

Query No. 11

Subject: *Presentation of gain or loss on account of mark to market valuation of the derivative contracts resulting from movements in exchange rates and interest rates of the underlying currencies.*¹

A. Facts of the Case

1. A public limited company (hereinafter referred to as ‘the company’), which is a wholly owned subsidiary of a listed government company, is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India.

2. The company operates overseas projects directly and/or through subsidiaries, by participation in various joint arrangements and investment in associates. Globally, E&P business is carried out by way of joint arrangements or investments in form of subsidiaries/ associates. In accordance with the requirement of Ministry of Corporate Affairs (MCA) Notification dated 16th February 2015, the company has been following Indian Accounting Standards (Ind ASs) w.e.f. 1st April 2016 (Transition Date 1st April 2015). The functional currency of the company is assessed as US Dollars (USD) in accordance with the provisions of Ind ASs. The company presents its financial statements in its presentation currency which is Indian National Rupee (INR).

3. In order to finance its overseas operations, the company arranges external commercial borrowings including but not limited to debentures and bonds denominated in external currencies. The company currently has (i) Euro (EUR) denominated bonds, (ii) Indian Rupee (INR) denominated debentures and (iii) Japanese Yen (JPY) denominated long term bank loan besides bonds and debentures in the company’s functional currency i.e. USD.

4. The said borrowings denominated in external currencies involve, inter alia, exchange risk and interest rate risk. In order to hedge such risks, the company enters into various derivative contracts, e.g. interest rate swaps and forward & option contracts. The company measures these financial instruments at fair value through profit or loss (FVTPL) in accordance with Indian Accounting Standard (Ind AS) 109 ‘Financial Instruments’. Any gain/loss arising on such valuation is recognised in the statement of profit and loss as per paragraph 20(a) of Ind AS 107 ‘Financial Instrument: Disclosures’.

5. During financial year (F.Y.) 2017-18, the company has entered into forward contracts covering Euro 199.50 Million and option contracts covering Euro 35 Million in respect of its Euro bonds. Further, the company has also entered into interest rate swap arrangement, swapping the coupon and principal amount of its INR denominated debentures into USD.

6. As mandated by Ind AS 109 and Ind AS 107, the company measured its derivative contracts at FVTPL by recognising net gain/loss in the statement of profit and loss. The said mark to market gain/loss was disclosed under ‘Finance Cost’ in the notes to the statement of profit and loss as a separate line item with heading ‘*Net loss (gain) on fair value of derivative contracts mandatorily measured at fair value through profit or loss*’.

7. During the course of government audit, it was highlighted by the Comptroller and Auditor General of India (C&AG) team that the net gain/loss arising on account of mark to market valuation of the derivatives is required to be classified under ‘Other Income’ as suggested in paragraph 9.2 of the Guidance Note on Division II - Ind AS Schedule III to the

¹ Opinion finalised by the Committee on 7.8.2019.

Companies Act, 2013 (hereinafter referred to as the ‘Schedule III Guidance Note’²), issued by the Institute of Chartered Accountants of India (ICAI).

8. The derivative contracts, mentioned in paragraph 5 above, are entered for the sole purpose of hedging the company’s cash flows against volatility in underlying exchange rates of foreign currencies in which borrowings are denominated and the company’s functional currency. Further, the periodic gains/losses on such derivative contracts are a result of mark to market valuation which essentially reflect the movement in exchange rates of underlying currencies.

9. The querist has stated that the foreign exchange fluctuation on restatement of foreign currency borrowings in functional currency at each period end is considered to be part of finance cost in accordance with paragraph 6 of Ind AS 23, ‘Borrowings Costs’. Further, the movement in mark to market valuation of derivative contracts will always be inversely related to the movement in foreign exchange fluctuations on restatement of foreign currency borrowings as these derivative contracts are entered specifically to hedge the company against such currency fluctuations. Accordingly, to understand the actual impact of foreign exchange fluctuations on long term foreign currency borrowings, both of these amounts need to be seen in conjunction. The net impact of the gain/loss due to foreign exchange fluctuation on restatement of foreign currency borrowings and loss/gain on mark to market valuation of derivative contracts taken against these borrowings is, in substance, the true impact of foreign exchange fluctuation on long term borrowings in the company’s financial statements.

10. According to the querist, it will be pertinent to mention that paragraph 9.5.5 (D) of the Schedule III Guidance Note (pre-revised) states that “Foreign exchange differences arising on foreign currency borrowings shall be disclosed under finance cost.” Thus, the intent of the paragraph mentioned above is to classify the costs of the borrowings associated with the exchange risk as finance costs. As explained in paragraph 9 above, the gain/loss on mark to market valuation of derivative contracts is intricately linked with the foreign exchange fluctuations on foreign currency borrowings and the sole purpose of entering into such derivative contracts is to cover the exchange and interest rate risks and manage the finance costs. Therefore, in financial statements, it is also classified under finance costs. This will enable the readers of the financial statements to correlate the interplay of finance costs incurred due to the external borrowings and the gain/loss on valuation of financial instruments executed to hedge the risks associated with the said external borrowings. It presents a comprehensive picture with respect to costs associated with the foreign currency borrowings (i.e. interest cost and foreign exchange fluctuations) and activities relating to covering the risks associated (i.e. gain/loss on derivative contracts) which may not be the case when the foreign currency fluctuations and gain/loss on derivatives are shown separately.

11. Therefore, according to the considered opinion of the querist, though the form of the net gain/loss on fair value measurement of derivative contracts may be of other income/other expense, but in substance, the said gain/loss is incurred to control the foreign exchange fluctuations included in finance costs and has a direct bearing thereon. In view of the same, it may be considered appropriate that the net gain/loss arising from fair valuation of derivative contracts is classified as a separate line item under the ‘finance costs’ so as to enable the readers of financial statements to correlate the offsetting effect of the said gain/loss on the gain/loss due to foreign exchange fluctuations on long term foreign currency borrowings.

² The Guidance Note on Division II – Ind AS Schedule III to the Companies Act, 2013 was initially issued by the ICAI in July 2017; however, the same has been subsequently revised in July 2019.

B. Query

12. In view of the above facts, the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India is sought on the appropriate presentation of the net gain/loss arising on account of the measurement of derivative instruments through FVTPL, i.e., whether:

- (i) the presentation of the gain/loss on mark to market valuation of derivative contracts taken to hedge the currency fluctuations on long term foreign currency borrowings by the company as a separate line item under 'finance cost' is appropriate; or
- (ii) the presentation as suggested in paragraph 7 above is to be followed.

C. Points considered by the Committee

13. The Committee notes that the basic issue raised by the querist relates to presentation of gain or loss on account of mark to market valuation of the derivative contracts, which, according to the querist, are solely taken to hedge the exchange and interest rate risks on the foreign currency borrowings. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for such derivative contracts, the assessment of the functional currency of the company, the adjustment in interest costs arising on account of foreign exchange gains and losses on foreign currency borrowings as per paragraph 6(e) of Ind AS 23, 'Borrowing Costs', presentation of the derivative instruments and the foreign currency borrowings in the balance sheet, etc. Further, the Committee presumes that the company has not opted for applying hedge accounting under Ind AS 109 and has measured the derivative contracts at fair value through profit and loss. Incidentally the Committee notes from the Facts of the Case that foreign exchange fluctuation on restatement of foreign currency borrowings in functional currency at each period end is considered to be part of finance cost by the company. In this regard, the Committee wishes to point out that not all exchange differences arising from foreign currency borrowings can be considered as finance cost or borrowing cost. The company should consider the requirements of paragraphs 6(e) and 6A of Ind AS 23 with regard to the extent of exchange differences required to be treated as borrowing costs. The Committee further notes that the foreign currency external commercial borrowings are measured by the querist at amortised cost using effective interest method under Ind AS 109, 'Financial Instruments'.

14. The Committee notes that paragraph 20 of Ind AS 107, Financial Instruments: Disclosures, states, inter alia, as follows:

“An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:

- (a) net gains or net losses on:
 - (i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with paragraph 6.7.1 of Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (eg financial liabilities that meet the definition of held for trading in Ind AS 109). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of

gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

...

- (b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of Ind AS 109 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss.”

From the above, the Committee notes that while Ind AS 107 requires disclosure of net gains or net losses on financial assets or financial liabilities measured at fair value through profit or loss either in the statement of profit and loss or in the Notes, it does not prescribe the line item within which the net gains or net losses should be presented. Paragraph 20(b) of Ind AS 107, requires separate disclosure of total interest expense (calculated using the effective interest method) for financial liabilities that are not measured at fair value through profit or loss (i.e. measured at amortised cost) either in the statement of profit and loss or in the notes. Further, paragraph 82 of Ind AS 1, ‘Presentation of Financial Statements’ while requires presentation of finance costs as a separate line item, it does not elaborate further as to what constitutes finance costs.

15. The Committee also notes that paragraphs 32, 33 and 35 of Ind AS 1, ‘Presentation of Financial Statements’ state as follows:

“32 An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.

33 An entity reports separately both assets and liabilities, and income and expenses. Offsetting in the statement of profit and loss or balance sheet, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity’s future cash flows. Measuring assets net of valuation allowances—for example, obsolescence allowances on inventories and doubtful debts allowances on receivables—is not offsetting.”

“35 In addition, an entity presents on a net basis gains and losses arising from a group of similar transactions, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading. However, an entity presents such gains and losses separately if they are material.”

From the above, the Committee notes that Ind AS 1 states that income and expenses should not be offset unless required or permitted by another standard. This is because offsetting detracts from the ability of users to understand fully the transactions, other events and conditions that have occurred and to assess the entity’s future cash flows. The only exception to this is where the offsetting reflects the substance of the transaction or other event. Paragraph 35 of Ind AS 1 explains that gains and losses arising from groups of similar transactions should be reported on a net basis. The individual transactions should, however, be reported separately if they are material. Whilst Ind AS 32 prescribes when financial assets and liabilities should be offset in the balance sheet, it contains no guidance on when related income and expenses should be offset. In the context of offsetting of income and expenses, Ind AS 109 states the following:

“B6.6.13 If items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of profit and loss. The presentation of hedging gains or losses in that statement depends on the group of items.

- B6.6.14 If the group of items does not have any offsetting risk positions (for example, a group of foreign currency expenses that affect different line items in the statement of profit and loss that are hedged for foreign currency risk) then the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items. This apportionment shall be done on a systematic and rational basis and shall not result in the grossing up of the net gains or losses arising from a single hedging instrument.”

These requirements imply that gains and losses from hedging instruments in hedging relationships would be presented in the same line item that is affected by the hedged item (at least to the extent the hedge is effective) rather than being shown separately, although this is not explicitly stated in Ind AS 109. Although the querist has not applied hedge accounting, the Committee is of the view that this presentation principle would be relevant.

16. The Committee also notes that paragraph B3 of Ind AS 107 states as follows:

- “B3 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this Ind AS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.”

From the above, the Committee notes that as per the requirements of B3, an entity should decide, in the light of its own circumstances, how to aggregate the information to display the overall picture without combining information with different characteristics. Accordingly, while aggregating information for disclosure purposes, it is necessary to consider the characteristics of the item(s) being aggregated with the characteristics of the head under which that item is being aggregated. In this context, the Committee notes paragraph B5 of Ind AS 107 as follows:

- “B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

...

- (e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20(a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income.”

From the above, the Committee notes that Ind AS 107 allows interest income to be presented under net gains/losses on financial instrument for disclosure purposes. The Committee further notes that interest (time value of money) is considered as one of the component in determination of fair value of financial instruments. Further as per Ind AS 23, ‘Borrowing Costs’, a portion of exchange differences (which is also one of the components of fair value of a foreign currency derivative or financial instrument) is considered as borrowing cost/finance cost to the extent that they are regarded as an adjustment to interest costs. Thus, drawing an

analogy, the Committee is of the view that the gain/loss on fair valuation of a foreign currency derivative or financial instrument may include elements having the characteristics of ‘finance costs’.

17. The Committee further notes that Note 3 of General Instructions for Preparation of Statement of Profit and loss in Part II of Division II of Schedule III to the Companies Act, 2013 requires disclosure of ‘finance costs’ to be bifurcated into ‘Exchange differences regarded as an adjustment to borrowing costs’ and ‘Other borrowing costs’ and paragraph 9.5.5 of the Schedule III- Guidance Note (Revised July, 2019 Edition) that deals with ‘Finance Costs’, provides as follows:

“D) Other borrowing costs

Other borrowing costs would include commitment charges, loan processing charges, guarantee charges, loan facilitation charges, discounts/premium on borrowings, *other ancillary costs incurred in connection with borrowings*, or amortization of such costs, etc. ...”

(Emphasis supplied by the Committee.)

From the above, the Committee notes that as per the above-reproduced requirements of paragraph 9.5.5 of the Guidance Note, foreign exchange differences relating to foreign currency borrowings or other ancillary costs incurred in connection with borrowings can be presented under ‘finance costs’. Accordingly, the Committee is of the view that in the extant case, considering the overall objective of hedging interest rate risk as well as exchange rate risk (and not solely the exchange rate risk) and the nature of derivatives/financial instruments, the gain/loss on fair valuation of the financial instruments is of the nature of ancillary cost incurred in connection with borrowings and therefore, it may not be inappropriate to present and disclose the same under ‘other borrowing cost’ under the head ‘Finance Costs’. However, as per the requirements of paragraph 20(a) and 20(b) of Ind AS 107, separate disclosure of the net gain or loss on the said derivative contracts and the interest expense on the foreign currency external commercial borrowings (being financial liabilities not measured at fair value through profit or loss) should be made within the ‘Finance costs’ schedule in the financial statements. Further, as per the requirements of paragraph 21 of Ind AS 107, a disclosure in respect of the same should be given by the company in its significant accounting policies.

D. Opinion

18. On the basis of above, the Committee is of the opinion that, as discussed in paragraphs 14 to 17 above, it may not be inappropriate to present and disclose the net gain or net losses arising on fair valuation of the derivative contracts/financial instruments in the extant case, entered into to hedge the foreign currency external commercial borrowings, as ‘other borrowing cost’ under the head ‘Finance costs’. However, as per the requirements of paragraph 20(a) and 20(b) of Ind AS 107, separate disclosure of the net gain or loss on the said derivative contracts and the interest expense on the foreign currency external commercial borrowings (being financial liabilities not measured at fair value through profit or loss) should be made within the ‘Finance costs’ schedule in the financial statements. Further, as per the requirements of paragraph 21 of Ind AS 107, a disclosure in respect of the same should be given by the company in its significant accounting policies.