of the hedging instrument and the hedged item are not closely aligned, there is an increased level of uncertainty about the extent of offset. Consequently, the hedge effectiveness during the term of the hedging relationship is more difficult to predict. In such a situation it might only be possible for an entity to conclude on the basis of a quantitative assessment that an economic relationship exists between the hedged item and the hedging instrument. In some situations a quantitative assessment might also be needed to assess whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements given in the Standard. An entity can use the same or different methods for those two different purposes.

3.4 Accounting for derivatives under hedge accounting

3.4.1 Fair value hedge - a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

- If the hedging instrument is a derivative, then it is measured at FVTPL.
- The hedged item is adjusted for changes in fair value attributable to the hedged risk during the period of the hedging relationship using the guidance in Ind AS 113, even if it is normally measured at amortised cost - e.g. a fixed rate borrowing. An entity would not typically recognise the firm commitment in the statement of financial position, however following fair value hedge accounting results in the change in the fair value of the firm commitment attributable to the hedged risk during the period of the hedging relationship being recognised as an asset or a liability in the statement of financial position, with a corresponding gain or loss recognised in profit or loss.
- The above adjustment to the carrying amount of the hedged item related to the hedged risk is recognised in profit or loss, even if such a change would normally be recognised in OCI (i.e. for financial assets that meet the conditions of para 4.1.2A and measured at fair value through OCI.
- However, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income those amounts shall remain in other comprehensive income.

3.4.2 Cash flow hedge - a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss

- If the hedging instrument is a derivative or a non-derivative financial asset or non-derivative financial liability measured at FVTPL, then the effective portion of changes in fair value of the hedging instrument is recognised in OCI. The ineffective portion of the gain or loss on the hedging instrument is recognised immediately in profit or loss.
- The separate component of equity associated with the hedged item - i.e. the cash flow hedge reserve - is adjusted to the lower of the following (in absolute amounts):

- o the cumulative gain or loss on the hedging instrument from inception of the hedge.
- o the cumulative change in fair value (present value) of the hedged item from inception of the hedge. This is the present value of the cumulative change in the hedged expected future cash flows.

- The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge - i.e. the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with the above is recognised in Other Comprehensive Income.
- Any remaining gain or loss on the hedging instrument or any gain or loss required to balance the change in the cash flow hedge reserve is hedge ineffectiveness that is recognised in profit or loss.
- If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity removes the accumulated amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability. This is not a reclassification adjustment as per Ind AS 1, *Presentation of Financial Statements* and hence it does not affect other comprehensive income.
- For cash flow hedges other than those covered above, the accumulated amount is reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (in accordance with Ind AS 1, *Presentation of Financial Statements)* in the same period or periods during which the hedged expected future cash flows affect profit or loss - e.g. in the periods during which interest income or interest expense is recognised or when a forecast sale occurs.
- However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment (as per Ind AS1).

3.4.3 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment as defined in Ind AS 21, shall be accounted for similarly to cash flow hedges as follows:

- The effective portion of the change in fair value of the hedging instrument - computed with reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured - is recognised in OCI and presented within equity in the foreign currency translation reserve.
- The ineffective portion of the gain or loss on the hedging instrument is immediately recognised in profit or loss.
- The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve should be reclassified from equity to profit or loss as a reclassification adjustment (as per Ind AS 1) in accordance with the principles of Ind AS 21 on the disposal or partial disposal of the foreign operation.

Elements that may be excluded from designated hedging instrument

A qualifying instrument must be designated in its entirety as a hedging instrument. Ind AS 109 permits only the following exceptions:

- separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value;
- separating the forward element and the spot element of a forward contract and designating as the hedging instrument

only the change in the value of the spot element of a forward contract and not the forward element; similarly, the foreign currency basis spread may be separated and excluded from the designation of a financial instrument as the hedging instrument; and

- a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.

Time value, if separated, would be accounted for as follows –

- distinguish the time value of options by the type of hedged item that the option hedges viz. a transaction related hedged item; or a time-period related hedged item.
- the change in fair value of the time value that hedges a transaction related hedged item should be recognised in other comprehensive income to the extent that it relates to the hedged item and should be accumulated in a separate component of equity which shall be accounted for as follows:
  - o if the hedged item subsequently results in the recognition of a non-financial asset or a non-financial liability, or a firm commitment for a non-financial asset or a non-financial liability for which fair value hedge accounting is applied, the entity should remove the amount from the separate component of equity and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (as per Ind AS 1) and hence does not affect other comprehensive income.
  - o for hedging relationships other than those covered above, the amount should be reclassified from the separate component of equity to profit or loss as a reclassification adjustment (as per Ind AS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss.
  - o however, if all or a portion of that amount is not expected to be recovered in one or more future periods, the amount that is not expected to be recovered should be immediately reclassified into profit or loss as a reclassification adjustment (as per Ind AS1).

- the change in fair value of the time value that hedges a time-period related hedged item should be recognised in other comprehensive income to the extent that it relates to the hedged item and should be accumulated in a separate component of equity. The time value at the date of designation of a hedging instrument, to the extent that it relates to the hedged item, should be amortised on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss or other comprehensive income, if the hedged item is an equity instrument for which it has elected to present changes in fair value in other comprehensive income.

Illustration 2: Continuing the illustration 1, following accounting entries would be done if the Company follows hedge accounting and separates the time value of money. We are following cash flow hedge as the forward has been entered to hedge variability of cash flows that is attributed currency exchange movement.

Year ended 31st March 2018	Year ended 31st March 2018	Year ended 31st March 2019
Loan taken		
Bank	65,000,000	NA
Borrowings	(65,000,000)	
Year-end restatement of borrowings		
Exchange loss	3,000,000	5,000,000
Borrowings	(3,000,000)	(5,000,000)
Marked to market value of derivatives (includes mark to market of time value/ forward element)		
Derivative assets	2,000,000	1,000,000
Other comprehensive income	(2,000,000)	(1,000,000)
Reclassification to profit or loss when the hedged item affects profit or loss (i.e. as and when foreign exchange restatement of loan affects profit or loss)		
Other comprehensive income	3,000,000	5,000,000
Exchange loss	(3,000,000)	(5,000,000)
Amortisation of time value		
Forward premium amortization	2,500,000	2,500,000
Other comprehensive income	(2,500,000)	(2,500,000)
Loan repayment		
Borrowings	NA	73,000,000
Derivative assets		(3,000,000)
Bank		(70,000,000)

Conclusion

Above illustrations clearly depicts that when applied appropriately, hedge accounting can result in a better alignment of an organization's financial reporting and economic realities. It does nevertheless require a level of expertise and effective documentation to ensure it is being applied appropriately and an investment of time and resources, both at inception of a hedge relationship and on an on-going basis, to maintain it. ■

Anger and intolerance are the enemies of correct understanding - *Mahatma Gandhi*