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Ind AS Industry Insights
Hedge accounting under Ind AS 109 – Implications for the manufacturing industry

The bottom line

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

What's happened?

Currently, Indian accounting standards do not have a comprehensive framework for derivative instruments and hedge accounting. The current accounting for forward exchange contracts used to hedge existing balance sheet exposures is governed by AS 11 *The Effects of Changes in Foreign Exchange Rates*. Entities were also allowed to manage volatility in profit and loss by optionally adopting hedge accounting described in AS 30 *Financial Instruments: Recognition and Measurement.*

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

Some of the key areas impacting the manufacturing industry are highlighted below.

1. Hedged items

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

The new Standard increases the range of economic hedges eligible for hedge accounting. For the manufacturing industry, this provides greater opportunity to achieve hedge accounting when hedging risk components of inputs or outputs from manufacturing activities.

What was the issue?

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

What has changed?

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

Example – Contractually specified risk components

- Entity P is a large manufacturer with an extensive network of factories and distribution outlets.

Fuel costs are significant. To reduce profit or loss volatility, the entity's risk management strategy allows it to hedge a component of the fuel price risk using diesel swaps for periods of up to three years. Entity P purchases fuel under a five year contract which specifies the formula for diesel price per litre. The amount of fuel to be purchased is not specified but vehicles fill up diesel as required. The volume used is billed on a monthly basis.

In this case, the diesel price risk component is separately identifiable as it is contractually specified and reliably measureable. Entity P can choose to apply cash flow hedge accounting for the highly probable forecast purchase of the first million litres of fuel during each calendar month.

Example – Non-contractually specified risk components

- Entity Q purchases coffee of a particular quality of specific origin under a contract with the supplier. The purchase price comprises (i) a variable element that is linked to the benchmark price for coffee which is of a different grade/quality; and (ii) a fixed spread to reflect the different quality that is being purchased. Entity Q enters into coffee futures to hedge its exposure to variability in cash flows from the benchmark coffee price and designates it as the hedged item. However, the changes in the fixed spread relating to different quality would be excluded from the hedge relationship.

1.2 Fair value option for physically settled commodity contracts

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

What was the issue?

Under AS 30, the physically settled forward contracts from the processing business had to be accounted for as own use contracts, whereas all other contracts were accounted for at fair value through profit or loss. The resulting accounting mismatch did not reflect how the entity managed the overall fair value risk of those contracts.

What has changed?

Upon transition to Ind AS, entities are permitted to designate own use contracts that already exist on the date of transition as measured at fair value through profit or loss (the fair value option) provided such a designation is made for all similar contracts. Going forward, an entity may apply the fair value option to new contracts at the date of inception. However, such designation is only allowed if it eliminates or significantly reduces an accounting mismatch.

Example

Entity X is in the business of procuring, transporting, storing, processing and merchandising sugar. The inputs and the outputs are commodities that are actively traded in liquid markets. The entity has both a broker business and a processing business, which are operationally distinct. However, Entity X analyses and monitors its net commodity risk position comprising the following – inventories; physically settled forward purchase and sales contracts; and exchange traded futures and options. The target is to keep the net fair value risk position close to nil.

2. Hedging instruments

2.1 Hedging with option contracts

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

What was the issue?

The fair value of an option consists of the intrinsic value and the time value. When using option contracts for hedging, only the intrinsic value is used for offsetting the fair value changes attributable to the hedged risk. Entities may designate an option as a hedging instrument in its entirety, or may separate the time value and designate only the intrinsic value. There is no change to this approach. However, under AS 30, the change in time value was recognized in profit or loss either way – (i) if the option was designated in its entirety, there was greater ineffectiveness resulting in a failed prospective assessment test with possible discontinuation of hedge accounting; (ii) if only the intrinsic value was designated, the time value would be accounted for at fair value through profit or loss, resulting in volatility in profit or loss.

What has changed?

Ind AS 109 does not change how an option is designated in a hedge relationship ie., in its entirety or just the intrinsic value. However, the new standard requires the change in the time value of an option, which can be volatile, to be recognised initially in other comprehensive income (OCI) with subsequent recognition as a basis adjustment or in profit or loss on a more predictable basis (e.g. amortised over the life of the hedge or recognised as a single amount when the hedged item affects profit or loss).

Example

Entity Y is a manufacturer with INR as its functional currency and is in the process of purchasing new plant and machinery from a supplier in Europe. The purchase price is EUR 10 million and delivery is expected in 9 months' time. Entity Y is exposed to foreign currency risk on this highly probable forecast transaction. The entity's risk management strategy is to hedge the downside risk by purchasing a call option for the foreign currency amount of EUR 10 million and designating only the intrinsic value of the call option. When the call option was purchased at inception, the time value was EUR 100,000. In this example, any fair value changes attributable to the time value of the option would be recognized in OCI until the machinery is purchased and adjusted as a basis adjustment to the cost of the machinery rather than in profit or loss.

2.2 Forward element of forward contracts

What was the issue?

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

What has changed?

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

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

Example

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

2.3 Synthetic or aggregated exposures

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

What was the issue?

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

What has changed?

Under Ind AS 109, exposures that include derivatives (i.e. synthetic exposures) can be designated as eligible hedged items. Therefore, if an additional derivative is added to the hedge relationship at a subsequent date, it would not be necessary to discontinue and re-designate the original hedge relationship. This change should enhance the effectiveness of such hedges and make hedge accounting more achievable in practice.

Example

Consider Entity Z with INR functional currency that has a forecast USD steel exposure hedged at $100 with a steel futures contract designated in a hedging relationship. Unlike the previous requirements, Ind AS 109 allows the synthetic fixed price $100 exposure to be treated as a hedged item in a subsequent hedge of the FX risk even though this hedged item includes a derivative (i.e. it includes the steel futures contract).

3. Effectiveness testing

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

Things to consider now

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

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

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