

### **Solution to Hedge Accounting Case Studies:**

Ind AS 109 requires the entity to classify and measure the forward contract (derivative instrument) at fair value through profit or loss (FVTPL). This gives rise to an accounting mismatch and creates volatility in the statement of profit and loss since the corresponding hedged transactions are not recognised until the company receives delivery of the raw materials.

While hedge accounting is not mandatory under Ind AS 109, it may be applied to mitigate the accounting mismatch if the hedge relationship meets the qualifying criteria. The company is required to analyse the underlying transaction, including the relationship between the hedged item (forecast imports in USD) and the hedging instrument (forward contract) to evaluate if hedge accounting may be applied.

The forward contract has been acquired to mitigate the variability in cash flows arising from exposure to foreign currency risk on the forecast import transaction. 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.

Ind AS 109 requires all derivatives to be classified as and measured at FVTPL, giving rise to volatility in profit and loss on each reporting date until maturity of the forward contract. Since the underlying hedged item is a forecast purchase in foreign currency, it does not affect the statement of profit and loss until the transaction occurs, i.e. until the material is delivered. If company A elects to not apply the hedge accounting principles in Ind AS 109, the accounting mismatch in the timing of the impact on the statement of profit and loss will remain.

### **Analysis:**

The company may therefore apply hedge accounting to mitigate this accounting mismatch provided the transactions meet the qualifying criteria under Ind AS 109, as indicated below:

- The USD/INR forward contract is a derivative transacted with an external party. Therefore, this is a qualifying hedging instrument.
- The hedged item is a 'highly probably' forecast purchase in USD that gives rise to foreign currency risk. The transaction may be considered as 'highly probable' based on an analysis of facts and circumstances that includes consideration of the extent and frequency of similar transactions in the past (past trends), quality of the budgeting process (for planned purchases and production), availability of adequate resources to complete the transaction, etc. Therefore, this would be considered to be 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 to hedge this risk.
- The forward contract to buy USD offsets the foreign currency risk arising from the USD obligation on the forecast purchase contract, thus indicating an economic relationship between the hedged item and hedging instrument. However, the maturity date of the forward contract is 31 May 2020 and the

forecast purchase is expected to occur on 15 May 2020, indicating that the critical terms of the transactions are closely aligned but do not completely match (as there would be a difference in the forward rates for the two maturity dates). The company would therefore need to use a quantitative method to establish that this hedging relationship is expected to be highly effective over the hedging period.

- The company may also 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.
- The forward contract has been transacted with a highly rated banking institution. Company A is itself also an investment grade entity based on external credit ratings. Hence, it may be expected that the effect of credit risk would not dominate the fair value changes.
- The notional amounts of the forward contract and the forecast purchase transaction 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. The analysis above indicates that this hedging relationship meets the qualifying criteria.

### **Hedge designation and effectiveness**

The company 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 the date of entering into the contract) of the underlying exposure. The forward element would therefore be separately accounted for as a cost of hedging.

The company may measure hedge effectiveness using the hypothetical derivative method. Under this method, the hedged item is defined as a hypothetical derivative with critical terms that exactly match the forecast purchase transaction, i.e. the hedged item would be a forward contract to purchase USD, maturing on 15 May 2020. Since the notional amounts of the forecast purchase transaction and the forward contract are the same, the hedge ratio is 1:1. 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 a cost of hedging. The company has elected to apply the 'cost of hedging'

approach when recognising the excluded forward element. Ind AS 109 requires this element to be divided into two parts:

- Aligned component – the component of the forward element that relates to the hedged item based on critical terms that exactly match the hedged item. This would be the forward premium for a maturity date of 15 May 2020.
- Remaining component – this is the remaining portion of the forward element that does not relate to the hedged item, i.e. the difference between the forward premium for a 31 May 2020 maturity date and a 15 May 2020 maturity date

The company would apply the cash flow hedge accounting model to this hedge relationship. Accordingly, the designated portion (i.e. spot element) and the excluded portion (i.e. forward element) of the forward contract.

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 forecast purchase results in the recognition of a nonfinancial asset, i.e. inventory, the accumulated effective component is removed from the cash flow hedging reserve and included in the initial cost of the inventory, when the purchase is recognised.
- The aligned component of the cost of hedging is accumulated in a separate component of equity (cost of hedging reserve) and the remaining component is recognised in profit or loss.
- The accumulated cost of hedging is recognised in the initial cost of inventory since the hedged item is a transaction that results in recognition of a non-financial asset.

Date	FV of Fwd contract (A)	FV change in spot element (B)	FV change in excluded element (C) (Refer Note 2 below)	FV change in aligned component (D) (Refer Note 3 below)	FV change in remaining component (E)
	(Change in fwd rates X notional)	(Change in spot rates X notional)	(Change in Fwd premium X notional)	(Change in Fwd premium X notional)	(C-D)
1 March 2020	-	-	-	-	-
31 March 2020	7,27,600	(13,69,600)	6,42,000	8,13,200	(1,71,200)
15 May 2020	5,13,600	(23,11,200)	17,97,600	19,26,000	(1,28,400)
31 May 2020	16,69,200 (Refer Note 1 below)				

- Hedge accounting would cease on occurrence of the forecast purchase transaction on 15 May 2020
- Forward premium of the forward contracts maturing on 31 May 2020 has been considered.
- Forward premium of the hypothetical derivative maturing on 15 May 2020 has been considered.

Date	Journal Entry	Amount (Debit)	Amount (Credit)
1 March 2020	No entry for entering into forward contract as the fair value of the forward contract is nil. No entry for payables/purchases since the procurement/payment will be made in the future.		
31 March 2020	<b>Hedge accounting impact at reporting date</b>		
	Derivative account	727,600	
	Cost of hedging reserve-OCI (aligned forward component)	813,200	

	To Cash flow hedge reserve- OCI (spot element)		13,69,200
	To Profit and loss (remaining forward component)		1,71,200
	<i>(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)</i>		
15 May 2020	<b>Hedge accounting impact on date of purchase</b>		
	Derivative account	5,13,600	
	Cost of hedging reserve- OCI (aligned forward component)	19,26,000	
	Cash flow hedge reserve- OCI (spot element)		23,11,200
	Profit and loss (remaining forward component)		1,28,400
	<i>(Recognised incremental change in spot element in the cash flow hedge reserve in accordance with cash flow hedge accounting and incremental change in fair value of the aligned forward element in a separate component of equity)</i>		
15 May 2020	<b>Actual purchases</b>		
	Purchases/inventory	28,86,43,200	
	Trade payables		28,86,43,200
	<i>(Recognition of purchases at spot rate as on 15 May 2020.)</i>		
15 May 2020	<b>Recycling cumulative gain/loss to cost of inventory on termination</b>		

	<b>of hedge accounting</b>		
	Cash flow hedge reserve	36,80,800	
	Cost of hedging reserve		27,39,200
	Inventory		9,41,600
	<i>(Hedge accounting is terminated on occurrence of the hedged item, i.e. the purchase)</i>		
31 May 2020	<b>Fair valuation of forward contract</b>		
	Derivative account	16,69,200	
	Profit and loss		16,69,200
	<i>(Incremental change in fair value of the forward contract recognised in profit and loss.)</i>		
	<b>Settlement of derivative contract</b>		
	Bank	29,10,400	
	Derivative account		29,10,400
	<i>(Net settlement of the forward contract on maturity)</i>		