Volatility in the equity markets has become commonplace. Likewise, in many cases related to and at times causing these moves, global currency markets have also been experiencing larger than normal swings. Fortunately for those companies with international business, foreign exchange hedging products such as forwards and options are available to mitigate the potentially adverse impact of currency fluctuations.

Hedging allows treasurers to protect profits and cash flow by locking in revenues, costs and global intercompany transactions. With the increase in volatility in the global currency markets causing larger negative impacts, more and more companies are considering putting a hedging program in place to mitigate this risk.

However, plans to hedge can, at times, be put on hold due to uncertainty over the accounting treatment of such a hedge. While this article is not to be taken as an accounting primer, a few basic pointers can be useful in getting over these hurdles.

**Balance Sheet Hedging**

The most obvious foreign currency exposures to hedge are balance sheet items, such as foreign-denominated payables, receivables, cash or other short-term assets or obligations. These are often hedged with forward contracts that match the underlying asset or liability in amount, currency and time frame. Short-term timing uncertainties can be managed with date-window forwards or by swapping a maturing contract to an earlier or later date.

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1 PNC does not provide accounting or legal advice; you should consult with your own independent advisors regarding your specific situation.

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Balance Sheet Hedging (Cont.)
Since you are hedging a balance sheet item, Accounting Standards Codification 830 (formerly known as FAS 52) applies, such that changes in the value of your hedge contract will be recognized on the income statement just as changes to the underlying hedged item are. ASC 830 requires foreign currency–denominated items to be recorded on the balance sheet at the current rate and changes in their value to be reflected in current income.

As an example, assume you have an underlying one-million-euro receivable due in 90 days. You decide to hedge this exposure and lock in the value in U.S. dollars by executing a 90-day forward contract to sell euros for dollars. As the underlying receivable changes in value (up or down), the value of your forward contract will move in the opposite direction, thereby providing an offset.

Hedging Forecasted Exposures
While most companies start with hedging balance sheet exposure as it is more visible, more companies are now looking to hedge forecasted exposures (sales or expenses). Hedging anticipated cash flows depends on the company’s ability to forecast reasonably accurately, although uncertainties can be managed by hedging a percentage of your anticipated exposure.

Accounting for cash flow hedges can be a bit trickier than the balance sheet hedges described above. Why? When you hedge a forecasted exposure, you have no underlying item on your balance sheet or a recognized revenue or expense on your financial statement. However, you do have a hedge whose value needs to be marked to market on a periodic basis. Under ASC 830, the change in value of your hedge is recognized in the current period income statement. This can introduce unwanted earnings volatility. However, there is an alternative accounting election, ASC 815 (formerly known as FAS 133), that may allow you to defer the mark to market changes.

Deferring Gains or Losses in Projected Cash Flow Hedging
If certain conditions prescribed in ASC 815 are met, it allows you to defer gains or losses in the value of the hedge until the forecasted item is recorded on the income statement. Until that point, changes in the value of the hedge are recorded in accumulated other comprehensive income (AOCI), and are later reclassified into income when the projected expense or revenue is recorded on the income statement. In order for a hedge to qualify for deferral accounting, it must be “highly effective.”

Effectiveness can often be established by documenting that the hedge and the underlying item are denominated in the same currency, in the same amounts and for the same time period (critical terms match). To qualify for hedge accounting under ASC 815, at the inception of the hedge, companies must document the specifics of the hedge relationship, including risk management objectives and strategy, the risk being hedged, and a description of the hedged item and hedge instrument along with the methodology used to test for effectiveness.
Accounting for Hedging Projected Cash Flows

An example of hedging projected cash flows would be a company paying in euros for a piece of equipment from a German supplier. If the company wants to avoid the cost of the equipment increasing in dollars due to a potentially rising euro, they could enter into a forward contract to purchase euros for the date or range of dates during which they expect to receive the equipment. If the equipment order is not yet invoiced, it will not appear on the balance sheet, so without hedge accounting, the value of the forward contract will fluctuate, with gains and losses going into earnings without an offsetting entry.

Hedge accounting allows the changes in the value of the forward contract to be held in the AOCI section of owners' equity until they are reclassified to earnings when the equipment is paid for. If the euro has strengthened, the equipment's cost is higher than the original purchase order, but the forward contract has gained in value by a similar amount, thereby offsetting the impact in earnings.

Engage Your Independent Advisors

This is a broad-brush overview of some of the fundamental accounting concepts used by companies hedging certain types of foreign currency exposures. Hedge accounting can be uncertain. You are strongly encouraged to discuss the accounting treatment of your hedges with your independent advisors. This article provides only a general description of hedge accounting and does not constitute legal, accounting or other professional advice.

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