

Accounting Treatment For Derivatives: Issues & Challenges

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For a common man, 'derivatives' are financial instruments whose value changes in response to the changes in underlying variables. The main types of derivatives are Financial and Commodity Derivatives. Further Financial Derivatives are reclassified into: futures, forwards, options, and swaps.

"The use of derivatives can result in large losses due to the use of leverage," reads a cautionary paragraph that cites major financial disasters such as the Nick Leeson affair in 1994, the bankruptcy of Long-Term Capital Management in 2000, the losses suffered by Amaranth Advisors and Société Générale.

Derivatives allow investors to earn large returns from small movements in the underlying asset's price. However, investors could lose large amounts if the price of the underlying moves against them significantly.

The markets for derivatives have been remarkable and have witnessed continued growth over the past decade. This reflects the increasing use of such instruments by business, either for speculation or for hedging purposes. Accordingly, the accounting treatment for derivatives and hedging activities has taken on a high degree of importance. Hedge accounting does not sit well with the standard setters' desired goal for financial instrument accounting, i.e. a full fair value model. Further, hedge accounting relies on management intent to link for accounting purposes what the standard setters see as two or more separate transactions. It also overrides accounting requirements that would otherwise apply to those transactions when viewed separately.

The accounting of financial instruments is not based on their use, whether those are used for hedging or not. In case they are not used for hedging, they could fall under any of the four categories: (i) Financial asset/liability at fair value through profit and loss account (ii) Held-to-maturity investments (iii) Loans and receivables and (iv) Available for sale.

How do you measure something that is yet to be realised? Difficult, but that's what the Institute of Chartered Accountants of India (ICAI), the body that seeks to regulate the profession of accountancy in India, has apparently asked its members, with regard to derivatives.

UNDERSTANDING FINANCIAL INSTRUMENTS

Financial asset/liability at fair value through profit and loss account would generally cover trading items and those that management voluntarily wishes to classify under this category. Changes in the fair value of financial asset/liability are taken to the income statement and consequently, the income statement would become highly volatile.

Derivatives would fall under this category, unless they are used for hedging purposes in which case hedge accounting will be applicable.

Held-to-maturity, financial assets are those investments in which investors are having positive intention to hold those assets till the maturity period. They do not include derivatives since they are included in the first category. A financial asset that fulfills the definition of loans and receivables are also not included in this category.

Besides, an investment which is otherwise held-to-maturity may be classified voluntarily by the management in the fair value category or available for sale category.

Held-to-maturity, investments are accounted for through the effective interest rate method and the consequent gains and losses are recognised in the income statement of the organization.

Standard setters believe that separate accounting is the best way to "tell it as it is", in other words, to apply the full fair value model. However, the wider financial reporting community could not be persuaded to accept the abolition of hedge accounting. Accounting Standard AS-30 on Financial Instruments-Recognition and Measurement has been issued by the institute as published in January 2008 journal.

As per the publication, this Accounting Standard will become mandatory in respect of accounting period commencing on or after April 1, 2011, for all commercial, industrial and business entities except a small and medium size entity.

Correspondingly, a limited revision has also been made to AS-11 so as to withdraw the requirements concerning

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forward exchange contracts from that Standard. ICAI is also in process of formulating a separate Accounting Standard AS-32 on Financial Instruments-Disclosures. As such, AS-30 deals with Recognition and Measurement, and AS-32 deals exclusively with Disclosure.

CONCEPT OF HEDGE ACCOUNTING

As required by the standard, on the date of this standard becoming mandatory, an entity should; measure all derivatives at fair value; and eliminate all deferred losses and gains, if any, arising on derivatives that under the previous accounting policy of the entity were reported as assets or liabilities.

Any resulting gain or loss (as adjusted by any related tax expense/benefit) should be adjusted against opening balance of revenue reserves and surplus.

On the date of this standard becoming mandatory, an entity should not reflect in its financial statements a hedging relationship of a type that does not qualify for hedge accounting under this standard (for example, hedging relationships where the hedging instrument is a cash instrument or written option; where the hedged item is a net position; or where the hedge covers interest risk in a held-to-maturity investment). However, if an entity designated a net position as a hedged item under its previous accounting policy, it may designate an individual item within that net position as a hedged item under Accounting Standards, provided that it does so on the date of this standard becoming mandatory.

If, before the date of this standard becoming mandatory, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in this standard, the entity should apply paragraphs 102 and 112 to discontinue hedge accounting. Transactions entered into before the date of this standard becoming mandatory should not be retrospectively designated as hedges.

TREATMENT OF EMBEDDED DERIVATIVES

As entity that applies this standard for the first time should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed on the date it first became a party to the contract or on the date on which a reassessment is required by appendix A paragraph A56, whichever is the later date.

RECENT ANNOUNCEMENT : ACCOUNTING TREATMENT FOR DERIVATIVES

Notwithstanding the applicability of AS-30, it is very important to understand the impact and effect of this announcement. The announcement on accounting for derivatives issued by ICAI on March 29, 2008, clarifies the best practice treatment to be followed for all derivatives, is as follows:

- (i) All derivatives except forward contracts covered by AS-11, can be accounted for on the basis of the requirements prescribed in AS-30, Financial Instruments: Recognition and Measurement.
- (ii) 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 date of balance sheet by marking them to market.

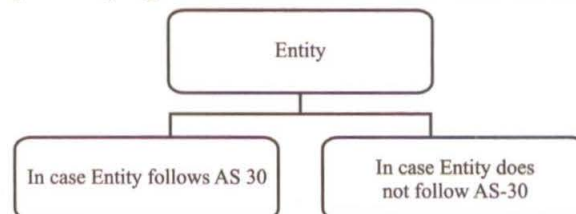
ISSUES INVOLVED INTO THE IMPLEMENTATION OF AS-30

Accounting Perspective:

Impact of Announcement:

The effect of the above announcement is as follows:

The impact can be understood by classifying the issue into two broader classifications i.e.



(a) In case an entity does not follow AS-30, the losses in respect of derivative contracts at the balance sheet date have to be provided for and disclosed.

(b) In case an entity follows AS-30, then the effect will be broadly as follows:

In case the derivatives do not meet the hedge accounting criteria as laid down in AS 30, the gains or losses in respect thereof will have to be recognised in the statement of profit and loss. The derivatives will have to be shown as financial assets or financial liabilities on the balance sheet, as the case may be, as per the requirements of the accounting standard.

In case the hedge accounting criteria, e.g., hedge effectiveness, qualifying hedges, documentation etc, as laid down in AS-30 are met, the entity will have to consider, keeping in view the requirements of AS-30, whether the hedge is a fair value hedge or cash flow hedge.

'Fair value hedge' and 'cash flow hedge' have been explained in AS-30 as follows:

(a) **Fair value hedge:** A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

(b) **Cash flow hedge:** A hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.

As per the standard, a hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or a cash flow hedge.

Accounting Treatment for Fair Value Hedges: Fair value hedges are accounted for as follows:

➤ The gain or loss for re-measuring the derivative hedge instruments at fair value should be recognised in the statement of profit and loss, and

➤ The gain or loss on the hedged items (the underlying) should adjust the carrying amount of the said items and be recognised in the statement of profit and loss.

Accounting Treatment for Cash flow Hedges : Cash flow hedges are accounted for as follows:

➤ (i) In case of effective cash flow hedges, the gain or loss on the hedging derivative is recognised directly in an appropriate equity account, say, hedge reserve account (the ineffective hedge portion is recognised in the statement of profit and loss account).

➤ (ii) If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised directly in the appropriate equity account in accordance should be reclassified into, i.e., recognised in the statement of profit and loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised).

➤ (iii) If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity should adopt (a) or (b) below:

(a) It reclassifies, i.e., recognises the associated gains and losses that were recognised directly in the appropriate equity account into the statement of profit and loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised).

(b) It removes the associated gains and losses that were recognised directly in the equity account, and includes them in the initial cost or other carrying amount of the asset or liability.

An entity should adopt either (a) or (b) as its accounting policy and should apply it consistently to all hedges to which (iii) above relates.

➤ (iv) For cash flow hedges, other than those covered by paragraphs (ii) and (iii) above, amounts that had been recognised directly in the equity account should be reclassified into, i.e., recognised in the statement of profit and loss in the same period or periods during which the hedged forecast transaction affects profit or loss (for example, when a forecast sale occurs).

AUDITING PERSPECTIVE

Recently, ICAI asked auditors to adopt a new accounting norm that forces companies to disclose and/or provide for all losses on derivative contracts. In the eye of the storm is Accounting Standard 30 (AS-30) that was earlier supposed to be mandatory from April 1, 2011.

The word on the street is that auditors who implement the standard as per the ICAI's wishes may end up opening the Pandora's Box for Indian companies.

But, what if they do not adopt? Do they have any option of not to opt?

“Irrespective of whether or not the ICAI's announcement is binding on corporates, the members of the Institute have to certainly take into account the guidance while giving their opinion on the March 31, 2008 financial statements,” as per the general opinion of financial experts .

TAXATION PERSPECTIVE

In the absence of special provisions, the current provisions are inadequate to handle the complexities involved

into it. It is expected that the Central Board of Direct Taxes (CBDT) will shortly provide guidelines for taxation aspects of Derivative transactions.

INTERNATIONAL PRACTICE

Statement of Financial Accounting Standard No. 133 issued by the Financial Accounting Standard Board, US defines the criteria /attributes which an instrument should have to be called as derivative and also provides guidance for accounting of derivatives. The Standard is facing tough opposition and controversies from the US business and industry.

CHALLENGES

1. The Income tax department may take a stand that profits and losses accrue on a day to day basis, in view of the daily settlement procedure. This could be contrary to the accounting guidelines, which (as it currently appears) may advocate profit (loss) recognition at the expiry of the contract.

2. It appears currently that accounting guidelines will require recognition of unrealised losses at financial year end, but not unrealised profits. The Income tax department may not agree with this conservative treatment.

3. Section 43(5) speaks of purchase and sale of any 'commodity', including shares and stocks. Index futures are not 'commodities'. Further, index futures are also not 'stocks and shares'. Hence, section 43(5) does not apply to futures transactions. The question of examining the provisos (exceptions) does not arise.

4. Exceptions to 'speculative transactions' as provided in Section 43(5) also include hedging transactions undertaken in respect of stocks and shares. Proviso & (b) to Section 43(5) states a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations'. It however remains to be seen whether index futures can be covered under 'stocks and shares'.

To our mind, it appears that if index futures are considered to be part of stocks and shares as per the wording of Section 43(5), then the proviso will also become applicable and hence hedging contracts through the mechanism of index futures will not be considered speculative. On the other hand, if index futures are not part of stocks and shares, then neither Section 43(5) nor the proviso applied and hence the entire gamut of index futures transactions will remain out of the purview of speculative transactions.

5. Explanation to Section 73 speaks of purchase and sale of shares of other companies. Index futures are not 'shares'. Hence, this explanation does not apply to futures transactions.

It is believed and understood that foreign exchange forward transactions are currently not being caught within the mischief of Sections 43 and 73. This lends more comfort to the possibility of index futures also being left out of this net, though only experience will indicate the stand the Income tax department will take.

Understanding AS-30 through Q & A

Generally asked Question	Answer
Q.1) What are the conditions where companies may gain?	Ans.1) Corporates with outstanding financial instruments and not adopting AS30 till March 31, 2008, will need to 'measure' unrealised gains/losses on financial instruments and 'record' only unrealised losses, while ignoring unrealised gains.
Q.2) Is there a problem with enforceability of the Institute's pronouncement?	Ans.2) The ambiguity surrounding the enforceability emanates from the fact, that the announcement is not part of any accounting standard or interpretation that is adopted as law. Currently, corporates prepare financial statements using accounting standards that are notified as law by the Companies (Accounting Standards) Rules 2006. They may need more clarity if they need to recognise unrealised losses on financial instruments, in case they do not early adopt AS30.
Q.3) On which aspect the clarification is urgently required?	Ans.3) Even pragmatic corporates that chose to early adopt AS30 will need clarification on AS30 principles that are not convergent with other prevailing accounting standards, e.g., recognition of unrealised gains on trading assets, etc. By virtue of being notified as law, adopting differing accounting principles could tantamount to breach of law.
Q.4) What if auditors are asked by companies not to adopt this?	Ans.4) Irrespective of this announcement being binding on corporates, the members of the Institute have to certainly take into account this guidance when giving their opinion on the March 31, 2008 financial statements.

CONCLUSION

The Indian accounting guidelines in this area need to be carefully reviewed. The international trend is moving towards marking the underlying securities as well as associated derivative instruments to market. Such a practice would bring into accounts a clear picture of the impact of derivatives related operations. Indian accounting is based on traditional prudence where profits are not recognised till realisation. So this new step of ICAI needs to be welcomed by the Accounting fraternity as it is a move towards internationalization & moreover rationalization of Indian Accounting Framework.

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