

Ind AS 109 Financial Instruments

Derivatives and Hedge Accounting

Agenda

- ▶ Derivatives
 - ▶ Meaning
 - ▶ Types of derivatives
 - ▶ Embedded derivatives
 - ▶ Separation and accounting of embedded derivatives
- ▶ Hedge accounting
 - ▶ Qualifying hedge instruments
 - ▶ Qualifying hedge items
 - ▶ Hedged risks
 - ▶ Hedge accounting models

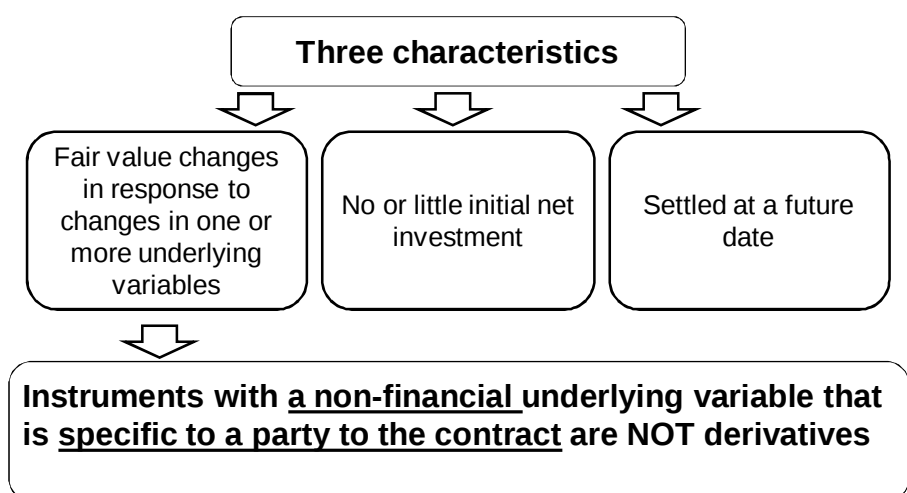
Derivatives including embedded derivatives



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Derivative definition



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Example-non financial underlying variable

Non-financial variables that are not specific to one party to the contract may include an index of earthquake losses in a particular region or an index of temperatures in a particular city.

Non-financial variables that are specific to one party to the contract- Linked to credit rating of the party to the contract

Examples of derivatives and underlyings

Type of contract		Main variable
Interest rate swap	→	Interest rate
FX forward	→	Foreign exchange rate
Commodity option	→	Commodity price
Credit default swap	→	Credit risk
Purchased or written stock call or put option	→	Equity price

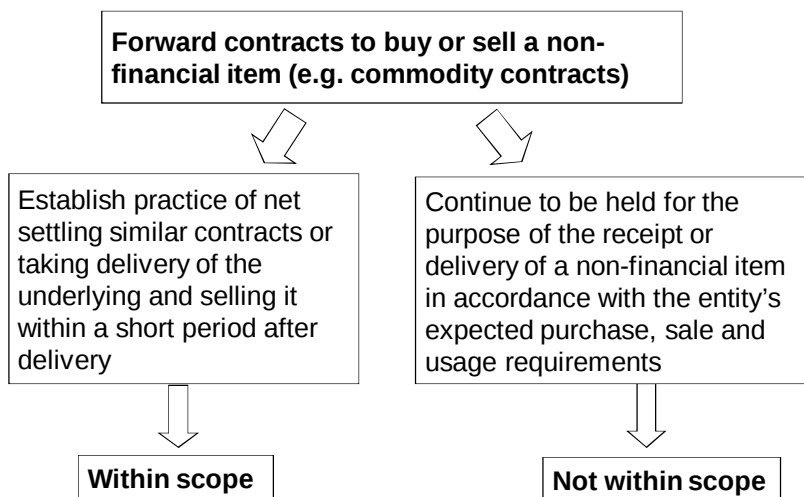
Why do entities use derivatives?

1. To manage risks

- ▶ Of price changes – e.g., fluctuating:
 - ▶ Exchange rates
 - ▶ Interest rates
 - ▶ Prices (shares, bonds, commodities, etc.)
- ▶ Of other causes – e.g.:
 - ▶ Default
 - ▶ Bad weather and other reasons

2. To speculate

Scope: Non-financial item contracts



Example – normal purchase/ sale exemption

- ▶ Company XYZ enters into a fixed-price forward contract to purchase 1,000 kg of copper in accordance with its expected usage requirements.
- ▶ The contract permits XYZ to take physical delivery of the copper at the end of twelve months, or to pay or receive a net settlement in cash, based on the change in fair value of copper.

Whether the contract is entitled to normal sale/ purchase exemption?

Response – example

- ▶ Contract has all characteristics of a derivative instrument
 - ▶ There Is No Initial Net Investment,
 - ▶ It Is Based On The Price Of Copper, And
 - ▶ It Is To Be Settled At A Future Date.

Response – example (cont.)

- ▶ However, it is entitled to normal sale/ purchase exemption if XYZ:
 - ▶ Intends to settle the contract by taking delivery;
 - ▶ Has no history for similar contracts of settling net in cash, or of taking delivery and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin.
- ▶ In such a case, contract would be accounted for as an executory contract rather than as a derivative.

Embedded derivatives

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract

An embedded derivative causes some of the cash flows of the combined instrument to vary in a similar way to a stand-alone derivative

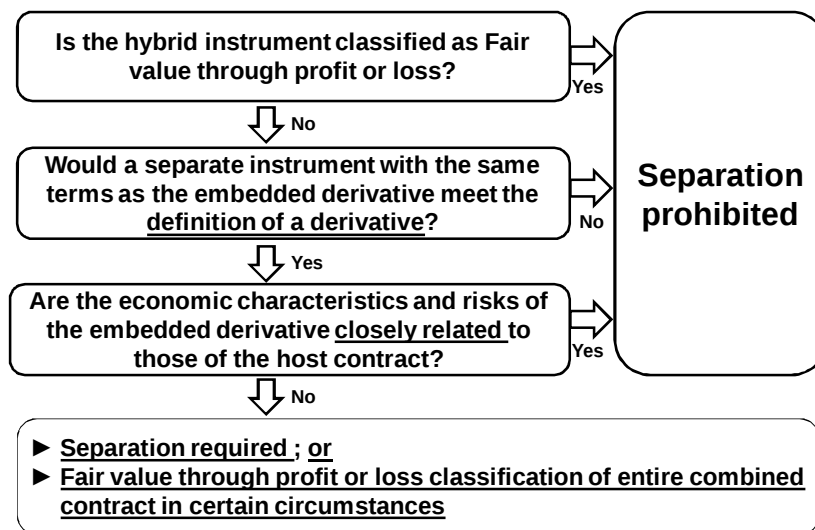
Requirements on separation of embedded derivatives retained from IAS 39 in relation to Financial Liability

An embedded derivative is attached to a financial instrument and is not contractually transferable independently of that instrument and has the same counterparty

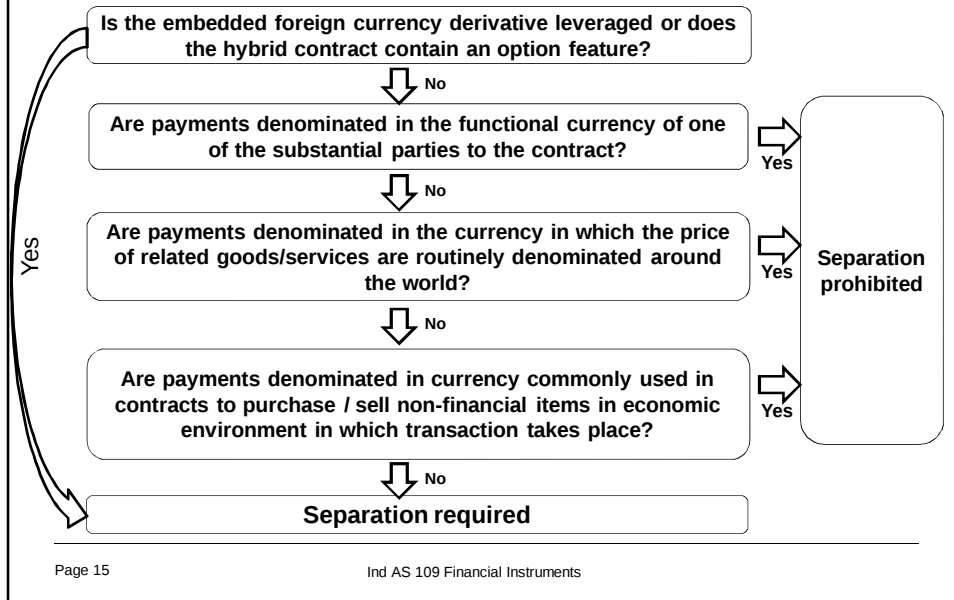
Examples of embedded derivatives

Type of contract	Embedded derivative
Bond with interest payments linked to an equity index	Equity-indexed payments
Inflation-indexed lease contract	Inflation-indexed payments
Bond with a call option	Call option
Sales contract in third currency	FX forward

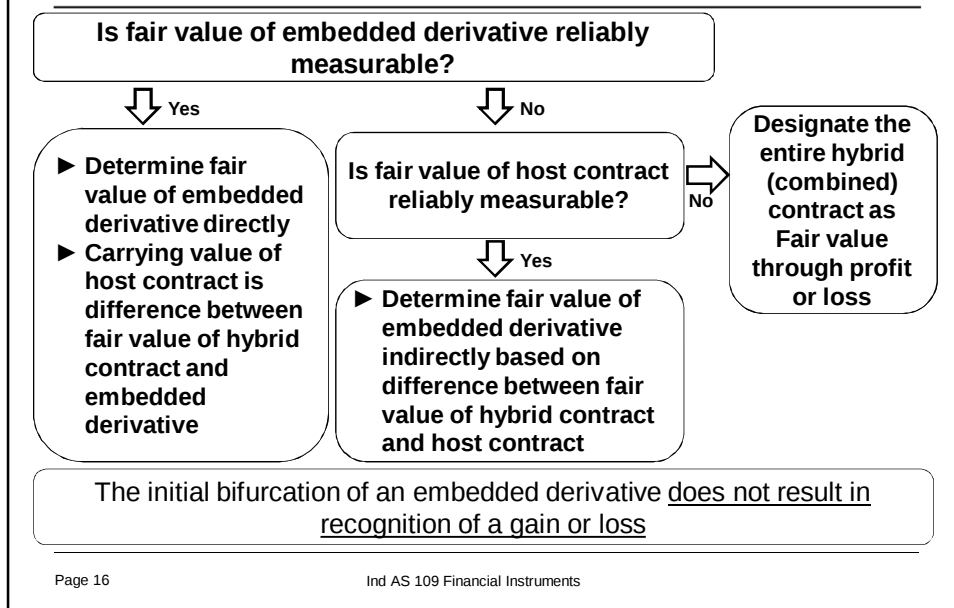
Separation of embedded derivatives



Separation of foreign currency embedded derivatives from non-financial instrument contract



Accounting for separable embedded derivatives



Hedge Accounting



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Objective of hedge accounting

Application of hedge accounting permits to:

- ▶ Remeasure both the items from which the risk exposure arises and the instruments used to manage the risk in profit or loss; or
- ▶ Defer recognition in profit or loss of certain gains and losses on derivatives by recognising them in OCI



Solves accounting mismatch in profit or loss

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Hedging instruments and costs of hedging



Qualifying hedging instruments (1)

Derivatives

**Separable embedded
derivatives**

**Non-derivatives designated as
hedging instruments for hedging
of any risk.**

**For example: Commodity price
linked investments can be used as
hedging instruments against
purchase of commodity**

**Written options may be designated
only for hedging of purchased
options**

Qualifying hedging instruments (2)

Derivatives should be designated as hedging instruments in their entirety except for:

- ▶ Intrinsic value of options
- ▶ Spot price element of forwards

Derivative may not be designated as hedging instruments for only a portion of its remaining period to maturity

Intra group hedge-instruments are not considered for consolidation purpose but may qualify for separate financial statements. (except currency risk)

A proportion of a financial instrument may be designated as the hedging instrument

A question for you: Qualifying hedging instruments

Are the following items qualifying hedging instruments?

- 1) An issued loan denominated in CU1 (functional currency is CU2) with a variable coupon.
- 2) 50% of an interest rate swap entered into with a subsidiary.
- 3) The first 10 cash flows of an interest rate swap out of a total of 20 cash flows.

CU1 = Currency Unit 1

CU2 = Currency Unit 2

Response:

Are the following items qualifying hedging instruments?

- 1) May be an eligible hedging instrument.
- 2) This is an eligible hedging instrument for hedge accounting in the separate financial statements. However, if it is an intra-group hedging instrument, this is not an eligible hedging instrument for hedge accounting in the consolidated financial statements. The designation of proportions of financial instruments as hedging instruments is allowed.
- 3) This is not an eligible hedging instrument because hedging instruments are designated for the entire period for which they are outstanding.

Hedged items



Qualifying hedge items

A single (or a group of items if they share the same risk):

- ▶ Recognised asset or liability
- ▶ Unrecognised firm commitment
- ▶ Highly probable forecast transaction
- ▶ Net investment in a foreign operation
- ▶ Equity investments at Fair value through other comprehensive income
- ▶ Net position hedging for fair value hedges and cash flow hedges of foreign exchange risk

Hedge items explained (1/2)

Equity investments at Fair value through other comprehensive income

IAS 39

Only hedge of exposures that could affect profit or loss qualify for hedge accounting.

IAS 109

An entity, may, at initial recognition, make an irrevocable election to present subsequent changes in fair value of equity investments not held for trading in OCI.

- ▶ Under Ind AS 109, an entity may hedge foreign exchange risk exposure or equity price risk exposure of equity investments at fair value through OCI (FVOCI)
 - ▶ For such hedge, fair value change of hedging instrument is recognized in OCI
 - ▶ Ineffectiveness is also recognized in OCI
 - ▶ On sale of the investment, gains or losses accumulated in OCI are not reclassified to profit or loss

Hedge items explained (2/2)

Net position as hedged item

IAS 39

Net position hedging that may reflect risk management strategy is **not allowed**.

IAS 109

Net position hedging for fair value hedges and cash flow hedges of foreign exchange risk is **allowed**.

- Ind AS 109 aligns hedge accounting with risk management strategy of hedging net position

A question for you: Qualifying hedged items

Are the following items qualifying hedged items?

- 1) A probable forecast transaction
- 2) An issued loan with a fixed coupon
- 3) CU1 100 of a net investment which amounts to CU1 150 in total (functional currency is CU2)
- 4) 50% of an interest rate swap
- 5) A net position of CU1 150 consisting of assets amounting to CU1 250 and liabilities amounting to CU1 100 (functional currency is CU2)

Response:

- 1) Not allowed, because only highly probable forecast transactions are eligible hedged items.
- 2) Allowed as a hedged item.
- 3) Allowed, as Ind AS 109 allows designating portions of net investments as hedged items.
- 4) Not allowed, Ind AS 109 generally precludes derivatives from being the hedged item and therefore it is not allowed.
- 5) Allowed, because hedge accounting is now allowed for hedges of net positions.

Types of Hedges



Types of Hedges

Main types of hedging relationships

Fair value hedge

Hedge of exposure to changes in fair value of a recognised asset or liability; an unrecognised firm commitment; or an identified portion of any of the above two, that is attributable to a particular risk

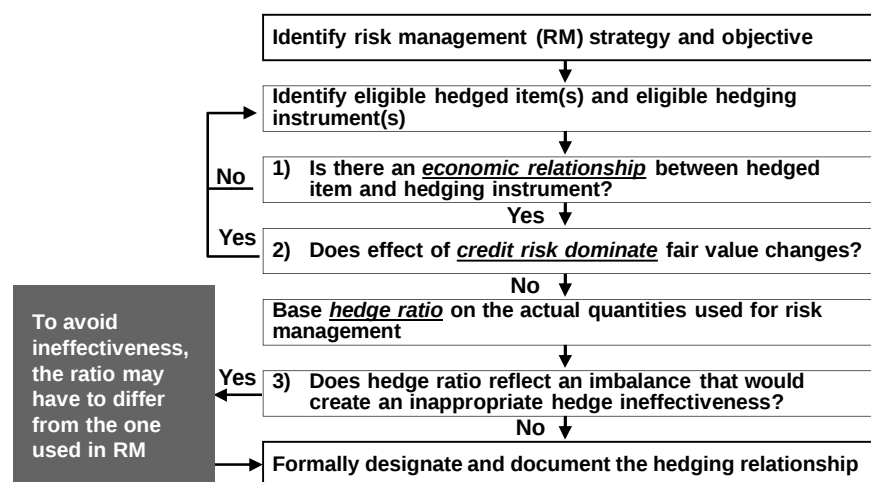
Cash flow hedge

Hedge of exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction (also an inter-company one) and could affect profit or loss

Net investment hedge

Hedge of a net investment in a foreign operation (including a hedge of a monetary item that is accounted for as part of the net investment)

Designating a hedging relationship



Risk management strategy and risk management objective

Risk management *strategy*

- ▶ Established at a high level (e.g., entity)
- ▶ Identifies risks (in general) and how entity responds to them
- ▶ Typically in place for longer period
- ▶ May include flexibility
- ▶ Often a formal policy document
- ▶ Part of hedge documentation

Risk management *objective*

- ▶ Applies at level of particular hedging relationship
- ▶ Describes how a particular hedging instrument is used to hedge a particular exposure designated as the hedged item
- ▶ Part of hedge documentation

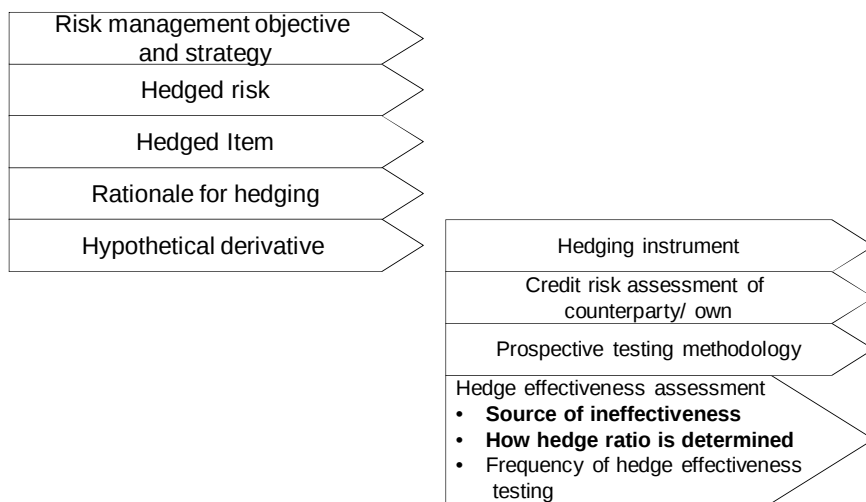
Examples of risk management strategy and risk management objective

Risk management strategy	Risk management objective
Maintain 40% of liabilities at floating interest rate	Designate an interest rate swap as a fair value hedge of a GBP 100m fixed rate liability
Assure long-term price stability of commodity purchases	Designate a coal forward contract to hedge the 100 tonnes of coal purchases in March 20XX
Hedge foreign currency risk of all forecast purchases in USD up to 12 months	Designate a foreign exchange forward contract to hedge the foreign exchange risk of the USD100 purchases in March 20XX

Hedge Documentation



Key pointers to be considered in hedge documentation



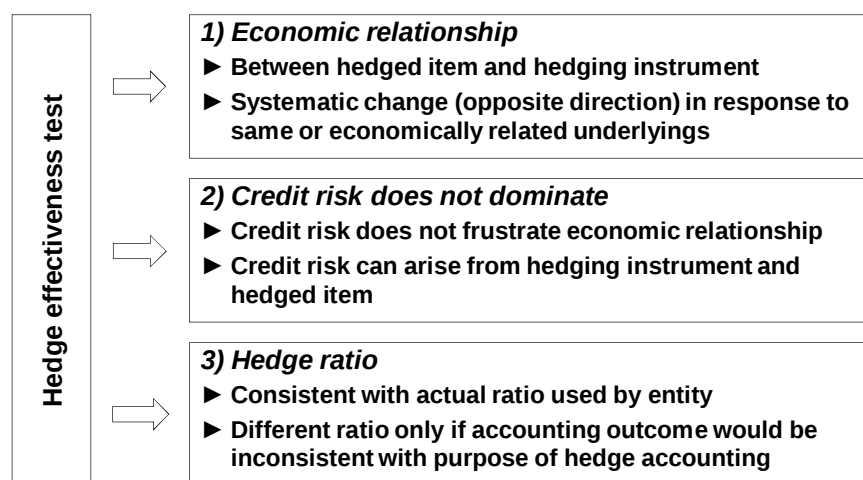
Hedge effectiveness assessment



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Hedge effectiveness assessment: overview



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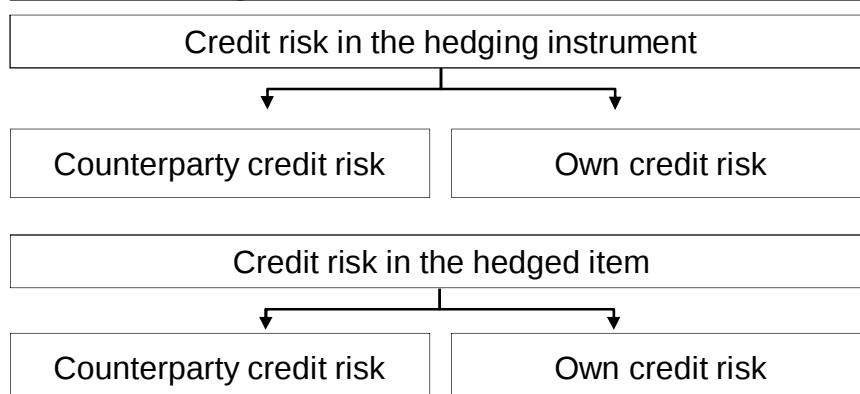
Applying the effectiveness assessment in practice

1) Is there an economic relationship between hedged item and hedging instrument?

- ▶ The economic relationship requires causality, not only correlation
- ▶ Causality can usually be demonstrated with only a qualitative assessment
- ▶ However, the standard indicates that when the critical terms are not aligned closely, a quantitative analysis would have to support the conclusion that an economic relationship exists

Applying the effectiveness assessment in practice (cont.)

2) Does the effect of credit risk dominate the fair value changes?



Applying the effectiveness assessment in practice (cont.)

3) Does the hedge ratio reflect an imbalance that would create hedge ineffectiveness resulting in an accounting outcome inconsistent with the purpose of hedge accounting?

When does a hedge ratio result in an accounting outcome inconsistent with hedge accounting? For example:

- ▶ Deliberate under-hedging to avoid recognising hedge ineffectiveness in a cash flow hedge
- ▶ Deliberate under-hedging to achieve fair value accounting in a fair value hedge

Example:

For example, an entity hedges 100 units of forecast transaction with only 80 units of derivative, simply to avoid recognising hedge ineffectiveness under the 'lower of' test.

Case Study 1

- ▶ A manufacturing company (AAA rated) in India, having INR as its functional currency, is expecting forecast sales in USD.
- ▶ The company assesses sales of USD 1mn for the next twelve months to be highly probable and wishes to hedge all of its forecasted sales by entering into a forward contract, with a well known bank having sound financial conditions, on the basis of its risk management policy.
- ▶ The company enters into a foreign exchange forward contract to hedge the forward rate risk of the highly probable USD sales and designates the forward contract as a hedging instrument.

Case Study 1 (contd)

Risk Management Objective	Designate foreign exchange forward contract to hedge 100% of the foreign exchange risk on forecasted USD sales.
Type of hedge	Cash Flow Hedge
Hedge Documentation	• Risk management strategy and objective • Hedged risk and hedging instrument • Prospective effectiveness testing • Source of ineffectiveness • How hedge ratio is determined
Effectiveness Testing	<u>Prospective Testing</u> • Economic hedging: Qualitative test – Critical terms matching (Currency, notional amount, start date and end date) • Credit Risk: Credit risk of the company and counterparty is considered to be negligible • Hedge ratio: The likely hedge ratio would be 1:1 to be in line with the risk management strategy of the company

Case Study 2

- ▶ A company issued INR 100mn debt instrument recently. The entity, based on its policy, wishes to convert all of its fixed rate debt into debt with variable pay.
- ▶ The treasurer enters into a INR 2mn receive fixed/pay variable IRS and designates the IRS in a hedge of INR 100mn of fixed rate liability. As a result, the entire INR 100mn of liability would be adjusted for changes in the hedged interest rate risk.

Case Study 2 (contd)

Risk Management Objective	Designate an interest rate swap as a fair value hedge of a fixed rate liability
Type of hedge	Fair value hedge
Is this a valid designation?	No, the designation is not valid. The hedge ratio is unbalanced as the real purpose of the hedging relationship is to achieve fair value accounting (related to changes in interest rate risk) for INR 100mn of the liability.
What should be the proper hedge ratio for the transaction to be a valid designation?	The hedge ratio used for hedge accounting purposes may be closer to 1:1

Discontinuing hedge accounting

- ♦ Is the hedged forecast transaction no longer highly probable?
- ♦ Is the hedging instrument expired, sold, terminated or exercised?
- ♦ Is the hedged item sold, settled or otherwise disposed of?
- ♦ Is the hedge no longer highly effective?

↓ Yes

Discontinue hedge accounting prospectively and revert to accounting under usual principles



Fair value hedge:

- ♦ Cumulative FV adjustment is amortized to profit or loss by adjusting the effective interest rate of the hedged item measured at amortised cost



Cash flow hedge:

- ♦ Forecast transaction still expected to occur à reclassify from OCI when transaction affects profit or loss i.e defer
- ♦ Forecast transaction not expected to occur à reclassify from OCI to profit or loss immediately

Thank you