HEDGE ACCOUNTING: MODELS, DOCUMENTATION AND EVALUATING THE EFFECTIVENESS TO THE CREDIT INSTITUTIONS

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Abstract:
The purpose of the paper is to present the accounting for the hedge operations against the risks at credit institutions. The regulating bodies in the field of accounting have elaborated the accounting for risk hedge operations, which are intended to neutralize the artificial volatility of the results generated from owning them in relation to the market price. In this paper we present the evaluation models, the documentation made and the evaluation of the efficiency for the hedge operations against risks as well as the accounting categories for covering operations.

Key words*: hedge accounting, fair value, cash flow, credit institutions*

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The credit institutions have in portfolio financial instruments that are subjected to several risk categories. The purpose of applying the hedge accounting is to reflect in accounting the effects of the strategies regarding the administration and hedging of risks.

Applying some specific treatments to the hedging accounting is required in cases in which the hedging instrument and the hedged element are differently accounted, according to normally applied rules, which leads to lacks of correlations regarding:

- evaluation modality – some financial instruments (hedged elements) are not assessed at fair value (ex: credits and loans) or the differences from their fair assessments are not recorded in the profit and loss account (ex: positive differences resulting form the reevaluation of the investments), while the derived instruments (which are used as hedging instruments) are evaluated at fair value;

- recognition – the foreseen transactions, most likely to be made, which are hedged elements are not acknowledged in the balance sheet or affect the income and expenditure accounts at later periods.

The hedge accounting has the purpose to reflect in the income and expenditures accounts, the effects of the hedging operations by acknowledging in the same period the results related to the hedged elements and to the hedging instruments. This is made by delaying the registration in the profit and loss account of the results related to the hedging elements and distinguishing them, provisionally, in the regularization accounts regarding the hedging instruments, and these will be transferred in the profit and loss account, symmetrically, during the periods in which the hedged risks influence the profit and loss account.

The application of the hedge accounting is not required if, according to the general evaluation rules, the results regarding both the hedged elements as well as the hedging instruments are recorded at the same time in the profit and loss account (for example in case of the hedging operations for the value variation of the transaction titles or of the derived instruments).

The hedging instruments may be only derived instruments, assigned as such, whose fair value or cash flows are expected to compensate the fair value of cash flows modifications of the assigned hedged elements. The sold options may not be assigned as hedging instruments.

Generally, a derived instrument is assigned as hedge instrument entirely. The only allowed exceptions are:

- in case of an option, separation of the intrinsic value from the time value and assigning only the intrinsic value as hedging instrument;

- in case of exchange forward contracts, separation of the interest element regarding the sight exchange rate.

A percentage of a derived instrument (such as 50% from the notion value of a derived instrument) may be assigned as hedging instrument. Still, a derived instrument may not be assigned as hedging instrument only for a part of its life period.

Only one derived instrument may be assigned as hedging instrument for hedging several types of risk in the following conditions:

- the various hedged risks must be able to be clearly identified;

- the efficiency of the hedging operation must be able to be proved; and

- it is possible to ensure a specific assignment of the derived instrument, for hedging various risk categories.

Two or several derived instruments (or their percentages) may be considered as being a single hedging instrument under the condition that the hedged instrument (or any of the composing instruments) not to be, in fact, a net unsold option (for which the institution cashes a premium).

The hedging elements may be assets, debts, firm commitments or very probable foreseen transactions that cumulatively fulfill the following conditions:

- expose the credit institution to the risk of modifying the fair value or the future cash flows; and

- are assigned as being hedged.

The hedged element may be :

- a single asset, a single debt, a single firm commitment or a single foreseen transaction, very probable;

- a group of assets, a group of debts, a group of firm commitments or a group of foreseen transactions, very probable, which present similar risk characteristics; or

- only in case of hedging the risk of the interest rate related to a portfolio, a part of a financial assets portfolio or financial debts which are exposed to the so hedged risk. It is not allowed to assign as hedged element a net value of an asset and debts portfolio.

The investment titles may be considered hedged elements only regarding the risks related to the currency exchange fluctuations or the credit risk.

Similar assets or similar debts may be aggregated and hedged against risk as a group only if the individual assets or individual debts from the group are exposed to the assigned risk as being covered and it is foreseen that the fair value modification which may be attributed to the hedged risk for each individual element in the group will be approximately proportional to the total fair value modification which must be attributed to the hedged risk of the group of elements.

The hedge accounting is applied to a hedging relation if and only if the following conditions are met at the same time :

- at the initiation of the hedging operation there is an assignment and a formal documentation of the hedging operation as well as of the risk administration objective and strategy, regarding the respective hedging operation.

The respective documentation must identify the hedging instrument, the transaction or the hedged element, the nature of the hedged risk and the way in which the credit institution will determine the efficiency of the hedging instrument in compensating the exposure to the fair value or cash flow modifications of the hedged element, that may be attributed to the hedged risk;

- it is foreseen that the hedging operation will have a high level of efficiency in compensating the fair value or cash flow modification that may be attributed to the hedged risk, according to the initial documentation regarding the risk administration strategy in case of that respective hedging relation;

- in case of hedging operations of a foreseen transaction, it must have a high level of probability and present an exposure to the cash flow variation that will ultimately affect the profit and loss account;

- the efficiency of the hedging operation may be credibly assessed , respectively the fair value or the cash flows afferent to the hedged element (and that can be attributed to the hedged risk) and the fair value of the hedging instrument may be credibly assessed;

- the hedging operation is periodically assessed, in which case we find that it had a high level of efficiency during the financial reporting periods in which it has been assigned as hedging operation.

The hedging operation is considered to have a **high level of efficiency** if the following conditions are fulfilled:

- at the initiation of the hedging operation and during the later periods it is foreseen that the hedging operation will have a high level of efficiency in compensating the fair value or of cash flows modifications that may be attributed to the hedged flow. This may be proved, for example, by comparison of prior modifications of fair value or of cash flows, related to the hedged element and that may be attributed to the hedged flow on the one hand and the ones regarding the hedging instrument on the other hand;

- the effective result of the hedging operation (the ratio between the fair value or cash flow modifications, afferent to the hedged element and that may be attributed to the hedged risk, on the one hand and the ones afferent to the hedging instrument, on the other hand) are delimited by the range 80-125%.

The accounting of the hedging operations involves:

- not making any supplemental accounting record regarding the hedged instruments, regardless if they are already recorded future transactions or assets/debts;

- the evaluation at fair value of the hedging instrument;

- the fair value modification of the hedging instrument, are recorded in the adjustment accounts regarding the hedging instruments;

- the fair value modifications afferent to the hedging instrument remain recorded in the adjustment accounts until the moment of acknowledgement in the profit and loss account of the cash flow or of the fair value variation afferent to the hedged risk. The gains or losses acknowledged in the adjustment accounts are transferred in the income and expenses accounts from hedging instruments during the same period in which the cash flows or the hedged fair value variations affect the profit and loss account;

- for the hedged elements that are assessed at the smallest value between the acquisition value and the market value (for example, the investments), the calculation of afferent provisions is made after taking into consideration the gains afferent to the hedging instrument, recorded in the adjustment accounts. After the conclusion of the hedging operation of such elements (as well as of the hedged elements such as credits and loans), the differences afferent to the hedging instrument, featured in the adjustment accounts, are transferred to the income and expenses accounts at the transfer of the hedged element, or staggered, for the duration remained until the maturity of the hedged element (for fixed income financial instruments kept after the conclusion of the hedging operation; at the moment of transfer of those titles, the differences remained non-staggered are fully recorded in the income or expenses accounts).

The credit institutions will cease the enforcement of the hedge accounting in case in which:

- the hedging instrument expires, is sold, concluded or exercised (replacement or extension of the hedging instrument does not lead to the cessation of enforcement of the hedge accounting if that replacement or extension is provided in the documentation regarding the hedging strategy), case in which the differences resulting form the reevaluation of the hedging instrument, the records in the adjustment accounts regarding the hedging instruments, are transferred in the income or expenses accounts;
- the hedging operation no longer meets the conditions for enforcing the hedging accounting; in this case, the derived instrument is still accounted according to the rules applicable to the derived instruments which are not hedging instruments; the related differences, featured until that moment in the adjustment accounts, are transferred in the income or expenses accounts;
- it is no longer expected that the foreseen transaction take place; in this situation, the gains or losses afferent to the hedging instrument, acknowledged in the adjustment accounts are transferred in the income or expenses accounts from derived instruments; or
- the assignment of that operation as being a hedging operation is annulled; in case of hedging a foreseen transaction, the gains or losses afferent to the hedging instrument remain recorded in the adjustment accounts until the foreseen transaction is made or until the moment it is no longer expected to be made; if it is no longer expected for the foreseen transaction to take place, the respective gains or losses are transferred in the income or expenses accounts from derived instruments.

The risk covering operations are classified, from the accounting point of view, according to IAS 39, as follows:

- Fair value hedge operations – in which the risk is given by modification of the fair value of an owned asset or debt, situation that will affect the profit and loss account. The modifications of the fair value may occur because of changes in interest rate, of the currency exchange rate or of the price of shares or merchandises traded on the exchange.
- Cash flow hedge operations – in which the risk is given by a potential volatility of the future cash flows, with effects on the profit and loss account. The future cash flows may refer to assets or debts already owned or to future transactions;
- Net investments hedge operations in entities abroad – this situation is dealt with in IAS 21. In addition, IAS 39 specifies the use of the hedge accounting for the exchange rate risk related to the participation in such an entity.

From the economical point of view, in a hedge operation it is important to make the compensation of risks and reduction of exposures. The economical effects of such an operation are the same, regardless of the type of hedged financial risk. The reflection in accounting varies according to the classification of these operations in one of the three categories previously presented.

Table – Hedge Accounting Rules

	Recognize in income statement	**Recognize directly in equity**	**Recognize in initial measurement of asset/liability**
Fair value hedge	All adjustments on hedging instrument & hedged item		
Cash flow hedge	Gain/loss on ineffective portion of hedging instrument Gain/loss previously recognized in equity when hedge does not result in asset/liability	Gain/loss on the effective portion of hedging instrument	Gain/loss previously recognized in equity
Hedge of net investment in foreign entity	Gain/loss on ineffective portion of hedging instrument	Gain/loss on the effective portion of hedging instruments	

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