Exposure Draft

Amendments to Guidance Note on Accounting for Derivative Contracts (IBOR Phase 2 Replacement Issues)

Last date for the comments: June 21, 2021

The ASB invites comments on limited aspect of this Exposure Draft, i.e., only on paragraph 62 and Appendix IV.

Interest Rate Benchmark Reform

62. Interest rate benchmark reform has impacted the way financial information is accounted for in the financial statements. To address the accounting issues necessary exceptions to the hedge accounting have been prescribed in this Guidance Note as under:

• Phase 1- Pre-replacement issues—issues affecting financial reporting in the period during which there is uncertainty about the timing or the amount of interest rate benchmark-based cash flows. To address these issues, an Announcement has been issued by the ICAI providing temporary exceptions from hedge accounting requirements, for accounting periods beginning on or after April 1, 2020. The same is included in the Guidance Note as Appendix III.

• Phase 2- Replacement issues—issues affecting financial reporting when the uncertainty regarding the timing and the amount of interest rate benchmark- based cash flows is resolved and hedging relationships are affected as a result of the reform. To address replacement issues arising from interest rate benchmark reform, Appendix IV has been added to provide practical expedient for modifications of the financial contracts that are affected by interest rate benchmark reform with the view to avoid undue impact on the financial statements where the transactions are economically equivalent to the previous basis (i.e., before and after interest rate benchmark reform).

Comments: The ED adds a new para No.62 on 'Interest Rate Benchmark Reform'. Basically it addresses the 'pre-replacement' issues under Phase-I and 'Replacement' issues under Phase: 2. The Comments are requested with reference to 'Replacement' issues described in Appendix-IV.

Appendix IV Interest Rate Benchmark Reform: Replacement issues

To address replacement issues (Phase 2) arising from Interest Rate Benchmark Reform, this Appendix has been added to the Guidance Note on Accounting for Derivative Contracts. End of Application of temporary exceptions to Hedge Accounting for non-contractually specified risk component due to interest rate benchmark reform (refer paragraph 74 of ICAI Announcement- Appendix III)

1. An entity shall prospectively cease applying paragraph 7 of ICAI Announcement (Appendix III) at the earlier of:

(a) when changes required by interest rate benchmark reform are made to the non-contractually specified5 risk component applying paragraph 2; or

(b) when the hedging relationship in which the non-contractually specified risk component is designated is discontinued.

Temporary exceptions from applying specific hedge accounting requirements arising from interest rate benchmark reform- Phase II

2. As and when the requirements in paragraphs 4-7 of the ICAI Announcement (Appendix III) cease to apply to a hedging relationship (see paragraphs 8-11 of the ICAI Announcement (Appendix III) and paragraph 1), an entity shall amend the formal designation of that hedging relationship as previously documented to reflect the changes required by interest rate benchmark reform, i.e., the changes are consistent with the requirements in paragraphs 9-11. In this context, the hedge designation shall be amended only to make one or more of these changes:

(a) designating an alternative benchmark rate as a hedged risk;

(b) amending the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged; or

(c) amending the description of the hedging instrument.

3. An entity also shall apply the requirement in paragraph 2(c) if these three conditions are met:

(a) the entity makes a change required by interest rate benchmark reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument (as described in paragraph 9);

(b) the original hedging instrument is not derecognised; and

(c) the chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument (as described in paragraphs 10-11).

4. The requirements in paragraphs 4-7 of the ICAI Announcement (Appendix III) may cease to apply at different times. Therefore, in applying paragraph 2, an entity may be required to amend the formal designation of its hedging relationships at different times, or may be required to amend the formal designation of a hedging relationship more than once. When, and only when, such a change is made to the hedge designation, an entity shall apply paragraphs 12-17 as applicable. An entity also shall apply paragraph 28 (for a fair value hedge) or paragraph 35 (for a cash flow hedge) of the Guidance

Note to account for any changes in the fair value of the hedged item or the hedging instrument.

5. An entity shall amend a hedging relationship as required in paragraph 2 by the end of the reporting period during which a change required by interest rate benchmark reform is made to the hedged risk, hedged item or hedging instrument. For the avoidance of doubt, such an amendment to the formal designation of a hedging relationship constitutes neither the discontinuation of the hedging relationship nor the designation of a new hedging relationship.

6. If changes are made in addition to those changes required by interest rate benchmark reform to the financial asset or financial liability designated in a hedging relationship (as described in paragraphs 9-11) or to the designation of the hedging relationship (as required by paragraph 2), an entity shall first apply the applicable requirements in the Guidance Note to determine if those additional changes result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, an entity shall amend the formal designation of the hedging relationship as specified in paragraph 2.

7. Paragraphs 12-18 provide exceptions to the requirements specified in those paragraphs only. An entity shall apply all other hedge accounting requirements of the Guidance Note, including the qualifying criteria in paragraphs 42 and 44 of the Guidance Note, to hedging relationships that were directly affected by interest rate benchmark reform.

Changes in the basis for determining the contractual cash flows of a financial asset or financial liability designated in hedging relationship as a result of interest rate benchmark reform

8. Changes in contractual cash flows are relevant for the practical expedients given in this Appendix if the same are result of interest rate benchmark reform.

9. The basis for determining the contractual cash flows of a financial asset or financial liability can change:

(a) by amending the contractual terms specified at the initial recognition of the financial instrument (for example, the contractual terms are amended to replace the referenced interest rate benchmark with an alternative benchmark rate); (b) in a way that was not considered by—or contemplated in—the contractual terms at the initial recognition of the financial instrument, without amending the contractual terms (for example, the method for calculating the interest rate benchmark is altered without amending the contractual terms); and/or (c) because of the activation of an existing contractual term (for example, an existing fall-back clause is triggered).

10. A change in the basis for determining the contractual cash flows is required by interest rate benchmark reform if, and only if, both these conditions are met:

(a) the change is necessary as a direct consequence of interest rate benchmark reform; and (b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the change).

11. Examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis (ie the basis immediately preceding the change) are:

(a) the replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate—or the implementation of such a reform of an interest rate benchmark by altering the method used to calculate the interest rate benchmark—with the addition

of a fixed spread necessary to compensate for the ~~basis~~ basic difference between the existing interest rate benchmark and the alternative benchmark rate; (b) changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

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(c) the addition of a fall back provision to the contractual terms of a financial asset or financial liability to enable any change described in (a) and (b) above to be implemented.

Accounting for qualifying hedging relationships

Cash flow hedges

12. For the purpose of applying paragraph 35 of the Guidance Note, at the point when an entity amends the description of a hedged item as required in paragraph 2(b), the amount accumulated in the cash flow hedge reserve shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

13. For a discontinued hedging relationship, when the interest rate benchmark on which the hedged future cash flows had been based is changed as required by interest rate benchmark reform, for the purpose of applying paragraphs 59-61 of the Guidance Note in order to determine whether the hedged future cash flows are still probable to occur, the amount accumulated in the cash flow hedge reserve for that hedging relationship shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

Groups of items

14. When an entity applies paragraph 2 to groups of items designated as hedged items in a fair value or cash flow hedge, the entity shall allocate the hedged items to subgroups based on the benchmark rate being hedged and designate the benchmark rate as the hedged risk for each subgroup. For example, in a hedging relationship in which a group of items is hedged for changes in an interest rate benchmark subject to interest rate benchmark reform, the hedged cash flows or fair value of some items in the group could be changed to reference an alternative benchmark rate before other items in the group are changed. In this example, in applying paragraph 2, the entity would designate the alternative benchmark rate as the hedged risk for that relevant subgroup of hedged items. The entity would continue to designate the existing interest rate benchmark as the hedged risk for the other subgroup of hedged items until the hedged cash flows or fair value of those items are changed to reference the alternative benchmark rate or the items expire and are replaced with hedged items that reference the alternative benchmark rate.

15. An entity shall assess separately whether each subgroup meets the requirements to be an eligible hedged item. If any subgroup fails to meet the requirements, the entity shall discontinue hedge accounting prospectively for the hedging relationship in its entirety. An entity also shall apply the requirements in paragraphs 28 and 35 of the

Guidance Note to account for ineffectiveness related to the hedging relationship in its entirety.

Designation of risk components

16. An alternative benchmark rate designated as a non-contractually specified6 risk component that is not separately identifiable at the date it is designated shall be deemed to have met that requirement at that date, if, and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within 24 months. The 24-month period applies to each alternative benchmark rate separately and starts from the date the entity designates the alternative benchmark rate as a non-contractually specified risk component for the first time (ie the 24-month period applies on a rate-by-rate basis).

17. If subsequently an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months, the entity shall cease applying the requirement in paragraph 16 and discontinue hedge accounting prospectively from the date of that reassessment for all hedging relationships in which the alternative benchmark rate was designated as a non-contractually specified risk component.

18. In addition to those hedging relationships specified in paragraph 2, an entity shall apply the requirements in paragraphs 16 and 17 to new hedging relationships in which an alternative benchmark rate is designated as a non-contractually specified risk component when, because of interest rate benchmark reform, that risk component is not separately identifiable at the date it is designated.

6 Refer footnote to paragraph 7 of the Announcement issued by the ICAI (Appendix III)

Disclosures

19. To enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy, an entity shall disclose information about:

(a) the nature and extent of risks to which the entity is exposed arising from financial instruments subject to interest rate benchmark reform, and how the entity manages these risks; and (b) the entity's progress in completing the transition to alternative benchmark rates, and how the entity is managing the transition.

Effective Date

20. An entity shall apply amendments stated in paragraphs 1-19 and 21-23 for annual periods beginning on or after 1st April 2021.

Transition

21. An entity shall designate a new hedging relationship (for example, as described in paragraph 18) only prospectively. However, an entity shall reinstate a discontinued hedging relationship if, and only if, these conditions are met:

(a) the entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging relationship if these amendments had been applied at that time; and

(b) at the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (after taking into account these amendments).

22. If, in applying paragraph 21, an entity reinstates a discontinued hedging relationship, the entity shall read references in paragraphs 16 and 17 to the date the alternative benchmark rate is designated as a non-contractually specified risk component for the first time as referring to the date of initial application of these amendments (i.e., the 24-month period for that alternative benchmark rate designated as a non-contractually specified risk component begins from the date of initial application of these amendments).

23. The entity shall recognise any difference (net of taxes) between the previous carrying amount and the carrying amount at the beginning of the annual reporting period of application of these amendments in the opening reserves and disclose separately.

Comments:

In Para:9(a) there is a minor correction [fall-back]

Few spelling errors are corrected. [para: 11(a) Line No.5: the word ‘basis’ replaced by the word ‘basic’

Para:2(a) may add-

(i) An entity to disclose how the entity is managing the transition to alternative benchmark rates, its progress at the reporting date and the risks arising from the transition.

(ii) An entity to disclose disaggregated by significant interest rate benchmark, the carrying amount of non-derivative financial assets, the carrying amount of non-derivative financial liabilities and the nominal amount of derivatives, each shown separately, that continue to reference interest rate benchmarks subject to interest rate benchmark reform;

(c) An entity to disclose for each significant alternative benchmark rate to which the entity is exposed, a description of how the entity determined the base rate and relevant adjustments to that rate, including any significant judgements the entity made to assess whether the required conditions were met; and

(d) An entity to disclose to the extent that interest rate benchmark reform has resulted in changes to an entity’s risk management strategy, a description of those changes and of how the entity is managing these risks.

Cash flow hedges

Comments:

Para: 12 deals with 'cash flow hedges'. the proposed disclosures are primarily qualitative in nature and therefore, there is a risk that entities will provide standardised disclosures. Disclosure of information about financial instruments disaggregated by interest rate benchmarks may require more quantitative information about alternative benchmark rates.

There is no certainty whether entities would disclose information with sufficient granularity for it to be meaningful and there is a risk that the disclosures would be summarised at such a level that it would not be useful.

It is highlighted that adverse consequences affecting the implementation of the reform cannot be excluded due to uncertainty that arises from the current COVID-19 pandemic situation. Alternatively, the identification criterion could be presumed to be met, provided measurement is performed on a reliable basis. The entity would subsequently have to check whether this presumption is not negatively challenged within the following 24 months.

Groups of items

Comments;

During the transition period the financial instruments might transition to a new rate at different times. Therefore, for cash flow hedges of groups of items, the hedged items could consist of items still referenced to the interest rate benchmark as well as items that are already referenced to the alternative benchmark rate. Therefore, when amending the description of the hedged items, the entity would allocate the hedged items to subgroups based on the benchmark rate to which they are referenced and designate the benchmark rate for each sub-group as the hedged risk. The entity would apply the proportionality test to each subgroup separately.

Designation of risk components

Comments:

The draft may consider clarifying the wording used to explain the expectation should always relate to the end of 24-month period, regardless of whether this expectation is made either during or at the end of the 24-month period. It is suggested that the Board has to continue to monitor future developments of alternative rate markets to assess whether it may become necessary to extend the 24-month temporary relief period for the separately identifiable assessment.

Disclosures

Comments:

Para:19 deals with 'Disclosures'. The Board may specify that the proposed disclosures particularly the quantitative information would not be required for the comparative period unless the entity restates comparative periods. The costs of providing such information may outweigh the benefits. In particular, the information for the comparative period would not be useful to investors because in the comparative period they would have either not started, or be in early stages, of effecting the reform; and preparing this information could be challenging, particularly if an entity applies the amendments earlier than the effective date. We highlight that the potential lack of comparability between different entities because their respective granularity of information disclosed may be different for the same alternative benchmark rate.

Also Standards do not currently require entities to disclose information about financial instruments that reference variable rates disaggregated by interest rate benchmarks. Also, while in some cases such information might be available and consistent with information already required by regulators, in other cases, it could require entities to make costly enhancements to reporting systems and implement additional controls and reconciliations; which in the light of a limited timeframe, could be challenging for preparers to do, in particular early adopters. Therefore, the standard may permit entities to disclose quantitative information in alternative ways.

It may worth clarifying whether the scope of the proposed disclosure would apply to financial instruments which, at reporting date, reference interest rate benchmarks subject to the reform but will mature prior to transitioning to alternative benchmark rates.

There could be potential challenges in disclosing this information in a meaningful way by reference to multinational entities that are exposed to different alternative benchmark rates.

Disclosure of information about the fixed spread adjustments for the different rates and different jurisdictions may not be meaningful without disaggregating that information between operating segments or geographic regions.

Permitting entities to select the most representative basis on which they provide the relevant quantitative information to achieve that objective could allow entities to leverage information already available which would reduce costs while still providing useful information.

The Disclosure may cover that it would require an entity to disclose quantitative information that enables investors to understand the magnitude of financial instruments that are left to transition to alternative benchmark rates, instead of requiring disclosure of carrying amounts of non-derivative financial assets and financial liabilities, and nominal amounts of derivatives. Specifically, entities would be required to disclose quantitative information about non-derivative financial assets, non-derivative financial liabilities and derivatives that, at the end of the reporting period, remain referenced to interest rate benchmarks subject to the reform. This information would be disaggregated by significant interest rate benchmark.

For the purposes of this disclosure, an entity would choose the representative basis for disclosing the quantitative information and explain what basis it applied in the financial statements.

Effective date:

Comments:

Para: 20 says effective date 1 April 2021. It is to be corrected as 1 April 2022 since we are already in June, 2021.

Transition:

Comments:

SIRC is of the view that the transition to alternative rate should generally be seen as an evolution in affected hedging relationships rather than a discontinuity. Further, the aforementioned principles would meet this objective of providing continuity to hedge accounting and address qualitative and quantitative concerns related to interest rate benchmark reform.

The principles acknowledge that anticipated changes to interest rate benchmarks will generally impact both the hedged item and hedging instrument, and therefore the hedging instrument and hedged item will respond to these same risks.

The principles above would require an entity to derive estimates and assumptions about market interest rates in projecting and valuing the future cash flows in a cash flow hedge. If forecast changes in derivative cash flows and hedged item cash flows are not anticipated to occur at the same time or otherwise have an exactly offsetting effect, then the effect of that expected mismatch should be reflected in ineffectiveness calculations and, as appropriate, profit or loss.

It is stressed that any hedge ineffectiveness resulting from transition is reported in profit or loss as it arises. There should be a clear differentiation between the impacts of interest rate benchmark reform on the prospective and retrospective effectiveness assessments versus the measurement of ineffectiveness. It is suggested that the Board should clarify that hedge disqualifications should not be caused by uncertainties related to interest rate benchmark reform nor by treating cash flows or values based on the new benchmark as of a fundamentally different type from those based on the old benchmark, it should also clarify that the requirements related to the measurement of ineffectiveness are not affected and continue to apply to the effects of such changes.

These principles-based proposals should permit retrospective application of the targeted relief, including reinstatement of hedges that were previously discontinued only because those principles were not previously applied.

Comments - II From other Members

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Guidance Note on Accounting for Derivative Contracts

Introduction

1. In the year 2007, the Institute of Chartered Accountants of India (ICAI), issued Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31*, Financial Instruments: Presentation.* Both of these Accounting Standards were to come into effect in respect of accounting periods commencing on or after April 1, 2009 and were to be recommendatory in nature for an initial period of two years. These were to become mandatory in respect of accounting periods commencing on or after April 1, 2011. Further, it was clarified, that from the date of AS 30 becoming recommendatory in nature, the following Guidance Notes on Accounting, issued by the ICAI, stood withdrawn:

   (i) Guidance Note on Guarantees & Counter Guarantees given by the Companies

   (ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds

   (iii) Guidance Note on Accounting for Securitisation

   (iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

2. In March 2008, the ICAI issued an announcement that in case of derivatives, if an entity does not follow AS 30, keeping in view the principle of prudence as enunciated in Accounting Standard (AS) 1*, Disclosure of Accounting Policies***,** the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market. This announcement was applicable to financial statements for the period ending March 31, 2008, or thereafter. In case of forward contracts to which Accounting Standard (AS) 11*, The Effects of Changes in Foreign Exchange Rates (revised 2003)* applies the entity needs to fully comply with the requirements of AS 11.

3. Subsequently, in the year 2008, Accounting Standard (AS) 32, *Financial Instruments: Disclosures,* was issued by the ICAI, which was also recommendatory initially and was to become mandatory in respect of accounting periods commencing on or after April 1, 2011.

4. Owing to global financial crisis which raised issues regarding accounting treatment of financial instruments, various accounting standards setting bodies including the ICAI examined these aspects. Later, the ICAI withdrew the recommendatory as well as mandatory status of AS 30, AS 31 and AS 32 in March 2011 by means of an announcement. The announcement clarified that considering that International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, issued by the International Accounting Standards Board (IASB), on which AS 30 is based, was under revision by the IASB. AS 30 was not expected to be continued in its present form, i.e., was expected to be revised. Further, the status of AS 30, AS 31 and AS 32 was clarified as below[1]:

   (i) To the extent of accounting treatments covered by any of the existing notified Accounting Standards (e.g. AS 11, AS 13 etc.), the existing Accounting Standards would continue to prevail over AS 30, AS 31 and AS 32.

   (ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (e.g. Loan impairment, investment classification or accounting for securitisations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30, AS 31, AS 32.

   (iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30, AS 31 and AS 32 subject to (i) and (ii) above.

5. Accordingly, currently, the relevant source of guidance for accounting of foreign currency forward exchange contracts is AS 11, which is notified under the Companies (Accounting Standards) Rules, 2006. AS 11 lays down accounting principles for foreign currency transactions and foreign exchange forward contracts and in substance similar contracts. However, it does not cover all types of foreign exchange forward contracts since contracts used to

[1] Subsequently, AS 30, AS 31and AS 32 were withdrawn by the ICAI in 2016. An Announcement was published in this regard in 'The Chartered Accountant' Journal, January 2017 Issue.

Types of hedge accounting

6. This Guidance Note recognises the following three types of hedging;

- the fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised.
- the cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
- the hedge of a net investment in a foreign operation.

Fair value hedge accounting model

7. A fair value hedge seeks to offset the risk of changes in the fair value of an existing asset or liability or an unrecognised firm commitment that may give rise to a gain or loss being recognised in the statement of profit and loss. A fair value hedge is 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 the statement of profit and loss.

8. When applying fair value hedge accounting, the hedging instrument is measured at fair value with changes in fair value recognised in the statement of profit and loss.

Fair Value Hedging Accounting Entry 01

Risk-Offsetting-Derivative-Hedging-Instrument A/c
with the amount of Fair Value Change Cr/Dr xxx

Profit / Loss Statement Dr/Cr xxx

Fair Value Hedging Accounting Entry 02

Risk-Exposing-Underlying-Hedged-Item

(Fixed-Rate Borrowing) A/c Dr/Cr xxx

with the amount of **Fair Value Change in respect of hedged risk**

Profit / Loss Statement Cr/Dr xxx

(subject to impairment testing under paragraph 31)

The hedged item is remeasured to fair value in respect of the hedged risk even if normally it is measured at cost, e.g., a fixed rate borrowing. Any resulting adjustment to the carrying amount of the hedged item related to the hedged risk is recognised in the statement of profit and loss even if normally such a change may not be recognised, e.g., for inventory being hedged for fair value changes.

9. The fair value changes of the hedged item and the hedging instrument will offset and result in no net impact in the statement of profit and loss except for the impact of **a higher infructuousness.**

Risk-Offsetting-Derivative-Hedging-Instrument's
Fair Value Change Cr/Dr xxx

Less : Risk-Exposing-Underlying-Hedged-Item

(Fixed-Rate Borrowing)'s **Fair Value Change in respect of hedged risk** Dr/Cr xxx

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Hedge infructuousness Extent Cr/Dr xxx

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10. An example of a fair value hedge is the hedge of a fixed rate bond with an interest rate swap, changing the interest rate from fixed to floating. Another example is the hedge of the changes in value of inventory using commodity futures contracts.

11. The adjusted carrying amounts of the hedged assets in a fair value hedging relationship are subject to impairment testing under other applicable Accounting Standards such as Accounting Standard (AS) 28*, Impairment of Assets,* Accounting Standard (AS) 2*, Valuation of Inventories,* Accounting Standard (AS) 13*, Accounting for Investments* etc.

Cash flow hedge accounting model

12. A cash flow hedge seeks to offset certain risks of the variability of cash flows in respect of an existing asset or liability or a highly probable forecast transaction that may be reflected in the statement of profit and loss in a future period.

13. A cash flow hedge is 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 or a firm commitment in respect of foreign currency and (ii) could affect the statement of profit and loss. An example of a cash flow hedge is the hedge of future highly probable sales in a foreign currency using a forward exchange contract. Another example of a cash flow hedge is the use of a swap to change the future floating interest payments on a recognised liability to fixed rate payments.

14. Under a cash flow hedge, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognised in equity, e.g., cash flow hedge reserve. This is intended to avoid volatility in the statement of profit and loss in a period when the gains and losses on the hedged item are not recognised therein.

Cash Flow Hedge Accounting Entry

Risk-Offsetting-Derivative-Hedging-Instrument A/c
with the amount of Fair Value Change

in Cash Flows to the extent offsetting the amount of

Fair Value Change in Cash Flows of
the Risk-Exposing Underlying-Hedged-Item
Cr/Dr xxx

Cash Flow Hedge FC Translation

Reserve A/c (Equity A/c) Dr/Cr xxx

15. In order to match the gains and losses of the hedged item

and the hedging instrument in the statement of profit and loss, the changes in fair value of the hedging instrument recognised in equity must be recycled from equity and recognised in the statement of profit and loss at the same time that the impact from the hedged item is recognised (recycled) in the statement of profit and loss. The manner in which this is done depends on the nature of the hedged item:

When the following **Cash Flow Hedge Accounting entry 01** is passed,

Risk-Exposing-Underlying-Hedged-Item A/c

Dr/Cr xxxv

With the amount of **Fair Value Change** in Cash Flows **in respect of hedged risk**

Profit / Loss Statement Cr/Dr xxx

the following Cash Flow Hedge Accounting entry 02 below also is to be passed, i.e.,

Cash Flow Hedge FC Translation Reserve A/c Cr/Dr xxx

with the amount of FV Change in Cash Flows **pertaining to the Risk-Offsetting-Derivative-Hedging-Instrument**

(see the Cash Flow Hedge Accounting Entry under paragraph 34)

Profit / Loss Statement Dr/Cr xxx

- if the hedged forecast transaction results in a financial asset or a financial liability being recognised, the gains or losses are recycled from equity as and when the asset acquired or liability incurred affects the statement of profit and loss, e.g., when interest income or expense is recognised.

Initially, the following 2 entries are passed, i.e.,

Cash Flow Hedge Accounting Entry 01 :

Financial Asset / Financial Liabilty /

Risk-Exposing-Underlying-Hedged-Item A/c

Dr/Cr xxx

With the amount of **Fair Value**

Change in Cash Flows **in respect of**

hedged risk (see paragraph 28)

Profit / Loss Statement Cr/Dr xxx

Cash Flow Hedge Accounting Entry 02 :

Risk-Offsetting-Derivative-Hedging-

Instrument A/c Cr/Dr xxx

with the amount of FV Change in Cash Flows

Cash Flow Hedge FC Translation Reserve A/c

(Equity A/c) (as per paragraph 34)
Dr/Cr xxx

Later, when interest income or interest expense occurs, in relation to the financial asset or liability (**Risk-Exposing-Underlying-Hedged-Item**), the following 2 entries are passed, i.e.,

Bank Entry 01 :

Bank A/c Dr/Cr

Interest income / expense A/c / P/L A/c Cr/Dr,

Cash Flow Hedge Accounting Entry Entry 02 :

Cash Flow Hedge (FC Translation) Reserve A/c
Cr/Dr xxx

with the amount of FV Change
in Cash Flows

Profit / Loss Statement Dr/Cr xxx

- if the hedged forecast transaction results in a non-financial asset or non-financial liability being recognised, either of the following two approaches may be applied:
  - the gains or losses are recycled from equity as and when the impact of asset acquired or liability incurred affects or is recognised in the statement of profit and loss, e.g., as depreciation or cost of sales is recognized **(further indenting done for this and the subsequent sub-paragraphs of this bullet point).**

    When the following Financial Asset or Liability related entries are passed,

    1) Financial-Asset-related Expense Dr

       Financial Asset Cr

    2) Financial Liability-related Expense Dr

       Financial Liability Cr,

    the following **Cash Flow Hedge Accounting Entry is also passed:**

    Cash Flow Hedge (FC Translation) Reserve A/c Cr/Dr xxx

    with the amount of FV Change in Cash Flows

    Profit / Loss Statement Dr/Cr xxx

  - the gains or losses are recycled from equity and included as a separate adjustment that is clubbed for financial statement presentation purposes with carrying amount of the asset acquired or liability incurred (referred to as the "basis adjustment").

Cash Flow Hedge Accounting Entry :

Cash Flow Hedge FC Translation Reserve A/c Cr/Dr xxx

with the amount of FV Change in Cash Flows

Financial Asset / Financial Liability – Basis Adjustment A/c Dr/Cr xxx

— in all other cases the gains or losses are recycled from equity as and when the hedged forecast transaction affects statement of profit and loss.

Cash Flow Hedge FC Translation Reserve A/c Cr/Dr xxx

with the amount of FV Change in Cash Flows

Profit / Loss Statement Dr/Cr xxx

Note that in the first two bullets above, any gain or loss (or portions thereof) that is not expected to be recovered in future periods are recycled from equity as soon as an entity becomes aware of the fact that those amounts are not expected to be recovered.

16. An example of a forecast transaction that results in the recognition of a financial liability is a forecast issuance of a bond, which is hedged for interest rate risk using a forward-starting interest rate swap. The fair value gains or losses on the swap would be deferred in equity until the bond is issued and the swap starts, after which date they would remain in equity until amortised into the statement of profit and loss over the life of the bond.

Until the Bond is issued and the Swap begins :

Cash Flow Hedge Accounting Entry 01 :

Risk-Offsetting-Derivative-Hedging-

Instrument Forward-Starting Interest Rate Swap A/c

with the amount of FV Change in Cash Flows
Cr/Dr xxx

Cash Flow Hedge FC Translation Reserve A/c

(Equity A/c) (as per paragraphs 34 & 36)
Dr/Cr xxx

When the Bond is issued and the Swap begins,

in each year over the Bond-Life :

Cash Flow Hedge Accounting Entry 02 :

Cash Flow Hedge (FC Translation) Reserve A/c
Cr/Dr xxx

with the amount of FV Change
in Cash Flows

Profit / Loss Statement Dr/Cr xxx

17. The choice of the basis adjustment approach is only relevant for hedges of forecast purchases of non-financial assets such as inventory or property, plant and equipment. This approach is permitted but not required and must be applied consistently as an accounting policy choice to all cash flow hedges that result in the acquisition of a non-financial asset or non- financial liability. Any basis adjustment or accumulated balance in the hedging reserve will require to be tested at least at every reporting date for impairment. For the purposes of this impairment assessment, the basis adjustment / relevant portion of the hedging reserve may be combined with the carrying amount of the hedged item and compared to its current realisable value.

Net investment hedging

18. An investor in a non-integral operation is exposed to changes in the carrying amount of the net assets of the foreign operation (the net investment) arising from the translation of those assets into the reporting currency of the investor.

19. Principles relating to the hedge of a net investment in a foreign operation are:

- foreign exchange gains and losses on a net investment in a non- integral foreign operation are recognised directly in equity. This occurs through the translation of the non-integral foreign operation's net assets for purposes of consolidation;
- gains and losses on foreign currency derivatives used as hedging instruments are recognised directly in equity to the extent that the hedge is considered to be effective;

FE gain/loss on a Net Investment in
Non-Integral Foreign Operational Net Assets

(Risk-Exposing-Underlying-Hedged-Item)

Dr/Cr xxx

Non-Integral Foreign Hedged
Operational Net Assets

FC Translation Reserve Cr/Dr xxx

FE gain/loss on Foreign Currency Derivatives

(Risk-Offsetting-Derivative-Hedging-Instrument)

Dr/Cr xxx

FC Derivative Hedging

NI in NIFO-NA FC Translation Reserve

Cr/Dr xxx

(to the extent <= FE gain/loss on a

NI in NIFO-NA)

- the ineffective **(or infructuous)** portion of the gains and losses on the hedging instruments (and any proportion not designated in the hedging relationship) is recognised in the statement of profit and loss immediately;

- any net deferred foreign currency gains and losses, i.e., arising from both the net investment and the hedging instruments are recognised in the statement of profit and loss at the time of disposal of the foreign operation.

FE gain/loss on Foreign Currency Derivatives

(Risk-Offsetting-Derivative-Hedging-

Instrument) Dr/Cr xxx

Profit / Loss Statement Cr/Dr xxx

(to the extent > FE gain/loss on a

NI in NIFO-NA)

FE gain/loss on Foreign Currency Derivatives

(Not used as Hedging Instrum) Dr/Cr

Profit / Loss Statement Cr/Dr xxx

20. This Guidance Note does not override the principles of AS 11. However, it introduces the hedge accounting criteria for hedging of net investments.

21. When the net investment is disposed off, the cumulative amount in the foreign currency translation reserve in equity is transferred to the statement of profit and loss as an adjustment to the profit or loss on disposal of the investment. Therefore, it is necessary for an entity to keep track of the amount recognised directly in equity separately in respect of each foreign operation,

[in the form of the 2 accounts, e.g..,

- **Non-Integral Foreign Hedged Operational Net Assets FC Translation Reserve A/c, and**
- **FC Deriv Hedging NI in NIFO-NA FC Translation Reserve A/c]**

in order to identify the amounts to be transferred to the statement of profit and loss on disposal.

Formal documentation at inception

22. At inception of a hedge, formal documentation of the hedge relationship must be established. The hedge documentation prepared at inception of the hedge must include a description of the following:

- the entity's risk management objective and strategy for undertaking the hedge;
- the nature of the risk being hedged;
- clear identification of the hedged item (asset, liability or cash flows) and the hedging instrument;
- demonstrate how the derivative contract helps meet that risk management objective;
- indentify how it plans to measure the derivative if the derivative contract is effective in meeting its risk management objective;
- demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring; and
- conclude that the risk that is being hedged could impact the statement of profit and loss.

23. This Guidance Note does not mandate a specific format for the documentation and in practice hedge documentation may vary in terms of lay-out, technology used etc. Various formats may be acceptable as long as the documentation includes the contents identified above.

24. A hedging relationship is effective if it meets all of the following requirements:

(i) There is an economic relationship between the hedged item and the hedging instrument.

(ii) The effect of credit risk does not dominate the value changes that result from that economic relationship.

(iii) The hedging relationship is expected to be highly effective in achieving the stated risk management objective and the entity is in a position to reliably measure the achievement of this objective both at inception and on an ongoing basis during the tenure of the hedging relationship.

Hedge effectiveness testing and measurement of ineffectiveness

25. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co- dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:

(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and

(b) separating the interest element and the spot price of a forward contract.

FE gain/loss on Option's Intrinsic Value

(Risk-Offsetting-Derivative-Hedging-

Instrument) Dr/Cr xxx

FC Option Hedging

Intrinsic Value (FC Translation) Reserve
Cr/Dr xxx

(to the extent <= FE gain/loss on

highly probable forecasted

sales transactions hedged using Option –

see Illustration 7 - Cash flow hedge
accounting - forecasted sale with an
option contract)

FE gain/loss on Option's Intrinsic Value

(Risk-Offsetting-Derivative-Hedging-

Instrument) Dr/Cr xxx

Profit / Loss Statement Cr/Dr xxx

(to the extent > FE gain/loss on

highly probable forecasted

sales transactions hedged using Option –

see Illustration 7 - Cash flow hedge accounting - forecasted sale with an option contract)

FE gain/loss on Option's Intrinsic Value (Not used as Hedging Instrum) Dr/Cr xxx

Profit / Loss Statement Cr/Dr xxx

26. An entity may consider the costs associated with a hedging instrumente.g. forward premium or time value of an option contract as a period cost (for example akin to interest costs when hedging an interest bearing asset or liability) or at a point in time (for example when hedging a forecasted sale or purchase) depending on the manner of designation and how the hedged item impacts the statement of profit and loss.

27. This Guidance Note does not prescribe one single method for how hedge effectiveness testing and ineffectiveness measurement should be conducted. The appropriate method for each entity will depend on the facts and circumstances relevant to each hedging programme and be driven by the risk management objective of the entity. Entities may apply commonly used measures such as critical terms match, dollar offset or regression methods as appropriate to assess hedge effectiveness.

28. Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. This Guidance Note does not prescribe bright line tests for effectiveness assessments but instead requires disclosure of the entity's risk management objectives and measures for assessing if these objectives are met.

49 When designating a hedging relationship, and on an ongoing basis, an entity will analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis will serve as the basis for the entity's assessment of meeting the hedge effectiveness requirements.

50. A hedging relationship will meet the hedge effectiveness requirements if:

(i) there is an economic relationship between the hedged item and the hedging instrument.

(ii) the effect of credit risk does not dominate the value changes that result from the economic relationship.

(iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantities of:

- the hedged item that the entity actually hedges; and
- the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and

(iv) the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness **or infructuousness** - whether or not it is recognised - to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

51. An entity will assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity should perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

52. If the critical terms of the hedging instrument and the hedged item - e.g. the nominal amount, maturity and underlying - match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.

53. If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity should adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again.

54. This Guidance Note does not also prescribe a single method of how **effectiveness degree** measurement should be conducted other than to require an entity to consider how **effectiveness degree** could affect a hedging relationship and require immediate recognition of **such a degree of ineffectiveness or infructuousness.**

55. Hedge **effectiveness degree** is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.

56. When measuring **effectiveness degree**, an entity is required to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

57. In certain situations, **ineffectiveness or infructuousness degree** is required to be recognised. These include

- 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.

The recognition of , **ineffectiveness or infructuousness degree** does not necessarily require hedge accounting to be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.

Termination of hedge accounting / reclassification of hedge reserves

58. An entity is not permitted to stop applying hedge accounting voluntarily unless the risk management objective of the entity, as was originally defined by the entity when first applying hedge accounting, is no longer met.

59. If an entity terminates a hedging instrument prior to its maturity / contractual term, hedge accounting is discontinued prospectively. Any amount previously recognised in the hedge reserve (in the case of cash flow or net investment hedges**, or more clearly,-**

- **in the case of cash flow hedges,**
  - **Cash Flow Hedge FC Translation reserve,**
- **in the case of foreign operations,**
  - **Non-Integral Foreign Hedged Operational Net Assets (NIFO-NA) FC Translation Reserve, and**
  - **FC Deriv Hedging NI in NIFO-NA FC Translation Reserve,**
- **in the case o f FC Options,**
  - **FC Option Hedging Intrinsic Value FC Translation Reserve)**

60.) is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings, e.g., when a forecasted purchase / sale actually impacts earnings or when a net investment is disposed off in the case of a net investment hedge.

61. In case of hedges of highly probable forecast transactions or commitments, if the forecasted transaction is no longer highly probable of occurring, (but still probable of occurring) then hedge accounting is discontinued prospectively but the amount recognised previously in the hedge reserve is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings (as specified in paragraph 35 of this Guidance Note). 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring.

62. In case of hedges of forecast transactions, if the forecasted transaction is no longer probable of occurring, then hedge accounting is discontinued and all amounts recognised in the hedge reserve are recognised immediately in the statement of profit and loss. 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring. Judgment may need to be exercised in situations where a forecasted transaction is delayed to determine if the delayed transaction is the one that was subject to the original hedging designation or not. This Guidance Note does not provide a bright line test in this context but recognises that judgment is required and an entity should disclose the manner in which such determinations are made in its financial statements.

Interest Rate Benchmark Reform

63.Interest rate benchmark reform has impacted the way financial information is accounted for in the financial statements. To address the accounting issues necessary exceptions to the hedge accounting have been prescribed in this Guidance Note as under:

- **Phase 1- Pre-replacement issues**—issues affecting financial reporting in the period during which there is uncertainty about the timing or the amount of interest rate benchmark-based cash flows. To address these issues, an Announcement has been issued by the ICAI providing temporary exceptions from hedge

accounting requirements, for accounting periods beginning on or after April 1, 2020. The same is included in the Guidance Note as Appendix III.

- **Phase 2- Replacement issues**—issues affecting financial reporting when the uncertainty regarding the timing and the amount of interest rate benchmark- based cash flows is resolved and hedging relationships are affected as a result of the reform. To address replacement issues arising from interest rate benchmark reform, Appendix IV has been added to provide practical expedient for modifications of the financial contracts that are affected by interest rate benchmark reform with the view to avoid undue impact on the financial statements where the transactions are economically equivalent to the previous basis (i.e., before and after interest rate benchmark reform).

Presentation in the financial statements

632. Derivative assets and liabilities recognised on the balance sheet at fair value should be presented as current and non-current based on the following considerations:

- Derivatives that are intended for trading or speculative purposes should be reflected as current assets and liabilities.
- Derivatives that are hedges of recognised assets or liabilities should be classified as current or non-current based on the classification of the hedged item.
- Derivatives that are hedges of forecasted transactions and firm commitments should classified as current or non-current based on the settlement date / maturity dates of the derivative contracts.

- Derivatives that have periodic or multiple settlements such as interest rate swaps should not be bi-furcated into current and non-current elements. Their classification should be based on when a predominant portion of their cash flows are due for settlement as per their contractual terms.

643. This Guidance Note does not permit any netting off of assets and liabilities except where basis adjustment is applied under cash flow hedges and hence all the amounts presented in the financial statements should be gross amounts. Amounts recognised in the statement of profit and loss for derivatives not designated as hedges may be presented on a net basis.

Disclosures in financial statements

654. An entity should satisfy the broader disclosure requirements by describing its overall financial risk management objectives, including its approach towards managing financial risks. Disclosures should explain what the financial risks are, how the entity manages the risk and why the entity enters into various derivative contracts to hedge the risks.

665 An entity should disclose the methodology used to arrive at the fair value of derivative contracts (whether used for hedging or not) and the extent of fair value gains/losses recognized in the statement of profit and loss and in equity.

676. The entity should disclose its risk management policies. This would include the hedging strategies used to mitigate financial risks. This may include a discussion of:

- how specific financial risks are identified, monitored and measured;
- what specific types of hedging instruments are entered into and how these instruments modify or eliminate risk; and
- details of the extent of transactions that are hedged.

687. An entity is also required to make specific disclosures about its outstanding hedge accounting relationships. The following disclosures are made separately for fair value hedges, cash flow hedges and hedges of net investments in foreign operations:

- a description of the hedge;
- a description of the financial instruments designated as hedging instruments for the hedge and their fair values at the balance sheet date;
- the nature of the risks being hedged;

- for hedges of forecast transactions, the periods in which the transactions are expected to occur, when they are expected to affect the statement of profit and loss, and a description of any forecast transactions that were originally hedged but now are no longer expected to occur. This Guidance Note does not specify the future time bands for which the disclosures should be made. Entities should

decide on appropriate groupings based on the characteristics of the forecast transactions;

- if a gain or loss on derivative or non-derivative financial assets and liabilities designated as hedging instruments in cash flow hedges has been directly recognised in the hedging reserve: -
  - — the amount recognised in hedge reserve during the period.
  - — the amount recycled from the hedge reserve and reported in statement of profit and loss.
  - — the amount recycled from hedge reserve and added to the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged forecast transaction.
- a breakup of the balance in the hedge reserve between realised and unrealised components, **[e.g.,**

1) a) Cash Flow Hedge FC Translation reserve – Realized

b) Cash Flow Hedge FC Translation reserve – Unrealized

2) a) Non-Integral Foreign Hedged Operational Net Assets (NIFO-NA) FC Translation Reserve – Realized

b) Non-Integral Foreign Hedged Operational Net Assets (NIFO-NA) FC Translation Reserve –

Unrealized

3) a) FC Derivarive Hedging NI in NIFO-NA FC Translation Reserve – Realized

b) FC Derivative Hedging NI in NIFO-NA FC Translation Reserve – Unrealized

4) a) FC Option Hedging Intrinsic Value FC Translation Reserve – Realized

b) FC Option Hedging Intrinsic Value FC Translation Reserve – Unrealized]

and a reconciliation of the opening balance to the closing balance for each reporting period **[e.g.,**

Movements in hedging reserves during the year

1) Cash Flow Hedge FC Translation reserve – Opening Balance

Movements during the year

Cash Flow Hedge FC Translation reserve - Closing Balance

2) Non-Integral Foreign Hedged Operational Net Assets (NIFO-NA) FC Translation Reserve – Opening Balance

Movements during the year

Cash Flow Hedge FC Translation reserve - Closing Balance

3) FC Derivarive Hedging NI in NIFO-NA FC

Translation Reserve - Opening Balance

Movements during the year

FC Derivarive Hedging NI in NIFO-NA FC

Translation Reserve - Closing Balance

4) FC Option Hedging Intrinsic Value FC Translation

Reserve - Opening Balance

Movements during the year

FC Option Hedging Intrinsic Value FC Translation

Reserve - Closing Balance]

698. Insofar as disclosure of derivatives designated for hedging foreign currency risks are concerned, the same should be disclosed in the Format attached as Appendix I to the Guidance Note, which also requires disclosure of all foreign exchange assets and liabilities including contingent liabilities, both hedged and unhedged.

7069. The Appendix II to this Guidance Note contains examples illustrating the principles contained in this Guidance Note.

Transitional provisions

710. This Guidance Note applies to all derivative contracts covered by it and are outstanding on the date this Guidance Note becomes effective. Any cumulative impact (net of taxes) should be recognised in reserves as a transition adjustment and disclosed separately. An entity is not permitted to follow hedge accounting as recommended in this Guidance Note retrospectively.

Effective Date

721. This Guidance Note becomes applicable for accounting periods beginning on or after 1st April, 2016; its earlier application, is encouraged.

Appendix IV

Interest Rate Benchmark Reform: Replacement issues

To address replacement issues (Phase 2) arising from Interest Rate Benchmark Reform, this Appendix has been added to the *Guidance Note on Accounting for Derivative Contracts*.

End of Application of temporary exceptions to Hedge Accounting for non-contractually specified risk component due to interest rate benchmark reform (refer paragraph 7[4] of ICAI Announcement- Appendix III)

1. An entity shall prospectively cease applying paragraph 7 of ICAI Announcement (Appendix III) at the earlier of:

   (a) when changes required by interest rate benchmark reform are made to the non-contractually specified[5] risk component applying paragraph 2; or

   (b) when the hedging relationship in which the non-contractually specified risk component is designated is discontinued.

Temporary exceptions from applying specific hedge accounting requirements arising from interest rate benchmark reform- Phase II

[4] End of application of clause of temporary exceptions except paragraph 7 (paragraphs 4-6) of the Announcement issued by the ICAI (Appendix III) were given alongwith that Announcement in its paragraphs 8-11.

[5] Refer footnote to paragraph 7 of the Announcement issued by the ICAI (Appendix III)

2. As and when the requirements in paragraphs 4-7 of the ICAI Announcement (Appendix III) cease to apply to a hedging relationship (see paragraphs 8-11 of the ICAI Announcement (Appendix III) and paragraph 1), an entity shall amend the formal designation of that hedging relationship as previously documented to reflect the changes required by interest rate benchmark reform, i.e., the changes are consistent with the requirements in paragraphs 9-11. In this context, the hedge designation shall be amended only to make one or more of these changes:

(a) designating an alternative benchmark rate as a hedged risk;

(b) amending the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged; or

(c) amending the description of the hedging instrument.

3. An entity also shall apply the requirement in paragraph 2(c) if these three conditions are met:

(a) the entity makes a change required by interest rate benchmark reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument (as described in paragraph 9);

(b) the original hedging instrument is not derecognised; and

(c) the chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument (as described in paragraphs 10-11).

4. The requirements in paragraphs 4-7 of the ICAI Announcement (Appendix III) may cease to apply at different times. Therefore, in applying paragraph 2, an entity may be required to amend the formal designation of its hedging relationships at different times, or may be required to amend the formal designation of a hedging relationship more than once. When, and only when, such a change is made to the hedge designation, an entity shall apply paragraphs 12-17 as applicable. An entity also shall apply paragraph 28 (for a fair value hedge) or paragraph 35 (for a cash flow hedge) of the Guidance

Note to account for any changes in the fair value of the hedged item or the hedging instrument.

5. An entity shall amend a hedging relationship as required in paragraph 2 by the end of the reporting period during which a change required by interest rate benchmark reform is made to the hedged risk, hedged item or hedging instrument. For the avoidance of doubt, such an amendment to the formal designation of a hedging relationship constitutes neither the discontinuation of the hedging relationship nor the designation of a new hedging relationship.

6. If changes are made in addition to those changes required by interest rate benchmark reform to the financial asset or financial liability designated in a hedging relationship (as described in paragraphs 9-11) or to the designation of the hedging relationship (as required by paragraph 2), an entity shall first apply the applicable requirements in the Guidance Note to determine if those additional changes result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, an entity shall amend the formal designation of the hedging relationship as specified in paragraph 2.

7. Paragraphs 12-18 provide exceptions to the requirements specified in those paragraphs only. An entity shall apply all other hedge accounting requirements of the Guidance Note, including the qualifying criteria in paragraphs 42 and 44 of the Guidance Note, to hedging relationships that were directly affected by interest rate benchmark reform.

Changes in the basis for determining the contractual cash flows of a financial asset or financial liability designated in hedging relationship as a result of interest rate benchmark reform

8. Changes in contractual cash flows are relevant for the practical expedients given in this Appendix if the same are result of interest rate benchmark reform.

9. The basis for determining the contractual cash flows of a financial asset or financial liability can change:

(a) by amending the contractual terms specified at the initial recognition of the financial instrument (for example, the contractual terms are amended to replace the referenced interest rate benchmark with an alternative benchmark rate);

(b) in a way that was not considered by—or contemplated in—the contractual terms at the initial recognition of the financial instrument, without amending the contractual terms (for example, the method for calculating the interest rate benchmark is altered without amending the contractual terms); and/or

(c) because of the activation of an existing contractual term (for example, an existing fallback clause is triggered).

10. A change in the basis for determining the contractual cash flows is required by interest rate benchmark reform if, and only if, both these conditions are met:

(a) the change is necessary as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the change).

11. Examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis (ie the basis immediately preceding the change) are:

(a) the replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate—or the implementation of such a reform of an interest rate benchmark by altering the method used to calculate the interest rate benchmark—with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate;

(b) changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

(c) the addition of a fallback provision to the contractual terms of a financial asset or financial liability to enable any change described in (a) and (b) above to be implemented.

Accounting for qualifying hedging relationships

Cash flow hedges

12. For the purpose of applying paragraph 35 of the Guidance Note, at the point when an entity amends the description of a hedged item as required in paragraph 2(b), the amount accumulated in the cash flow hedge reserve shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

13. For a discontinued hedging relationship, when the interest rate benchmark on which the hedged future cash flows had been based is changed as required by interest rate benchmark reform, for the purpose of applying paragraphs 59-61 of the Guidance Note in order to determine whether the hedged future cash flows are still probable to occur, the amount accumulated in the cash flow hedge reserve for that hedging relationship shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

Groups of items

14. When an entity applies paragraph 2 to groups of items designated as hedged items in a fair value or cash flow hedge, the entity shall allocate the hedged items to subgroups based on the benchmark rate being hedged and designate the benchmark rate as the hedged risk for each subgroup. For example, in a hedging relationship in which a group of items is hedged for changes in an interest rate benchmark subject to interest rate benchmark reform, the hedged cash flows or fair value of some items in the group could be changed to reference an alternative benchmark rate before other items in the group are changed. In this example, in applying paragraph 2, the entity would designate the alternative benchmark rate as the hedged risk for that relevant subgroup of hedged items. The entity would continue to designate the existing interest rate benchmark as the hedged risk for the other subgroup of hedged items until the hedged cash flows or fair value of those items are changed to reference the alternative benchmark rate or the items

expire and are replaced with hedged items that reference the alternative benchmark rate.

15. An entity shall assess separately whether each subgroup meets the requirements to be an eligible hedged item. If any subgroup fails to meet the requirements, the entity shall discontinue hedge accounting prospectively for the hedging relationship in its entirety. An entity also shall apply the requirements in paragraphs 28 and 35 of the Guidance Note to account for ineffectiveness related to the hedging relationship in its entirety.

Designation of risk components

16. An alternative benchmark rate designated as a non-contractually specified[6] risk component that is not separately identifiable at the date it is designated shall be deemed to have met that requirement at that date, if, and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within 24 months. The 24-month period applies to each alternative benchmark rate separately and starts from the date the entity designates the alternative benchmark rate as a non-contractually specified risk component for the first time (ie the 24-month period applies on a rate-by-rate basis).

17. If subsequently an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months, the entity shall cease applying the requirement in paragraph 16 and discontinue hedge accounting prospectively from the date of that reassessment for all hedging relationships in which the alternative benchmark rate was designated as a non-contractually specified risk component.

18. In addition to those hedging relationships specified in paragraph 2, an entity shall apply the requirements in paragraphs 16 and 17 to new hedging relationships in which an alternative benchmark rate is designated as a non-contractually specified risk component when, because of interest rate benchmark reform, that risk component is not separately identifiable at the date it is designated.

[6] Refer footnote to paragraph 7 of the Announcement issued by the ICAI (Appendix III)

Disclosures

19. To enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy, an entity shall disclose information about:

(a) the nature and extent of risks to which the entity is exposed arising from financial instruments subject to interest rate benchmark reform, and how the entity manages these risks; and

(b) the entity's progress in completing the transition to alternative benchmark rates, and how the entity is managing the transition.

Effective Date

20. An entity shall apply amendments stated in paragraphs 1-19 and 21-23 for annual periods beginning on or after 1st April 2021.

Transition

21. An entity shall designate a new hedging relationship (for example, as described in paragraph 18) only prospectively. However, an entity shall reinstate a discontinued hedging relationship if, and only if, these conditions are met:

(a) the entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging relationship if these amendments had been applied at that time; and

(b) at the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (after taking into account these amendments).

22. If, in applying paragraph 21, an entity reinstates a discontinued hedging relationship, the entity shall read references in paragraphs 16 and 17 to the date the alternative benchmark rate is designated as a non-contractually specified risk component for the first time as referring to the date of initial application of these amendments (i.e., the 24-month period for that alternative benchmark rate designated as a non-contractually specified risk component begins from the date of initial application of these amendments).

23. The entity shall recognise any difference (net of taxes) between the previous carrying amount and the carrying amount at the beginning of the annual reporting period of application of these amendments in the opening reserves and disclose separately.