THE STANDARD STANCE

An expert insight into key accounting matters

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HEDGE ACCOUNTING

Companies are exposed to different kinds of risks like foreign currency risk, interest rate risk, commodity price risk, etc. To eliminate or reduce their risk exposure, companies implement various risk management strategies. Hedge accounting plays a vital role in managing risk. Under Ind AS 109, an entity can designate certain financial instruments as hedging instruments and apply hedge accounting to align the accounting treatment of these instruments with the risk management strategy.

Hedge accounting modifies the normal basis for recognising gains and losses (or revenues and expenses) on associated hedging instruments and hedged items so that both are recognised in P&L (or OCI) in the same accounting period. This matching concept eliminates or reduces the volatility in the statement of comprehensive income that otherwise would arise if the hedged item and the hedging instrument were accounted for separately under Ind AS.

Consider the following example:

The entity has taken a hedging instrument in Year 1 to hedge its highly probable forecast sales which will occur in Year 4. The entity will be impacted by the gains and losses on hedging instruments from Year 1, whereas the highly probable forecast sales will impact the P&L in Year 4. Under normal accounting, as illustrated in Figure 1, gains and losses on hedging instruments are recorded in the P&L in the period in which they occur, irrespective of the occurrence of the gains and losses on the hedged item. However, under hedge accounting, the timing of recognition gains and losses are matched with the gains and losses on the hedged item as illustrated in Figure 2. The following illustrates the effect of hedge accounting for a cash flow hedge.

Figure 1

Impact on profit or loss without hedge accounting

Year	P&L Impact of hedge item	P&L Impact of hedging instrument	Impact on OCI	Net P&L Impact	Cumulative P&L Impact
1	-	150	-	150	150
2	-	375	-	375	525
3	-	225	-	225	750
4	-1,200	450	-	-750	-

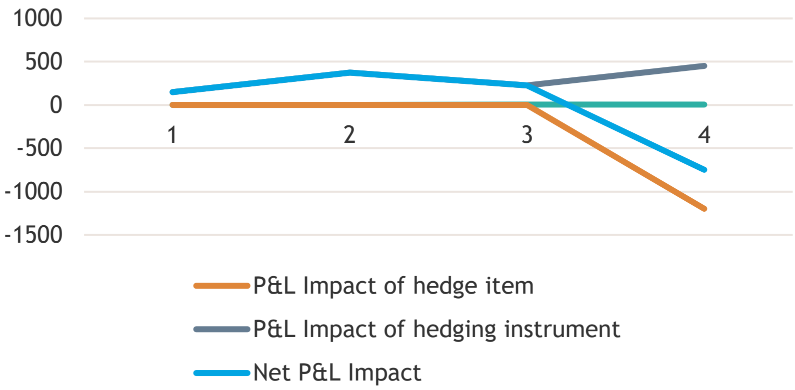
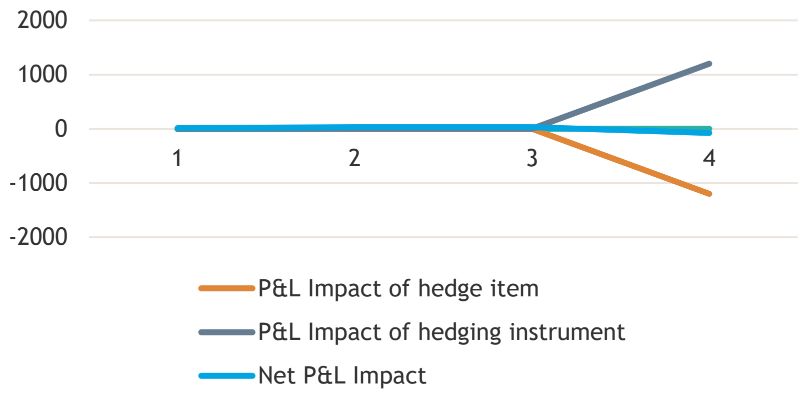


Figure 2

Impact on profit or loss with cash flow hedge accounting

Year	P&L Impact of hedge item	P&L Impact of hedging instrument	Impact on OCI	Net P&L Impact	Cumulative P&L Impact
1	-	0*	150	15	15
2	-	0*	375	30	45
3	-	0*	225	30	75
4	-1,200	1,200	-750	-75	-

*Assuming the cash flow hedge is 100% effective



The straight blue line in Figure 2, compared with an erratic blue line in Figure 1, indicates that hedge accounting has eliminated the volatility in profit or loss.

This issue of Standard Stance aims to provide an overview of the key principles and requirements of hedge accounting under Ind AS 109, highlighting its importance and providing practical insights. It also addresses some of the key issues to consider while applying hedge accounting.

OVERVIEW OF KEY PRINCIPLES AND REQUIREMENTS

Hedge Accounting Objectives

Hedge accounting serves two primary objectives:

- **Aligning accounting with risk management:** Hedge accounting aims to reflect the economic reality of hedging activities in the financial statements. This ensures that changes in the fair value or cash flows of hedged items and hedging instruments are recognised consistently.
- **Reducing earnings volatility:** By recognising changes in the fair value of hedging instruments and hedged items in a manner that offsets the risk being hedged, hedge accounting helps mitigate the impact of volatility on the income statement.

Types of Hedges

Ind AS 109 recognises three types of hedges:

- **Fair Value Hedge:** This type of hedge is used to hedge the exposure to changes in the fair value of a recognised asset or liability or an unrecognised firm commitment.
- **Cash Flow Hedge**: Cash flow hedges are used to hedge the exposure to variability in cash flows that could affect profit or loss, arising from highly probable forecast transactions, recognised assets or liabilities.
- **Net Investment Hedge:** This type is applied to hedge the foreign currency risk of a net investment in a foreign operation.

Hedge Documentation

To qualify for hedge accounting under Ind AS 109, an entity must establish and document the following:

- The risk management objective and strategy for undertaking the hedge
- The nature of the hedged item and the risk being hedged
- The characteristics of the hedging instrument
- How the hedge will be assessed on an ongoing basis for effectiveness
- A description of the method used to assess the effectiveness of the hedge
- A description of sources of expected ineffectiveness and how the hedge ratio was determined

Hedge Effectiveness Assessment

To apply hedge accounting, an entity must assess and document the effectiveness of a hedge. Effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item. A hedging relationship meets the hedge effectiveness requirements if an economic relationship exists between the hedged item and the hedging instrument; the effect of credit risk does not dominate the value changes that result from the economic relationship; and the hedge ratio is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

Accounting for Hedging Instruments and Hedged Items

Hedging instruments and hedged items are accounted for as follows:

- **Fair Value Hedge:** Changes in the fair value of both the hedging instrument and the hedged item are recognised in profit or loss.
- **Cash Flow Hedge:** Changes in the fair value of the hedging instrument are recognised in other comprehensive income (OCI) to the extent the hedge is effective. Any ineffective portion is recognised in profit or loss.
- **Net Investment Hedge:** This is accounted similarly to cash flow hedges. The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve is reclassified from equity to profit or loss as a reclassification adjustment on the disposal or partial disposal of the foreign operation.

De-designation and Termination of Hedge Accounting

Voluntary de-designation of hedge accounting is prohibited. Hedge accounting should be discontinued prospectively only when the hedging relationship (or part of the relationship) ceases to meet the qualifying criteria for hedge accounting. The criteria for de-designation are specified in Ind AS 109, and an entity must ensure that it reflects the change in accounting treatment appropriately in the financial statements.

KEY ISSUES TO ADDRESS

Entities engaging in hedge accounting need to address several key issues to ensure compliance and accurate financial reporting. Here are some of the critical issues to consider:

- **Risk Management Strategy:** Define and document a clear risk management strategy that includes objectives, policies, and procedures for hedging activities. The risk management strategy should align with the entity's overall business strategy.
- **Hedge Identification:** Identify and document the specific risks that are being hedged, whether they are fair value, cash flow, or net investment hedges. Determine the hedged item and the hedging instrument clearly.

- **Hedge Effectiveness:** Regularly assess and document the effectiveness of the hedge relationship. The effectiveness must fall within the acceptable range to qualify for hedge accounting treatment. The method of demonstrating hedge effectiveness is not mandated, but it should be documented and, if changed, this fact should be documented, along with the sources of ineffectiveness. Common methods of demonstrating hedge effectiveness include the dollar offset method and regression analysis.
- **Prospective Assessment:** The assessment of whether the hedge meets the effectiveness requirements is forward-looking only. It must be done, at a minimum, at each reporting date and on any significant change in circumstances affecting the hedge. Any ineffectiveness identified must be recorded through P&L.
- **Hedge Documentation:** Maintain detailed hedge documentation, including hedge designation, risk management objectives, and how the hedge will be assessed for effectiveness. Accurate documentation is essential for audit and compliance purposes.
- **De-designation and Hedge Relationship Changes:** Define procedures for de-designating hedges and handling changes to the hedge relationship. These changes could include modifying the hedged item, hedging instrument, or hedge ratio.
- **Hedge Accounting Method:** Decide whether the fair value method or cash flow method will be used to account for hedges. Different methods may have different implications on financial statements.
- **Basis Adjustment:** Consider how to account for any basis adjustments arising from a hedging instrument and the hedged item. This is particularly relevant for fair value hedges.
- **Hedged Items and Risk Components:** Address the accounting treatment of components of a non-financial item and how they are hedged (for example, the interest rate component of a variable rate loan).
- **Cash Flow Forecast Modifications:** Document how changes to cash flow forecasts for forecast transactions will be handled in the financial statements. These modifications could affect the accounting for cash flow hedges.
- **Hedge Accounting Disclosures:** Ensure compliance with extensive disclosure requirements, including information about the nature and extent of hedging activities, risk management objectives and policies, and the effect of hedging on the financial statements.
- **Expert Advice and Education:** Given the complexity of hedge accounting under Ind AS 109, entities should seek expert advice, provide adequate training to personnel involved in hedge accounting, and stay updated with any changes or interpretations of the standard.

CONCLUDING REMARKS

Hedge accounting under Ind AS 109 is a crucial component of financial reporting, enabling entities to align their accounting treatment with their risk management strategies. By recognising the economic reality of hedging activities, Ind AS 109 helps reduce earnings volatility and provides more accurate financial statements. Addressing the above issues is essential to ensure effective and compliant hedge accounting under Ind AS 109.

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