Accounting and Taxation of Forward Contracts

Presented By:

CA Trushit Shah, Pratik Mehta & Bhavya Chheda

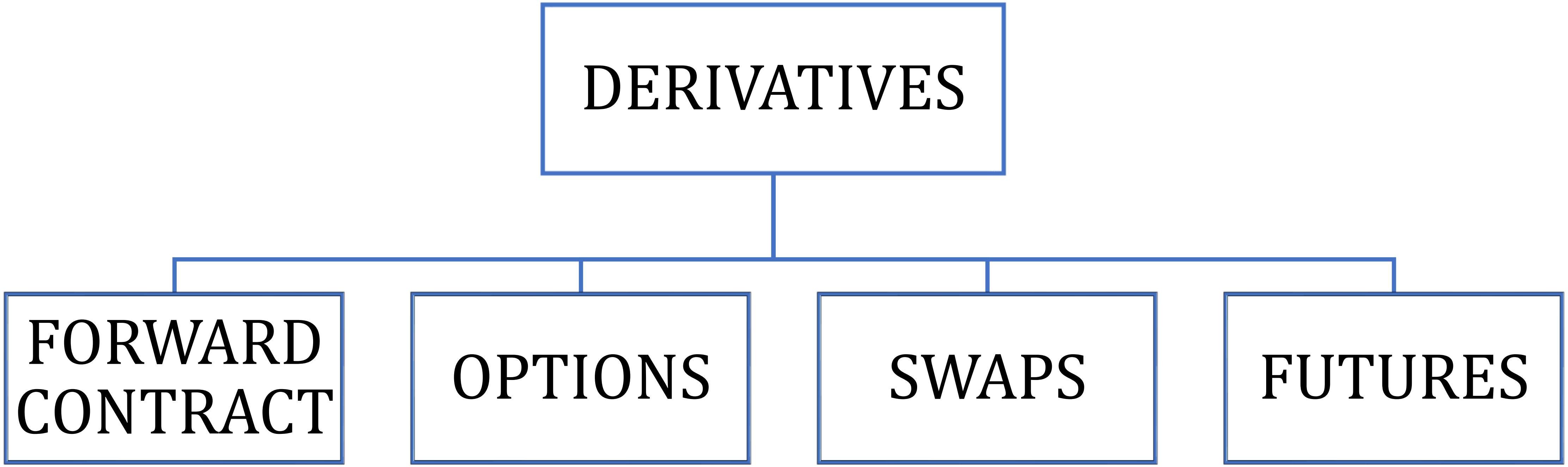
TOPICS TO BE COVERED:

Definition	Scope	AS 11
Guidance Note	Examples	ICDS - VI

INTRODUCTION

- A derivative is a contract between two parties;
- expected to settle at a future date;
- Its value is determined from the underlying assets;
- No initial investment or any small amount of initial investment is required;
- Underlying assets can be commodities, currencies, rates, stocks & bonds.

TYPES OF DERIVATIVES



DEFINITION OF FORWARD CONTRACT

an agreement	to exchange	different foreign currencies	at a forward rate.

DEFINITION OF FORWARD RATE

Specified	Exchange rate for	Exchange of two currencies	at a specified future date.

Covered within Scope

As per AS 11:

- For transactions in the nature of Forward exchange contracts.

AS per Guidance Note:

- All derivative contracts that are not covered by other notified standards,
- Guidance on accounting of assets covered by AS-2, AS 10 etc, which are designated as hedged items.

(notified standards are silent on hedge accounting using derivative instruments)

- Applies to all entities that do not apply Ind AS.

Not Covered within Scope

As per AS 11:

- × Contracts used to hedge highly probable forecast transaction & firm commitments.

AS per Guidance Note:

- × Forward exchange contract. (or other financial instruments which in substance are forward contracts covered by AS 11).
- × Derivative covered by regulation specific to a sector or specified set of entities. Eg: NBFC's regulated by RBI
- × Accounting for embedded derivative contract as there are potential conflicts with requirements of other notified AS.
- × Deal with macro-hedging & accounting for non-derivative financial assets/liabilities.

Examples

Instruments	Covered Under
Forward contract booked against import / export invoice	AS 11
Forward contract booked against import / export order	Guidance Note
Future contract booked against import / export invoice	Guidance Note
Future contract booked against import / export order	Guidance Note
Interest rate swaps	Guidance Note
Option contract	Guidance Note

AS 11

Forward Contract (para 36 to 39)

Forward Exchange Contract

- **Forward Exchange contract**
  - Not intended for trading or speculation : **Reporting currency**
    - Available / Required on the settlement date.
      - **Para 36**
    - Not available / required on the settlement date.
      - **Para 38**
  - Intended for trading or speculation
    - **Para 39**
  - Hedge risk of **firm commitment/highly probable forecast transaction**
    - **GN on Derivative**

Accounting as per AS 11

Para 36

- **Premium/discount** - Amortise over life of contract.
- **Exchange Difference** - Charge to P&L in reporting period in which exchange rate changes
- **Profit/Loss on cancellation/renewal** - Charge to P&L.

Para 38 (if para 36 does not apply)

- **Premium/discount** - Not to be recognised separately
- **Forward contract** - Accounted on MTM basis

Para 39

- **Premium/discount**- Not to be recognised separately.
- **Forward contract**- Accounted on MTM basis.

Examples

Type of Contract	Date of Booking of Derivative Contract	Amount in USD	Export Date	Export USD	Maturity of derivative contract	Receivable due on	Basis of Forward Booking	Treatment as per AS 11	Treatment as per Guidance Note
Forward	01-01-20	1,00,000	01-01-20	1,00,000	30-04-20	30-04-20	Export Invoice	Para 36	X
Future	01-01-20	1,00,000	01-01-20	1,00,000	30-04-20	30-04-20	Export Invoice	X	✓
Forward	20-02-20	80,000	15-02-20	1,00,000	01-04-20	30-04-20	Export Invoice	Para 38	X
Forward	01-02-20	80,000	15-02-20	1,00,000	30-04-20	30-04-20	Export order	X	✓

Example

- A Ltd. entered into forward contract to sell USD 1,00,000 on March 1, 2020, for delivery on April 30, 2020 against export receivables due on April 30, 2020.

	1st March 2020	31st March, 2020	30th April, 2020
Spot Rate	70.25	71	71.5
30 Day forward rate.	71	72.50	-
60 Day forward rate.	72	-	-

Question:

- What would be the treatment in the books of A Ltd. in the FY 2019-20 & 2020-21;

Solution

- Since the above Forward Contract was enteres against export receivables of $1,00,000; then in such case **Para 36** will apply:

- **AS on 31st March 2020 :**

1. **Premium** - Amortise over life of the contract.

= [**Contracted Forward rate** Rs 72 − **Spot rate as on 1 March, 2020** Rs 70.25] × **Contracted Amt** $ 1,00,000

= Premium Rs 1,75,000 (Gain)

- Premium Amortised for FY 2019-20 = Rs 1,75,000 / 2months x 1month = **Rs. 87,500 (Gain)**

Solution

2. **Exchange Gain/Loss** – Charge to P&L

[**Spot rate as on 31st March, 2020** Rs 71 − **Spot rate as on 1st March, 2020** Rs 70.25] × **Contracted Amt** $ 1,00,000

Particulars	USD (A)	Rate difference B	Gain/(Loss) (AxB)
Forward Contract	1,00,000	=(71-70.25)	Rs (75,000)
Export receivables	1,00,000	=(71-70.25)	Rs 75,000

- Gain/(Loss) on Forward Contract for FY 2019-20 –Rs (75,000).
- Gain/(Loss) on Export receivables for FY 2019-20 –Rs 75,000.

Solution

- **As on 30th April, 2020**:

1. Premium:

- Premium Amortised for FY 2020-21 = Rs 1,75,000 / 2months x 1month = Rs. **87,500 (Gain)**

2. Exchange Gain/Loss – Charge to P&L

{ [**Spot rate as on 30th April, 2020** Rs 71.5] − [**Spot rate as on 31st March, 2020** Rs 71] } × [**Contracted Amt** $ 1,00,000]

Particulars	USD (A)	Rate difference B	Gain/(Loss) (AxB)
Forward Contract	1,00,000	= (71.5-71)	Rs (50,000)
Export receivables	1,00,000	= (71.5-71)	Rs 50,000

- Gain/(Loss) on Forward Contract for FY 2020-21 –Rs 50,000 (Loss)
- Gain/(Loss) on Export receivables for FY 2020-21 –Rs 50,000 (Gain)

Example

- A Ltd. entered into forward contract to sell USD 1,00,000 on March 1, 2020, for delivery on April 10, 2020 against export receivables due on April 30, 2020.

	1st March 2020	31st March, 2020	10th April, 2020	30th April, 2020
Spot Rate	70.25	71	70	71.5
15 Day forward rate.	71	72.50	-	-
45 Day forward rate.	72	-	-	-
60 Day forward rate.	73			

Question:

- What would be the treatment in the books of A Ltd. for the FY 2019-20 & 2020-21.

Solution

- Since the maturity date of Forward Contract is before the settlement date of transaction. (**para 38** will apply):

- **As on 31st March, 2020 :**

= [**Forward rate as on 31st March, 2020** Rs 72.5 − **Contracted Forward Rate** Rs 72] × **Contracted Amt** $ 1,00,000

= Rs 50,000 (Loss)

- Loss on MTM basis for FY 2019-20 charged to P&L - Rs 50,000

Solution

➢ **As on 10th April, 2020 :**

= { **Spot rate as on 15th April, 2020** Rs 70 − **Forward rate as on 31st March, 2020** Rs 72.5 } × **Contracted Amt** $ 1,00,000

= Rs 2,50,000 (Gain)

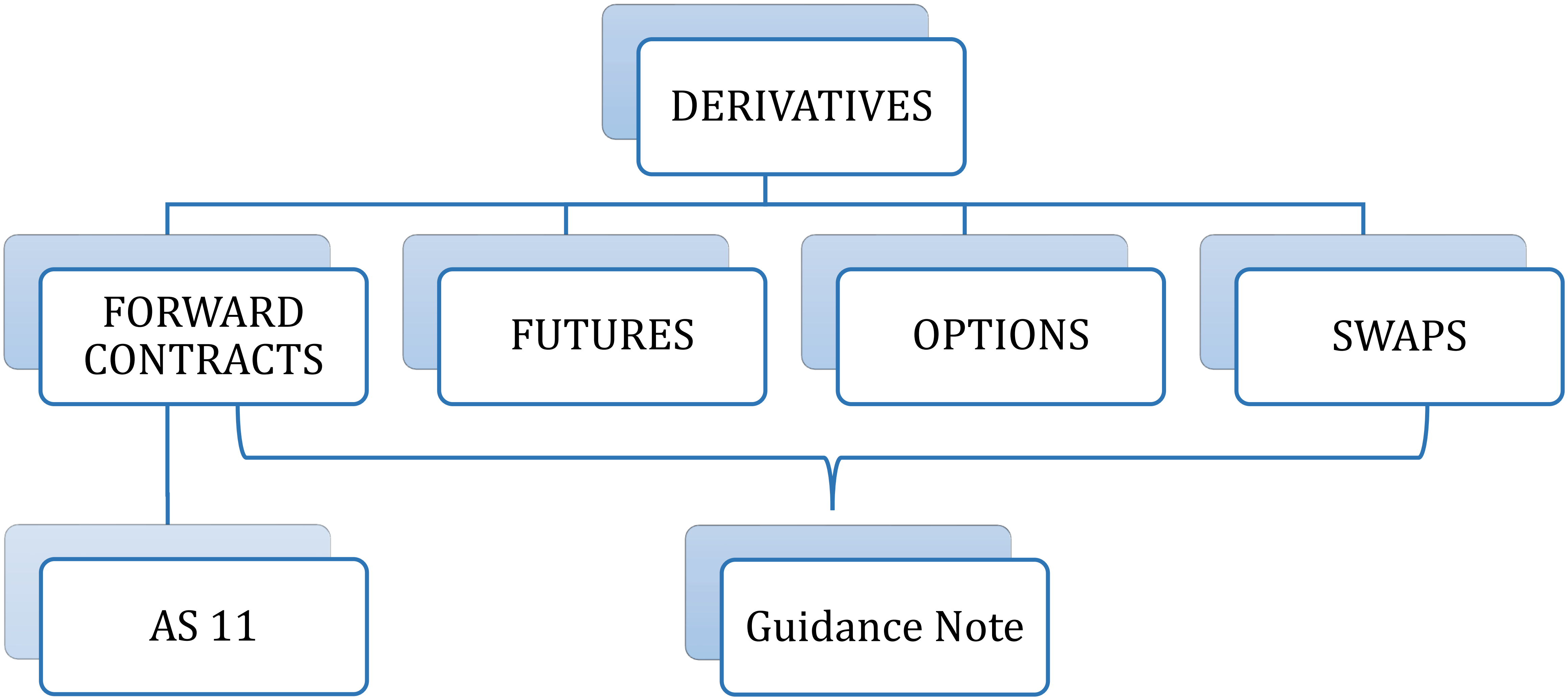
➢ Gain on MTM basis charged to P&L - Rs 2,50,000

Guidance Note

on Accounting for Derivative Contracts

(Applicable for accounting periods beginning on or after April 1^{st}, 2016
to all entities that do not apply Ind AS)

COVERAGE


DERIVATIVES
FORWARD CONTRACTS
FUTURES
OPTIONS
SWAPS
AS 11
Guidance Note

DEFINITION OF HEDGED ITEM

Hedged Item is

- A
- Portfolio
- Group

- Liability
- Asset
- Firm Commitment
- Highly Probable forecast transaction
- Net Investment

That

Exposes the entity to risk of changes in Fair Value or Cash Flow

AND

Is designated as being Hedged

DEFINITION OF HEDGING INSTRUMENT

A designated derivative

who’s FV or Cash Flow

is expected to offset

changes in FV or Cash Flow of

Designated Hedged Item

DEFINITION OF FIRM COMMITMENT

A binding agreement

for exchange of

specified quantity of resources

at a future date(s).

DEFINITION OF FORECAST TRANSACTIONS

An uncommitted but

anticipated future transaction

GUIDANCE NOTE

Key Accounting Principles :

1. Fair value
2. Hedge accounting not followed – Gain/loss charge to P&L.
3. Entity applying hedge accounting, should be able to identify:
   - Risk management objective,
   - Risk that it is hedging,
   - how it will measure the derivative instrument if its risk management objective is being met,
   - Document - at inception of the hedge relationship (on an ongoing basis).
4. An entity may decide to use hedge accounting for certain derivative contracts. For derivatives not included as part of hedge accounting, apply (1) & (2)
5. Adequate disclosures should be made in FS regarding:
   - accounting policies,
   - risk management objectives,
   - hedging activities

GUIDANCE NOTE

HEDGE ACCOUNTING

- Designation as a hedging instrument
- Need for hedge accounting
- Types of hedge accounting
- Termination of hedge accounting/ reclassification of hedge reserves

GUIDANCE NOTE

- **DESIGNATION OF A DERIVATIVE CONTRACT AS A HEDGING :**

An entity is permitted but not required to designate a derivative contract as a hedging instrument.

NEED FOR HEDGE ACCOUNTING

ACCOUNTING MISMATCH IN

MEASUREMENT

RECOGNITION

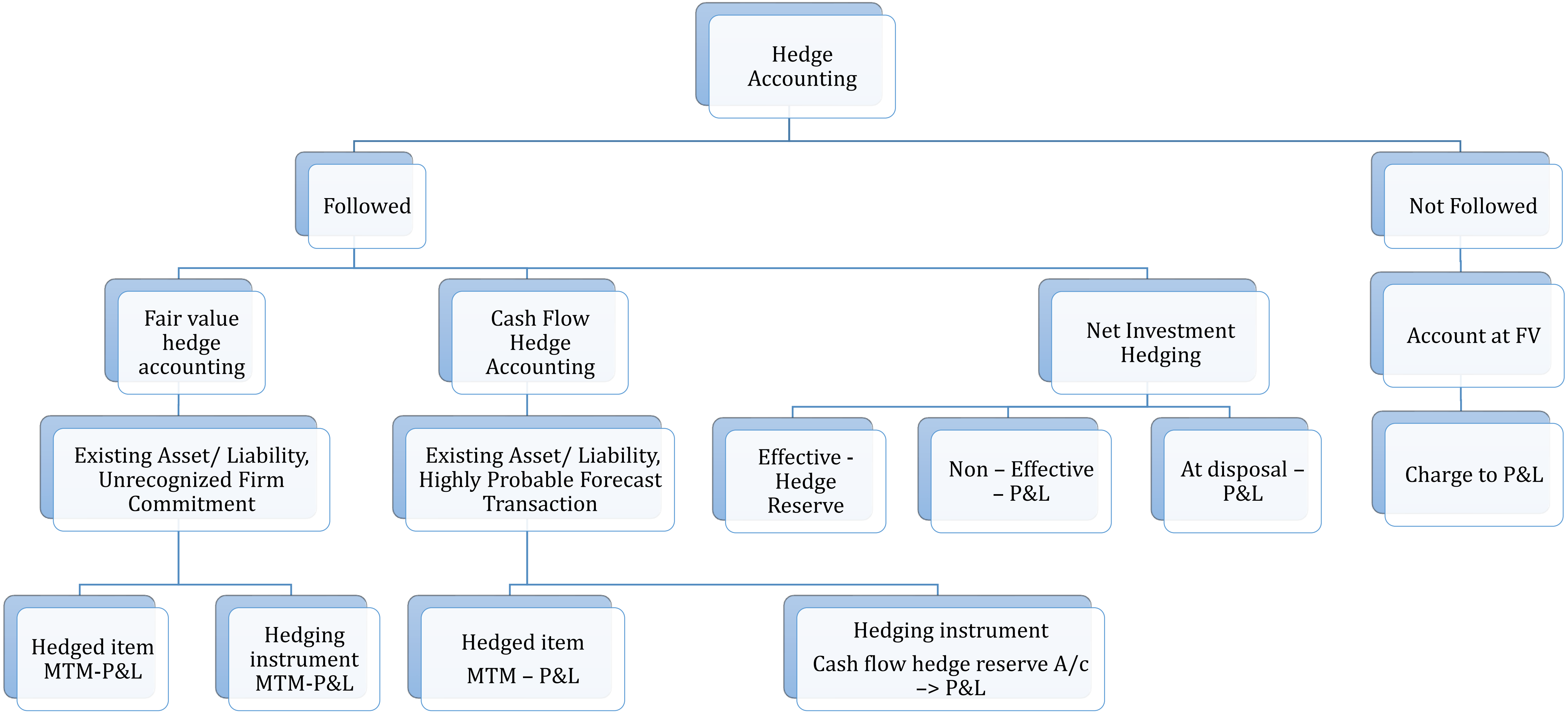
GUIDANCE NOTE

- **TYPES OF HEDGE ACCOUNTING :**

TYPES

- Fair Value Hedge
- Cash Flow Hedge
- Net Investment Hedging

GUIDANCE NOTE



Cash Flow Hedge :

Example 1:

01-Jan-19

TBZ Ltd exported goods to MB Ltd. $100,000
Forward contract for same entered into

Spot	Forward (4 month)
71	71.2

31-Mar-19

Reporting Date
Receivables - $100,000
Forward contract - $100,000

Spot	Forward (1 month)
70.50	70.60

30-Apr-19

MB Ltd makes payment to TBZ Ltd.

Spot
70

Solution

- Since the above Forward Contract was undertaken against Trade Receivables for $1,00,000; then in such case **Para 36** will apply:

- **As on 31st March 2019 :**

1. **Premium** - Amortise over life of the contract.

= [**Contracted Forward rate** Rs 71.2 − **Spot rate as on 1 Jan, 2019** Rs 71] × **Contracted Amt** $ 1,00,000

= Premium Rs 20,000 (Gain)

- Premium Amortised for FY 2018-19 = Rs 20,000 / 4months x 3month = **Rs. 15,000 (Gain)**

Solution

2. **Exchange Gain/Loss** – Charge to P&L

{ **Spot rate as on 31st March, 2019** Rs 70.5 − **Spot rate as on 1st Jan, 2019** Rs 71 } × **Contracted Amt** $ 1,00,000

Particulars	USD (A)	Rate difference B	Gain/(Loss) (AxB)
Forward Contract	1,00,000	=(70.5-71)	Rs 50,000
Receivables	1,00,000	=(70.5-71)	Rs (50,000)

- Gain/(Loss) on Forward Contract for FY 2018-19–Rs 50,000.
- Gain/(Loss) on Trade Receivables for FY 2018-19 –(Rs 50,000)

Solution

- **As on 30 April 2019**:

1. Premium:

- Premium Amortised for FY 2019-20 = Rs 20,000/ 4months x 1month = **Rs. 5,000 (Gain)**

2. Exchange Gain/Loss – Charge to P&L

{ **Spot rate as on 30th April, 2019** Rs 70 − **Spot rate as on 31st March, 2019** Rs 70.5 } × **Contracted Amt** $ 1,00,000

Particulars	USD (A)	Rate difference B	Gain/(Loss) (AxB)
Forward Contract	1,00,000	= (70-70.5)	Rs 50,000
Receivables	1,00,000	= (70-70.5)	Rs (50,000)

- Gain/(Loss) on Forward Contract for FY 2019-20 – Rs 50,000
- Gain/(Loss) on Trade Receivables for FY 2019-20 – Rs (50,000)

Cash Flow Hedge :

Example 2:

01-Jan-19

T Ltd exported goods to M Ltd
$100,000
Forward contract for same entered into

31-Mar-19

Reporting Date
Receivables - $100,000
Forward contract - $100,000

30-Apr-19

M Ltd makes payment to T Ltd

01-Oct-18

T Ltd received Export order of $100,000 from M Ltd

	1- Oct-18	01-Jan-19	31-Mar-19	30-Apr-19
Spot	72.50	71	70.05	70
7 month Forward	73.50	-	-	-
4 month Forward	-	71.20	-	-
1 month Forward	-	-	70.06	-

Cash Flow Hedge :

Example 2:

01-Oct-18

T Ltd received Export order of $100,000 from M Ltd.

Spot	Forward (4 month)
72	73.50

01-Jan-19

T Ltd exported goods to M Ltd.
$100,000
Forward contract for same entered into

Spot	Forward (4 month)
71	71.2

31-Mar-19

Reporting Date
Receivables - $100,000
Forward contract - $100,000

Spot	Forward (1 month)
70.50	70.60

30-Apr-19

M Ltd makes payment to T Ltd.

Spot
70

GUIDANCE NOTE

Fair Value Hedge :

Example 1:

ABC Ltd. is an exporter of goods. In the month of July 2013, it receives the order for supply of goods to US customers in the month of January 2014 and as per the payment cycle with the customers, it expects to realise USD 100,000 in April 2014.

ABC Ltd has decided to fully hedge the sales from foreign currency risk. Immediately after getting the order, to hedge the firm commitment in foreign currency it enters into a derivative transaction with XYZ Bank, for future sale of USD 100,000 in the month of April 2014 @ ` 65 per USD (Spot Rate was ` 64.50 per USD).

For this purpose, it is assumed that the company has entered into a cash flow hedge, which is generally the case for hedging foreign currency risk. Further, it is assumed that:

(impact of discounting of MTM of the hedging instrument has been ignored in this simplified illustration).

	1st July, 2013	31st January, 2014	31 March, 2014	30th April, 2014
Spot	64.50	61	60.50	60
1 month Forward			60.60	
3 month Forward		61.20		
10 month Forward	65			

GUIDANCE NOTE

- **Fair Value Hedge :**

Solution:

1st July, 2013

ABC Limited entered to sell a forward exchange contract for USD 100,000 having ten months maturity on April 30, 2014.

Snapshot of MTM statement from Bank

Facility: Forward Contract

Deal Ref No	Deal Date	Maturity Date	Currency Bought by IndusInd	Notional Amount Bought By Indusind	Outstanding Notional Amount Bought by Indusind	Contract Rate	Currency Sold by IndusInd	Notional Amount Sold By Indusind	Outstanding Notional Amount Sold by Indusind	MTM Value (in Rs)		Net MTM (in Rs)	Prodcode
										Cutomer In The Money	Cutomer Out of Money		
29239451	15-Oct-19	19-Oct-20	USD	400,000.00	400,000.00	74.1650	INR	29,666,000.00	29,666,000.00	142,511.44		-142,511.44	FX
27589629	18-Jul-19	22-Jul-20	USD	500,000.00	500,000.00	71.9850	INR	35,992,500.00	35,992,500.00		526,311.92	526,311.92	FX
26730212	04-Jun-19	08-Jun-20	USD	500,000.00	500,000.00	72.0275	INR	36,013,750.00	36,013,750.00		335,274.06	335,274.06	FX
25870691	22-Apr-19	31-Mar-20	USD	500,000.00	500,000.00	72.4550	INR	36,227,500.00	36,227,500.00	205,837.66		-205,837.66	FX
27909392	05-Aug-19	07-Aug-20	USD	500,000.00	500,000.00	73.5200	INR	36,760,000.00	36,760,000.00	150,734.75		-150,734.75	FX
24543272	04-Feb-19	06-Feb-20	USD	500,000.00	500,000.00	74.5850	INR	37,292,500.00	37,292,500.00	1,469,532.38		-1,469,532.38	FX
30542284	24-Dec-19	28-Dec-20	USD	500,000.00	500,000.00	74.2550	INR	37,127,500.00	37,127,500.00		53,139.77	53,139.77	FX
28861588	24-Sep-19	28-Sep-20	USD	400,000.00	400,000.00	74.1050	INR	29,642,000.00	29,642,000.00	184,019.62		-184,019.62	FX
29728956	11-Nov-19	17-Nov-20	USD	500,000.00	500,000.00	74.1900	INR	37,095,000.00	37,095,000.00	82,586.71		-82,586.71	FX
26281863	13-May-19	15-May-20	USD	500,000.00	500,000.00	73.3300	INR	36,665,000.00	36,665,000.00	389,075.71		-389,075.71	FX
25870745	22-Apr-19	24-Apr-20	USD	500,000.00	500,000.00	72.6650	INR	36,332,500.00	36,332,500.00	154,672.45		-154,672.45	FX

Sub Total: -1,864,244.99

Net MTM Grand Total: -1,864,244.99

GUIDANCE NOTE

Fair Value Hedge :

Example 2:

On January 1, 2019, MQI Ltd issued $100 million 3-year bond @ 6% fixed interest payable semi-annually. MQI Ltd wants to hedge this bond to a variable- rate one.

On the same day it enters into an interest rate swap with EOS Ltd where it agrees to receive 6% fixed and pay LIBOR of 5.7% for the first 6 months . The interest is subject to be revised every six monthly based on LIBOR. On July 1, 2019, the interest rate is reset to 6.3%

Issuance of Bond & Interest rate swap entered	Year ending	Interest Payment	Revision of Interest Rates	Interest Payment
01-01-19	31-03-19	30-06-19	01-07-19	31-12-19

GUIDANCE NOTE

Fair Value Hedge :

Solution:

Hedged Item – 6% fixed interest Bond. Hedging instrument – Variable rate Swap

Issuance of Bond & Interest rate swap entered	Year ending	Interest Payment	Revision of Interest Rates	Interest Payment
01-01-19	31-03-19	30-06-19	01-07-19	31-12-19

GUIDANCE NOTE

Hedge Effectiveness:

Entity should assess whether a hedging relationship meets the hedge effectiveness requirement.

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 requirement

whichever comes **first**.

<u>GUIDANCE NOTE</u>

Hedge Ineffectiveness:

Hedge ineffectiveness is measured based on the <u>actual performance</u> of the **hedging instrument** and the **hedged item**, by comparing the changes in their values in currency unit amounts.

No method is prescribed for 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.

If recognition is ineffective, the Hedge Accounting **need not** be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.

GUIDANCE NOTE

Hedge Ineffectiveness:

Examples of situations where ineffectiveness is to be recognized are:

- in a cash flow hedge, when the forecasted hedged transaction is no longer probable of occurring
- in a fair value hedge, when the hedging instrument is no longer considered to be an effective hedge of the hedging instrument; and
- in any hedge relationship, if the risk management objective is changed or no longer expected to be met.

GUIDANCE NOTE

▪ TERMINATION OF HEDGE ACCOUNTING/ RECLASSIFICATION OF HEDGE RESERVES:

- Voluntary termination is prohibited - Except management objective originally defined is no longer met.
- Hedge accounting is discontinued prospectively when:
    - Termination a hedging instrument prior to its maturity / contractual term,
    - In case of hedges of highly probable forecast transactions or commitments,

    if forecasted transaction - no longer ‘highly’ probable, but still probable (>50%) of occurring.
- For both the above cases - Amount in hedge reserve is charged to P&L only in the period when hedged item impacts P&L.
- In case of hedges of forecast transactions, if the forecasted transaction - no longer probable of occurring, then hedge accounting is discontinued - all amounts in hedge reserve are charged to P&L.

GUIDANCE NOTE

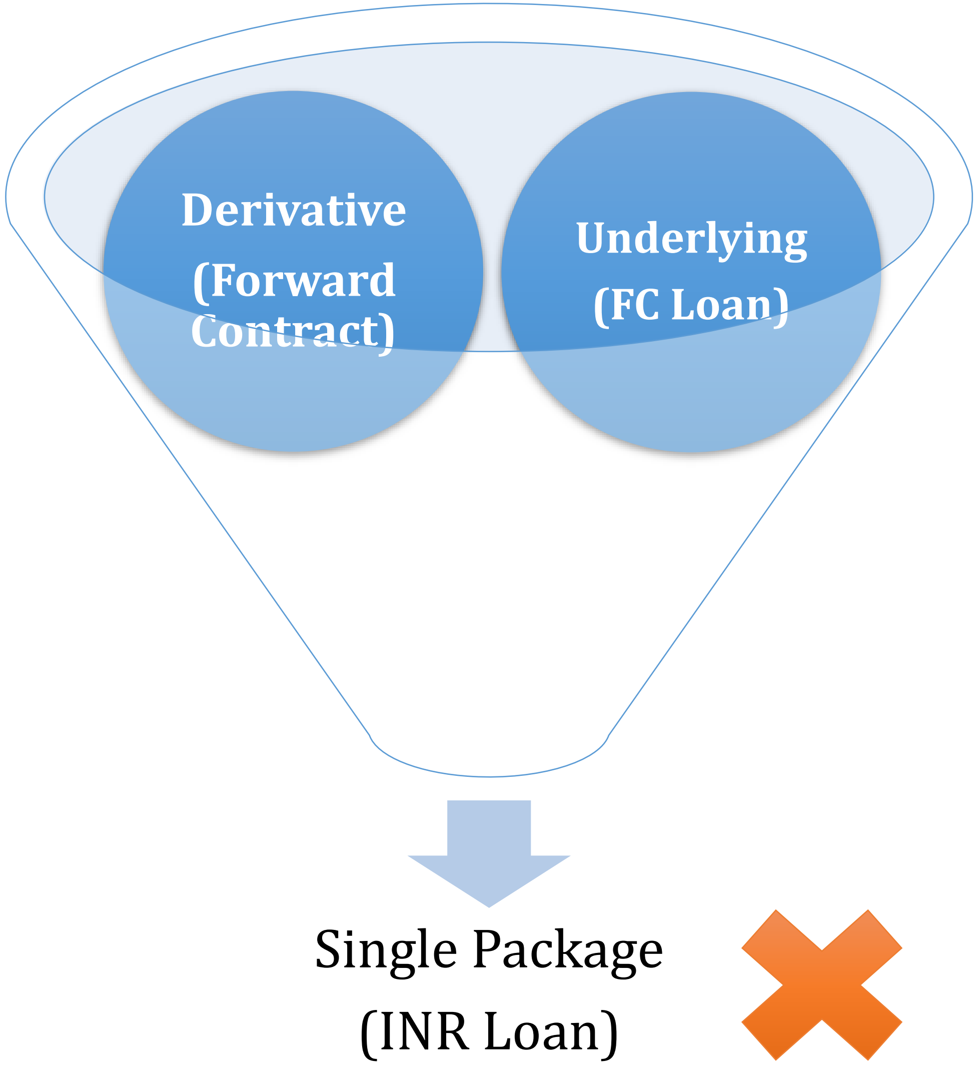
Synthetic Accounting Not Permitted:

What is Synthetic Accounting?

- Accounting of combining a derivative and the underlying together as a single package.

Example:

An entity has a foreign currency borrowing hedged by entering into Forward Contract, the loan and contract should be recognised separately and NOT in a package as INR loan.



ICDS VI

- Accounting is done as per **Para 36** of AS 11 i.e. Premium Amortization

Gain & Loss will be allowed

- Other Cases (MTM)

Gain & Loss will be allowed on Settlement.