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**Guidance Note on Accounting for
Derivative Contracts**



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Committee : Research Committee

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Foreword

Business transactions involving derivatives contracts is a novel concept. Such transactions are complex and are ever evolving. In the absence of any authoritative comprehensive literature on the subject, a diversity of practices with regard to accounting for derivatives was being noticed resulting into lack of uniformity in presentation of operating results and financial conditions of various enterprises.

The Research Committee, of the Institute, which is entrusted with the task of formulating Guidance Notes on Accounting, decided to formulate a 'Guidance Note on Accounting for Derivative Contracts' as an interim measure so as to bring uniformity in accounting of derivatives contracts. Accordingly, this Guidance Note has been formulated to provide guidance on derivative accounting until Accounting Standards on the subject are formulated and/or enforced.

I would like to congratulate CA. Subodh K. Agrawal, Past President and Chairman, Research Committee, CA. Sanjiv Kumar Chaudhary, Vice-Chairman and other members of the Research Committee including other colleagues in the Council who have contributed immensely towards bringing out this publication.

I am confident that this Guidance Note will be highly useful to the members of the Institute as well as to others concerned.

New Delhi
June 1, 2015

CA. Manoj Fadnis
President

Preface

Currently, in India, with regard to derivatives, authoritative guidance for accounting of forward exchange contracts or another financial instrument that is in substance a forward exchange contract is available in Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates*. It was felt that with regard to other derivative contracts not covered within the scope of AS 11, there is a lack of authoritative accounting guidance. Although the Institute of Chartered Accountants of India (ICAI) issued various pronouncements to provide guidance to members and others for accounting of derivative contracts, it was noted that in the absence of a comprehensive authoritative literature on the subject, varied accounting practices were followed for accounting of derivative contracts.

In view of the above, the Research Committee of the Institute, decided to formulate a 'Guidance Note on Accounting for Derivative Contracts', to be issued under the authority of the Council of the Institute, with a view to establish uniform accounting principles for accounting of derivative contracts. The Guidance Note provides guidance on accounting for financial and commodity derivative contracts consistent with the extant international practices.

Various examples have been included in the Appendix to the Guidance Note with a view to provide guidance on application of the principles provided in the Guidance Note.

In order to formulate the draft of the Guidance Note, the Committee constituted a Study Group under the convenership of CA. Nilesh S. Vikamsey, Central Council Member. I will also like to put on record my thanks to CA. V. Venkataramanan, who was instrumental in preparing the basic draft of the Guidance Note with inputs from CA. Jayesh Gandhi, both members of the above Study Group. Other members of the Study Group were CA. Bhavna G. Doshi, CA. Vijay S. Maniar, CA. Ashutosh Pednekar, CA. Anagha Thatte, CA. Gautam V. Shah, CA. M. Abhishek and CA. P.S. Kumar. I will also place on record my special thanks to other members of the Research Committee specially CA. V. Murali, immediate past Chairman, Research Committee, current Vice-Chairman, CA. Sanjiv K. Chaudhary and my other esteemed Council colleagues.

We are confident that this endeavour of the Institute will be beneficial to all the members and others concerned.

June 1, 2015
New Delhi

CA. Subodh K. Agrawal
Chairman, Research Committee

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Guidance Note on Accounting for Derivative Contracts

(Guidance Note on Accounting for Derivative Contracts was considered and approved by the Council at its 342nd meeting held in New Delhi and was subsequently hosted on the website of the Institute in the month of May, 2015.

Subsequently the Council, at its 343rd meeting, held in New Delhi, considered and approved a Format on Disclosures of Foreign Currency Exposures. It has been decided to include this Format in the Guidance Note on Accounting for Derivative Contracts for ease of reference of disclosures related to derivatives at one place.

The following version of the Guidance Note on Accounting for Derivative Contracts includes the aforesaid Format for Disclosure of Foreign Currency Exposures.)

Introduction

1. In the year 2007, the Institute of Chartered Accountants of India (ICAI), issued Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31, *Financial Instruments: Presentation*. Both of these Accounting Standards were to come into effect in respect of accounting periods commencing on or after April 1, 2009 and were to be recommendatory in nature for an initial period of two years. These were to become mandatory in respect of accounting periods commencing on or after April 1, 2011. Further, it was clarified, that from the date of AS 30 becoming recommendatory in nature, the following Guidance Notes on Accounting, issued by the ICAI, stood withdrawn:

- (i) Guidance Note on Guarantees & Counter Guarantees given by the Companies
- (ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds
- (iii) Guidance Note on Accounting for Securitisation

(iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

2. In March 2008, the ICAI issued an announcement that in case of derivatives, if an entity does not follow AS 30, keeping in view the principle of prudence as enunciated in Accounting Standard (AS) 1, *Disclosure of Accounting Policies*, the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market. This announcement was applicable to financial statements for the period ending March 31, 2008, or thereafter. In case of forward contracts to which Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates (revised 2003)* applies the entity needs to fully comply with the requirements of AS 11.

3. Subsequently, in the year 2008, Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, was issued by the ICAI, which was also recommendatory initially and was to become mandatory in respect of accounting periods commencing on or after April 1, 2011.

4. 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 by means of an announcement. The announcement clarified that considering that International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, issued by the International Accounting Standards Board (IASB), on which AS 30 is based, was under revision by the IASB. AS 30 was not expected to be continued in its present form, i.e., was expected to be revised. Further, the status of AS 30, AS 31 and AS 32 was clarified as below:

- (i) To the extent of accounting treatments covered by any of the existing notified Accounting Standards (e.g. AS 11, AS 13 etc.), the existing Accounting Standards would continue to prevail over AS 30, AS 31 and AS 32.
- (ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (e.g. Loan impairment, investment classification or accounting for securitisations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30, AS 31, AS 32.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30, AS 31 and AS 32 subject to (i) and (ii) above.

5. Accordingly, currently, the relevant source of guidance for accounting of foreign currency forward exchange contracts is AS 11, which is notified under the Companies (Accounting Standards) Rules, 2006. AS 11 lays down accounting principles for foreign currency transactions and foreign exchange forward contracts and in substance similar contracts. However, it does not cover all types of foreign exchange forward contracts since contracts used to hedge highly probable forecast transactions and firm commitments are outside the scope of AS 11.

6. This Guidance Note will apply to all entities that do not apply Indian Accounting Standards (Ind AS).

Objective

7. The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure for derivative contracts so as to bring uniformity in their accounting and presentation in the financial statements. This Guidance Note also provides accounting treatment for such derivatives where the hedged item is covered under notified Accounting Standards, e.g., a commodity, an investment, etc., because except AS 11, no other notified Accounting Standard prescribes any accounting treatment for derivative accounting. This Guidance Note, however, does not cover foreign exchange forward contracts which are within the scope of AS 11. This Guidance Note is an interim measure to provide recommendatory guidance on accounting for derivative contracts and hedging activities considering the lack of mandatory guidance in this regard with a view to bring about uniformity of practice in accounting for derivative contracts by various entities.

Scope

8. This Guidance Note covers all derivative contracts that are not covered by an existing notified Accounting Standard. Hence, it does not apply to the following:

(i) Foreign exchange forward contracts (or other financial instruments which in substance are forward contracts covered) by AS 11.

(ii) Derivatives that are covered by regulations specific to a sector or specified set of entities.

9. Entities such as banking, non-banking finance companies ('NBFCs'), housing finance companies and insurance entities are required to follow the accounting treatment for derivative contracts, if any, prescribed by the concerned regulators such as the Reserve Bank of India (RBI) in case of banking entities and the NBFCs, National Housing Bank (NHB) in case of housing finance companies and Insurance Regulatory and Development Authority (IRDA) in case of insurance entities. In case the concerned regulator has not prescribed any accounting treatment for derivative contracts, the recommendations contained herein should be followed.

10. This Guidance Note also provides guidance on accounting of assets covered by Accounting Standard (AS) 2, *Valuation of Inventories*, Accounting Standard (AS) 10, *Accounting for Fixed Assets*, Accounting Standard (AS) 13, *Accounting for Investments*, etc., which are designated as hedged items, since such notified Accounting Standards are silent on hedge accounting using derivative instruments for items covered by these Standards. In contrast, AS 11 provides guidance specific to foreign currency forward contracts. Accordingly, guidance for accounting for derivatives and hedging relationships which pertain to hedged items covered under such notified Accounting Standards, e.g., commodities stock, fixed assets, investments etc., is provided in this Guidance Note. However, this Guidance Note does not provide guidance on accounting for items and transactions covered in AS 11, which is a notified Standard. Similarly, accounting for embedded derivative contracts is not part of the scope of this Guidance Note since there are potential conflicts with the requirements of certain other notified Accounting Standards such as AS 2, AS 13 etc. Further, this Guidance Note does not deal with macro-hedging and accounting for non-derivative financial assets/liabilities which are designated as hedging instruments since its objective is to provide guidance on accounting for derivative contracts only and not hedge accounting in its entirety.

11. This Guidance Note, thus, applies to following derivative contracts whether or not used as hedging instruments:

(i) Foreign exchange forward contracts (or other financial instruments that are in substance forward contracts) that are hedges of highly

probable forecast transactions and firm commitments (therefore outside the scope of AS 11);

- (ii) Other foreign currency derivative contracts such as cross currency interest rate swaps, foreign currency futures, options and swaps if not in the scope of AS 11;
- (iii) Other derivative contracts such as traded equity index futures, traded equity index options, traded stock futures and option contracts; and
- (iv) Commodity derivative contracts;

This list is meant to be illustrative only and is not exhaustive.

12. Examples of contracts covered within the scope of AS 11 and thus not covered within the scope of this Guidance Note include:

- Foreign currency forward or future contract entered into to hedge the payment of a monetary asset or a monetary liability recognised on balance sheet, e.g., a debtor, creditor, loan, borrowing etc.
- A currency swap contract (principal only; no interest rate element) that hedges the repayment of the principal of a foreign currency loan.

This list is meant to be illustrative only and is not exhaustive.

Definitions

13. For the purpose of this Guidance Note, the following terms are used with the meanings specified as below:

Derivative: A derivative is a financial instrument or other contract 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 (sometimes called the “underlying”);
- it requires no initial net investment or an initial 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; and

- it is settled at a future date.

Firm Commitment: A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified future date or dates.

Forecast transaction: A forecast transaction is an uncommitted but anticipated future transaction.

Hedging Instrument: A hedging instrument is a designated derivative whose fair value or cash flows are expected to offset changes in the fair value or cash flows, of a designated hedged item. For the purposes of applying hedging in consolidated financial statements, the counterparty of a derivative instrument needs to be outside the consolidated group.

Hedged Item: A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged. A hedged item could also be a portfolio or group of identified assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations.

Hedge Effectiveness: Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

Hedge Ratio: The ratio between the hedging instrument(s) and the hedged item(s) that is maintained during the course of a hedging relationship.

The other terms which are used in the Guidance Note and are not defined above would be deemed to have the same definitions as those contained in the Framework for Preparation and Presentation of Financial Statements and Accounting Standards issued by the ICAI.

Key Accounting Principles

14. The accounting for derivatives covered by this Guidance Note is based on the following key principles:

- (i) All derivative contracts should be recognised on the balance sheet and measured at fair value.

- (ii) If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognised in the statement of profit and loss.
- (iii) If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an ongoing basis.
- (iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.
- (v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.

Synthetic Accounting not permitted

15. This Guidance Note does not permit synthetic accounting, i.e., accounting of combining a derivative and the underlying together as a single package. For instance, if any entity has a foreign currency borrowing that it has hedged by entering into a cross currency interest rate swap, it would require the entity to recognise the loan liability separately from the cross currency interest rate swap and not treat them as a package (synthetic accounting) as INR loan. Alternatively, if any entity has borrowed in terms of INR which it swaps with foreign currency borrowing it would not treat such a loan as a foreign currency borrowing.

Recognition of derivatives on the balance sheet at fair value

16. This Guidance Note requires that all derivatives are recognised on the balance sheet and measured at fair value since a derivative contract represents a contractual right or an obligation.

17. Fair value in the context of derivative contracts represents the 'exit price' i.e. the price that would be paid to transfer a liability or the price that

would be received when transferring an asset to a knowledgeable, willing counterparty. The fair value would also incorporate the effect of credit risk associated with the fulfilment of future obligations. The extent and availability of collateral should be factored in while arriving at the fair value of a derivative contract.

Hedge Accounting

Designation of a derivative contract as a hedging instrument

18. An entity is permitted but not required to designate a derivative contract as a hedging instrument. Where it designates a derivative contract as a hedging instrument, it needs to, as a minimum:

- (i) identify its risk management objective;
- (ii) demonstrate how the derivative contract helps meet that risk management objective;
- (iii) specify how it plans to measure the fair value of the derivative instrument if the derivative contract is effective in meeting its risk management objective (including the relevant hedge ratio);
- (iv) document this assessment (of points (i), (ii), (v), (vi) and (vii) of this paragraph) at inception of the hedging relationship and subsequently at every reporting period;
- (v) demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring;
- (vi) conclude that the risk that is being hedged could impact the statement of profit and loss; and
- (vii) adequately disclose its accounting policies, risk management objectives and hedging activities (as required by this Guidance Note) in its financial statements.

19. In India, for a large number of derivative contracts that are undertaken in the Over The Counter (OTC) market, authorised dealers (generally banks) are required by the concerned regulator (e.g. the Reserve Bank of India (RBI)) to determine whether all or some of the above criteria are met before permitting an entity to enter into such a contract. The permissibility of a contract under RBI regulations, whilst persuasive, is not a sufficient condition

to assert that it qualifies for hedge accounting under this Guidance Note. Certain derivative instruments that are traded on stock exchanges such as foreign exchange futures contracts or equity options / equity futures do not have such requirements and in those cases, in particular, it will be important to demonstrate compliance with the above criteria before hedge accounting can be applied.

20. In case a derivative contract is not classified as a hedging instrument because it does not meet the required criteria or an entity decides against such designation, it will be measured at fair value and changes in fair value will be recognised immediately in the statement of profit and loss.

21. It is clarified that derivatives cannot be designated for a partial term of the derivative instrument. A derivative may be used in a hedging relationship relating to a portion of a non-financial item as long as the hedged portion is clearly identifiable and capable of being measured reliably. Examples of such non-financial components include exchange (for instance London Metal Exchange) traded prices components of metal inventory and crude oil components of aviation turbine fuel.

Need for hedge accounting

22. Hedge accounting may be required due to accounting mismatches in:

- *Measurement* – some financial instruments (non-derivative) are not measured at fair value with changes being recognised in the statement of profit and loss whereas all derivatives, which commonly are used as hedging instruments, are measured at fair value.
- *Recognition* – unsettled or forecast transactions that may be hedged are not recognised on the balance sheet or are included in the statement of profit and loss only in a future accounting period, whereas all derivatives are recognised at inception.

23. An example of measurement mismatch is the hedge of interest rate risk on fixed rate debt instruments that are not held with the intention of trading. Another example of a measurement mismatch could be a derivative undertaken to hedge the price risk associated with recognised inventory.

24. Recognition mismatches include the hedge of a contracted or expected but not yet recognised sale, purchase or financing transaction in a foreign currency and future committed variable interest payments.

25. In order that the statement of profit and loss reflects the effect of the hedge properly, it is necessary to match the recognition of gains and losses on the hedging instrument and those on the hedged item. Matching can be achieved in principle by delaying the recording of certain gains and losses on the hedging instrument or by accelerating the recording of certain gains and losses on the hedged item in the statement of profit and loss. Both of these techniques are used while applying hedge accounting, depending on the nature of the hedging relationship.

Types of hedge accounting

26. This Guidance Note recognises the following three types of hedging;
- the fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised.
 - the cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
 - the hedge of a net investment in a foreign operation.

Fair value hedge accounting model

27. A fair value hedge seeks to offset the risk of changes in the fair value of an existing asset or liability or an unrecognised firm commitment that may give rise to a gain or loss being recognised in the statement of profit and loss. A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect the statement of profit and loss.

28. When applying fair value hedge accounting, the hedging instrument is measured at fair value with changes in fair value recognised in the statement of profit and loss. The hedged item is remeasured to fair value in respect of the hedged risk even if normally it is measured at cost, e.g., a fixed rate borrowing. Any resulting adjustment to the carrying amount of the hedged item related to the hedged risk is recognised in the statement of profit and loss even if normally such a change may not be recognised, e.g., for inventory being hedged for fair value changes.

29. The fair value changes of the hedged item and the hedging instrument will offset and result in no net impact in the statement of profit and loss except for the impact of ineffectiveness.

30. An example of a fair value hedge is the hedge of a fixed rate bond with an interest rate swap, changing the interest rate from fixed to floating. Another example is the hedge of the changes in value of inventory using commodity futures contracts.

31. The adjusted carrying amounts of the hedged assets in a fair value hedging relationship are subject to impairment testing under other applicable Accounting Standards such as Accounting Standard (AS) 28, *Impairment of Assets*, Accounting Standard (AS) 2, *Valuation of Inventories*, Accounting Standard (AS) 13, *Accounting for Investments* etc.

Cash flow hedge accounting model

32. A cash flow hedge seeks to offset certain risks of the variability of cash flows in respect of an existing asset or liability or a highly probable forecast transaction that may be reflected in the statement of profit and loss in a future period.

33. A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction or a firm commitment in respect of foreign currency and (ii) could affect the statement of profit and loss. An example of a cash flow hedge is the hedge of future highly probable sales in a foreign currency using a forward exchange contract. Another example of a cash flow hedge is the use of a swap to change the future floating interest payments on a recognised liability to fixed rate payments.

34. Under a cash flow hedge, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognised in equity, e.g., cash flow hedge reserve. This is intended to avoid volatility in the statement of profit and loss in a period when the gains and losses on the hedged item are not recognised therein.

35. In order to match the gains and losses of the hedged item and the hedging instrument in the statement of profit and loss, the changes in fair value of the hedging instrument recognised in equity must be recycled from equity and recognised in the statement of profit and loss at the same time

that the impact from the hedged item is recognised (recycled) in the statement of profit and loss. The manner in which this is done depends on the nature of the hedged item:

- if the hedged forecast transaction results in a financial asset or a financial liability being recognised, the gains or losses are recycled from equity as and when the asset acquired or liability incurred affects the statement of profit and loss, e.g., when interest income or expense is recognised.
- if the hedged forecast transaction results in a non-financial asset or non-financial liability being recognised, either of the following two approaches may be applied:
- the gains or losses are recycled from equity as and when the impact of asset acquired or liability incurred affects or is recognised in the statement of profit and loss, e.g., as depreciation or cost of sales is recognised.
- the gains or losses are recycled from equity and included as a separate adjustment that is clubbed for financial statement presentation purposes with carrying amount of the asset acquired or liability incurred (referred to as the “basis adjustment”).
- in all other cases the gains or losses are recycled from equity as and when the hedged forecast transaction affects statement of profit and loss.

Note that in the first two bullets above, any gain or loss (or portions thereof) that is not expected to be recovered in future periods are recycled from equity as soon as an entity becomes aware of the fact that those amounts are not expected to be recovered.

36. An example of a forecast transaction that results in the recognition of a financial liability is a forecast issuance of a bond, which is hedged for interest rate risk using a forward-starting interest rate swap. The fair value gains or losses on the swap would be deferred in equity until the bond is issued and the swap starts, after which date they would remain in equity until amortised into the statement of profit and loss over the life of the bond.

37. The choice of the basis adjustment approach is only relevant for hedges of forecast purchases of non-financial assets such as inventory or property, plant and equipment. This approach is permitted but not required

and must be applied consistently as an accounting policy choice to all cash flow hedges that result in the acquisition of a non-financial asset or non-financial liability. Any basis adjustment or accumulated balance in the hedging reserve will require to be tested at least at every reporting date for impairment. For the purposes of this impairment assessment, the basis adjustment / relevant portion of the hedging reserve may be combined with the carrying amount of the hedged item and compared to its current realisable value.

Net investment hedging

38. An investor in a non-integral operation is exposed to changes in the carrying amount of the net assets of the foreign operation (the net investment) arising from the translation of those assets into the reporting currency of the investor.

39. Principles relating to the hedge of a net investment in a foreign operation are:

- foreign exchange gains and losses on a net investment in a non-integral foreign operation are recognised directly in equity. This occurs through the translation of the non-integral foreign operation's net assets for purposes of consolidation;
- gains and losses on foreign currency derivatives used as hedging instruments are recognised directly in equity to the extent that the hedge is considered to be effective;
- the ineffective portion of the gains and losses on the hedging instruments (and any proportion not designated in the hedging relationship) is recognised in the statement of profit and loss immediately;
- any net deferred foreign currency gains and losses, i.e., arising from both the net investment and the hedging instruments are recognised in the statement of profit and loss at the time of disposal of the foreign operation.

40. This Guidance Note does not override the principles of AS 11. However, it introduces the hedge accounting criteria for hedging of net investments.

41. When the net investment is disposed off, the cumulative amount in the foreign currency translation reserve in equity is transferred to the statement of profit and loss as an adjustment to the profit or loss on disposal of the investment. Therefore, it is necessary for an entity to keep track of the amount recognised directly in equity separately in respect of each foreign operation, in order to identify the amounts to be transferred to the statement of profit and loss on disposal.

Formal documentation at inception

42. At inception of a hedge, formal documentation of the hedge relationship must be established. The hedge documentation prepared at inception of the hedge must include a description of the following:

- the entity's risk management objective and strategy for undertaking the hedge;
- the nature of the risk being hedged;
- clear identification of the hedged item (asset, liability or cash flows) and the hedging instrument;
- demonstrate how the derivative contract helps meet that risk management objective;
- identify how it plans to measure the derivative if the derivative contract is effective in meeting its risk management objective;
- demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring; and
- conclude that the risk that is being hedged could impact the statement of profit and loss.

43. This Guidance Note does not mandate a specific format for the documentation and in practice hedge documentation may vary in terms of lay-out, technology used etc. Various formats may be acceptable as long as the documentation includes the contents identified above.

44. A hedging relationship is effective if it meets all of the following requirements:

- (i) There is an economic relationship between the hedged item and the hedging instrument.

- (ii) The effect of credit risk does not dominate the value changes that result from that economic relationship.
- (iii) The hedging relationship is expected to be highly effective in achieving the stated risk management objective and the entity is in a position to reliably measure the achievement of this objective both at inception and on an ongoing basis during the tenure of the hedging relationship.

Hedge effectiveness testing and measurement of ineffectiveness

45. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:

- (a) 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 excluding change in its time value; and
- (b) separating the interest element and the spot price of a forward contract.

46. An entity may consider the costs associated with a hedging instrument e.g. forward premium or time value of an option contract as a period cost (for example akin to interest costs when hedging an interest bearing asset or liability) or at a point in time (for example when hedging a forecasted sale or purchase) depending on the manner of designation and how the hedged item impacts the statement of profit and loss.

47. This Guidance Note does not prescribe one single method for how hedge effectiveness testing and ineffectiveness measurement should be conducted. The appropriate method for each entity will depend on the facts and circumstances relevant to each hedging programme and be driven by the risk management objective of the entity. Entities may apply commonly used measures such as critical terms match, dollar offset or regression methods as appropriate to assess hedge effectiveness.

48. Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a

risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. This Guidance Note does not prescribe bright line tests for effectiveness assessments but instead requires disclosure of the entity's risk management objectives and measures for assessing if these objectives are met.

49 When designating a hedging relationship, and on an ongoing basis, an entity will analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis will serve as the basis for the entity's assessment of meeting the hedge effectiveness requirements.

50. A hedging relationship will meet the hedge effectiveness requirements if:

- (i) there is an economic relationship between the hedged item and the hedging instrument.
- (ii) the effect of credit risk does not dominate the value changes that result from the economic relationship.
- (iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantities of:
 - the hedged item that the entity actually hedges; and
 - the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and
- (iv) the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness - whether or not it is recognised - to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

51. An entity will 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.

52. If the critical terms of the hedging instrument and the hedged item - e.g. the nominal amount, maturity and underlying - match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.

53. If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity should adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again.

54. This Guidance Note does not also prescribe a single method of how ineffectiveness measurement should be conducted other than to require an entity to consider how ineffectiveness could affect a hedging relationship and require immediate recognition of such ineffectiveness.

55. Hedge ineffectiveness is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.

56. When measuring hedge ineffectiveness, an entity is required to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

57. In certain situations, ineffectiveness is required to be recognised. These include

- in a cash flow hedge, when the forecasted hedged transaction is no longer probable of occurring;
- in a fair value hedge, when the hedging instrument is no longer considered to be an effective hedge of the hedging instrument; and
- in any hedge relationship, if the risk management objective is changed or no longer expected to be met.

The recognition of ineffectiveness does not necessarily require hedge accounting to be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.

Termination of hedge accounting / reclassification of hedge reserves

58. An entity is not permitted to stop applying hedge accounting voluntarily unless the risk management objective of the entity, as was originally defined by the entity when first applying hedge accounting, is no longer met.

59. If an entity terminates a hedging instrument prior to its maturity / contractual term, hedge accounting is discontinued prospectively. Any amount previously recognised in the hedge reserve (in the case of cash flow or net investment hedges) is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings, e.g., when a forecasted purchase / sale actually impacts earnings or when a net investment is disposed off in the case of a net investment hedge.

60. In case of hedges of highly probable forecast transactions or commitments, if the forecasted transaction is no longer highly probable of occurring, (but still probable of occurring) then hedge accounting is discontinued prospectively but the amount recognised previously in the hedge reserve is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings (as specified in paragraph 35 of this Guidance Note). 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring.

61. In case of hedges of forecast transactions, if the forecasted transaction is no longer probable of occurring, then hedge accounting is discontinued and all amounts recognised in the hedge reserve are recognised immediately in the statement of profit and loss. 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring. Judgment may need to be exercised in situations where a forecasted transaction is delayed to determine if the delayed transaction is the one that was subject to the original hedging designation or not. This Guidance Note does not provide a bright line test in this context but recognises that judgment is required and an entity should disclose the manner in which such determinations are made in its financial statements.

Presentation in the financial statements

62. Derivative assets and liabilities recognised on the balance sheet at fair value should be presented as current and non-current based on the following considerations:

- Derivatives that are intended for trading or speculative purposes should be reflected as current assets and liabilities.
- Derivatives that are hedges of recognised assets or liabilities should be classified as current or non-current based on the classification of the hedged item.
- Derivatives that are hedges of forecasted transactions and firm commitments should be classified as current or non-current based on the settlement date / maturity dates of the derivative contracts.
- Derivatives that have periodic or multiple settlements such as interest rate swaps should not be bi-furcated into current and non-current elements. Their classification should be based on when a predominant portion of their cash flows are due for settlement as per their contractual terms.

63. This Guidance Note does not permit any netting off of assets and liabilities except where basis adjustment is applied under cash flow hedges and hence all the amounts presented in the financial statements should be gross amounts. Amounts recognised in the statement of profit and loss for derivatives not designated as hedges may be presented on a net basis.

Disclosures in financial statements

64. An entity should satisfy the broader disclosure requirements by describing its overall financial risk management objectives, including its approach towards managing financial risks. Disclosures should explain what the financial risks are, how the entity manages the risk and why the entity enters into various derivative contracts to hedge the risks.

65. An entity should disclose the methodology used to arrive at the fair value of derivative contracts (whether used for hedging or not) and the extent of fair value gains/losses recognized in the statement of profit and loss and in equity.

66. The entity should disclose its risk management policies. This would include the hedging strategies used to mitigate financial risks. This may include a discussion of:

- how specific financial risks are identified, monitored and measured;
- what specific types of hedging instruments are entered into and how these instruments modify or eliminate risk; and
- details of the extent of transactions that are hedged.

67. An entity is also required to make specific disclosures about its outstanding hedge accounting relationships. The following disclosures are made separately for fair value hedges, cash flow hedges and hedges of net investments in foreign operations:

- a description of the hedge;
- a description of the financial instruments designated as hedging instruments for the hedge and their fair values at the balance sheet date;
- the nature of the risks being hedged;
- for hedges of forecast transactions, the periods in which the transactions are expected to occur, when they are expected to affect the statement of profit and loss, and a description of any forecast transactions that were originally hedged but now are no longer expected to occur. This Guidance Note does not specify the future time bands for which the disclosures should be made. Entities should decide on appropriate groupings based on the characteristics of the forecast transactions;
- if a gain or loss on derivative or non-derivative financial assets and liabilities designated as hedging instruments in cash flow hedges has been directly recognised in the hedging reserve: -
 - the amount recognised in hedge reserve during the period.
 - the amount recycled from the hedge reserve and reported in statement of profit and loss.
 - the amount recycled from hedge reserve and added to the initial measurement of the acquisition cost or other carrying amount of

a non-financial asset or non-financial liability in a hedged forecast transaction.

- a breakup of the balance in the hedge reserve between realised and unrealised components and a reconciliation of the opening balance to the closing balance for each reporting period.

68. Insofar as disclosure of derivatives designated for hedging foreign currency risks are concerned, the same should be disclosed in the Format attached as Appendix I to the Guidance Note, which also requires disclosure of all foreign exchange assets and liabilities including contingent liabilities, both hedged and unhedged.

69. The Appendix II to this Guidance Note contains examples illustrating the principles contained in this Guidance Note.

Transitional provisions

70. This Guidance Note applies to all derivative contracts covered by it and are outstanding on the date this Guidance Note becomes effective. Any cumulative impact (net of taxes) should be recognised in reserves as a transition adjustment and disclosed separately. An entity is not permitted to follow hedge accounting as recommended in this Guidance Note retrospectively.

Effective Date

71. This Guidance Note becomes applicable for accounting periods beginning on or after 1st April, 2016; its earlier application, is encouraged. From the date this Guidance Note comes into effect the following Announcements issued by the Council of the ICAI stand withdrawn:

- (i) Applicability of Accounting Standard (AS) 11 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction issued on the basis of the decision of the Council at its meeting held on June 24-26, 2004.
- (ii) Disclosures regarding Derivative Instruments published in 'The Chartered Accountant', December 2005 (pp 927).

- (iii) Accounting for Derivatives published in 'The Chartered Accountant', May 2008 (pp.1945).
- (iv) Application of AS 30, *Financial Instruments: Recognition and Measurement* published in 'The Chartered Accountant', April 2011 (pp. 1575) to the extent of the guidance covered for accounting for derivatives within the scope of this Guidance Note.

Appendix I

Format for Disclosure of Foreign Currency Exposures

Exposures in Foreign Currency:

I. Assets	Foreign Currency	Current Year			Previous Year		
		Exchange Rate	Amount in Foreign currency	Amount in ₹	Exchange Rate	Amount in Foreign currency	Amount in ₹
Receivables (trade & other)							
Other Monetary assets (e.g. ICDs/Loans given in FC)							
Total Receivables (A)							
Hedges by derivative contracts (B)							
Unhedged receivables (C=A-B)							
II. Liabilities	Foreign Currency	Current Year			Previous Year		
		Exchange Rate	Amount in Foreign currency	Amount in ₹	Exchange Rate	Amount in Foreign currency	Amount in ₹
Payables (trade & other)							
Borrowings (ECB and Others)							
Total Payables (D)							

Hedges by derivative contracts (E)							
Unhedged Payables (F=D-E)							
III. Contingent Liabilities and Commitments	Foreign Currency	Current Year			Previous Year		
		Exchange Rate	Amount in Foreign currency	Amount in ₹	Exchange Rate	Amount in Foreign currency	Amount in ₹
Contingent Liabilities							
Commitments							
Total (G)							
Hedges by derivative contracts (H)							
Unhedged Payables (I=G-H)							
Total unhedged FC Exposures (J=C+F+I)							

Explanatory notes:

Note 1: Exposures in Assets and Liabilities to be presented currency wise.

Note 2: Exposure in any foreign currency(s) which are not material may be aggregated. However, any currency in which exposure is more than 10% of the total exposure should be reported separately; at least 75% of total exposure should be reported currency wise.

Note 3: Additional disclosures of any foreign currency exposure in an asset not hedged by an entity on the ground that the same is covered by a corresponding foreign currency exposure in a liability and vice versa, to the extent having same maturity date and the amount (known as 'natural hedge') may be made in the notes.

Appendix II

Illustrative examples of application of Guidance Note

1. Application of cash flow hedge

ABC Ltd. is an exporter of goods. In the month of July 2013, it receives the order for supply of goods to US customers in the month of January 2014 and as per the payment cycle with the customers, it expects to realise USD 100,000 in April 2014.

ABC Ltd has decided to fully hedge the sales from foreign currency risk. Immediately after getting the order, to hedge the firm commitment in foreign currency it enters into a derivative transaction with XYZ Bank, for future sale of USD 100,000 in the month of April 2014 @ ₹ 65 per USD (Spot Rate was ₹ 64.50 per USD).

For this purpose, it is assumed that the company has entered into a cash flow hedge, which is generally the case for hedging foreign currency risk.

Further, it is assumed that:

- At the time of booking of sale in January 2014, the USD rate was ₹ 61, and forward rate for delivery on April 30, 2014 was ₹ 61.20.
- On the reporting date on March 31, 2014, the USD rate was ₹ 60.50, and forward rate for delivery on April 30, 2014 was ₹ 60.60.
- At the time of realisation USD rate was ₹ 60/- on April 30, 2014.

The above transaction should be accounted in the following manner (impact of discounting of MTM of the hedging instrument has been ignored in this simplified illustration).

	ABC Limited entered to sell a forward exchange contract for USD 100,000 having ten months maturity on April 30, 2014		
	Forward Exchange Rate	65.00	
	Spot Rate as at July 01, 2013	64.50	
	No entry in the books		

Upto January 31, 2014	ABC Limited accounts the MTM effect in the books Forward Contract Rate Entered Forward Contract Available in the market with similar maturity	65.00 61.20	
	Forward Contract Receivable To Cash Flow Hedge Reserve	3,80,000	3,80,000
January 31, 2014	ABC Limited recognises the revenue by booking an invoice for USD 100,000, having credited period of 90 days (i.e. due date – April 30, 2014) Spot rate as at January 31, 2014 Forward Contract Available in the Market with similar maturity	61.00 61.20	
	Recognition of Revenue Accounts Receivable To Revenue	61,00,000	61,00,000
	Recognition of Hedging gain Cash Flow hedge reserve To Statement of Profit & Loss	3,80,000	3,80,000
March 31, 2014	Spot Rate Forward Contract Available in the Market with similar maturity	60.50 60.60	
	Restatement of Accounts Receivable Forex Gain/Loss (P&L) To Accounts Receivable	50,000	50,000
	MTM Effect of Forward Cover Forward Contract Receivable To Forex Gain/Loss (P&L)	60,000	60,000

April 30, 2014	Spot rate	60.00	
	Realisation of Accounts Receivable		
	Bank	60,00,000	
	Forex Gain/Loss (P&L) To Accounts Receivable	50,000	60,50,000
	Maturity of Forward Contract		
	Bank	5,00,000	
	To Forward Contract Receivable		4,40,000
	To Forex Gain/Loss (P&L)		60,000

2. Cash flow hedge of the repayment of a loan

Company X is an Indian company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X borrows from a bank USD 1 million six month debt carrying a floating interest rate of three month LIBOR plus 50 basis points. As per the Company's risk management policies, it enters into a Cross Currency Interest Rate Swap (CCIRS) with a bank to swap the above floating interest bearing USD debt into a fixed interest bearing INR debt.

Since the CCIRS does not fall within the scope of AS 11 and has been entered into to hedge the exposure of currency and interest rate risk arising from the debt instrument, it would be within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following on March 31, 2014:

- (i) Translate the USD loan at closing rate and record the foreign exchange gain/ loss in the statement of profit and loss.
- (ii) Record a derivative asset/ liability based on the fair value (Mark To Market 'MTM' value) of the CCIRS with a corresponding credit/debit in Cash Flow Hedging Reserve.

- (iii) Record the net interest expense in statement of profit and loss, i.e., the USD floating interest expense adjusted for the settlement of the interest rate swap for the period.
- (iv) Reclassify from the Cash Flow Hedging Reserve to statement of profit and loss the amount by which the hedged item, i.e., the debt has impacted the statement of profit and loss. (In this case, the amount of translation foreign exchange gain/ loss that has been recorded for the loan).

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Loan – Translated at the closing USD – INR conversion rate.
- Derivative asset/ liability – MTM of the CCIRS.
- Cash Flow Hedging Reserve - MTM of the CCIRS less amount reclassified to the statement of profit and loss.

3a. Commodity contract – cash flow hedge of a forecasted sale with an exchange traded future

Company Z is a producer and wholesaler of copper with annual reporting period ending on March 31 each year. On January 1, 2014, Company Z forecasts sales of 100 tonnes of copper expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of copper prices, Company Z enters into a 'sell' futures contract on the Commodity Exchange to sell 100 tonnes of copper (same grade) with maturity of September 30, 2014. As per its risk management policies, Company Z designates this futures contract as a cash flow hedge of highly probable forecasted sales of 100 tonnes of copper inventory in September 2014.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in cash flows arising from price risk, this would fall within the scope of this Guidance Note.

According to this Guidance Note, Company Z will record the following on March 31, 2014

Record a derivative asset/ liability based on the fair value (MTM) of the commodity future contract with a corresponding credit/ debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the commodity future contract.
- Cash Flow Hedging Reserve - MTM of the commodity future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 2014, along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss , which potentially records the sales at the hedged price.

3b. Commodity contract – fair value hedge of forecasted sales with an exchange traded future

Continuing the above example, consider that Company Z designates the commodity futures contract as a fair value hedge of a portion of its inventory, i.e., 100 tonnes of copper. The Company documents it as a hedge of the exposure to changes in fair value of the inventory due to commodity price risk. As at March 31, 2014, the price of copper increases thereby resulting in an increase in the fair value of inventory and MTM loss on the derivative.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in fair values due to price risk, it would fall within the scope of this Guidance Note.

According to this Guidance Note, Company Z will record the following on March 31, 2014:

- (i) Record a derivative liability based on the fair value (MTM) of the commodity future contract with a corresponding debit to the statement of profit and loss.
- (ii) Record an increase in inventories for the change in fair value as a hedge accounting adjustment through statement of profit and loss. Accounting Standard (AS) 2, *Valuation of Inventories*, requires

inventories to be carried at the lower of cost and net realisable value. Hence, this will be recorded as a separate hedge accounting adjustment distinguished from the valuation of inventories under AS 2.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/liability – MTM of the commodity future contract.
- Inventory – valued as per AS 2 at cost.
- Inventory hedge accounting adjustment – basis adjustment to record change in fair value.

When sales of the hedged inventory occur in the future, the hedging related fair value adjustment to inventory will be released to the statement of profit and loss and can be classified as part of 'cost of goods sold'.

4. Hedging a portion of a non-financial item – Commodity future

Company X is a producer and wholesaler of steel with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of 200 tonnes of steel expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of expected cash flows from forecasted sales of steel, as per its risk management policies, Company X enters into a 'sell' futures contract on the commodity exchange for 200 tonnes of iron ore which is one of the significant components of the steel making process and significantly impacts the price of steel.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in cash flows arising from price risk, this would fall under the scope of this Guidance Note. This will not result into a perfect hedge since the hedged commodity, i.e., steel and the hedging instrument used, i.e., iron ore futures, are not perfectly correlated. The Guidance Note permits such designation if it is as per the company's risk management policies and strategy.

According to this Guidance Note, Company X will record the following on March 31, 2014:

Record a derivative asset/ liability based on the fair value (MTM) of the iron ore future contract with a corresponding credit/ debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the iron ore future contract.
- Cash Flow Hedging Reserve - MTM of the iron ore future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 2014 along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss .

5. Exchange traded contract – Fair value hedge of investment portfolio

Company Z holds a closed portfolio of equity shares classified as long term investments under AS 13. As per its risk management policies, Company Z hedges its exposure to variability of expected fair value of the investments by entering into equity futures contract on a recognised stock exchange.

Since this derivative is outside the scope of AS 11 and is entered into to hedge a specific exposure, this would fall within the scope of this Guidance Note.

Under this Guidance Note, Company Z will record the following on March 31, 2014:

- (i) Record a derivative liability/derivative asset based on the fair value (MTM) of the equity futures contract with a corresponding debit to the statement of profit and loss.
- (ii) Record an increase/decrease in long term investments for the change in fair value as a hedge accounting adjustment through statement of profit and loss. Accounting Standard (AS) 13, *Valuation of Investments*, requires long term investments to be carried at cost. Hence this will be recorded as a separate hedge accounting

adjustment distinguished from the valuation of investments under AS 13.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the equity futures contract.
- Long term investments – valued as per AS 13 at cost.
- Investment hedge accounting adjustment – adjustment to record change in fair value.

6. Cash flow hedge accounting – forecasted sale with a forward contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014, Company X enters into a sell USD – buy INR forward contract which matures on September 30, 2014.

Since the forward contract is taken to hedge highly probable forecasted sales transaction, it does not fall within the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following on March 31, 2014:

Record a derivative asset/liability based on the fair value (MTM) of the foreign currency forward contract with a corresponding credit/debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency forward contract.
- Cash Flow Hedging Reserve – MTM of the foreign currency forward contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 30, 2014 along with the maturity of the foreign currency forward contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

7. Cash flow hedge accounting - forecasted sale with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014 Company X enters into a sell USD – buy INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an 'At the Money' strike price option). As a result, the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the 'cost of hedging'.

Since the option contract is taken to hedge highly probable forecasted sales transactions, it does not fall within the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/ debit to Cash Flow Hedging Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency option contract.

- Cash Flow Hedging Reserve - MTM of the foreign currency option contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen on September 30, 2014, along with the maturity of the foreign currency option contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

8. Cash flow hedge accounting – hedging the repayment of foreign currency debt with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X has USD 1 million of foreign currency debt that it needs to repay on September 30, 2014. As per its risk management policies, in order to hedge the variability in cash flows arising from the repayment of this debt in foreign currency, on January 1, 2014 Company X enters into a buy USD – sell INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an 'At the Money' strike price option). As a result the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the 'cost of hedging'.

The option contract is outside the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/debit to Cash Flow Hedging Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date.

In addition,

- Company X will also reclassify from the Cash Flow Hedge Reserve, a proportionate amount of the option premium paid as a 'cost of hedging' type adjustment into the statement of profit or loss; and
- To the extent that there is intrinsic value in the option contract that offsets the translation gain/loss on the foreign currency debt, Company will additionally reclassify such amounts to the statement of profit or loss.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/ liability – MTM of the foreign currency option contract.
- Cash Flow Hedging Reserve - MTM of the foreign currency option contract adjusted for the 'cost of hedging' reclassification and the intrinsic value reclassification, if any.

On September 30, 2014, in addition to the above treatment, the debt will be repaid at the spot rate, the option settled or expires worthless (as the case may be) and any balance in the cash flow hedge reserve will be reclassified to the statement of profit and loss for the period ended on that date.