

Hedging and internal control post-FAS 133

FAS 133 has changed the way treasuries manage financial risks. Sebastian di Paola and Olivier Cattoor of PwC examine the new rules and their implications.

Hedging and hedge accounting are, perhaps unfortunately, two very different things. The need of accounting standard setters to ensure that rules are sufficiently specific to avoid earnings manipulation are almost invariably at odds with the need for dynamic and flexible corporate financial risk management. This conflict stems largely from the fact that hedging is, by its very nature, highly judgmental and that the boundary between hedging and position taking is notoriously difficult, sometimes impossible, to define in practice. Accountants, and in particular the standard setters, do not like this sort of grey area, since it opens the door for fiddling the bottom line. Treasurers and risk professionals on the other hand are at pains to point out that placing excessive restrictions on hedging activities is not in the best interests of shareholders as it limits the ability to react to market circumstances by adapting the corporate risk profile.

With FAS 133, the standard setters have taken a hard line which largely avoids this debate, by focusing on the micro-level relationship between a hedging instrument and a hedged item and ignoring the question of whether enterprise-wide risk reduction (required in certain earlier standards) is actually achieved.

With the new rules on derivatives and hedging the US's Financial Accounting Standards Board (FASB) has done something which goes beyond what we would normally expect of an accounting standard setter. FAS 133 does more than just define how the debits and credits should be recorded, since it implicitly goes a long way in describing the way the internal policies and processes of companies using derivatives for hedging ought to look. This is really more like regulation than accounting and is almost certainly a reaction by the FASB to a perceived failure by the market to properly control derivatives activities.

Cost benefit analysis is the first major step in any implementation of FAS 133 and should not be short circuited

Accounting as a driver for derivatives internal control

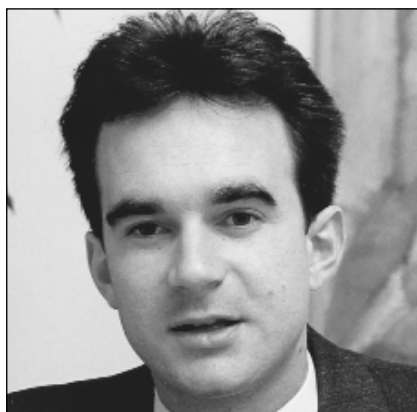
The increasing use of derivatives by corporates over the last 20 years has reflected the increasing sophistication of the non-financial community in the area of risk management and the drive to enhance shareholder value by better harnessing market risk. Unfortunately, the lack of clear and enforced policies on the use of derivatives has, particularly in the 1990s, led to a series of well publicised control failures which in terms of their number (rather than size) are no doubt only the tip of the iceberg. Inevitably this has led to calls for stricter regulation of derivatives activities within both banks and corporates and for harmonised accounting standards.

The debate on whether the new rules

on derivatives accounting are ultimately the best answer to the lack of transparency and comparability which previously existed will no doubt rage on. However, those directly affected by the standard have had to put aside their initial feelings and get on with the job of implementing the policy and process changes required to comply effectively with the standards.

Cost benefit analysis

The initial gut reaction of many of the treasurers affected has been to suggest that the simplest and most economically justified approach was to ignore the accounting impact and continue with the hedging policies they had applied in the past, since these were presumably the most appropriate for protecting corporate value. If this meant that many derivatives hedges would simply be marked-to-market through earnings for accounting purposes, then so be it. However, a better understanding of the impact on reported earnings of such an approach has led most treasurers, usually following discussions with the CFO, to conclude that hedge accounting was required, at least for some hedging strategies, and that some degree of change to existing policies and processes would be needed.



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Indeed shareholder value studies and analysis of stock market behaviour have shown that investors and hence share prices are highly sensitive to earnings volatility.

The process of determining where hedge accounting is required essentially boils down to a cost benefit analysis. Companies must weigh up, per strategy, the cost of implementing the changes required for hedge accounting versus the benefit in terms of reduced earnings volatility.

This analysis is the first major step in any implementation of FAS 133 and should not be short circuited, since it forms the basis for the board or CFO to determine the company's FAS 133 implementation approach.

Those who avoided this first step and did not obtain formal sign-off on the conclusions have often found themselves back at square one when, further down the implementation process, it became clear that sub-optimal decisions had been made up-front.

Hitting a moving target

The process of reviewing strategies and procedures to ensure compliance with FAS 133's strict documentation and monitoring requirements has been hampered for many by the fact that the rules are, in a number of respects, a moving target. Ongoing interpretation of FAS 133 by the Derivatives Implementation Group (DIG), as well as the amendment which was released in June (FAS 138), has made it difficult for implementers and for system vendors to define exactly what it was they were trying to implement. Many have had to revisit their initial conclusions and revise post-FAS 133 policies to take account of the latest from the DIG. Companies implementing IAS 39 face a similar challenge from the ongoing work of the Interpretations Guidance Committee (the IGC), which has now issued its fourth batch of interpretative Q&As.

The area of foreign exchange hedging via centralised treasury centres has caused particular problems, especially

as regards FAS 133's initial prohibition on netting of exposures for hedge accounting. This prohibition has now been relaxed in respect of hedges of forecast exposures (cashflow hedges), though not without considerable additional restrictions on how the centralised netting is to be conducted.

Other impacts of FAS 133: embedded derivatives and commodities

In addition to the usual derivatives known to treasury, the standard also captures so-called 'embedded derivatives': these are sub-components of other instruments or contracts which, though their host is not a derivative, themselves satisfy the definition (an equity option embedded in a convertible bond is the classic example). Embedded derivatives may be found throughout the organisation, not just in the treasury function, and as such companies implementing the standard are required to perform a search for unusual pricing or settlement clauses in

Hedges of forecast FX via a centralised treasury

Linking derivatives to exposures

Getting hedge accounting for hedges of forecast commercial foreign currency flows is particularly onerous, due to the daunting systems and process challenge of identifying and linking foreign currency commercial exposures (which arise from a multitude of ongoing transactions entered into throughout the group) with the hedges taken out by treasury. While the exposures themselves are highly decentralised, the hedging of those exposures on the market is generally performed centrally by group treasury, which nets the affiliates' foreign currency exposures to reduce the hedging cost. In such structures, the exposure item and hedging instrument generally exist in different and unconnected systems. FAS 133 requires that these transactions should be linked in some way to ensure proper documentation, to test effectiveness and to properly recycle OCI balances.

Detailed specification of hedged foreign currency exposure

FAS 133 requires that specification of the hedged exposure should be sufficiently detailed to enable objective determination of the occurrence of the forecasted exposure. In other words, the company needs to be able to determine precisely when the hedged forecasted transaction actually occurs, and is recorded on the balance sheet as a payable or receivable. At this point the hedge becomes a hedge of a balance sheet item (which is revalued at the spot rate under FAS 52) rather than a forecast. The accounting for the hedging derivative is also modified at this point, with gains and losses being recorded in P&L rather than OCI.

The gains and losses on the hedging derivative, which had been deferred in OCI during the forecast period, must be released at the same time as the hedged transaction affects P&L in the consolidated financial statements. In practice, this requirement implies that release of the balance of deferred gains and losses takes place, for example:

- immediately in the case of a sale which directly impacts earnings;

- in the case of a sale to an intermediary sales branch (ie an inter-company sale), at the time the sales branch makes a sale outside the group (DIG issue H13);
- in line with the depreciation charge when hedging the purchase of a fixed asset; and
- in the case of a hedge of inventory purchases in foreign currency, when cost of goods sold is recognised, ie at the time of the ultimate sale of inventory or related finished goods.

In both the second and last case, OCI release could take place some considerable time after the hedged inventory purchase or inter-company sale transaction is recorded on the balance sheet. Given the virtually insurmountable practical difficulty of linking individual inventory components to deferred gains and losses, companies must make assumptions about stock turnover periods to support the timing of recognition of deferred gains and losses in P&L. These assumptions should be supported with factual evidence to pass the test of an external audit and the resulting financial statements must, of course, be materially correct.

Enhancing foreign currency forecasting capability

Numerous implementers have identified improved forecasting as one of their key needs under FAS 133, but are also able to point to this as an area where treasury can benefit significantly from the improved process. Indeed, treasury has long sought to obtain better forecast information from affiliates, and many argue that FAS 133 is the perfect tool to enforce this.

Forecast transactions need to be at least 'probable' of occurring to be allowed as hedged items, and companies need to confirm at least on a quarterly basis that these forecasts are still expected to occur. This implies a need to revisit or flex forecasts on a regular basis. The probability issue can, however, be dealt with by using sliding hedge ratios (such as hedging only 50% of the forecast

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normal commercial contracts and assess whether these constitute embedded derivatives which might require separate accounting (at Fair Value of course). This has proved a particular challenge for those active in the utilities, energy and other commodities sectors and can be an extensive exercise. Unlike hedge accounting there are no decisions to be made here (other than perhaps choosing to avoid certain derivative-type clauses in the future), since the accounting treatment for FAS 133-embedded derivatives, which are generally not hedges, is fixed.

An additional challenge for those buying and selling commodities is the fact that forward purchases and sales may meet the definition of a derivative and hence need to be recorded at their fair value, creating potentially significant volatility in the bottom line. On this point, many will wish to benefit from the 'normal purchases and sales' exception which has been expanded by FAS 138. This exception enables companies to avoid having to mark-to-market OTC forward purchases of commodities which will result in actual delivery and use in the business.

Significant impact on hedging policies

It is clear from existing experience that FAS 133 will often drive changes in treasury policy. Many have already adjusted

In spite of all this change and of the anti-FAS 133 sentiment which is doubtless out there, many companies which have already implemented now see some positive side to FAS 133

their hedging strategies or decided no longer to hedge some exposures. Most FX hedgers have redefined the roles and responsibilities of group treasury and affiliates in view of the complex processes required when hedging forecasts. In addition, various common hedging instruments, such as foreign currency options and collars, have suffered at the hands of FAS 133's effectiveness test as a result of the volatility of time value.

In spite of all this change and of the anti-FAS 133 sentiment which is doubtless out there, many companies which have already implemented now see some positive side to FAS 133. They view the standard as an opportunity to get treasury out of its ivory tower and

closer to the underlying business, and to encourage affiliates to produce information which is more relevant to treasury, particularly in the form of improved forecasts.

Still, on the plus side, the implementation of FAS 133 has created an opportunity for companies to revisit their approach to managing financial risks and to ensure that exposures are properly captured and policies aligned to corporate objectives. The standard also now provides a common language for the treasury and accounting functions to come together on the complex issue of controlling derivatives. Ultimately, the thrust of the standard from a process perspective is likely to drive some degree of improvement in the control environment as companies rationalise their hedging policies and implement better automated and transparent processes, with improved integration from front office to accounting. Nonetheless treasurers will continue for years to come to regret the loss of flexibility in risk management decisions and to suffer from some of the more extreme aspects of the new rules. ■

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beyond six months); in this case the first 50% of transactions are usually probable even if the full 100% were not. Over-hedging is sanctioned by all or part of the hedging derivative being re-qualified as trading, resulting in P&L volatility. Hedges may be de-designated during their life cycle, but cherry-picking aimed at earnings manipulation is clearly not permitted.

Centralised versus decentralised processing approach

The fact that the treasury management system (TMS) is generally only available at the level of treasury drives most companies towards a centralised approach to compliance. In this model, treasury acts as a service centre, documenting, testing and managing hedge relationships on behalf of affiliates and generating the FAS 133 hedge accounting entries to be used in the consolidated financial statements. In order for hedging relationships to be maintained centrally in this manner, foreign currency exposures, in the form of detailed FX forecasts, must be imported or centrally input into the TMS. This could be achieved by uploading spreadsheets or, with more companies using browser-based TMS technology, via the intranet. This model means that, as a minimum, affiliates must provide treasury with decent and regular forecasts. For those using ERP systems such as SAP, the solution to some of the processing issues, such as gathering forecast data and identifying the timing of the actual transactions may lie in the enterprise-wide system's ability to pull all this data together seamlessly.

The danger of centralising the process in this manner, lies in the risk of disconnection between the hedging instrument and the true life cycle of related commercial flows. Some companies have therefore chosen to opt for a decentralised model for managing FAS 133 hedging relationships by establishing appropriate functionality, such as TMS, at affiliate levels.

Use of the TMS as main platform for FAS 133 compliance

Automation of the FAS 133 process is a key to success. Most companies choose to use the TMS as the centralised platform for FAS 133 compliance and many have changed systems to implement a TMS with relevant FAS 133 functionality and strong instrument pricing capability (to support fair value measurement of relevant derivatives).

Other solutions to the FX hedging conundrum

In light of the practical difficulty of managing hedge relationships where the hedging instrument and hedged items exist in different entities and systems, some have chosen to adapt their foreign exchange profiles, by locating all exposures in a single entity, which is also the hedging entity. Factoring and re-invoicing solutions can both achieve this objective, allowing the treasury centre to bear all FX risk and removing affiliates from the foreign currency equation altogether. A more extreme answer to the problem, but one which has been adopted by a few companies with lower levels of exposure has been to simply decide not to hedge at all. ■