

# Ind AS Industry Insights

## Hedge accounting under Ind AS 109 – Implications for the retail and consumer business industry



### The bottom line

The new hedge accounting model under Ind AS 109 *Financial Instruments* will allow entities to reduce profit or loss and balance sheet volatility by applying hedge accounting in more circumstances. The change in accounting treatment is expected to prompt some companies to review their risk management activities which may have been previously restricted for the purpose of hedge accounting.

### What's happened?

Currently, Indian accounting standards do not have a comprehensive framework for derivative instruments and hedge accounting. AS 11 *The Effects of Changes in Foreign Exchange Rates* deals with foreign currency forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities. Forward exchange contracts entered into, to hedge a firm commitment or highly probably forecast transaction, are not within the scope of AS 11. As per ICAI's Announcement, where the accounting is not prescribed in current Indian GAAP, entities may apply the principles set out in AS 30 *Financial Instruments*:

*Recognition and Measurement.* However, if AS 30 is not applied, the ICAI Announcement *Accounting for Derivatives* requires that mark-to-market losses are recognized for outstanding derivative contracts as on the balance sheet date.

Going forward, for entities that transition to Ind AS, hedge accounting will be done as prescribed by Ind AS 109. The new model will more closely align an entity's hedge accounting with its risk management, resulting in more useful information for users of financial statements. The requirements are more principles-based than before and allow companies more opportunities to mitigate earnings volatility.

Some of the key areas impacting the retail and consumer business industry are highlighted below.

### 1. Hedged items

#### 1.1 More opportunities to apply hedge accounting for non-financial items

The new Standard increases the range of economic hedges eligible for hedge accounting. For the retail and consumer business industry, this provides greater opportunity to achieve hedge accounting when hedging risk components, as illustrated below.

### What was the issue?

Previously, under AS 30, non-financial items could be designated as a hedged item (i) in their entirety i.e. for all risks, (ii) for foreign exchange (FX) risk, or (iii) for all risks except FX risk. Therefore, if an entity was hedging only a component of risk, for example the commodity component of a purchase contract, it could choose to (a) not apply hedge accounting for that component in isolation; or (b) designate the entire item or a proportion of it. Not applying hedge accounting or designating the entire item (or a proportion of it) when this was not the intention of the economic hedge gave rise to hedge ineffectiveness and profit or loss volatility that did not reflect the risk management objective of the hedge.

### What has changed?

Upon transition to the new hedge accounting model under Ind AS 109, a risk component of a non-financial item will be eligible as a hedged item, provided it is "separately identifiable and reliably measurable". This criteria would generally be met if the risk component is contractually specified. It is also possible that non-specified risk components meet the criteria in some cases. Allowing a closer match between the hedged risk and the hedging derivative should result in more common risk management strategies to qualify for hedge accounting and therefore, lesser volatility (i.e., ineffectiveness) in profit or loss.

### Example – Contractually specified risk components

Entity A hedges its future coffee purchases based on its production forecast. Hedging starts up to 15 months before delivery for part of the forecast purchase volume. Entity A increases the hedged volume over time (as the delivery date approaches) and uses two types of contracts to manage the coffee price risk:

- exchange-traded coffee futures contracts; and
- coffee supply contracts for Arabica coffee from Colombia delivered to a specific manufacturing site. These contracts price a tonne of coffee based on the exchange-traded coffee futures contract price plus a fixed price differential plus a variable logistics services charge using a pricing formula. The coffee supply contract is an executory contract in accordance with which Entity A takes actual delivery of coffee.

For deliveries that relate to the current harvest, entering into the coffee supply contracts allows Entity A to fix the price differential between the actual coffee quality purchased (Arabica coffee from Colombia) and the benchmark quality that is the underlying of the exchange-traded futures contract.

However, for deliveries that relate to the next harvest, the coffee supply contracts are not yet available, so the price differential cannot be fixed. Entity A uses exchange-traded coffee futures contracts to hedge the benchmark quality component of its coffee price risk for deliveries that relate to the current harvest as well as the next harvest.

Entity A determines that it is exposed to three different risks: coffee price risk reflecting the benchmark quality, coffee price risk reflecting the difference (spread) between the price for the benchmark quality coffee and the particular Arabica coffee from Colombia that it actually receives, and the variable logistics costs.

For deliveries related to the current harvest, after Entity A enters into a coffee supply contract, the coffee price risk reflecting the benchmark quality is a contractually specified risk component because the pricing formula includes an indexation to the exchange-traded coffee futures contract price. Entity A concludes that this risk component is separately identifiable and reliably measurable.

For deliveries related to the next harvest, Entity A has not yet entered into any coffee supply contracts (i.e. those deliveries are forecast transactions). Hence, the coffee price risk reflecting the benchmark quality is a non-contractually specified risk component. Entity A's analysis of the market structure takes into account how eventual deliveries of the particular coffee that it receives are priced. Hence, on the basis of this analysis of the market structure, Entity A concludes that the forecast transactions also involve the coffee price risk that reflects the benchmark quality as a risk component that is separately identifiable and reliably measurable even though it is not contractually specified.

Consequently, Entity A may designate hedging relationships on a risk components basis (for the coffee price risk that reflects the benchmark quality) for coffee supply contracts as well as forecast transactions.

### 1.2 Fair value option for physically settled commodity contracts

Ind AS 109 introduces a fair value option for physically settled forward commodity contracts that meet the "own use" criteria and would otherwise be measured at cost (often nil and hence effectively off balance sheet). This option would be a practical alternative to applying fair value hedge accounting for entities that hedge such own use commodity contracts with financial derivatives measured at fair value through profit or loss.

### What was the issue?

Certain contracts to buy or sell a non-financial item that qualify for “own use” are not subject to derivative accounting as they are outside the scope of AS 30 and are treated as regular sales and purchase contracts. A typical example includes a purchase of a commodity by an entity that uses it to produce goods for sale.

Some entities manage on an overall basis their net commodity risk exposure comprising the following – commodity inventories; physically settled executory forward purchase and sales contracts; and exchange traded futures and options measured at fair value. As some of the purchase and sale contracts may not be recognized in the statement of financial position this can lead to accounting mismatches. Because of the large number of transactions these entities enter into and the constant changes in the net exposure, hedge accounting is an onerous and sometimes impractical way of accounting for these transactions.

### What has changed?

To mitigate the need for hedge accounting, the alternative requirements result in an extension of fair value option in Ind AS 109 to contracts that meet the “own use” scope exception if doing so eliminates or significantly reduces an accounting mismatch. On transition to Ind AS, entities will be allowed to designate contracts at fair value through profit or loss, but only if it meets the specific requirements and the entity designates all similar contracts.

## 2. Hedging instruments

### 2.1 Hedging with option contracts

Under the new standard, the accounting treatment of option contracts designated as hedging instruments would be less volatile in profit or loss. The new requirements apply to a variety of vanilla and structured option contracts including those that hedge commodity price risk, interest rate risk and foreign exchange risk.

### What has changed?

The fair value of an option consists of the intrinsic value and the time value. When using option contracts for hedging, only the intrinsic value is used for offsetting the fair value changes attributable to the hedged risk. Entities may designate an option as a hedging instrument in its entirety, or may separate the time value and designate only the intrinsic value. There is no change to this approach. However, under AS 30, the change in time value was recognized in profit or loss either way – (i) if the option was designated in its entirety, there was greater ineffectiveness

resulting in a failed prospective assessment test with possible discontinuation of hedge accounting; (ii) if only the intrinsic value was designated, the time value would be accounted for at fair value through profit or loss, resulting in volatility in profit or loss.

### What has changed?

Ind AS 109 does not change how an option is designated in a hedge relationship i.e., in its entirety or just the intrinsic value. However, the new standard requires the change in the time value of an option, which can be volatile, to be recognised initially in other comprehensive income (OCI), with subsequent recognition as a basis adjustment or in profit or loss on a more predictable basis (e.g. amortised over the life of the hedge or recognised as a single amount when the hedged item affects profit or loss). The objective of this approach is to eliminate the profit or loss volatility that would otherwise arise from fair valuing the time value directly through profit or loss.

### Example

Entity D holds inventories which exposes it to commodity price risk. To hedge the price risk, the entity purchases an option (a floor) with an 18 month term to protect itself from price declines below INR 700,000 per tonne. The critical terms of the option match that of the hedged item. The changes in time value of the option is recognized in OCI over the life of the hedge. This is a hedge of a period related item, and hence the original time value amount (say, INR 1,800,000) is reclassified from equity to profit or loss on a rational basis, which in this case may be a straight line basis. Hence INR 100,000 is reclassified to profit or loss each month such that over the life of the hedge relationship the total amount recognized in OCI of INR 1,800,000 has been reclassified to profit or loss with nothing left in equity at the end of the hedged period.

### 2.2 Forward element of forward contracts

### What was the issue?

Previously, entities using foreign currency forward contracts in hedging relationships could designate either (i) the instrument in its entirety; or (ii) only the spot element. The second alternative i.e., to separate the interest element and designate only the spot price was permitted because the premium on the forward can generally be measured separately. Consequently, the interest element of the forward contract would be measured at fair value through profit or loss.

### What has changed?

Ind AS 109 allows an entity to exclude the forward element of a forward contract and designate only the changes in the spot element in a hedging relationship. In these cases, the normal hedge accounting mechanics apply to the designated spot element depending on the type of hedge (i.e., cash flow hedge, fair value hedge or net investment hedge).

For the undesignated forward element of the forward, there is a choice over how changes in its value are accounted for which allows the undesignated element to be treated in the same way as the undesignated time value of an option as discussed above. The choice is made on a hedge-by-hedge basis and applies for the term of the designated hedge.

### Example

Entity E with INR functional currency has an investment in subsidiary S with € functional currency. In the group accounts, €1m of the net investment in the foreign operation is hedged for changes in the foreign exchange rate between INR and € using a forward contract where the forward points are calculated to be INR 200,000. The critical terms of the forward and the hedged item match. The term of the forward and the hedge is two years. The change in value of the undesignated forward element is deferred in other comprehensive income over the life of the hedge. Hence over the life INR 200,000 will be recognised in other comprehensive income. A hedge of a net investment in a foreign operation is a hedge of a time-period related hedged item hence the forward element amount is reclassified from equity to profit or loss over the two years of the hedge on a rational basis. In this situation, straight line amortisation would be regarded as a rational basis hence INR 100,000 is reclassified from other comprehensive income to profit or loss each year such that at the end of two years the net accumulated forward element amount in equity is nil (i.e. INR 200,000 is deferred in other comprehensive income and INR 200,000 is reclassified from equity to profit or loss).

### 2.3 Synthetic or aggregated exposures

Entities often purchase or sell items that expose them to more than one type of risk. Common examples involve the purchase or sale of commodities in a foreign currency that involve exposures to commodity price risk, FX risk etc. The price risk may be hedged using a commodity futures contract while the FX risk may be hedged using a FX forward contract.

### What was the issue?

The issue with using multiple derivatives for hedging a single transaction is that not all risks may be hedged for the same period – i.e., an entity may first enter into a futures contract to cover the price risk and enter into the FX forward contract after about a month. Since derivatives are precluded from being designated as part of a hedged item for hedge accounting under AS 30, the first hedge would have to be discontinued and re-designated along with the new derivative.

### What has changed?

Under Ind AS 109, exposures that include derivatives (i.e. synthetic exposures) can be designated as eligible hedged items to better reflect the risk management objective of transacting multiple derivatives to hedge different risk exposures. For example, when an additional derivative is added to the hedge relationship at a subsequent date, under the new standard, it would not be necessary to discontinue and re-designate the original hedge relationship. This change should enhance the effectiveness of such hedges and make hedge accounting more achievable in practice.

### Example

Consider the example where a forecast exposure includes a forecast derivative. Entity F with INR functional currency has a forecast foreign debt issuance. When issued, the debt will be hedged for FX risk using a cross-currency interest rate swap (CCIRS), thereby exchanging the foreign currency interest and principal flows for INR. The new standard allows the synthetic forecast INR debt issuance to be designated in a pre-hedge of the interest rate risk even though the hedged item includes a derivative (i.e., the CCIRS).

### 3. Effectiveness testing

Hedge accounting relationships would no longer have to meet the 80-125% offset criteria previously required for prospective and retrospective effectiveness testing. Instead an entity would need to demonstrate that an 'economic relationship' exists between the hedged item and hedging instrument on a prospective basis. This will reduce the burden of complying with the hedge accounting requirements. Under Ind AS 109, provided the economic relationship is present at the beginning of each hedged period, come the end of the period, actual hedge ineffectiveness is measured regardless of the amount. For example, if the hedge happens to be only 60% effective, then that is the effectiveness recorded (unlike previously where no hedge accounting would be applied because it falls outside the 80-125% range). This change could result in more hedging relationships qualifying for hedge accounting, especially when combined with other changes to the requirements.

### Things to consider now

The changes introduced in Ind AS 109 should be well understood by not only the accounting function but also those responsible for risk management. Risk management policies should be reviewed in light of these changes and their effect on longer term risk management decisions considered. Furthermore, they should be considered as part of any planning and decisions around risk management, treasury and accounting systems.

Allowing hedge accounting for risk components in non-financial items will increase the scope for applying hedge accounting. However, greater judgement needs to be exercised when hedging risk components that are not contractually specified. Analysis to demonstrate that the hedged risk component is separately identifiable and reliably measurable will be necessary. Once these criteria are satisfied, the next hurdle will be to demonstrate that the hedge is expected to meet the hedge effectiveness requirements, although these are less restrictive under the new model.

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