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FIRST NOTES
KPMG in India

The ICAI issues a guidance note on accounting for derivative contracts

18 May 2015

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Sector:

All

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Relevant to:

All

Audit committee

CFO

Others

Transition:

Immediately

Within the next 3 months

Post 3 months but within 6 months

Post 6 months

Background

There has been some lack of guidance on the accounting for derivative contracts and hedging activities. In order to bring uniformity of practice in accounting for derivative contracts by various entities in India, on 12 May 2015, the ICAI issued a guidance note of accounting for derivative contracts (guidance note).

This guidance note provides guidance on recognition, measurement, presentation and disclosure for derivative contracts. The 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.

The guidance note is an interim measure (till Ind AS 109, *Financial Instruments* is applicable) 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. For certain entities that do not require to move to Ind AS, this guidance note may have an enduring impact.

The guidance note also provides illustrative examples for application of the guidance note. The guidance note becomes applicable for accounting periods beginning on or after 1 April 2016. Early voluntary adoption is encouraged.

This issue of First Notes highlights key aspects of this guidance note, which are as follows:

- Scope
- Accounting of derivatives
- Hedge accounting
- Presentation and disclosures in the financial statements
- Transitional provisions
- Comparison with AS 30, *Financial Instruments: Recognition and Measurement*.

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History of authoritative guidance on derivative accounting in India

- In 2007, the ICAI issued AS 30*, Financial Instruments: Recognition and Measurement* and AS 31, *Financial Instruments: Presentation* which were recommendatory in nature for an initial period of two years. Both these standards were to be effective from accounting periods commencing on or after 1 April 2011. While these standards provide persuasive guidance, they have not been made mandatory for application by companies till date.

- In March 2008, the ICAI issued an announcement relating to the accounting of derivatives. According to the announcement, if an entity did not follow AS 30, keeping in view the principle of prudence as stated in AS 1, *Disclosure of Accounting Policies*, the entity was required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market. This became applicable for financial statements for the period ended 31 March 2008, or thereafter. In case of forward contracts to which AS 11, *the Effects of Changes in Foreign Exchange Rates,* applies, entities need to fully comply with the requirements of AS 11.

- Currently, prior to the issuance of the guidance note, 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 for hedge highly probable forecast transactions and firm commitments are outside the scope of AS 11.

Scope: key aspects of the guidance note

The guidance note covers all derivative contracts that are not covered by an existing notified accounting standard. It also provides guidance on accounting of assets covered by AS 2, *Valuation of Inventories*, AS 10, *Accounting of Fixed Assets*, 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. Accordingly, guidance for accounting for derivatives and hedging relationships which pertain to hedged items covered under such notified accounting standards, e.g. a commodities stock, fixed assets, investments, etc. is provided in this guidance note. AS 11 continues to provide guidance specific to foreign currency forward contracts.

The guidance note applies to following derivative contracts whether or not used as hedging instruments:

- 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)

- Other foreign currency derivative contracts such as cross currency interest rate swaps, foreign currency futures, options and swaps not in the scope of AS 11

- Other derivative contracts such as traded equity index futures, traded equity index options, traded stock futures and option contracts, and

- Commodity derivative contracts.

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

Scope exclusions

The guidance note does not apply in the following cases:

- Foreign exchange forward contracts covered under AS 11 e.g.,
  - 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

- Derivatives that are covered by regulations specific to a sector or specified set of entities e.g. entities such as banking, non-banking finance companies (NBFCs), housing finance companies, insurance entities, etc. where the concerned regulator has prescribed accounting treatment for derivative contracts. If the concerned regulator has not prescribed any accounting treatment for derivative contracts, the recommendations contained in the guidance note should be followed.

- Accounting for embedded derivative contracts is not covered since there are potential conflicts with the requirements of certain other notified accounting standards such as AS 2*,* AS 13, etc.

- Entities that have adopted Indian Accounting Standards (Ind AS).

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Accounting for derivatives

The guidance note includes definitions of various terms such as derivative, firm commitment, forecast transaction, hedging instrument, hedged item, hedge effectiveness, etc.

It requires all derivatives to be recognised on the balance sheet and measured at fair value. Fair value in the context of derivative contracts represents ‘exit price’.

The guidance note defines exit price as 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.

The accounting for derivatives covered by this guidance note is based on the following 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 for 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

The 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.

Hedge accounting

The guidance note provides detailed guidance in cases where an entity designates a derivative contract as a hedge instrument which is as follows:

- Designation of a derivative contract as a hedging instrument is optional. However, once it is applied, it needs to be based on the entities risk management objectives and goals and then can not be subsequently turned off or on if the risk management objective remains the same.
- Lays down minimum steps to be followed by an entity in cases where it designates a derivative contract as a hedge instrument.
- Clarifies that derivatives cannot be designated for a partial term of the derivative instrument.
- Recognises three types of hedges and lays down accounting and measurement principles relating to (i) fair value hedge accounting model (ii) cash flow hedge accounting model, and (iii) net investment hedging.
- Provides for elaborate documentation of hedge relationship at inception of a hedge and must include descriptions as prescribed in the guidance note.
- Prescribes that an entity should assess whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity should perform the ongoing assessment at each reporting date or when there is a significant change in the circumstances that affect hedge effectiveness requirements, whichever comes first.
- Does not prescribe bright-line tests for effectiveness assessments; instead requires disclosure of the entities risk management objectives and measures for assessing, if these objectives are met.
- Does not 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.
- Prohibits voluntary hedge de-designation if risk management objectives and hedging instruments are unchanged.

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Presentation and disclosures in financial statements

The guidance note provides that derivative assets and liabilities recognised in a balance sheet at fair value should be presented as current and non-current and explains guidance on such presentation. An entity is required to disclose its financial risks, methodologies used to arrive at fair value of derivative contracts, extent of fair value gains/losses recognised in the financial statements, its risk management policies, etc. Further, specific disclosures are required for outstanding hedge accounting relationships.

Transitional provisions

The guidance note applies to all derivative contracts covered by it and are outstanding as on 1 April 2016. Any cumulative impact (net of taxes) should be recognised in reserves as a transition adjustment and disclosed separately. Retrospective application of hedge accounting (as recommended in this guidance note) is not permitted.

Comparison with AS 30

Compared to the earlier guidance under AS 30, hedge accounting is considerably easier to apply in many situations and in particular there is additional guidance on the following aspects:

- Synthetic accounting
- Fair value of derivatives – focus on exit price
- Situations where the hedged item is covered by an existing notified standard (AS 10, AS 13, and AS 11)
- The application of this guidance to non-foreign currency derivatives
- What constitutes a hedgable risk including aggregated and net exposures and components of non-financial items
- Which instruments can qualify as hedging instruments including improving the ability to hedge with options
- Removes bright line 80/125 per cent hedge effectiveness test requirements
- Allows for qualitative assessments in certain situations
- Clarifies that permissibility (e.g. Reserve Bank of India) of a product is not adequate to qualify for hedge accounting
- Permits basis adjustments for hedges relating to recognition of non-financial items
- Prohibits voluntary hedge de-designation if risk management objectives and hedging instruments are unchanged
- Presentation in the financial statements including guidance on current vs non-current designation.

Our comments

- To a large extent, entities already following AS 30 type accounting policies and guidance may not be impacted and transition to this guidance note is expected to be relatively smooth for such entities. The change for other entities, could however, be significant.
- The guidance note is expected to be easier to apply in many situations as compared to guidance in AS 30.

The bottom line

Though the guidance note is only an interim measure and provides recommendatory guidance on accounting for derivatives till Ind AS is implemented in India, it may however bring about uniformity of practice for entities in India. It may also bring about greater transparency in the area of derivative and hedge accounting.

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KPMG in India

Ahmedabad
Commerce House V, 9th Floor 902
& 903, Near Vodafone House
Corporate Road, Prahaladnagar
Ahmedabad 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bengaluru 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Centre
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604, 6th Floor, Tower - 1,
Godrej Waterside, Sector – V,
Salt Lake, Kolkata - 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3058 5764/65
Fax: +91 20 3058 5775

Introducing KPMG in India IFRS Institute

KPMG in India is pleased to re-launch IFRS Institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

IFRS Notes

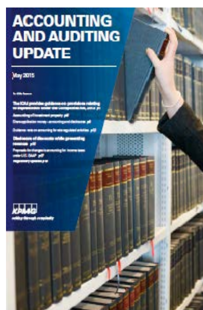
The IASB proposes to defer the effective date of the new revenue standard

On 28 April 2015, the International Accounting Standards Board (IASB) voted to publish an exposure draft (ED) proposing a one-year deferral of the effective date of the revenue standard to 1 January 2018.

The IASB and FASB Joint Transition Resource Group have discussed a number of application issues and some companies have called for more time to implement the new requirements, due to the significance of the changes they may face and the complexity of the IT solutions needed. The U.S. Financial Accounting Standards Board (FASB) has voted to propose a one-year deferral of the effective date of the standard earlier in April 2015. Accordingly, the IASB is planning to issue an ED with proposed clarifications to the standard as well as to keep the effective date of the IASB's and the FASB's revenue standard aligned.

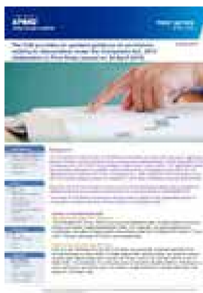
The IASB will consult on the proposed deferral of the effective date by one-year before it is confirmed, as it is required by its due process. Early application of the standard would, however, still be permitted.

Missed an issue of Accounting and Auditing Update or First Notes?



The May 2015 edition of the Accounting and Auditing Update captures the recent issue of the application guide on the provisions of Schedule II to the Companies Act, 2013. This month we cover an overview of the Real Estate Investment Trust (REIT) Regulations issued by the Securities and Exchange Board of India (SEBI) and also discuss the relevant accounting requirements for an investment property under Ind AS. We also highlight the requirements of the Companies Act, 2013 with respect to the share application money and bring out key differences vis-à-vis Companies Act, 1956. The Institute of Chartered Accountants of India (ICAI) recently issued a guidance note on accounting for rate regulated activities. We have provided an overview of the requirements of the guidance note in this issue. In addition, we cast our lens on the recently issued ICAI's Expert Advisory Committee's opinion on accounting of discounts by a company. We also provide a perspective as per Ind AS 115, *Revenue from Contracts with Customers*, on the accounting treatment of discounts.

Finally, in addition to our regular round up of regulatory updates, we have also provided an update on the proposed amendment on accounting for income taxes on intercompany transfers and balance sheet classification of deferred tax asset and liability including transition guidance under the U.S. GAAP.

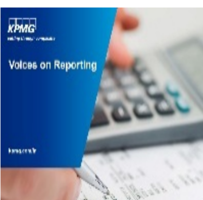


The ICAI provides an updated guidance on provisions relating to depreciation under the Companies Act, 2013

(Addendum to First Notes issued on 24 April 2015)

On 10 April 2015, the Institute of Chartered Accountants of India (ICAI) issued an application guide to address certain practical issues arising in the implementation of the Schedule II to the Companies Act, 2013 (2013 Act) relating to depreciation of the assets. The application guide also provides examples for a better understanding of the Schedule II to the 2013 Act. As opposed to the Schedule XIV of the Companies Act, 1956, the Schedule II to the 2013 Act brings along a number of changes in how Indian companies compute depreciation.

Recently, the ICAI issued a revised version of the application guide which provides an updated guidance for computing depreciation for assets working in double/triple shift. Our issue of First Notes summarises key aspects added by the application guide on computation of depreciation for assets working in double/triple shift.



KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

On 22 April 2015, we covered following topics :

(1) an overview of key changes and implementation challenges for companies that adopt ICDS from this year

(2) an overview of the financial reporting and regulatory developments introduced under the Indian GAAP during the year ended 31 March 2015.

Feedback/queries can be sent to aaupdate@kpmg.com

Back issues are available to download from: www.kpmg.com/in

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