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Hedge accounting and its indications in India: a review

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Abstract

The new business era has invited risk to the sector in many forms. It's a challenge to every business to avoid risk and maximize its wealth. The motive of an organization would be less risk and high returns to achieve this companies are practicing several tools one such is hedge accounting. It aims to provide a better link between an entity's risk management strategy, the rationale for hedging and the impact of hedging on the financial statements. The risk management strategy is established at the highest level of an entity and identifies the risk to which the entity is exposed and whether how the risk management activities should address those risks. The new hedge accounting model under IND AS 109 Financial Instruments will allow entities to loss and balance sheet volatility by applying hedge accounting in more circumstances. The change in accounting treatment is expected to prompt some companies to review their risk management activities which may have been previously restricted for the purpose of hedge accounting.

Key words: financial instruments, hedge accounting, risk management.

Introduction

The increasing pace of changes in business environment impacting every aspect of the business world. Every company is different in its operation with multiphase technology evolution has transformed workflows and created new efficiencies through the simplification and automation of complex manual tasks.A decade ago, hedge accounting was the domain of inflexible, complicated, multi-tabbed and frequently cross- linked spreadsheets. Designation, effectiveness testing, exposure gathering, hedging activity and trade management were all handed manually. As hedge accounting regulations matured, more Treasury and Accounting departments provides recognizing the need and wanting to meet customer demands began to offer hedge accounting opportunities.

Meaning of hedge accounting

Companies are exposedto financial risks arising from many aspects of their business. Companies implement different risk management strategies to eliminate or reduce their risk exposure. In simple terms hedge accounting is a technique that modifies the normal basis for recognizing gains and losses on associated hedging instruments and hedged items, so that both are recognized in P&L or Other Comprehensive Income (OCI) in the same accounting period. This matching concept

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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 IFRS. Under IFRS 9, hedge accounting continues to be optional, and management should consider the cost and benefits when deciding whether to use it.

Hedge accounting in india

In the year 2012 when SEBI promulgated its Alternative Investment Funds (AIF) regulations, governing hedge, real estate and private equity funds registered in that country. SEBI distinguished 3 categories of AIF: those funds receiving incentives from the government, those which operate in the country on the understanding that they will not "undertake leverage or borrowing other than to meet day-to-day operational requirements", and those that may employ leverage "including through investment in listed or unlisted derivatives". These are known as Category I, II, and III.

- Category I consist of infrastructure funds and others thought to have positive externalities for society at large;
- Category II consist of Private Equity, Venture Capital and debt funds
- Category III of hedge funds

These 3 categories are treated in significantly disparate ways by the law in India. The funds in the first two categories are tax pass- through status, whereas hedge funds were not is the major difference between the categories.

- In the year 2011 SEBI established an Alternative investments policy Advisory Committee to study "the further development of the alternative investment and startup ecosystem in India". The chairperson of the committee was and is N.R. Narayana Murthy, the founder of Infosys.
- The committee has provided SEBI with two new reports on AIFs, one in the year 2016, and the other at the end of the year.
- The first report suggested various tax and regulatory charges that might facilitate the capital raising ability of AIFs.
- The second report was in the nature of a follow up.
- These reports represent a cumulative sense among the Indian leading alternative investment vehicles which are advantageous to the country.
- The report submitted on January 2016 stated, between 2001and 2015," Venture capital and private equity of more than 10300 crores was invested in Indian companies. In more than 3100 companies across 12 major sectors, including those important for the country's development" such as mobile telecom and information technologies.

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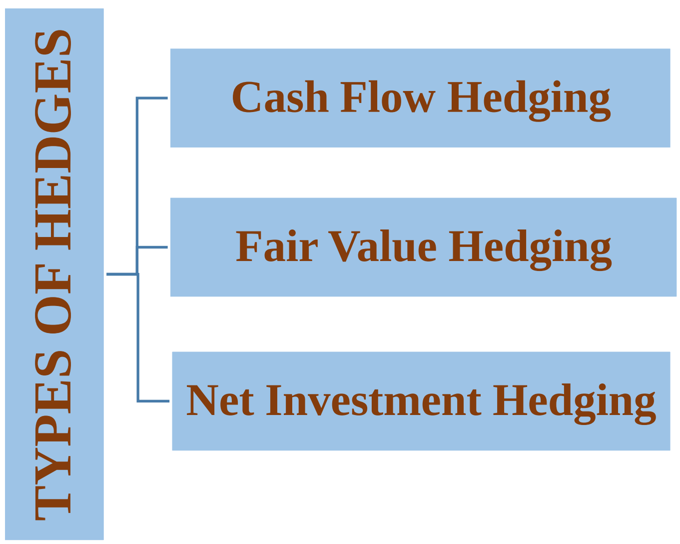
The second report

- The second report in the year 2016, points out all the money entering alternative vehicles was coming from abroad, that "the domestic funding of AIFs has grown rapidly by 108% approximately during the last 12 months".
- This report applauded India-Mauritius Double Tax Avoidance Agreement (DTAA), designed to encourage the flow of money through Mauritius to India.
- One of the key to the two reports recommendations is a proposal to offer pass- through tax status to Category III AIFs.
- The recommendations include a waiver of the service tax paid by funds on the management fee, introduction of a securities transaction tax, and the application of the capital gains tax to certain income of category II funds.

Types of hedges



1. Cash Flow Hedging

It is done to protect cash flow positions of the organization from change in the exchange rate fluctuations. The risk being hedged in a cash flow hedge is the exposure to variability cash flows that is attributable to a particular risk associated with a recognized asset or liability, an unrecognized firm commitment or a highly probable forecast transaction, and could affect P&L.

Provisions

- Under IAS 39, the entity could elect, as a policy choice, the treatment to maintain the accumulated gains or losses in equity and reclassify them to P&L at the same moment that the non-financial items affects P&L. this accounting policy choice is no longer allowed under IFRS 9

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- Where the net position of group of items containing offsetting risk positions is designated as the hedged item, the cash flow hedge model can only be applied to the foreign currency risk.
- The designation of that net position must specify both the reporting period in which the forecast transaction are expected to affect P&L and also the nature and volume that are expected to affect P&L and OCI.
- For cash flow hedges of a group of items with no offsetting risk position, the presentation of hedging gains or losses are appointed to the line items. IAS 39 did not prescribe the presentation of gains or losses in P&L.

2. Fair Value Hedging

It is the hedging of exposures of all foreign currency receivables and payables in the books which are subject to revaluation and changes in the debit and credit side of P&L. Fair value hedging is done either in Offshore Treasury Center's like New York, London, Singapore, Australia, Tokyo, Hong Kong, Dubai, Philippines and Malta Financial Centre or local currency books.

Provisions

- The risk being hedged in a fair value hedge is a change in the fair value of an asset or liability or an unrecognized firm commitment that is attributable to a particular risk and could affect P&L. changes in fair value might arise through changes in interest, foreign exchange rates, and equity or commodity prices.
- The carrying value of the hedged item is adjusted for fair value changes attributable to the risk being hedged, and those fair value changes are recognized in P&L. The hedging instrument at the fair value, with the changes in fair value also recognized in P&L.
- The risk being hedged in a cash flow hedge is the exposure to variability in cash flows that is attributable to a particular risk associated with a recognized asset and liability, an unrecognized firm commitment or a highly probable forecast transaction, and could affect P&L.

3. Net Investment Hedging

Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net asset of that foreign operation are included in the financial statements. The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of the net assets equal to or less than the carrying amount of the net assets of the foreign operation.

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Provisions

- An entity might have overseas subsidiaries, associates, joint ventures or branches. It might hedge the currency risk associated with the translation of the net assets of these foreign operations into the parent entity's functional currency.
- The amount of a net investment in a foreign operation under IAS 21 is the reporting entity's interest in the net assets of that operation, including any recognized goodwill.
- Exchange differences arising on the consolidation of these net assets are deferred in equity until the foreign operation is disposed of or liquidated.
- They are recognized in P&L, on disposal or liquidation, as part of the gain or loss on disposal.
- The foreign currency gains or losses on the hedging instrument are deferred in OCI, to the extent that the hedge is effective, until the subsidiary is disposed of or liquidated, when they become part of the gain or loss on disposal.

Conclusion

Hedging relationships that qualified for hedge accounting in accordance with IAS 39, that also qualify for hedge accounting in accordance with IFRS 9, are regarded as continuing hedging relationships. Any gain or loss from such rebalancing must be recognized in P&L. application of its hedge accounting requirements for all hedging relationships which means that on the date of transition, all existing hedging relationship should be moved from the existing model under IAS 39 into the new model in IFRS 9

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