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Oil price risk management

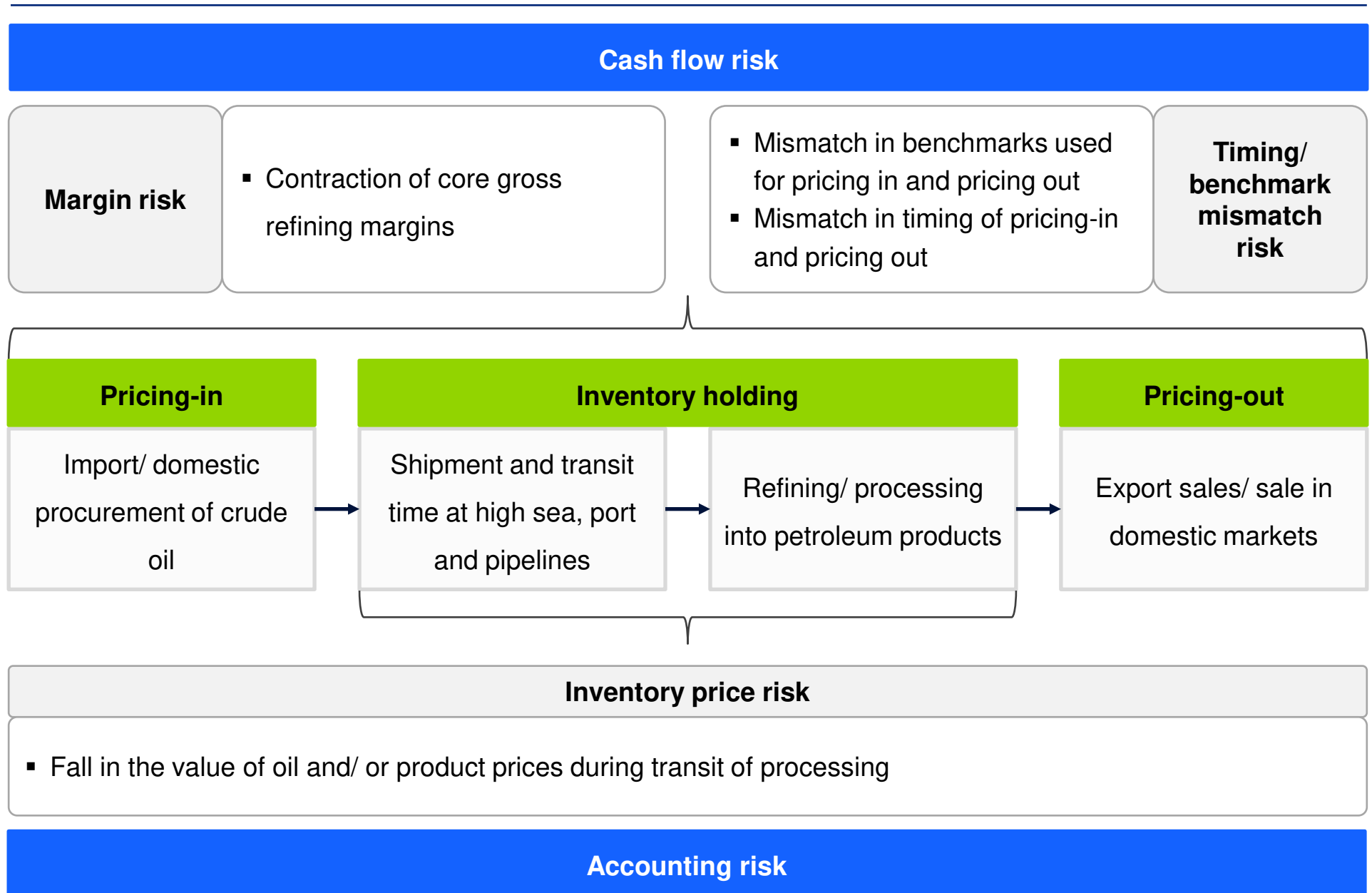
Implications and impact of hedge accounting

A panoramic view of a city skyline at night, featuring numerous skyscrapers with illuminated windows and a complex highway interchange with light trails from traffic. The sky is a mix of blue and orange, suggesting dusk or dawn.

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Inherent oil price risk



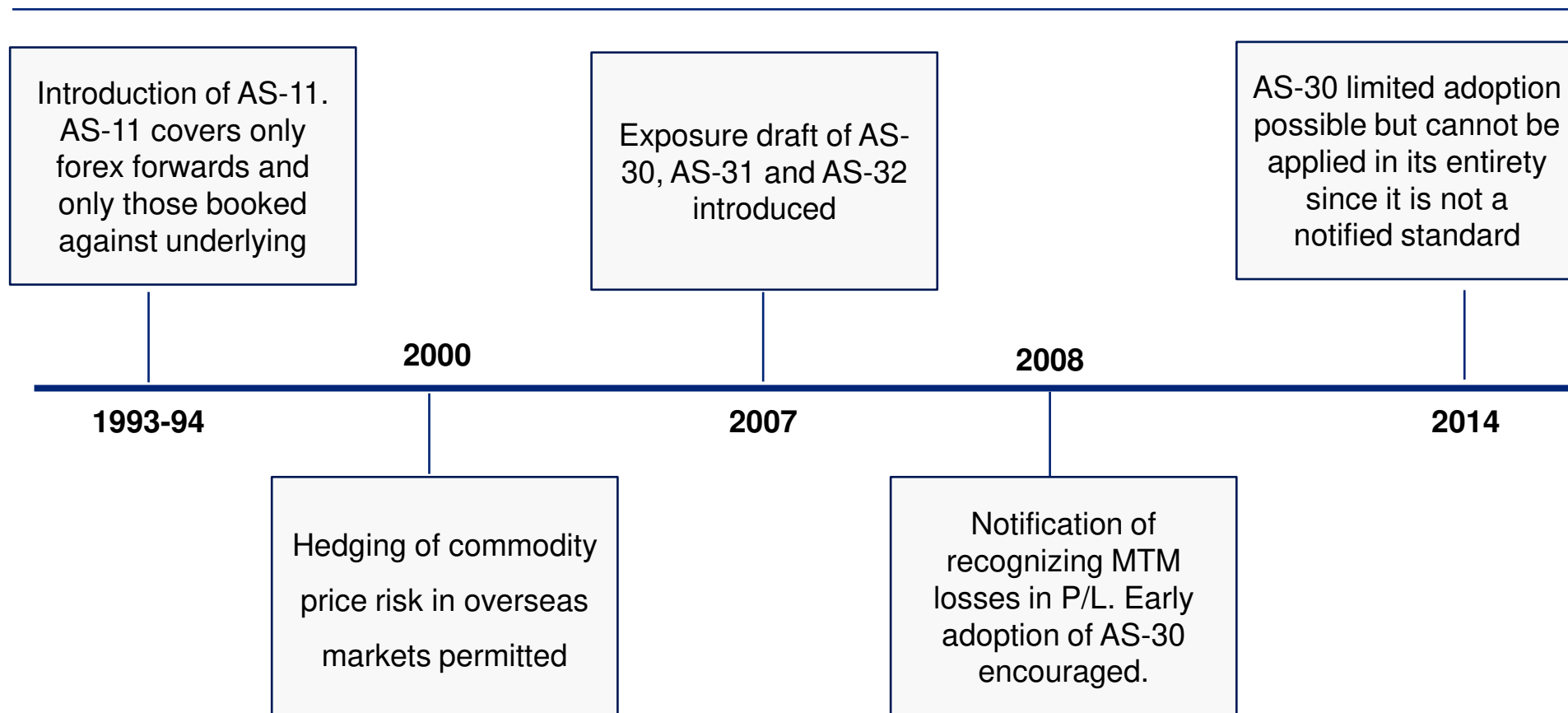
Mitigation strategies and their use by Indian refiners

| SNo | Nature of inherent risk | Typical instruments | Accounting options | Accounting challenges |
|-----|---------------------------------------|--|--|--|
| 1 | Margin risk | <ul style="list-style-type: none"> Crack spreads Product swaps | <ul style="list-style-type: none"> Gain ignored and loss taken to P/L under AS-11 notification Limited application of hedge accounting under AS-30 | <ul style="list-style-type: none"> Most companies have not adopted hedge accounting principles under AS-30 |
| 2 | Timing/ benchmark mismatch risk | <ul style="list-style-type: none"> Crude swaps | <ul style="list-style-type: none"> Gain ignored and loss taken to P/L under AS-11 notification Limited application of hedge accounting under AS-30 where assessed in conjunction with margin risk | <ul style="list-style-type: none"> Most companies have not adopted hedge accounting principles under AS-30 Difficulty in clubbing specific transaction for managing timing risk and margin risk |

Mitigation strategies and their use by Indian refiners

| SNo | Nature of inherent risk | Typical instruments | Accounting options | Accounting challenges |
|-----|-------------------------|--|---|---|
| 3 | Inventory price risk | <ul style="list-style-type: none"> ▪ Crude futures ▪ Crude swaps | <ul style="list-style-type: none"> ▪ Gain ignored and loss taken to P/L under AS-11 notification ▪ Limited application of cash flow hedge accounting under AS-30 where hedges are tagged against future sales | <ul style="list-style-type: none"> • Conflict between AS-30 and AS-2 with respect to inventory valuation |

Timeline of accounting guidelines



Accounting guidelines for hedges have increasingly progressed from off-balance sheet to on-balance sheet. However, demonstrating intent and genuine offset between hedges and underlying exposures is the key to enable appropriate representation in financial statements.

Current state of application of hedge accounting guidelines

- 1 AS-30, AS-31 and AS-32 are not notified standards under the Companies Act
- 2 AS-30, AS-31 and AS-32 can only be applied to the extent they do not conflict with existing accounting standards
- 3 Only hedge accounting provisions of the aforesaid standards can be applied
- 4 In substance, only hedge accounting provisions of the aforesaid standards can be applied
- 5 Application of hedge accounting relies on intention at inception of the hedging transactions
- 6 Hedge documentation and statistical hedge effectiveness testing form the basis for proving intent
- 7 Fair valuation becomes an important factor in application of hedge accounting

Hedge accounting standards

| SNo | Standard | What it covers | Portions to be applied | Equivalent international standards |
|-----|----------|--|---|--|
| 1 | AS-30 | Accounting for all financial instruments including derivatives | Hedge accounting and fair valuation of derivatives | <ul style="list-style-type: none"> • IFRS: IAS-39 and IFRS-13 • US GAAP: FAS-133 and FAS 157 |
| 2 | AS -31 | Presentation of financial instruments | Representation of derivatives in financial statements | <ul style="list-style-type: none"> • IFRS: IAS-32 • US GAAP: FAS-133 |
| 3 | AS-32 | Disclosures | Disclosures pertaining to mark to market of derivatives, outstanding positions, hedging strategy and amounts being carried in hedge fluctuation reserve | <ul style="list-style-type: none"> • IFRS: IFRS-7 • US GAAP: FAS-161 |

How is hedge accounting different

What does hedge accounting do?

- The main aim of hedge accounting is to **reduce P/L volatility** during the life of the hedge, allowing the derivative to affect the P/L in the **same period** as the underlying hedged item (also protecting the structured margin).
- In the case of underlying exposures carried in the books it allows the underlying to be fair valued through the P/L, thus offsetting volatility caused by the derivative
- In the case of future underlyings (future transactions or firm commitments) it allows the P/L volatility to be deferred to an equity reserve

AS-11

- Addresses only assets and liabilities outstanding **as per the books** of accounts
- ICAI announcements require that mark to market profit/loss in accounted for in the financial statements **irrespective of the period** in which the underlying exposures are likely to be settled
- Does **not require stringent documentation** and linking of hedge to exposures at inception
- Hedging against highly probable forecasts not recognized, hence **structured margins** are not protected.
- **Leads to volatility in P&L**

AS-30

- Addresses hedges against **forecasts** and booked transactions
- Recognizes that profit and loss from hedge transactions should reflect in the financial statements in the **same period** as profit and loss from underlying exposures. **Structured margins** can be protected.
- Requires stringent documentation and **proving hedge rationale** to qualify for off-setting hedge and business cash flows
- **Reduces P/L volatility where hedging strategy is appropriate and documentation standard are adhered to.**

What happens if hedge accounting not applied

ICAI guidelines require unrealized MTM losses on derivatives to be taken to P/L and gains to be ignored. This creates P/L volatility from one accounting period to another.

Impact areas on application of hedge accounting

| Derivative transactions | | | |
|-------------------------|---|---|--|
| SNo | Impact area | Current situation | AS-30, AS-31 and AS-32 |
| 1 | Establishing intention at inception | Guidance in this regard is vague and open to interpretation | Very clear guidance on establishing intention at the inception of each transaction |
| 2 | Hedges initiated prior to accounting for underlying exposures | Not recognized | Recognizes a hedge based on intention and provides for recognition in the appropriate period |
| 3 | Documentation to prove intention | No clear guidance | Stringent documentation norms |
| 4 | Valuation | No clear guidance | Fairly clear guidance on what constitutes fair valuation |
| 5 | Use of statistical methods to prove effectiveness of hedges | Not required | Increased stress on proving hedge effectiveness through statistical methods |
| 6 | Disclosing the hedging strategy | Not required | To be disclosed in Notes to Accounts |
| 7 | Explaining and quantifying risk | Not required | To be disclosed in Notes to Accounts |
| 8 | Instruments that can be used for hedging | Criteria not specified | Certain instruments cannot be used as hedging instruments due to their nature |

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