This article aims to:
Illustrate the accounting for a forward contract designated in a hedging relationship by an NBFC.
Introduction

The entities are exposed to various kinds of risks including foreign currency, interest rate, credit, commodity price and other risks. It thus becomes imperative for institutions to set up effective risk management policies. Many entities, such as banks and other financial institutions use derivative financial instruments to reduce income volatility and economically hedge against these risks.

For entities following Accounting Standards, accounting for derivative financial instruments is governed by Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates and the Guidance Note on Accounting for Derivate Contracts, issued by the Institute of Chartered Accountants of India (ICAI). For entities following Ind AS, these instruments are accounted for in accordance with Ind AS 109, Financial Instruments.

Ind AS 109 requires all derivative contracts to be classified and measured at Fair Value Through Profit or Loss (FVTPL). Accordingly, all changes in fair value of these instruments are recognised in profit and loss. These changes may not be offset by gains or losses on underlying transactions, which may lead to volatility in the reported results. In order to reduce income volatility, entities may choose to apply hedge accounting (provided the hedging relationship meets the qualifying criteria). By adopting hedge accounting, entities closely align their accounting to their risk management activities, and thus represent useful information to users of financial statements.

In this article we aim to demonstrate accounting for a forward contract used to mitigate foreign currency risk arising from a loan taken by a Non-Banking Financial Company (NBFC). It also highlights the qualifying criteria for hedge accounting as prescribed in Ind AS 109.

Example:

Company B (the company), a reputed NBFC in India has a portfolio of foreign currency and INR borrowings. Most of the loans have been taken from reputed banks based in India. Considering the volume of foreign currency loans and the volatility in the USD/INR exchange rates, the company has identified foreign currency risk as a key financial risk. In accordance with its documented risk management procedures, the company hedges its foreign currency exposure using forward contracts and currency swaps.

On 30 June 2019, company B obtained a foreign currency loan of USD30 million\(^1\) at INR71\(^2\) per USD at 4.5 per cent per annum repayable after 12 months from Bank L (i.e. 29 June 2020). On the same day, company B entered into a forward contract to buy USD30 million on 29 June 2020 at INR73.5 per USD from Bank L. Both, company B and Bank L are highly rated institutions, based in India. The following are the forward rates applicable during the period of the transaction:

<table>
<thead>
<tr>
<th>Date</th>
<th>USD/INR spot rate</th>
<th>USD/INR forward rate for 29 June 2020</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June 2019</td>
<td>71</td>
<td>73.5</td>
<td>-</td>
</tr>
<tr>
<td>31 March 2020</td>
<td>73.2</td>
<td>74</td>
<td>15,000,000</td>
</tr>
<tr>
<td>29 June 2020</td>
<td>74.2</td>
<td>74.2</td>
<td>21,000,000</td>
</tr>
</tbody>
</table>

Forward premium: \((73.5 - 71) \times USD30,000,000 = INR 75,000,000\)

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1. Transaction costs have been ignored for the purpose of this illustration
2. All foreign exchange rates and interest rates considered are for illustrative purposes only, and may not represent the current market condition.
**Accounting issue**

While hedge accounting is not mandatory under Ind AS 109, it may be applied to mitigate uncertainties in cash flows and volatilities in the statements of profit and loss, if the hedge relationship meets the qualifying criteria. The company is required to analyse the underlying transaction, including the relationship between the hedged item (loan of USD30 million taken from Bank L) and the hedging instrument (forward contract) to evaluate if hedge accounting may be applied.

**Accounting guidance**

The forward contract has been acquired to mitigate the variability in income and cash flows arising from exposure to foreign currency risk on the restatement and repayment of the foreign currency loan. The company is required to evaluate if it can designate and account for this hedge relationship as a cash flow hedge under Ind AS 109. Figure 1 below illustrates the qualifying criteria to be met in order to apply hedge accounting to this hedging relationship.

**Figure 1: Qualifying criteria for applying hedge accounting under Ind AS 109**

- **Is there a qualifying hedged item and hedging instrument?**
  - Yes
  - No

- **Is the hedging relationship consistent with the entity’s risk management objective?**
  - Yes
  - No

- **Is there an economic relationship between the hedged item and hedging instrument?**
  - Yes
  - No

- **Does the effect of the credit risk dominate the fair value changes?**
  - Yes
  - No

- **Does the hedge ratio (based on actual quantities used for risk management) reflect an imbalance that would create hedge ineffectiveness?**
  - Yes
  - No

The entity is permitted to apply hedge accounting (Ensure formal designation and documentation)

Hedge accounting cannot be applied
- Measure the hedging instrument at FVTPL
- Measure the hedged item based on applicable Ind AS.

**Source:** Financial Instruments: Application issues under Ind AS, KPMG India’s publication, March 2017

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3. Ind AS 109 defines three types of hedging relationships:
- Fair value hedge
- Cash flow hedge; and
- Net investment hedge.

A "cash flow hedge" is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all of, or a component of, a recognised asset or liability or a highly probable forecast transaction, and could affect profit or loss.
Analysis

The hedged item is a foreign currency borrowing, and would be repaid at the exchange rate existing on the date of repayment of the loan. In order to eliminate or reduce the exposure arising from changes in the cash flows due to changes in the USD/INR exchange rate, the entity may consider applying cash flow hedge accounting for the transaction.

Qualifying criteria

- The USD/INR forward is a derivative transacted with an external party. Therefore, this is a qualifying hedging instrument.
- The foreign currency borrowing has been taken from Bank L, an external party, further, it is reliably measureable. Therefore, it is a qualifying hedged item.
- The entity has identified foreign currency risk as a key financial risk and has documented risk management policies relating to the use of forward contracts and currency swaps to hedge this risk.
- The forward contract to buy USD offsets the foreign currency risk arising from the USD obligation on the foreign currency loan, thus indicating an economic relationship between the hedged item and hedging instrument. Further, since the maturity date of the contract and loan is on 29 June 2020, this indicates that the critical terms of the instruments completely match.
- The company may consider excluding the forward element of the derivative contract from the hedging relationship and designate only the spot element (i.e. changes in spot rates as the hedged risk) in order to prevent the forward element from affecting hedge effectiveness. Under this approach, the forward element may be separately accounted for as a ‘cost of hedging’ based on the guidance in Ind AS 109.
- Both, company B and bank L are highly rated institutions, hence it may be expected that the effect of credit risk would not dominate the fair value changes.
- The notional amount of the forward contract and the amount of the foreign currency loan are identical, indicating a hedge ratio of 1:1. Therefore, the hedge ratio does not reflect an imbalance that would give rise to hedge ineffectiveness.

This analysis indicates that this hedging relationship meets the qualifying criteria.

Hedge designation and effectiveness

Company B has elected to exclude the forward element and designate only the change in spot element of the forward contract as the hedging instrument in a cash flow hedge of foreign currency risk on the forecast purchase. The forward element represents the difference between the forward price and the current spot price (on date of entering into the contract) of the underlying exposure (i.e. the forward premium). The forward element would therefore be separately accounted for as a cost of hedging. This is illustrated separately in this article.

The critical terms of the forward contract exactly match with the foreign currency loan (hedge ratio is 1:1, and date of maturity of the contract matches with the repayment date of the loan). The change in the fair value of the forward contract would exactly offset the change in the fair value of the hedged item, based on changes in spot rates (being the designated risk). Therefore, the hedge relationship is expected to be highly effective in nature and the company may apply cash flow hedge accounting.

Cost of hedging

When the forward element of a forward contract is separated and excluded from the designated hedging instrument, Ind AS 109 requires the change in fair value of such excluded portion to be either recognised at FVTPL or accounted for as cost of hedging. The company has elected to apply the ‘cost of hedging’ approach when recognising the excluded forward element. Since the forward contract is fully aligned with the underlying loan, the total amount of the forward element is considered as the ‘aligned’ component and will be accumulated in a separate component of equity as ‘cost of hedging reserve’.

Cash flow hedge accounting

The company would apply the cash flow hedge accounting model to this hedging relationship. Accordingly, the designated portion (i.e. spot element) and the excluded portion (i.e. forward element) of the forward contract would be accounted as illustrated in figure 2 on the next page.
The effective portion of the change in fair value of the hedging instrument due to a change in spot rates (100 per cent in this illustration) is recognised in a cash flow hedging reserve, which is a component of Other Comprehensive Income (OCI).

Hedge ineffectiveness, being the portion of change in the fair value of the hedging instrument that does not offset changes in the hedged item (nil, in this illustration) is recognised in the statement of profit and loss.

Since the hedged item is a recognised liability, and the hedged risk is foreign currency risk on restatement and repayment of the loan, the accumulated amount is reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the period(s) during which the hedged expected future cash flows affect profit or loss.

The aligned component of the cost of hedging is accumulated in a separate component of equity (cost of hedging reserve) and the remaining component (nil, in this illustration) is recognised in profit or loss.

The accumulated cost of hedging is amortised on a systematic and rational basis over the period during which the hedge adjustment for the designated hedging instrument could affect profit or loss. This period is likely to be the hedged period.
**Accounting entries**

The following are the illustrative accounting entries for the example above (the effect of time value has been ignored for the purpose of this illustration)

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounting entry</th>
<th>Amount (INR in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June 2019</td>
<td>No entry for entering into forward contract since the fair value of the forward contract is nil.</td>
<td></td>
</tr>
<tr>
<td>30 June 2019</td>
<td><strong>Loan received</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash (USD30 million*INR71)</td>
<td>Dr 2,130</td>
</tr>
<tr>
<td></td>
<td>Borrowing</td>
<td>Cr 2,130</td>
</tr>
<tr>
<td></td>
<td>(Recognised loan taken from Bank L)</td>
<td></td>
</tr>
<tr>
<td>31 March 2020</td>
<td><strong>Restatement of loan</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>FOREX gain/loss ((INR73.2-INR71)*USD30 million)</td>
<td>Dr 66</td>
</tr>
<tr>
<td></td>
<td>Borrowing</td>
<td>Cr 66</td>
</tr>
<tr>
<td></td>
<td>(Restatement of foreign currency loan on reporting date)</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Hedge accounting impact on reporting date</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Derivative asset (Fair value of derivative)</td>
<td>Dr 15</td>
</tr>
<tr>
<td></td>
<td>Cost of hedging reserve (forward element)</td>
<td>Dr 51</td>
</tr>
<tr>
<td></td>
<td>Cash flow hedge reserve (spot element)</td>
<td>Cr 66</td>
</tr>
<tr>
<td></td>
<td>(Recognised change in spot element in the cash flow hedge reserve in accordance with cash flow hedge accounting and change in fair value of the aligned forward element in a separate component of equity)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash flow hedge reserve</td>
<td>Dr 66</td>
</tr>
<tr>
<td></td>
<td>FOREX gain/loss</td>
<td>Cr 66</td>
</tr>
<tr>
<td></td>
<td>(Effective portion of cash flow hedge transferred to profit or loss)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Profit and loss (INR75 million/12 months * 9 months)</td>
<td>Dr 56.25</td>
</tr>
<tr>
<td></td>
<td>Cost of hedging reserve</td>
<td>Cr 56.25</td>
</tr>
<tr>
<td></td>
<td>(Amortisation of cost of hedging reserve on a proportionate basis over the period of the hedge)</td>
<td></td>
</tr>
<tr>
<td>29 June 2020</td>
<td><strong>Restatement of loan</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>FOREX gain/loss</td>
<td>Dr 30</td>
</tr>
<tr>
<td></td>
<td>Borrowing</td>
<td>Cr 30</td>
</tr>
<tr>
<td></td>
<td>(Restatement of foreign currency loan on reporting date)</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Hedge accounting impact on reporting date</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Derivative asset (Change in fair value of derivative)</td>
<td>Dr 6</td>
</tr>
<tr>
<td></td>
<td>Cost of hedging reserve</td>
<td>Dr 24</td>
</tr>
<tr>
<td></td>
<td>Cash flow hedge reserve</td>
<td>Cr 30</td>
</tr>
<tr>
<td></td>
<td>(Recognised change in spot element in the cash flow hedge reserve in accordance with cash flow hedge accounting and change in fair value of the aligned forward element in a separate component of equity)</td>
<td></td>
</tr>
</tbody>
</table>
Cash flow hedge reserve  | Dr 30
FOREX gain/loss     | Cr 30
(Effective portion of cash flow hedge transferred to profit or loss)

Profit and loss       | Dr 18.75
Cost of hedging reserve | Cr 18.75
(Amortisation of cost of hedging reserve on a proportionate basis over the period of the hedge)

Interest              | Dr 100.17
Bank                  | Cr 100.17
(Payment of interest on loan at spot rate)

Borrowing (USD30 million*INR74.2)  | Dr 2,226
Bank                  | Cr 2,226
(Borrowing repaid at spot rate on date of repayment)

Bank                  | Dr 21
Derivative asset      | Cr 21
(Settlement of derivative asset)

For foreign currency loans received prior to the beginning of its first Ind AS reporting period, i.e. outstanding as on 1 April 2018, the company might have availed of the provisions in paragraph 46 or 46A of AS 11. These provisions permitted capitalisation of the exchange differences on translation of the loan into the cost of a related asset, or accumulation in a Foreign Currency Monetary Item Translation Difference Account (FCMITDA). In such a case, the company may then elect to continue this accounting treatment for the existing loans under Ind AS, as permitted by Ind AS 101, First-time adoption of Ind AS. Consequently, under Ind AS, the translation difference on the existing loans would then continue to be capitalised into the related asset, or accumulated in FCMITDA and subsequently amortised over the life of the loan.

The principles of Ind AS 109 seem to permit designating these loans as a hedged item in a hedge of foreign currency risk, since the translation differences ultimately affect profit or loss in the form of depreciation or amortisation of FCMITDA. This is supported by guidance in Ind AS 109 that considers a scenario where cash flow hedge accounting is applied to a hedge of the foreign currency risk arising from highly probable forecast transaction to acquire a non-financial asset (e.g. plant and equipment). If the hedged forecast transaction subsequently results in the recognition of a non-financial asset, then Ind AS 109 states that the entity should remove accumulated amount from cash flow hedge reserve and include it directly in the initial cost or carrying amount of the asset.

One could consider that the principles of Ind AS 109 seem to permit designating these loans as a hedged item in a hedge of foreign currency risk, since the translation differences ultimately affect profit or loss in the form of depreciation or amortisation of FCMITDA. However, this issue was considered by the Ind AS Transition Facilitation Group (ITFG). In its third bulletin, ITFG opined that an entity that avails of the option available under Ind AS 101, and continues to capitalise (to the cost of the related asset) the foreign exchange differences arising from a long-term foreign currency loan, has no corresponding foreign currency exposure (arising from that loan) that affects profit or loss. Accordingly, hedge accounting under Ind AS 109 will not be applicable for foreign currency swaps transacted to hedge the foreign currency risk of such foreign currency loans. NBFCs should therefore carefully evaluate these transactions on first-time adoption of Ind AS and monitor further developments in this area.
Consider this

- Hedge accounting may be applied on a transaction-by-transaction basis or for a group of similar transactions.

- One of the critical criteria for an effective hedging relationship is formal designation and documentation of the hedging relationship and other details of the hedged item and hedging instrument. Ind AS 109 does not mandate a specific format for the documentation, accordingly, hedge documentation may vary in terms of layout, methodology and processes used. Various formats are acceptable as long as the documentation includes the essential requirements prescribed in Ind AS 109.

- For transactions recognised directly in equity or in OCI, all current and deferred taxes are also recognised in equity or in OCI. In respect of hedge accounting, this means that current and deferred taxes on gains or losses on hedging instruments recognised in OCI in a cash flow or net investment hedge are also recognised in OCI until such time as the gain or loss is reclassified to profit or loss.

- Designation of a hedging instrument for only a portion of the time that it remains outstanding is specifically prohibited. However, an entity may designate a financial instrument as the hedged item for only a portion of its period to maturity. It is possible to designate a hedging relationship after initial recognition of the hedged item, hedging instrument or both.

- Although Ind AS 109 does not require the costs of hedging to be separately presented in the statement of profit or loss and OCI, they still need to be separately accounted for when they are excluded from the hedging instrument. This is because Ind AS 107 requires disclosure of a reconciliation of each component of equity and an analysis of OCI. Specifically, disclosures are required about:
  - The effective portion of the gain or loss on the hedging instrument when it is initially recognised in OCI and when it is subsequently removed from OCI and
  - Amounts relating to elements excluded from a designated hedging instrument, showing separately the amounts that related to transaction-related hedged items and the amounts that related to time-period related hedged items.

- The choice for separating the forward element from a forward contract and foreign currency basis spreads of a financial instrument is available on a hedge-by-hedge basis and there is no requirement to have a consistently applied policy.