Long-term projects with foreign-currency-forecasted transactions pose an economic risk. This risk stems from fluctuating foreign exchange rates.

When corporate treasuries use derivatives to hedge the forecasted, non-functional currency cash flows of contracts, there is accounting volatility from the change in the value of the derivative being recognized immediately; on the other hand, the change in value of the underlying may not be recognized until later.

Firms can consider applying hedge accounting to reduce income statement volatility. They have a choice of (A) designating the entire change in fair value of hedging instrument in hedge relationship; or (B) designating only changes in fair value of the hedging instrument attributable to the changes in spot rate, excluding the forward points from the hedging relationship.

Firms additionally have a choice of (1) using a single derivative to hedge its foreign currency exposure to the ultimate cash settlement date; or (2) using two separate hedges (one through revenue/expense recognition, and the other from recognition to settlement), where the hedge accounting relationship would terminate when the hedged sale or purchase occurs and the foreign currency receivable or payable is recognized.

The ideal strategy for each firm needs to be aligned with its overall risk management strategy.

**Background**
A firm can enter into a long-term contract to construct specialized equipment. If the revenue received or cost incurred is in a different currency, then the firm faces foreign currency transaction risk.
Each contract can be identified as a project with multiple milestones. The complex nature of the project makes the timing of each milestone within that project uncertain, and potentially subject to change during the life of the project.

Accounting literature specifically contemplates forecasted transactions that are probable but uncertain (with respect to the specific timing of the transaction).

**Objective and Strategy**

**Let's say that a firm’s risk management objective** is to hedge foreign currency risk inherent in long-term projects.

**To meet this objective**, the hedged item in a cash flow hedge should be identified with sufficient specificity, according to accounting literature. This specificity is essential to (1) assess when the hedged transaction will occur; (2) determine whether the hedging relationship is expected to be highly effective; and (3) measure hedge ineffectiveness.

Long-term projects have revenue and/or cost and cash milestones. As mentioned in the introduction, each firm has a choice of using a single derivative to hedge its foreign currency exposure (up to the cash milestone) or using two separate hedges: one allocated to the revenue or expense milestone, and a subsequent hedge when revenue or cost is recognized in earnings.

In the first case, the firm uses a single derivative to hedge two exposures: (1) the foreign currency risk associated with the revenue recognition or cost recognition period; and (2) the foreign currency risk associated with re-measurement of a foreign currency monetary item.

In the second case, the firm can terminate the derivative (and hedge accounting) when the revenue or cost milestone is recognized. The subsequent hedge will provide a re-measurement offset for the re-measurement of foreign currency monetary item.
Every firm needs to identify the hedged item at the inception of the hedge relationship.

Accounting literature also requires contemporaneous documentation regarding the timing of the hedged forecasted transaction. Long-term projects are complex in nature, and that can impact timing of the milestones. Every firm should therefore document a range of time to comply with the hedge accounting requirement.

When the hedged transaction does not occur within that period, a missed forecasted transaction could result, and the derivative gain or loss would be reclassified from other comprehensive income to profit or loss. This could have significant program-wide consequences, as it may call into question the ability of the firm to forecast its exposures reliably.

**Assessing Hedge Effectiveness and Measuring Ineffectiveness**

The hedging instrument is the foreign currency forward contract. A firm can choose to designate the entire change in fair value of the hedging instrument (i.e., spot rates plus forward points), or simply designate only changes in fair value of hedging instrument attributable to the changes in the spot rate. In the latter case, the entity is recording the time value portion to profit or loss each period.

Hedge effectiveness is assessed and measured periodically using the hypothetical derivative method. This method requires the creation of a hypothetical derivative that would perfectly hedge the risk exposure.

The assessment will depend on whether a firm chooses to designate the entire change in fair value or only the spot component. In the first case, the assessment will be based on the full fair value of the forward contract, and no component of the fair value will be excluded from hedge assessment or ineffectiveness measurement.
In case the firm has designated only the spot component, then the assessment will be based on the fair value changes attributable only to the spot rate changes of the forward contract. This assessment should be performed both at inception and ongoing basis.

Only the effective portion of a designated derivative needs to be booked under the “other comprehensive income” category. The effective portion is the cumulative change in fair value of the derivative that is less than or equal to the cumulative change in hedge transaction. Any ineffectiveness or excluded components (e.g., changes in value other than due to spot-to-spot, for the spot-to-spot method) would be included in current earnings.

**Hedge Recognition**

The effective portion of the gain or loss on a designated derivative instrument should be reported under “other comprehensive income,” while the ineffective portion (and any excluded component) should be recognized under earnings. Accounting guidance requires the effective portion that is in “other comprehensive income” to be reclassified into earnings in the same period in which the hedged forecasted transaction affects earnings.

In case a firm chooses to hedge up to the cash milestone, then it will need to reclassify the effective portion from other comprehensive income to earnings, both when the forecasted revenue or cost is recognized in earnings and when the related recognized asset or liability foreign currency re-measurement impacts earnings.

In case a firm chooses to elect hedge accounting up to revenue or the cost milestone, then it will need to re-classify the effective portion from other comprehensive income to earnings (when the forecasted revenue or cost is recognized in earnings).
Parting Thoughts
Each firm should choose the strategy that fits in its overall risk management objective. Consideration must be given to operational complexity and the availability of systems solution to manage the hedge accounting program.

Deepali Ray, CFA is an Assistant FX Controller for GE – Corporate Treasury. She manages the hedge accounting program for GE’s Industrial businesses.