Using Hedge Accounting to Manage Accounting Risk

By Deepali Ray

Managing foreign exchange risk is an integral treasury function in today's global environment. Treasuries use derivative instruments to manage their foreign exchange economic exposure. Hedging economic exposure can give rise to accounting exposure.

The accounting guidance has provisions for qualifying hedges to address this accounting risk by electing hedge accounting. Hedge accounting, however, should not be considered as standard accounting policy election. Careful consideration needs to be given to qualifications necessary to elect hedge accounting.

Accounting Risk

The current accounting standards classify derivative instruments as assets or liabilities, and require them to be reported in financial statements at fair value. Additionally, the change in fair value is recognized in earnings, unless hedge accounting is applied. This may create significant volatility in a firm's accounting results.

The accounting standards permit special accounting for derivative instruments that qualify for hedge accounting. If a derivative instrument meets hedge accounting criteria, then the entity may designate the derivative as a foreign currency hedge. When a transaction qualifies for hedge accounting, the timing of the effective portion of the gain or loss recognition on a hedging instrument matches the timing and recognition in earnings of (1) the change in fair value of hedged risk; or (2) the effect of exposure to variability of cash flow of hedged item.

Considerations

The following requirements of hedge accounting need to be met:

1. Determine the eligibility of the designated hedging instrument and the designated hedged item.
2. Measure and assess hedge effectiveness (it must be highly effective), to continue hedge accounting throughout hedging relationship.
3. Every hedging relationship must be documented, comprehensively, starting at the inception of each relationship.

Eligibility Criteria

An eligible foreign currency hedge is a hedge of the foreign currency exposure that can arise from: (a) unrecognized firm commitments – e.g., a hedge of a foreign-currency denominated unrecognized firm commitment with an unrelated party; (b) recognized assets or liabilities – e.g., a hedge of a foreign-currency denominated asset or liability; (c) foreign currency forecasted transactions e.g., a hedge of a forecasted purchase or the sale of a foreign currency-denominated asset with a third party; (d) inter-company foreign currency forecasted transactions e.g., a hedge of a forecasted inter-company purchase or the sale of a foreign currency-denominated asset; or (e) net investments in foreign operations – e.g., a hedge of the foreign currency exposure of a net investment in a consolidated foreign operation.

Hedge Effectiveness

The application of hedge accounting requires an expectation that the hedging instrument will be highly effective in achieving offsetting changes in fair value or cash flows attributable to the FX risk during the period that the hedge is designated.

The completion of an effectiveness assessment needs to be done at hedge inception, and periodically thereafter (at least as frequently as every three months). This periodic assessment needs to be performed on both a prospective basis (to reconfirm forward-looking expectations) and on a retrospective basis (to determine whether the hedging relationship has been highly effective).

For hedging relationships that are not considered to be perfectly effective, the extent of ineffectiveness in achieving the risk management objectives documented at the inception of the hedging relationship must be assessed each period, and the amount of ineffectiveness must be reported in current period earnings.

Documentation

Formal contemporaneous documentation of the hedging relationship at hedge inception is required. The application of hedge accounting requires extensive documentation. To qualify for hedge accounting, an entity must clearly document (at the inception of a hedging relationship) both its risk management objective and its strategy for entering into the derivative transaction, as well as the nature of the hedged exposure and hedging instruments.

Given the nature of the hedge accounting criteria, it should be presumed that - absent contemporaneous, formal and complete documentation - a hedging instrument does not qualify for hedge accounting.

Closing Thoughts

The complexity of accounting for derivatives can create significant challenges. In fact, just to qualify for hedge accounting, a firm must meet numerous requirements.

However, in this instance, the ends justify the means. Derivative instruments allow firms to disaggregate risks, and to then manage those risks separately. Qualifying for and maintaining hedge accounting enables entities to address accounting risk effectively.

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