Foreign Currency Forward Contracts and Cash Flow Hedging

Managing the Foreign Exchange Risk

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The global economy and financial markets have been evolving rapidly over the past few decades, and the pressures on companies to do business internationally have risen significantly. Businesses operating internationally have experienced severe currency volatility in recent years. Currency volatility not only impacts a company's financial statements; it also affects decisions on mergers and acquisitions, current and future procurement plans, investments, and divestitures. Foreign exchange (FX) fluctuations and unmanaged FX risks affect a business's cash flows, income and loss, assets, liabilities, credit, and even market capitalization.

Current FX risk management practices, such as currency cash flow hedging using forward exchange contracts, can be helpful to international businesses. Recently proposed changes by U.S. and international standards setters may have an impact on their use and accounting.

Planning for Hedge Programs

Any international company should evaluate and analyze the benefits and pitfalls of any potential FX hedge strategy and institute a program tailored to the company's objectives and goals. A formal hedge program requires management to identify the risks, define strategies to mitigate these risks, and define risk governance policies for hedge programs. Timing should not play a role in the implementation of a hedge program, because the objective of a hedge program is averting risk, not maximizing profit or minimizing loss.

FX hedges have some unique characteristics that make them different from other types of hedge programs. Accounting Standards Codification (ASC) Topic 815, "Derivatives and Hedging," has retained certain provisions of ASC Topic 830, "Foreign Currency Matters."

ASC 815 permits hedge accounting for FX risks involving any of the following:

- Unrecognized firm commitments with a financial component
- Recognized assets or liabilities (including available-for-sale securities)
- Foreign currency–forecasted transactions
- Intercompany foreign currency–forecasted transactions
- Net investments in foreign operations.

FX hedge programs can be structured as one of the following hedge programs:

- A fair-value hedge of an unrecognized firm commitment or a recognized asset or liability
- A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, and the forecasted functional currency–equivalent cash flows associated with a recognized asset or liability or a forecasted intercompany transaction
- A hedge of a net investment in a foreign operation.

Cash Flow Hedges

Companies can mitigate the FX risk of either foreign currency–denominated unrecognized firm commitments or recognized assets and liabilities by engaging in a hedge program. Businesses can designate the hedging relationship as either a fair value hedge or a cash flow hedge, depending on its objectives and the type of hedge instrument that is being used. When an entity's objective is to eliminate the variability of the functional currency–equivalent cash flows of the hedged item, then it is more appropriate to use the cash flow hedge model.

Cash flow hedges can be used to mitigate the risk of the foreign currency translation for the following transactions:

- Hedges of a forecasted purchase or sale of foreign currency–denominated financial assets or nonfinancial assets (e.g., fixed assets) with an unrelated third party
- Hedges of a forecasted intercompany purchase or sale of foreign currency–denominated financial assets or nonfinancial assets
- Hedges of a forecasted transaction related to a recognized asset or liability for which remeasurements are recognized in income (e.g., receipt or payment of interest on a foreign currency–denominated debt instrument)
- Hedges of a forecasted receipt or payment of service-related revenues denominated in a foreign currency (e.g., royalties or franchise fees)

FASB has determined that none of the following shall be designated as a hedged item or transaction in a cash flow hedging model under ASC 815-20-25-43(b)(1):

- An investment accounted for by the equity method in accordance with the requirements of ASC 323-10
- A noncontrolling interest in one or more consolidated subsidiaries
- Transactions with stockholders as stockholders, such as projected purchases of treasury stock and payments of dividends.

Foreign Currency Forward Contracts for Forecasted FX Transactions

A forecasted transaction, such as a forecasted sale to a third party, that is denominated in a foreign currency presents earnings exposure due to the movements in foreign exchange rates. This exposure can be mitigated through a foreign currency forward contract.

The use of a forward contract in a foreign currency cash flow hedge of a forecasted transaction is relatively straightforward and follows the basic cash flow hedge model. However, certain unique implementation issues arise when forward exchange contracts are used in a cash flow hedge of a recognized foreign currency–denominated asset or liability. These issues result from the different bases for measuring the forward contract (based on forward rates) and the resulting assets or liabilities (based on spot rates). This difference, depending upon the methodology that a company adopts, may get reflected in earnings.

Accounting for Foreign Currency Forward Contracts

ASC 815-30-35-38 through 41 describe the accounting for cash flow hedges. According to the guidance, the effective portion of a derivative's gain or loss is reflected in other comprehensive income and is classified into earnings, as the hedged transaction impacts earnings. The ineffective portion, however, is generally reported in earnings immediately. The accounting for cash flow hedges for forecasted FX intercompany transactions was previously discussed by the authors in the October 2010 *CPA Journal* (Josef Rashty and John O'Shaughnessy, "Foreign Currency Forward Contracts and Cash Flow Hedging: Navigating Accounting and Disclosure Requirements").

Hedge Effectiveness and Documentation

Hedge effectiveness refers to the extent that the changes in the fair value of a hedging instrument offset the changes in the fair value of the hedged item (the underlying). Hedge effectiveness must be assessed and documented at the time of hedge designation as well as in subsequent periods (at least quarterly). A qualifying hedge transaction requires compliance with rigorous documentation requirements.

In an FX forward contract, effectiveness is assessed by comparing the changes in the spot rate of the currency underlying the forward contract with the changes in the spot rate of the currency in which the forecasted transaction is to be consummated. If both currencies are the same, it is highly unlikely that the hedge relationship will be ineffective.

Although there are no bright lines for determining whether a hedge is highly effective, the FASB staff has stated informally that, in order for a hedge to be highly effective, the cumulative change in the value of the derivative instrument expressed as a ratio of the cumulative change in the fair value of the hedged item (the underlying) must fall within the range of 80% to 125%. A derivative instrument only qualifies for cash flow hedge accounting if it is highly effective.

Other Considerations

Over- and underhedges. Under the recognition model for cash flow hedges, ineffectiveness is recognized only to the extent that the cumulative change in the fair value of the derivative instrument exceeds the cumulative change in the expected future cash flows from the hedged transaction. Therefore, the ineffectiveness from an "overhedge" (i.e., where the cumulative change in fair value of the derivative is greater than the cumulative change in the expected future cash flows of the hedged transaction) is recorded in earnings. But ineffectiveness from an "underhedge" (i.e., where the cumulative change in fair value of the derivative is less than the cumulative change in the expected future cash flows of the hedged transaction) is not recorded in earnings.

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Shortcut methods. ASC 815 allows the use of a shortcut method in a limited number of plain vanilla hedging relationships. The shortcut method allows an entity to assume that there is no ineffectiveness present without having to perform detailed effectiveness assessments otherwise required to apply hedge accounting, and it allows an entity to not record any ineffectiveness related to the hedging relationship (ASC 815-20-25-104 through 106). FX forward contracts are not permitted to be accounted for as hedges using the shortcut method.

Critical terms matching methods. In a cash flow hedge, if the critical terms of the derivative and the hedged forecasted transaction are the same, an entity can subsequently assess hedge effectiveness by verifying and documenting two conditions: The critical terms have not changed, and no adverse developments exist regarding risk of default by the derivative counterparty (ASC 815-20-25-84).

Background on the Financial Instruments Convergence Project

In late 2010 and early 2011, the International Accounting Standards Board (IASB) and FASB narrowed their focus and concentrated their resources on completing certain high-priority convergence projects. These projects included revenue recognition, leasing, other comprehensive income, fair value measurement, and financial instruments. At that time, the boards' target completion date for the above projects was June 30, 2011, which was extended to late 2011 and subsequently to mid-2012.

FASB and the IASB have jointly reconsidered the accounting for all financial instruments, including hedge accounting. Despite starting a joint project, the two standards setters have been pulled in different directions by political forces, and as a result have arrived at different conclusions. FASB released its highly anticipated exposure draft (ED) in May 2010 ("Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments [Topic 825] and Derivatives and Hedging [Topic 815]"). The ED states that the goal remains for both boards to issue comprehensive improvements to this complex area that will foster the comparability of information about financial instruments. However, each board has faced different imperatives that have resulted in different approaches to accounting for certain types of financial instruments.

The IASB released for public comment an ED on accounting for hedging activities in December 2010 (phase 3, "Hedge Accounting"). This proposal, when finalized, will add the new hedge accounting requirements to IFRS 9, *Financial Instruments* (which replaced IAS 39). Unlike FASB's ED, which barely touched upon hedge accounting issues, the IASB's ED has undertaken a comprehensive review of the hedge accounting model and has attempted to closely align the model with the actual risk management activities of companies that hedge their financial and nonfinancial risk exposures.

In February 2011, in an unprecedented decision, FASB asked its constituents to comment on the IASB's proposed changes to hedge accounting. FASB also asked whether the IASB's proposal is indeed a better starting point than its own earlier ED.

FASB received feedback on both the IASB's ED and its own, and plans to consider this feedback in its future redeliberations. In August 2011, FASB discussed the feedback on its February 2011 discussion paper soliciting comments on the IASB's hedge accounting proposal. FASB said that auditors and preparers generally supported the IASB's "principles-based, risk management strategy–oriented" approach, with some reservations about certain aspects of the IASB model that might be operationally challenging. Some others argued that the best approach would be to make targeted changes to the current FASB model because it is not fundamentally flawed. Many auditors and preparers also urged the boards to converge their two different models.

The IASB completed its redeliberations and issued a staff draft of the final standard in November 2011; a final standard is expected in the first half of 2012. Furthermore, the IASB has begun its deliberations on the second phase of its hedging project: macro hedging (related to hedging risks in "open" portfolios).

FASB's Proposed Changes to Hedge Accounting

FASB's ED proposed the following changes to hedge accounting:

- It would relax the rules pertaining to the assessment of hedge effectiveness by reducing the effectiveness threshold from highly effective to reasonably effective.
- It would eliminate the shortcut method and critical terms matching method as allowable techniques to assess effectiveness.
- It would recognize in earnings any hedge ineffectiveness resulting from underhedges of cash flows, in addition to the current recognition of overhedges.
- It would eliminate the ability to voluntarily dedesignate hedging relationships. (Many respondents to the ED did not support this provision.)

The updated FASB model on hedge accounting maintains the existing structure and framework of current U.S. GAAP: The measurement of hedge ineffectiveness, the presentation of hedge accounting in the financial statements, and the types of hedge relationships remain intact. FASB's proposal, does, however, makes it easier for companies to qualify and maintain hedge accounting. For example, it changes the "highly effective" concept to "reasonably effective," it permits the use of qualitative assessments for hedge effectiveness, and it abolishes mandatory quarterly assessments. Under FASB's more relaxed proposals, more companies that currently do not use hedge accounting may be motivated to consider implementing a hedge program as part of their risk management framework.

Despite there being some advantages to its new model, FASB also included some new concepts that would make qualifying for hedge relationships more challenging. For example, due to the elimination of the shortcut method, accounting for fair value hedges of fixed-rate debt would be more difficult, as the so-called long haul approach would be used to report ineffectiveness. Another example that would make qualifying for a hedge relationship less appealing is the provision for recognition in earnings of any hedge ineffectiveness resulting from underhedges in addition to overhedges.

IASB's Proposed Changes to Hedge Accounting

The IASB's proposed hedging model in its December 2010 ED is much more ambitious than FASB's proposal. For the most part, FASB maintained the basic structure of the existing hedging model, including what constitutes an eligible hedge strategy, how hedge ineffectiveness is measured, and how the effects of hedge accounting are presented in the balance sheet and income statement. In contrast, the IASB took on a large-scale project and dealt with substantial issues, such as allowing a nonfinancial risk component to be separately hedged and introducing the concept of rebalancing a hedge (a hedge requires rebalancing when a hedge relationship loses its effectiveness, but the risk management objective remains the same).

At its September 2011 meeting, the IASB concluded that redeliberations were essentially complete. It decided that reexposure would not be necessary and issued a staff draft in November 2011. In December 2011, the IASB issued an amendment that delayed the effective date of the guidance to annual periods beginning on or after January 1, 2015—the original effective date was for annual periods beginning on or after January 1, 2013. The final standard is expected to be issued in the first half of 2012.

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Comparative Analysis of the IASB and FASB Proposals

A complete analysis of the IASB's ED is beyond the scope of this article, but the following is a brief discussion of some of the main differences between the two proposed EDs and how they will impact cash flow hedges and FX forward contracts.

Qualifying criteria. Under the IASB's ED, a hedge relationship must produce an unbiased result, which means that the ratio of the hedging instrument to the hedged item should not result in an intentional mismatch.

FASB's ED introduces the concept of a hedge being "reasonably effective" in lieu of the existing threshold of "highly effective."

Both boards intend to lower the highly effective threshold that is currently used in ASC 815 and IAS 39, *Financial Instruments: Recognition and Measurement*, thereby granting companies more flexibility to enter into hedging relationships.

Some commentators, however, have expressed concerns that the IASB's proposed model is more restrictive than FASB's ED and may require an unnecessary degree of precision in order for a transaction to qualify for hedge accounting.

Frequency of testing for hedge effectiveness. The IASB's ED requires entities to perform an ongoing assessment of the effectiveness of the hedge program at the end of each period or upon a significant change in circumstances affecting the hedge effectiveness requirements. This IASB requirement resembles the current U.S. GAAP guidance, with the exception that ASC 815 also requires a retrospective assessment of the hedge effectiveness every period.

FASB's ED removes this requirement, however, and replaces it with a qualitative (or quantitative, if necessary) assessment only when circumstances suggest that the relationship can no longer be reasonably effective.

The commentators generally favored FASB's less restrictive approach.

Discontinuation of hedge program. Not only does the IASB's ED permit the discontinuation of a hedge program when the hedge instrument has expired or been sold, terminated, or exercised; it also allows discontinuation when the risk management objectives are no longer met. Thus, the proposed IASB ED prohibits the voluntary discontinuation of hedge accounting when the risk management objective remains the same and all the other qualifying criteria are still met.

Some commentators, however, have expressed concerns that the IASB's proposed model is more restrictive than FASB's ED and may require an unnecessary degree of precision in order for a transaction to qualify for hedge accounting.

FASB's proposal similarly prohibits companies from dedesignating an otherwise reasonably effective ongoing hedge.

Even though both proposals rule out a voluntary termination of hedge accounting aside from effectively terminating the hedging instrument itself, the IASB's proposal would permit an early hedge termination if the company's risk objectives have changed. This position allows more alignment with a company's actual risk management objectives.

Rebalancing of hedge programs. The IASB's ED also introduces the concept of rebalancing a hedge relationship. An entity first determines whether its original risk management objectives have changed. If so, it can rebalance the hedge relationship to minimize any expected ineffectiveness. The rebalancing only covers adjustments to the quantities of the hedged item or the hedging instrument for the purpose of maintaining a ratio that complies with the requirements of the hedge effectiveness assessment. For example, an entity may have a change in the volume of an expected transaction and engage in hedge rebalancing in order to make mid-course corrections to eliminate ineffectiveness from hedging relationships without any need to discontinue any otherwise existing highly effective hedges.

Current U.S. GAAP and FASB's proposed ED, on the other hand, can only effect a change in a hedge relationship by dedesignating a hedge program and redesignating a new one. This requirement creates volatility in a company's profit and loss and results in additional expenses.

Unlike the IASB's proposal, FASB's proposal prohibits companies from dedesignating an otherwise "reasonably effective" ongoing hedge program. This restrictive provision of dedesignation or discontinuation has not been well received by many, because a company can always close a hedge program and open a new one. Critics argue that the prohibition FASB has imposed is one more of form than substance.

Hedging of a group of items. The IASB's proposal provides that a group of gross positions can be hedged together if the following two conditions are met: The group consists of items that are individually eligible as a hedged item, and the items in the group are managed together on a group basis for risk management purposes.

Current and proposed U.S. GAAP permits hedges of a group of liabilities, assets, firm commitments, or forecasted transactions if the individual items that make up the group all share the same risk exposure designated in the hedge.

The IASB's proposal for hedging a group of items is less restrictive than current and proposed U.S. GAAP even though, in reality, groups that are eligible under either of the two proposals are generally those that would also qualify for hedge accounting on an individual basis. Commentators have generally preferred the IASB model, because it is less restrictive and is more aligned with the approach that a risk manager usually takes to address the risks to be hedged.

Hedging net positions. The IASB's ED would allow a group of net positions to be eligible for a hedging relationship. The IASB removed the restriction that the offsetting cash flows in a net position must all affect the income statement in the same reporting period. Instead, the eligibility criteria would be extended to require that the items within the net position be specified in such a way that the pattern of how they will affect the income statement is set out as part of the initial hedge designation. The IASB requires that cash flow hedges of net positions only be available for hedges of foreign currency risk.

Current and proposed U.S. GAAP does not permit the designation of a net position. Under U.S. GAAP, entities achieve the hedging results of a net position by designating a percentage of the gross exposure to form the net position. For example, if an entity forecasts the purchase of certain foreign currency and sales of the same currency, and the ratio of sales to purchases is 80%, then it designates the first 20% of the foreign currency purchase as an FX forward contract.

Thus, under FASB's proposal, an entity can use this method to achieve the same objective as it would have achieved through hedging a net position, whereas the IASB would permit an entity to directly designate a net position for hedge accounting.

Hedging of nonfinancial items. The IASB's ED permits a component of a nonfinancial item to be designated as a hedged item if the component is separately identifiable and reliably measurable. For example, the price of electricity may be tied to the cost structure of a power plant. Contractually agreed-upon prices may include, for example, the price of coal or the cost of emission rights.

The current U.S. GAAP treatment and the proposed FASB guidance permit a nonfinancial item to be designated as the hedged item only for its foreign currency risk or all of its risk in its entirety.

Commentators have argued that the proposed IASB model is more aligned with risk management and business perspective.

Has Convergence Been Achieved?

FASB and the IASB have issued two proposals to amend their hedging models, but there are key differences between the two models. FASB's ED provides for easier access to hedge accounting, whereas the IASB's model is more ambitious and includes proposals that more effectively line up accounting with risk management activities. The IASB expects to issue its final standard in early 2012, whereas FASB is still redeliberating based on comments received from its constituents regarding its ED and the IASB's proposal. Has convergence been achieved? Probably not, at least so far in this case; the issues surrounding the convergence of U.S. and international hedge accounting reflect the many challenges that the SEC faces in fully adopting IFRS in coming years. ❑

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