



The advantages of hedge accounting

An interest swap is a practical way of covering interest rate risks. Provided that a number of rules are observed, it is permissible to use hedge accounting in such cases. In this article, senior consultant Mark van den Berg explains the advantages of hedge accounting with the help of an example from the business community.

Besides having global economic consequences, the current credit crisis has implications for the way various companies implement International Accounting Standard (IAS) 39. The interbank interest rate market, a reference interest rate for calculating market value, is no longer a suitable reference. What's more, many companies now have to amend the conditions of their existing loans because of their failure to meet ratio requirements. All of this influences the application of IAS 39. Many are now asking themselves if the hedge agreements have to be broken and new ones made, or can the present hedge relationships remain in place? Another factor is that hedge relationships that were highly effective in the past have recently proved to be ineffective. This makes it likely that hedge relationships will have to be broken. This article discusses current issues in hedge accounting based on three cases.

Hedge accounting

More than four years ago, many companies started reporting according to the International Financial Reporting Standards (IFRS). The most important of these accounting rules from a treasurer's point of view is IAS 39 (Financial Instruments: Recognition and Measurement). The objective of IAS 39 is to lay down rules for presenting financial contracts (such as derivatives) in the accounts and the conditions that must be met if a company wishes to apply hedge accounting. In brief terms, a company must satisfy the following conditions:

- At the start of the hedge, the hedge relationship must be formally documented.
- The hedge relationship must be highly effective, both prospectively and retrospectively, and the likely cash flows must be highly probable.
- The effectiveness of the hedge relationship must be tested periodically. Ineffectiveness is allowed, provided that the hedge relationship achieves an effectiveness score of between 80% and 125%.

Case I Amendment of conditions of existing loans

Say, for example, that you have a variable interest rate loan and that you hedge that loan with an interest swap, under which you receive the variable interest and pay the fixed interest. On balance, you pay the fixed interest plus the credit mark-up. The hedge relationship satisfies the conditions applicable to hedge accounting.

Due to internal and external factors, you now fail to meet the financial covenants you have agreed with the banks. The banks demand amendment of the conditions of the existing loan, which in effect means refinancing. In the IAS 39 context this is regarded as termination of the hedge relationship, because the hedged item (i.e. the loan) has been repaid and refinanced again. Consequently, the hedge relationship no longer satisfies the modalities laid down in the hedge documentation.

To be able to use hedge accounting again in the new situation, the existing swaps will need to be re-accommodated in a new hedge relationship with a new hedge item. But in order to use hedge accounting for a new hedge relationship, IAS 39 requires that at the start of the hedge relationship the swaps must have a market value of 0. This will definitely not be the case with an existing swap and a hypothetical swap will need to be used to find out whether the hedge relationship can be regarded as highly effective and thus whether hedge accounting may be used.

preparing the hedge documentation and by periodically evaluating the swaps and the plan based on internal models. This provides a timely indication of whether the hedge effectiveness will be jeopardised, e.g. because the plan has been delayed or because the cash flows are following a different pattern. Zanders also draws up the reports that identify market value movements (including the models, methods and used market data) plus scenarios for planning and the resulting effectiveness.

Case III Purchase of gas oil swaps

Let's say that you need to purchase gas oil for the transport of your goods. The gas oil is purchased each month at the average price of gas oil in the month concerned. The price of gas oil (closely linked to the price of oil) has exhibited volatile movements in recent years. However, the company is unable immediately to include price increases in the price of its end-product. Therefore, the company wants to be assured of a constant purchase price for a prolonged period of time. In such an instance, Zanders can advise you on the hedging possibilities and the scope for hedge accounting.

A possible hedge in the above case is a gas oil swap (these are offered by various financial institutions). This means that each month the company receives the average price of gas oil in that month (thus enabling it to pay the supplier of the existing contract) and pays the financial institution a constant fixed price per month. The company now pays a de facto fixed price for the

“The effectiveness of the hedge relationship must be tested periodically”

Zanders has recently advised various clients on how to resolve issues of this kind, including laying down the modalities of the hypothetical derivative and computing scenario analyses for determination of the future effectiveness (or ineffectiveness) of the hedge.

Case II Project financing

For project financing a cash flow plan is drawn up beforehand so as to determine the withdrawals and repayments of the loan. This might include a real estate construction whereby money flows back during the project from buildings already sold. The financing is often based on a variable interest rate and can be converted, via an interest swap, to a fixed-interest profile. To use hedge accounting it is necessary to draw up the hedge documentation and the prospective analysis.

Imagine that, due to the current crisis, certain activities are being deferred and the swap (concluded at the outset) has become ineffective. This means that the hedge effectiveness may fall below the required level. As the plan must be revised using a hypothetical derivative, it is not automatically possible to rely on the bank's valuation of these products, which consists only of the valuation of the swap itself and provides little insight into the valuation.

Zanders can assist you in addressing these or similar issues by

gas oil. If you are considering hedge accounting, Zanders can help you prepare the hedge documentation, the prospective analysis and the retrospective analysis.

An important part of hedge accounting is calculation of the market values of the underlying risks and the hedge instruments (the gas oil swap in our example). Zanders has a specialised 'valuation desk' that makes these market valuations and can also compute an effectiveness test. Valuations can be done periodically if desired. <



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