PRESENTATION
ON FORWARD CONTRACT SCENARIOS

AS- 11 AND NECESSITY OF AS- 30

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Accounting Treatment of Forward Cover in Different scenario

AGENDA

- Forward Exchange Contract;
- Understanding Forward Exchange Contract;
- Types of Examples on Forward Exchange Contracts;
- Forward Exchange Contract for hedging the existing asset/liability;
- A Case Study of above;
- Forward Exchange Contract for Trading/Speculation;
- Forward Exchange Contract for Firm Commitment/Highly probable Forecast Transaction;
- ICAI Announcement – ACCOUNTING FOR DERIVATIVES;
- What is Derivative Contract;
- Understanding MTM;
- A Case Study on Firm Commitment (AS 30);
- Concept of Hedge Effectiveness Test; and
- Suggested Accounting Policy.

FORWARD EXCHANGE CONTRACT

Forward exchange contract means an agreement to exchange different currencies at a forward rate. (Ref: Para 7.8 of AS 11)

Date?

Qty?

Rate?

That means: "Contract to deliver/ receive "specified quantity" of foreign currency at a "specified rate" (forward rate) and on a "specified date".

FORWARD EXCHANGE CONTRACT

Example: Forward Exchange Contract Entered into for ***Hedging*** Purposes (accounting treatment as per Para 36 & 37 of AS 11)

On 1st January, 2005, 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 30th June, 2005. On 1st January 2005 itself, the company entered into a forward exchange contract for the transaction to mitigate the risks associated with changes in exchange rates.

The exchange rates (Rs. per US $) are as below:

Period	1.1.2005	31.3.2005	30.06.2005
Spot rate	45	47	52
Forward rate (for six months)	48	-	-
Forward rate (for three months)	-	51	-

In above case,

Underlying Liabilities: Loan payable

Risk: Exchange rate as on 30.6.2005 (at the time of repayment of loan)

Hedging: to minimize the Exchange rate risk

Underlying items, Risk and hedging condition are satisfy in above example and based on that this transactions are accounted as per Para 36 & 37 of AS 11.

Example: Forward Exchange Contract Entered into for **trading/ speculation** Purposes (accounting treatment as per Para 38 & 39 of AS 11)

On 1st January 2005, company entered into a forward exchange contract

Period	1.1.2005	31.3.2005	30.06.2005
Spot rate	45	47	52
Forward rate (for six months)	48	-	-
Forward rate (for three months)	-	51	-

As in above example, there is no underlying item so that we can say that company has entered into a forward exchange contract for Trading / speculation purpose.

Example: Forward Exchange Contracts entered into to Hedge the Foreign Currency Risk of **Firm Commitments or Highly Probable Forecast Transactions** (accounting treatment as per ICAI an Announcement on Announcement - ACCOUNTING FOR DERIVATIVES, 2008)

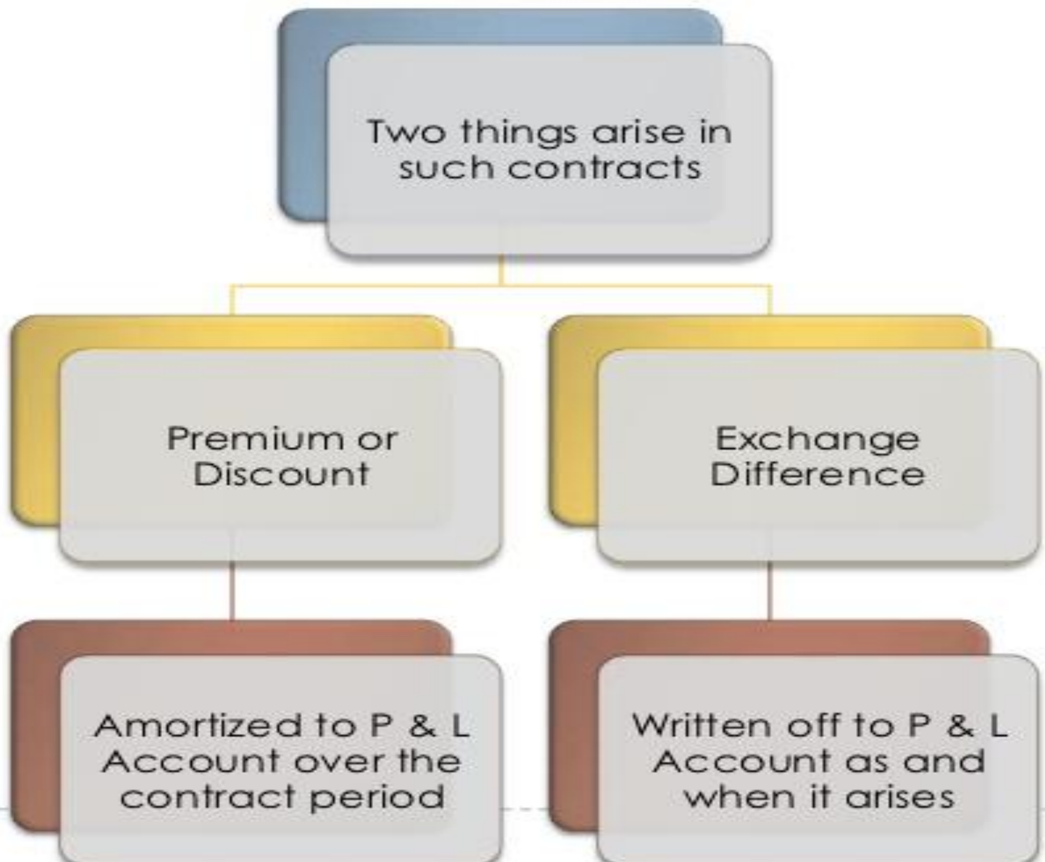
On 1st January 2005, company entered into a forward exchange contract for a contract of purchase of material US $ 1 Lakh as on 1.6.2005 and settlement on 30.6.2005

Period	1.1.2005	31.3.2005	30.06.2005
Spot rate	45	47	52
Forward rate (for six months)	48	-	-
Forward rate (for three months)	-	51	-

As on 1.6.2005, spot rate is Rs. 50

HEDGING

As per Para 37 of AS-11, Any risk associated with changes in exchange rates may be mitigated by entering into forward exchange contracts.



AS -11 {FORWARD EXCHANGE CONTRACT FOR HEDGING PURPOSE}

FORWARD CONTRACT TO BUY THE FOREIGN CURRENCY

An Importer has USD 5000 payable in 6 months.

	1st Jan	31st March	30th Jun
Spot	**47**	**47.20**	**47.60**
Fwd Rate (6 Months)	**47.50**		

Pass Journal Entries.

1st Jan

Purchases A/c Dr. 23, 50,000
To Sundry Creditors A/c 23, 50,000
(Procured for USD 50000 @47/-)

Fwd Contract Receivable A/c Dr. 23, 50,000
Fwd Prem. /Disc. – Deferred A/c Dr. 25,000
To Fwd Contract Payable A/c **23, 75,000**
(Fwd Cover taken @ 47.50 for USD 50000)

31st March

FE Gain/Loss A/c Dr. 10,000
To Sundry Creditors A/c 10,000
(Restatement of Sundry Creditors on 31st March)
(47.20 – 47) x USD 50000

Fwd Contract Receivable A/c Dr. 10,000
To FE Gain/Loss A/c 10,000

Profit & Loss A/c Dr. 12,500
To Fwd Prem. /Disc. – Deferred A/c 12,500
{Amortization of Fwd premium i.e. (25000/6)*3 Months}

<u>30th Jun</u>

FE Gain/Loss A/c Dr. 20,000
To Sundry Creditors A/c 20,000
(Restatement of Sundry Creditors on 30th June)
(47.60 – 47.20) x USD 50000

Fwd Contract Receivable A/c Dr. 20,000
To FE Gain/Loss A/c 20,000

Sundry Creditors A/c Dr. 23, 80,000
To Bank A/c 23, 80,000
(USD 50,000 @47.60 Paid off)

Fwd Contract Payable A/c Dr. **23, 75,000**
Bank
(Spot – Fwd Rate)X USD Paid:
(47.60-47.50) x USD 50000 Dr. 5,000

To Fwd Contract Receivable A/c 23,80,0000

Note : In Imports, Liability i.e. Payable is Fixed and hedged to create Assets i.e. Fwd Contract Receivable by way of Forward Cover.For which Gians/Losses in Payable is set off against Receivable.

Forex Forward Contracts for Trading or Speculation

- When foreign exchange contracts are entered to earn profit by trading or speculation, the accounting treatment shall be different since the object is to gain rather than hedging.
- As per Para 39 of AS-11, premium or discount on such forwards need not be recognised.
- It means that the value of contract is marked to its current market value.

FIRM COMMITTTMENTS OR HIGHLY PROBABLE FORECAST TRANSACTIONS

AS 11 (revised 2003) is not applicable to forward exchange contracts entered into in respect of firm commitments or highly probable forecast transactions.

A 'firm commitment' is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. (Commercial Invoice based forwards : Underlying).

'Forecast transaction' is an uncommitted but anticipated future transaction.(Past performance based forwards)

ICAI Announcement – ACCOUNTING FOR DERIVATIVES

- ICAI has come out with the announcement in Feb' 2011, on application of AS 30, Financial Instruments: Recognition and Measurement, which contains accounting for derivatives.

- This is subject to any existing accounting standard or any regulatory requirement, which will prevail over AS 30.

ICAI Announcement – ACCOUNTING FOR DERIVATIVES

In case an entity does not follow AS 30, keeping in view the principle of prudence as enunciated in AS 1, Disclosure of Accounting Policies, the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market.

ICAI Announcement – ACCOUNTING FOR DERIVATIVES

- The entity needs to disclose the policy followed with regard to accounting for derivatives in its financial statements;
- The Auditors should consider making appropriate disclosures in their reports if the aforesaid accounting treatment and disclosures are not made.

ICAI Announcement – ACCOUNTING FOR DERIVATIVES

AS 30 requires the following:

- If Hedge accounting is not followed, then mark all forward contracts to market, and dispose of the resultant changes being gain or loss to P&L.

- If Hedge accounting is followed, the gain or loss in fair value will be accumulated in a separate equity reserve (Hedging Reserve).

Possible Accounting Treatment

i. If there is a proper documentation (all invoices and Purchase Orders),
ii. Hedge effectiveness test (80% to 125% of Contracted Rate) at every quarter end; and
iii. Quarterly Certifications by Statutory Auditor.

<u>DERIVATIVE CONTRACT</u>

<u>FINANCIAL CONTRACT</u> (e.g. FORWARDS/ OPTIONS/ SWAPS/ FUTURES)

→ DERIVED FROM → VALUE OF EXPECTED FUTURE PRICE MOVEMENTS OF → UNDERLYING ASSETS.

THIS IS USED AS AN INSTRUMENT TO HEDGE RISK FOR ONE PARTY OF CONTRACT.

MTM : “Mark to Market”

MTM : “Mark to Market” means that the carrying amount of the contract will be restated using a forward rate applicable for the remaining unexpired period of the contract.

For Example, if a contract fixes the forward rate on 1-12-2013 as USD 1 = ` 65 as the rate for a transaction to be done after six months i.e. 31-05-2014, then as on 31-03-2014, which is Balance Sheet Date, we will have to check the forward rate available in the market for remaining two months (01-04-2014 to 31-05-2014), which may be, say, USD 1 = ` 66, and use this rate for restating the forward contract.

AS 30 – Illustration

- Entered into a USD 100 payable commitment to import raw materials on 1st Jan;
- Delivery of Raw Material is on 31st December and payment on same date;
- On 1st Jan , Entity enters into Fwd Contract to hedge the risk;
- As part of Hedging Policy, the entity first enters for shorter period till 30th Jun; and
- Roll it over on 30th Jun to meet the Cash flow on 31st Dec

	1st Jan	31st Mar	30th Jun	30th Sep	31st Dec
Spot	42	43	**43.75**	44.25	43.50
Fwd Rate (30th Jun)	42.50	**43.50**			
Fwd Rate (31st Dec)			44.00	44.50	43.50
MTM **(Incremental Fwd Rate)**	Nil	1	0.25	0.50	- 1.00
Cum. MTM	Nil	1	1.25	1.75	0.75

Pass Journal Entries.

<u>1st Jan</u>

Fair value of Contract is "Nil". No Entry is required in financial books.

<u>31st Mar</u>

Derivative Assets A/c Dr. 100
To Hedging Reserve A/c 100
(MTM Gain on Contract i.e. USD 100 @ 1/=)

<u>30th Jun</u>

Commitment is not recognized. Contract is rolled forward. Rolled over Contract is new contract as part of existing Hedging Strategy. It is still a Cash Flow Hedge.

Derivative Assets A/c Dr. 25
To Hedging Reserve A/c 25
(MTM Gain on Contract i.e. USD 100 @ 0.25)

Bank A/c Dr. 125
(Spot – Fwd Rate)X USD Paid:
(43.75-42.50) x USD 100
To Derivative Assets A/c 125

<u>30th Sep</u>

Derivative Assets A/c Dr. 50
To Hedging Reserve A/c 50
(MTM Gain on Contract i.e. USD 100 @ 0.50)

31st Dec

Purchases A/c Dr. 4350
To Sundry Creditors A/c 4350
(Purchase at Spot Rate: 43.50 x USD 100)

Sundry Creditors A/c Dr 4350
To Bank A/c 4350
(Payment of liability to vendor)

Hedging Reserve A/c Dr 100
To Derivative Assets A/c 100
(MTM Loss on Contract i.e. USD 100 @ 1/=)

Derivative Asset A/c Dr. 50
To Bank A/c 50
Net Settlement Loss paid to Bank (Spot – Fwd Rate)X USD Paid: (43.50-44.00) x USD 100

Hedging Reserve A/c Dr. 75
(Balancing Figure)
To Purchases A/c 75
(Balance in Hedging Reserve transferred to Cost of Goods Sold)

Check : Purchase = Original Spot+ Fwd Premium =
= 42+0.50 (Fwd Premium-I)+0.25 (Fwd Premium-II)x USD 100
=4275/=

HEDGE EFFECTIVENESS

CASH FLOW HEDGE

FORWARD CONTRACTS OUTSTANDING

30-Jun-13

Date/ Month of maturity of forward cover	Date of Inception of Forward Contract	Foreign Currency	Spot Rate as on the date of forwarc contract	Forward rate	Spot Rate as on Reporting Day	Forward rate on reporting date for the resepective maturity date	Dis rate	Balance no of months to maturity	Discounted forward contract rate	Discounted forward rate as at reporting date for resepective maturity date	CHANGE IN SPOT RATE	CHANGE IN DISCOUNTED FWD RATE	Effectiveness	If ineffective, take to P&L
Effectiveness testing, when the liability is recognised:														
Jul-13	22-Jan-13	USD	53.05	55.2000	59.36	60.02	7.50%	1	54.87	59.66	-6.31	(4.79)	132%	
Aug-13	15-Feb-13	USD	53.42	55.3100	59.36	60.66	7.50%	2	54.65	59.93	-5.94	(5.29)	112%	

Effectiveness testing, when the liability is yet to be recognised:

Date/ Month of maturity of forward cover	Date of Inception of Forward Contract	Foreign Currency	Spot Rate as on the date of forwarc contract	Forward rate	Spot Rate as on today	Forward rate on reporting date for the resepective maturity date	Dis rate	Balance no of months to maturity	Discounted forward contract rate	Discounted forward rate as at reporting date for resepective maturity date	CHANGE IN SPOT RATE	CHANGE IN DISCOUNTED FWD RATE	Effectiveness	If ineffective, take to P&L
Sep-13	4-Mar-13	USD	54.42	56.6900	59.36	61.28	7.50%	3	55.67	60.18	-4.94	(4.51)	110%	
Oct-13	15-Apr-13	USD	54.23	56.2600	59.36	61.88	7.50%	4	54.92	60.41	-5.13	(5.49)	94%	
Nov-13	14-May-13	USD	54.29	56.1100	59.36	62.47	7.50%	5	54.44	60.62	-5.07	(6.17)	82%	
Dec-13	5-Jun-13	USD	55.87	58.1800	59.36	63.06	7.50%	6	56.11	60.82	-3.49	(4.70)	74%	-4.70

SUGGESTED ACCOUNTING POLICY

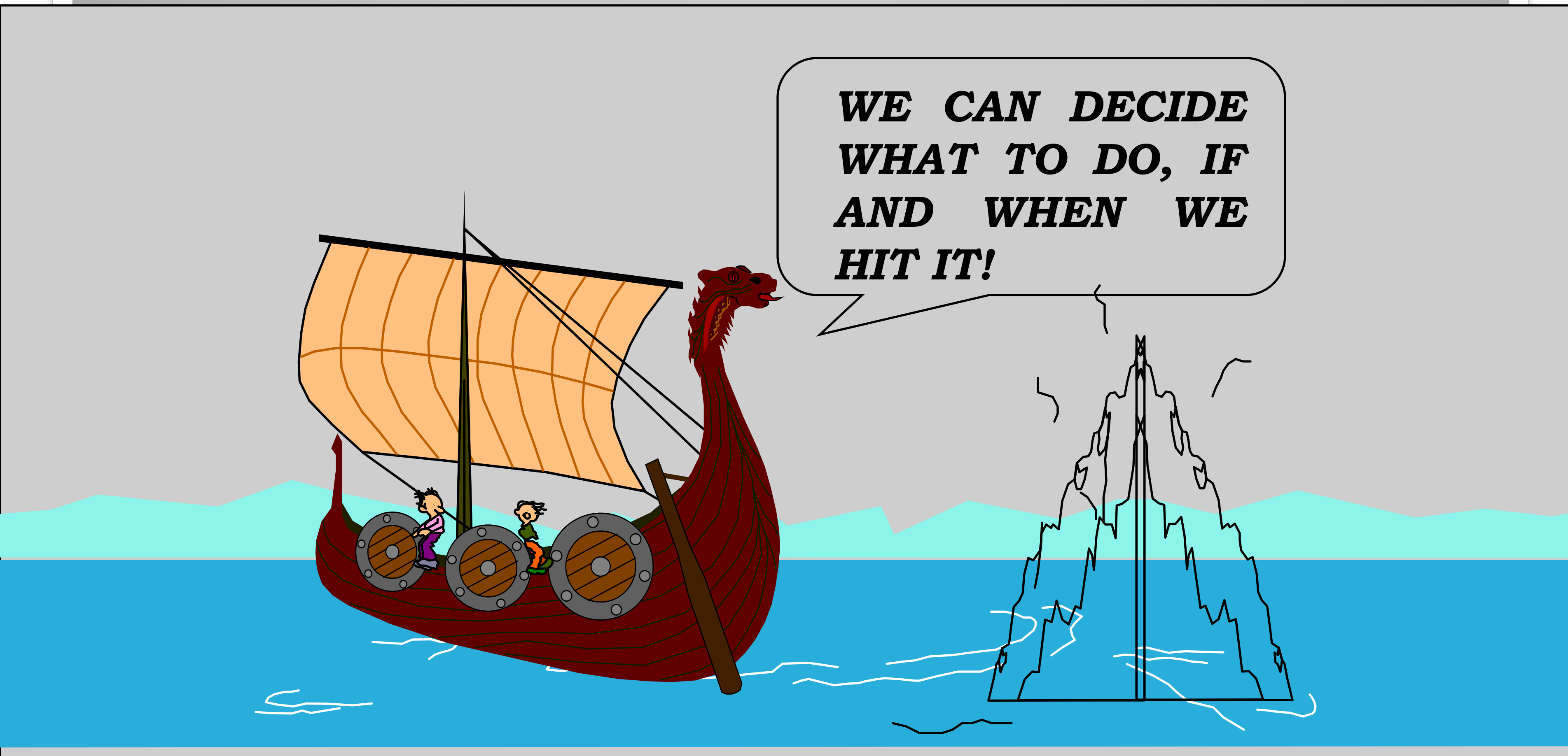
The present accounting policy on forex transactions should be continued as it relates to AS-11. An additional policy may be added as under for Hedge Accounting -Accounting policy Suggested as applicable, if AS 30 is adopted.

“The Company is exposed to foreign currency fluctuations on foreign currency assets, liabilities, firm commitment and forecasted cash flows denominated in foreign currency. It uses foreign currency forward contracts to hedge its risks associated with foreign currency fluctuations and enters into forward contracts, where the counterparty is a bank. The use of foreign currency forward contracts is governed by the company's policies approved by the board of directors. It does not use derivative financial instruments for speculative purposes.”

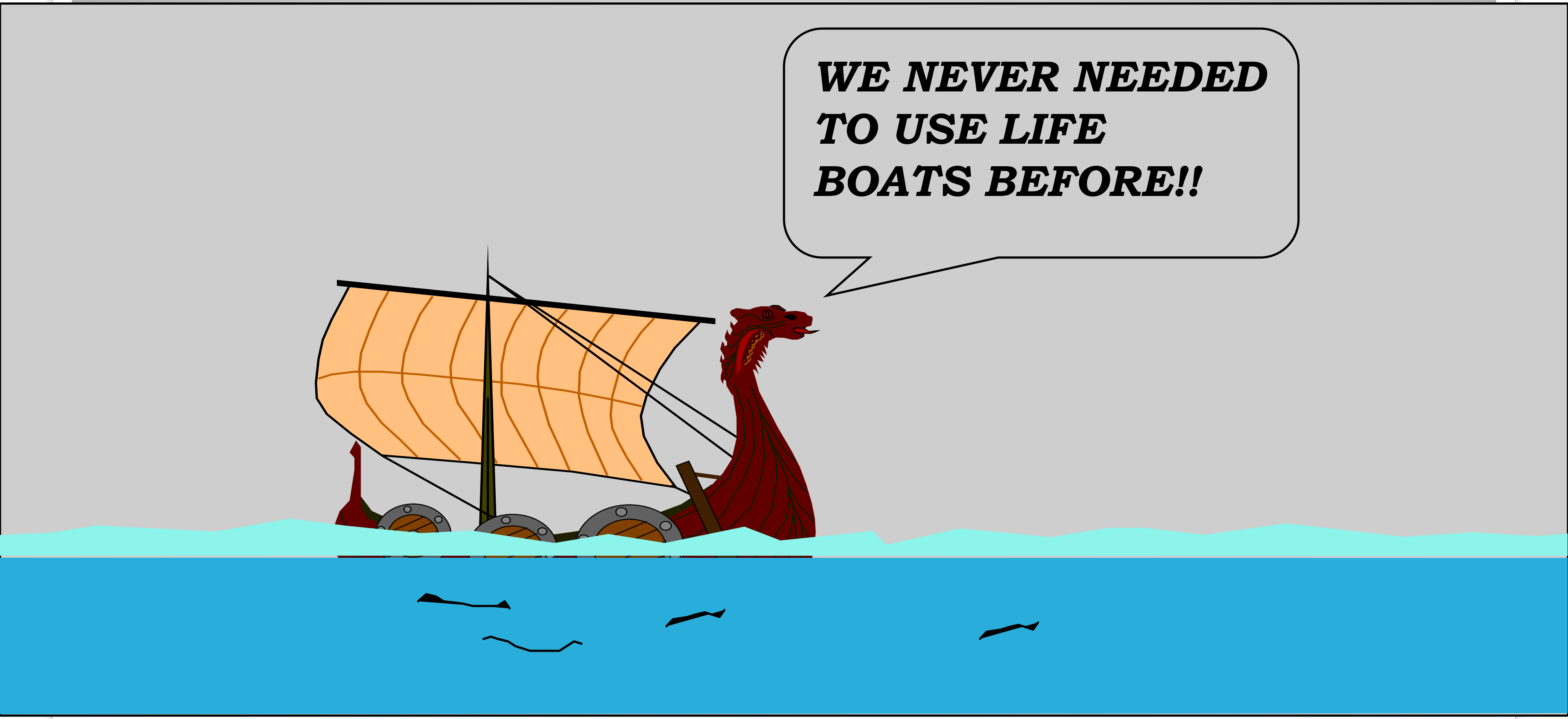
“The company has adopted Accounting Standard 30 (AS 30) "Financial Instruments: Recognition and Measurement", and accordingly, the changes in the fair values of forward contracts designated as cash flow hedges are recognized directly in 'Hedging Reserve Account' which is part of shareholders' funds and recognized in the Profit and Loss Statement upon the occurrence of the hedged transactions. The changes in fair value relating to the ineffective portion of the cash flow hedge derivative contracts, if any, are recognized in the Profit and Loss Statement of every reporting period.”

Successful Risk Management

Successful Risk Management



Successful Risk Management

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