Forex Fluctuations - Hedge accounting Impact

06 Oct 2013

Agenda

- Exchange rate Volatility
- Impact on accounting
- Accounting Solution
  - AS 11
  - AS 30
- Examples of hedge Accounting
  - AS 11
  - AS 30
- Q & A

Exchange rate volatility

- The value of Indian rupee is experiencing significant fluctuations and has depreciated significantly against major currencies
- One US$, whose value was approx. Rs.54 on 31 March 2013, was being valued approx. at Rs.60 on 30 June 2013. It went to its peak at 68.85 and now trading near to 62
- Obviously, it is a cause of concern for Indian companies having foreign currency exposure

Impact on Accounting

- Primary concern appears to be to protect P&L from exchange fluctuations arising on foreign currents assets/ liabilities

- Impact goes beyond transaction risk

- **Transaction risk** refers to impact of exchange rate changes on the value of committed cash flows/ assets or liabilities recognized in the financial statements, e.g., exchange fluctuations on foreign currency loans, receivables and payables

- The normal provisions of AS 11 require exchange gain/ loss arising on restatement of foreign currency monetary items to be recognized immediately in P&L

Accounting Solutions

- Special accounting used to reflect hedge relationship in the financial statements
- Objective is to manage / smoothen profit of loss
  - Matches earnings recognition of hedging instruments with that of hedged item
  - Normal derivative accounting does not apply
- Designated hedging relationship between hedging instrument and hedged item is required
- Hedge accounting governed by AS 11/ AS 30
- AS 30 / IAS 39 also lays down conditions for documentation and hedge effectiveness

Accounting Solutions - AS 11 Hedge

- An enterprise may enter into a forward exchange contract, which is not intended for trading or speculation purposes

- The premium or discount of such a forward exchange contract should be amortised as expense or income over the life of the contract.

- Exchange differences recognized in the statement of profit and loss in the reporting period in which the exchange rates change.

- Any profit or loss arising on cancellation or renewal should be recognised as income or as expense for the period.

- P&L account would show a gain/loss on Hedged item (foreign currency loan) with a corresponding loss/gain on Hedging instrument (forward exchange contract).

Example on AS 11

- On 01.01.05, a company entered into a foreign currency transaction by taking a loan of US$ 1 lakh. The amount of loan is required to be paid on 30.06.05.
- On 01.01.05 itself, the company entered into a forward exchange contract for the transaction to mitigate the risks associated with the changes in exchange rates.

Period	01.01.05	31.03.05	30.06.05
Spot rate	45	47	52
Forward Rate (for 6 months)	48	-	-
Forward Rate (for 3 months)	-	51	-

Example (Cont.)

In case of other than trading and speculation purposes (i.e. Hedging)

Assuming that the accounting year of the Company is the financial year, the journal entries for the above transaction are as below:

(All amounts in Rs. lakhs)

01.01.05

Entry passed for taking the foreign currency loan

(i)	Bank a/c	45	
	To Foreign currency loan a/c		45

Entry passed for entering into forward exchange contract

(ii) Foreign currency receivable a/c	45	
Deferred Premium a/c	3	
To Amount payable to bank		48

Example (Cont.)

31.03.05

Entry passed for amortisation of proportionate premium on forward exchange contract for 3 months

(iii)	Premium a/c	1.5	
	To Deferred Premium a/c		1.5

Entry passed for booking exchange loss on foreign currency loan at the balance sheet date [(47-45)*1 Lakh]

(iv)	Foreign exchange loss a/c	2	
	To Foreign currency loan a/c		2

Entry passed for booking of exchange gain on forward exchange contract (47-45)

(v)	Foreign currency receivable a/c	2	
	To Foreign exchange gain a/c		2

Example (Cont.)

30.06.05

Entry passed for amortization of proportionate premium on forward exchange contract for next 3 months

(vi)	Premium A/c	1.5	
	To Deferred Premium A/c		1.5

Entry passed for booking exchange loss on foreign currency loan [(52- 47)*1 Lakh

(vii)	Foreign Exchange Loss A/c	5	
	To Foreign Currency Loan A/c		5

Entry passed for booking of exchange gain on forward exchange contract (52-47)

(viii)	Foreign currency receivable A/c	5	
	To Foreign exchange gain A/c		5

Example (Cont.)

Entry passed for amount paid to bank for the settlement of forward exchange contract

(ix)	Amount payable to bank A/c	48	
	To Bank A/c		48

Entry passed for valuing amount of foreign currency at spot rate

(x)	Foreign currency received A/c	52	
	To Foreign currency receivable A/c		52

Entry passed for repayment of loan in foreign currency

(xi)	Foreign currency loan A/c	52	
	To Foreign currency received A/c		52

Example (Cont.)

It may be noted that on 31.03.05, the P&L account would show a loss on foreign currency loan with a corresponding gain on forward exchange contract.

Similar is the case on 30.06.05.

Thus, the hedge accounting reflects the mitigating effect of the change in the value of the hedged item (foreign currency loan) and hedging instruments (forward exchange contracts).

Capitalization/Amortization of Foreign Exchange Differences – AS 11

- The Central Government, vide notification dated 31 March 2009 has amended the AS 11".The effects of changes in foreign exchange rates".

- A new paragraph (Para 46 and 46A) has been inserted to allow amortisation/capitalisation of foreign exchange differences arising on long term monetary items.

  - If the long term foreign currency monetary item relates to an acquisition of depreciable capital asset, exchange differences arising on such monetary items should be added to or deducted from the cost of such asset.

  - If the long term foreign currency monetary item relates to other than an acquisition of depreciable capital asset, exchange difference should be accumulated in the 'Foreign Currency Monetary Item Translation Difference Account' and amortised over the life of the monetary item

Accounting Solutions - Key steps to achieve AS 30 Hedge

- Identify the hedged item or transaction
- Identify the nature of the risk being hedged
- Identify the hedging instrument
- Demonstrate that the hedge has and will continue to be effective (Hedge effectiveness)
- Monitor effectiveness
- Documentation
- Identify the type of hedge: fair value or cash flow

Hedged item

- A hedged item is
  - an asset, liability, firm commitment, forecast future transaction or net investment in a foreign operation
  - that exposes the entity to risk of changes in
    - fair value; or
    - future cash flows; and
  - is designated as being hedged
- A hedged item can be designated as such for whole or part of its life

Hedging instrument

- A hedging instrument;
  - a designated derivative or (in limited circumstances a non-derivative financial instrument)
  - whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item
- A non-derivative financial instrument may be designated only as a hedging instrument for foreign currency risk

Hedge effectiveness

- Degree to which changes in the fair value or cash flows of the hedged item are offset by changes in the fair value in or cash flows of the hedging instrument

- Hedge must be assessed to be “highly effective” (80-125%)
  - i.e., Δ in FV of derivative / Δ in FV of hedged item

- There are two tests for hedge effectiveness:
  - Prospective effectiveness – the hedge is expected to be highly effective at inception and on an ongoing basis
  - Retrospective effectiveness – the hedge has actually been highly effective in the period
  - Effectiveness within the range of 80% – 125%

- Test periodically to determine it has been highly effective (retrospective and continued prospective)

Documentation

- To apply hedge accounting, formal documentation required at inception of the hedge

- Specifically the documentation must set out the following key elements of a hedge relationship:

  - The entity's risk management strategy and objective for undertaking the hedge
  - Identification of the hedging instrument
  - Identification of the hedged item and hedged risk
  - Identification of the type of hedge relationship - cash flow, fair value
  - How the entity plans to assess hedge effectiveness
  - The date of designation

Cash flow hedges

- Hedging the exposure to changes in the cash flows attributable to a particular risk associated with a recognised asset, liability, or highly probable forecasted transaction and could affect reported profit or loss

- Aims to provide protection from the variability of cash flows arising from market price movements

Examples of cash flow hedges

- Floating-rate debt issued by the entity and hedged using a "receive floating/pay fixed" interest rate swap. This protects the future interest cash flows to be paid on the debt against changes in interest rates.

- Forecasted USD foreign currency sales of airline seats in September hedged by a USD/euro forward contract. This protects the euro cash flows to be received from the sales against changes in exchange rates.

- A firm commitment to buy a machine in six months' time for a fixed USD foreign currency amount hedged by a USD/euro forward contract. This protects the future euro cash flows to be paid against changes in exchange rate

Example: Cash flow hedge –
Anticipated sales hedged with a forward contract

- XYZ Limited used INR as its functional currency.
- It expects to sell USD 1,000,000 and receive payment on 31 March 2014
- Therefore on 1 October 2013, it enters into a 6 months forward contract to sell USD 1,000,000 and receive INR 60,000,000 on 30 June 2014 (at a forward rate of USD 1: INR 60)
- **Key data:**

Date	Spot rate	Forward rate as on 31 March 2014	Forward contract fair value
1 Oct 2013	USD 1: INR 62	USD 1: INR 60	
31 Dec 2013	USD 1: INR 64	USD 1: INR 63	(2,955,665)[1]
31 March 2014	USD 1: INR 65		(5,000,000)[2]

1. [(USD 1,000,000*60)-(USD 1,000,000*63)]/(1.015), with 1.5% representing XYZ's assumed discount rate for one quarter (6% annualised)
2. USD 1,000,000*(65-60)

Example: Cash flow hedge –
Anticipated sales hedged with a forward contract

#	Particulars	Debit	Credit
1	1 Oct 2013		
	No entry is required because the fair value of the forward contract is zero at inception	-	-

2	31 Dec 2013		
	To account for the change in fair value of the forward contract		
	Hedging reserve	2,955,665	
	Forward contract (loss on forward)		2,955,665

Example: Cash flow hedge –
Anticipated sales hedged with a forward contract

#	Particulars	Debit	Credit
3	31 March 2014		
	To account for the change in fair value of the forward contract		
	Hedging reserve	2,044,335	
	Forward contract (loss on forward)		2,044,335

4	31 March 2014		
	To account for the cash paid on settlement of forward contract		
	Forward Contract	5,000,000	
	Cash/Bank		5,000,000

Example: Cash flow hedge –
Anticipated sales hedged with a forward contract

#	Particulars	Debit	Credit
5	31 March 2014		
	To record sales transaction at the prevailing spot exchange rate on the date of sale		
	Cash/Bank/debtors	65,000,000	
	Sales		65,000,000

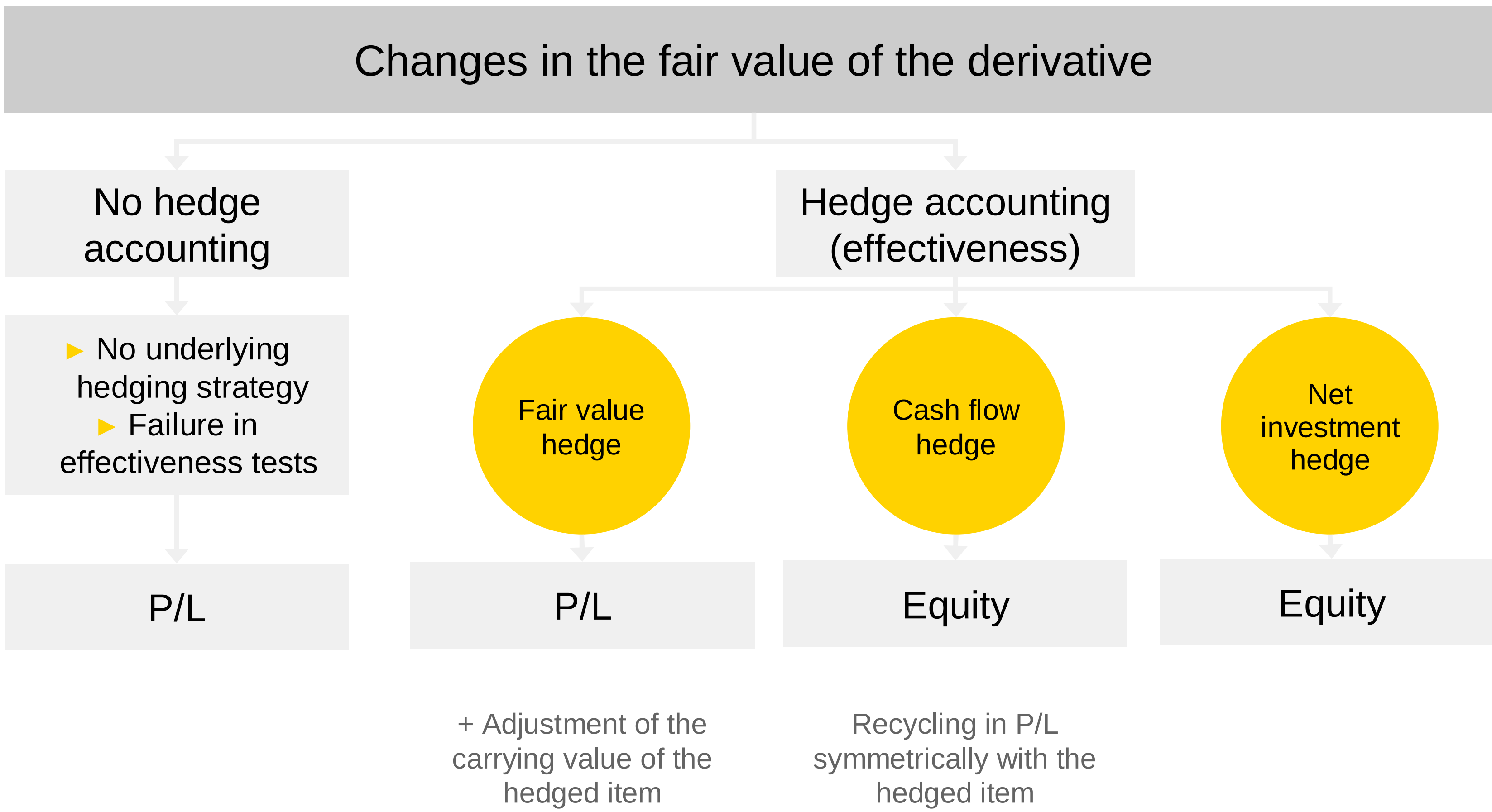
6	31 March 2014		
	To reclassify the amount relating to hedge item affecting earnings from equity		
	Sales	5,000,000	
	Hedging reserves		5,000,000

Example: Cash flow hedge – Anticipated sales hedged with a forward contract

- The above hedge had the effect of locking in XYZ’s sales revenue on a USD 1,000,000 sales at INR 60,000,000. despite subsequent changes in the exchange rate.

- The hedged result is achieved by the combination of the actual revenue at the spot rates (INR 65,000,000) and the loss on the forward contract (INR 5,000,000), reclassified from the equity (hedging reserve) at the date of the sale.

General framework of hedge accounting



Q & A

Q & A


Thank You