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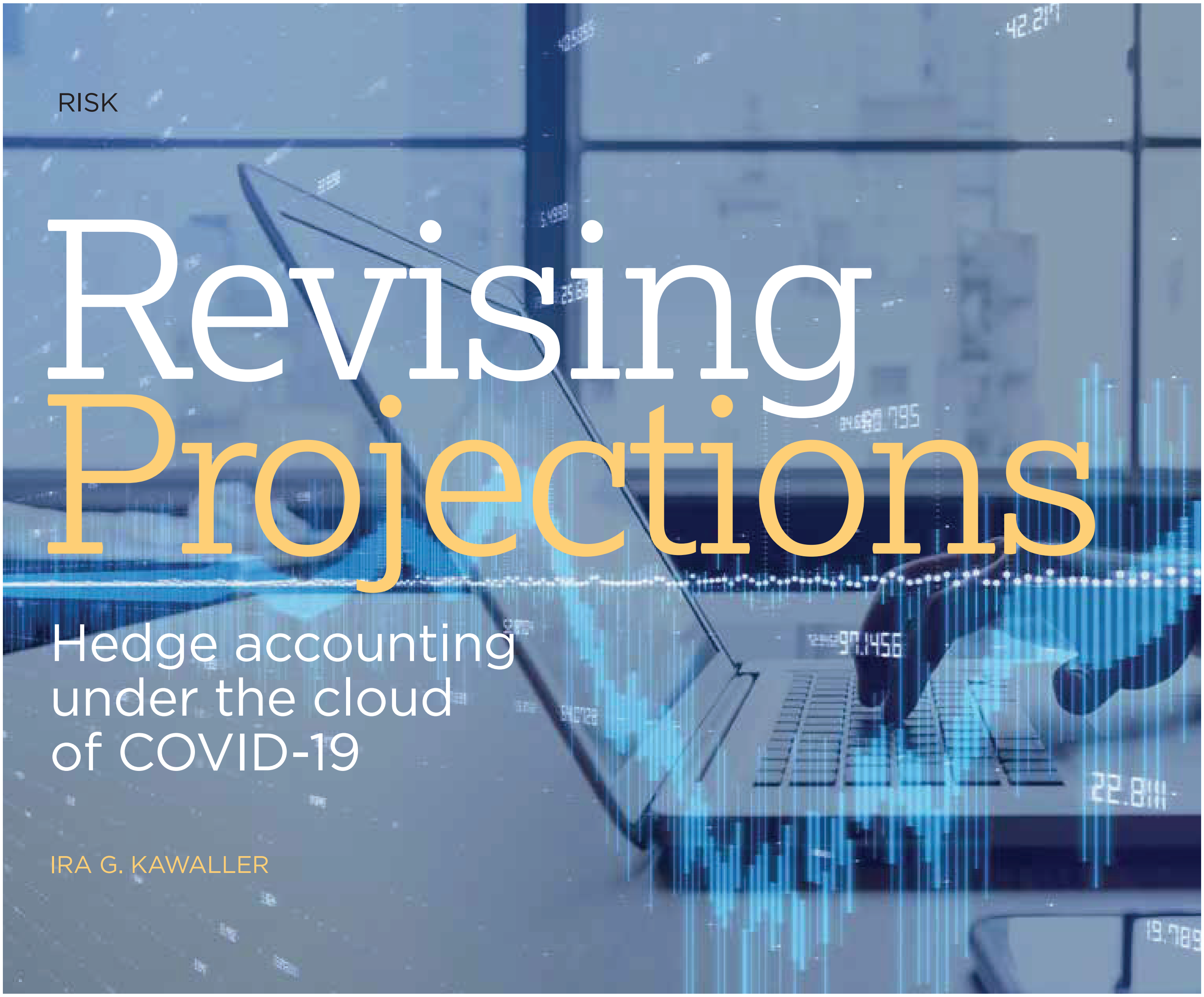

Revising Projections

Hedge accounting under the cloud of COVID-19

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The impact of the COVID-19 virus has been far-reaching, severely disrupting the world economy. And while the scale of the downturn may not yet be fully understood, the one unassailable fact is that many pre-virus projections will prove to be unrealistic. Given the dramatic change in circumstances, businesses will need to revise expectations and, among other things, reevaluate their derivatives-based hedging programs.

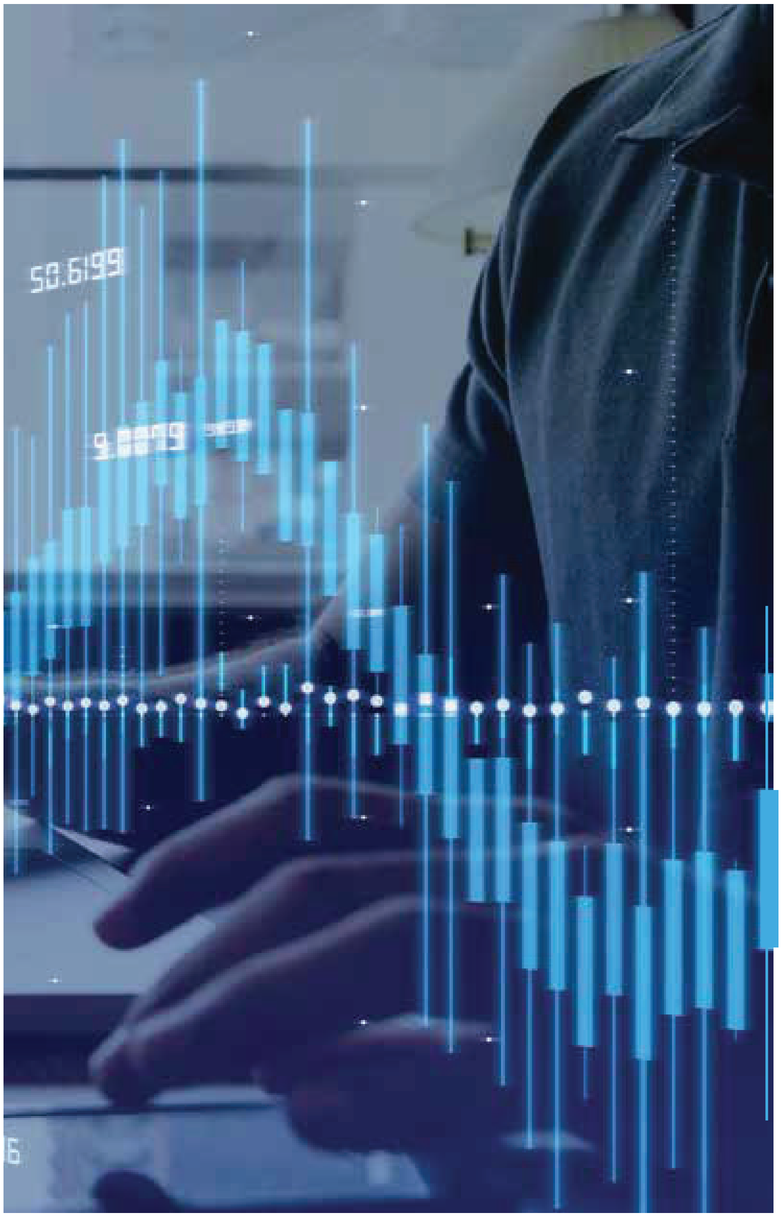
This issue will be most pressing for cash flow hedges of commodity and currency exposures.

Cash flow hedge accounting

By way of background, cash flow hedges pertain to using derivatives in connection with uncertain forecasted cash flow exposures due to pricing that has yet to be determined. In many such cases—in particular for expected purchases or sales of commodities and prospective exchanges in currencies— exact volumes of expected transactions may also not be known with certainty when the hedge is first being instituted. And in those situations, the lower volume of expected transactions may put the firm in an over-hedged position.

Under cash flow accounting, the gain or loss on a hedging derivative (save any excluded portion of that gain or loss relating to effectiveness testing issues) would initially be recorded in other comprehensive income and later reclassified to earnings coincidently with the earnings impact of the designated hedged item. Importantly, hedge accounting is an elective, but qualifying for this treatment requires meeting the prerequisite conditions of preparing properly articulated hedge documentation and satisfying prospective and retrospective effectiveness tests.

A further requirement for cash flow hedge accounting is that the hedging entity must affirm that the uncertain forecasted event designated as the hedged item is probable of occurring. The intent of this requirement



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is to assure that the deferral of recognized income is restricted to derivative results that can legitimately be paired with the results of a bona fide exposure and that derivative results cannot be deferred otherwise.

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Reclassification and resizing

Lower volumetric expectations necessarily precipitate two adjustments to the hedging program. First, upon realizing that some initially expected volume of business (e.g., purchases, sales, and/or currency exchanges) won't happen, the portion of the derivative's gain or loss relating to that overage would have to be reclassified to earning. Critically, reclassification would be appropriate only when the firm can assign a high degree of confidence that the forecasted volume will not happen. Any sense that that volume might still be attained means that the decision to reclassify would be premature, and reclassification should be delayed until a more definitive determination can be made.

The second adjustment relates to resizing the hedge. If an initial volume of a designated hedged item is not expected to occur, failure to liquidate some portion of the original derivative position would mean that that portion would no longer be serving as a hedge. Many firms have risk policies that specifically proscribe using derivatives for speculation—and that's what the overage of our derivatives position has become—so this circumstance would make mandatory the liquidation of the portion of the derivative position pertaining to the excess of the true exposure. Failure to take this action could have legal consequences, as shareholders could see the violation of company policy as a serious abrogation of responsibility.

Barring any policy-based obligation to liquidate some portion of an original derivative position, it would seem to be a matter of discretion as to whether the size of the derivative position should be reduced. Regardless, if the position is not liquidated, the firm should clearly recognize that the character of at least some portion of the derivative has become speculative.

The new reality

As of the time of this publication, the virus has likely wreaked havoc in the lives of many of us, but that history shouldn't distract us from prudent risk management practices going forward. We all need to deal with it and adjust to the new realities that it presents.

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