To hedge account – or not to hedge account?

Brian Kirkpatrick of Air Products and Chemicals explains how the company's European team prepared itself for the tough task of implementing FAS 133.

This article describes the process of implementing FAS 133 for Air Products and Chemicals' European team. It does not cover the actual requirements of the new standard, which are dealt with elsewhere in this issue's Spotlight.

Hitherto...

Before FAS 133, we have hedged the large volume of individual cashflows on an aggregate basis, offsetting long and short positions, to achieve the most streamlined and cost-effective result. For accounting purposes, deals have been allocated to individual commited equipment projects to satisfy the requirements of FAS 52 for hedge accounting treatment and to enable gains and losses to be booked to individual project accounts, thereby holding project managers fully accountable for ensuring that exposures are identified and dealt with.

FAS 133 threatened these arrangements, with its stricter criteria for designation of hedges and its more detailed hedge effectiveness requirements.

FAS 133 threatens...

Life looked to become much bleaker after FAS 133. The tough designation criteria threatened to reduce dealing efficiency by restricting our ability to aggregate and offset exposures, leading to higher volumes, lower individual deal values, and wider deal spreads. More resources would be needed to administer these higher volumes, to keep track of the designation and documentation requirements, to carry out valuations and monitor hedge effectiveness, and to process complex accounting entries. Business control over individual projects would be reduced as it became more difficult to allocate FX gains and losses to project accounts. And to the extent that we would be unable to designate hedges or achieve hedge effectiveness, there would be potential volatility in the P&L as the gains and losses on hedges were booked to it period by period, different from the periods when the underlying exposures themselves would be booked.

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Implementation would not be a simple task, there was a lot that was not clear (and still is), and many implications only emerged as we worked through the tasks. Our approach was to establish a team formally charged with this task, comprising representatives from treasury, accounting and the business area affected by the requirements of the new standard (in our case, equipment projects).

Brian Kirkpatrick

Air Products is a US-listed multinational manufacturing and distributing industrial gases, speciality chemicals and process equipment used in the industrial gases business. The company uses the standard range of derivatives to manage its debt profile, interest rate and foreign exchange exposures. The European business accounts for 25-30% of the worldwide business. In Europe most of the derivatives activity relates to the FX exposures arising from projects for the construction and sale of process equipment. Such projects range up to $80m in value and may take up to two years to execute.

FX exposures may arise on both revenues and costs. Air Products' policy is to hedge these exposures as soon as a project becomes firm (for example, on receipt of a customer order).

As well as cross-functional, it is a trans-Atlantic team, with counterparts at the head office in the US, to achieve a consistent application. Senior financial management were briefed at an early stage, in order to get guidance on the degree of tolerance for stated earnings volatility in the P&L.

Senior business area managers were also briefed to make them aware of the potential impact of implementing the standard on the data available to manage their business.

Guiding principles...

We established the following guiding principles:

- we would continue our existing risk management policy as being economically correct for the business;
- if the purpose of our risk management contracts is to protect the business from financial risk, the financial statements should reflect this purpose; and
- following points one and two, we would pursue a balance between minimising earnings volatility in the financial statements and the cost of qualifying for hedge accounting.

However we discovered that, especially with the uncertainties involved in executing equipment projects, it is easy to fail (or too costly to satisfy) FAS 133's criteria for hedge accounting, with the result that the financial statements may not give a fair view.

The impact on earnings and resources…

An early task was to work out the impact of applying FAS 133 to the hedges we had in place under different scenarios, varying from full designation (and therefore hedge accounting) wherever possible to designation of only large value exposures. Not surprisingly, the degree of volatility varied inversely with the cost of compliance. We found that the 80:20 rule applied relatively well here. If we designated hedges on 80% by value of the exposures, the level of earnings volatility was acceptable. This implied doing specific deals and designation for all individual cashflows in excess of $400k, for which the resulting volume of dealing and administration was manageable.

We have therefore settled on this as a working procedure. All exposures below this value will be aggregated and offset by currency and timing and net hedges established. This means that gains and losses on these deals will be booked to the P&L each period. While this is not material for external reporting purposes, it does mean that it is difficult to book them to the individual project accounts (and thereby deferring their impact on the P&L) as we have in the past, without creating difficulties of reconciliation between management and legal books. In turn, this means we cannot hold project managers fully responsible for managing currency exposure on their projects. We are still looking for ways to overcome this.

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In this way, we have developed an approach based on pragmatism and materiality.

We do not know if the balance between volatility and the minimum deal designation level will always hold, because of the variable nature of our equipment projects. This will need to be monitored.

From one to another…

The transition from existing procedures to the new FAS 133 basis required careful planning. Cashflows which would qualify for specific designation had to be identified. New deals were put in place for them and, since the overall exposure was unchanged, adjustments made to the existing net deals. Such adjustments are not without cost, of course, and suitable explanations had to be prepared for bank dealers to explain such strange behaviour. In addition, the transition accounting entries were prepared by the accountants, to be booked in the first quarter of adoption. We carried out a dry run during the preceding quarter to ensure there would be no nasty surprises.

Administration

The burden of administration is considerable and complex. It needs to be clear and specific, at the transaction level, to demonstrate at all times the entitlement under FAS 133 to the special accounting treatment. With large volumes it would be difficult to keep track without significant help from systems.

Because Air Products was required to implement the new standard on 1 October – earlier than most US corporates – we have been unable to benefit from the upgrades made by the leading treasury management systems providers.

We will take advantage of this in due course, however, and regard this as crucial to coping with the requirements of the standard.

Key issues

The main points emerging from our experience are as follows:

- this is a major project requiring a cross-functional team;
- senior and business area managers must be involved in decision-making;
- we continue with our economic hedging strategy – the FAS 133 tail does not wag the dog;
- the potential impact of FAS 133 needs to be evaluated – financial statements (earnings volatility), costs and resources business practices (for us, equipment projects management);
- we adopted a pragmatic, materiality-based approach; and
- before implementation, we got clearance from our auditors. ■

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Past articles on FAS 133 in *The Treasurer*

The details may have changed but these articles provide useful background

April 2000, p. 36 – Les Halpin, Integrity
September 1999, p. 61 – Nilly Essaides, FAS133.com
April 1999, p. 18 – Sebastian di Paola, PricewaterhouseCoopers (part 2)
March 1999, p. 15 – Sebastian di Paola, PricewaterhouseCoopers (part 1)

Each of these articles can be downloaded from the ACT website: http://www.treasurers.org/thetreasurer/edit.html