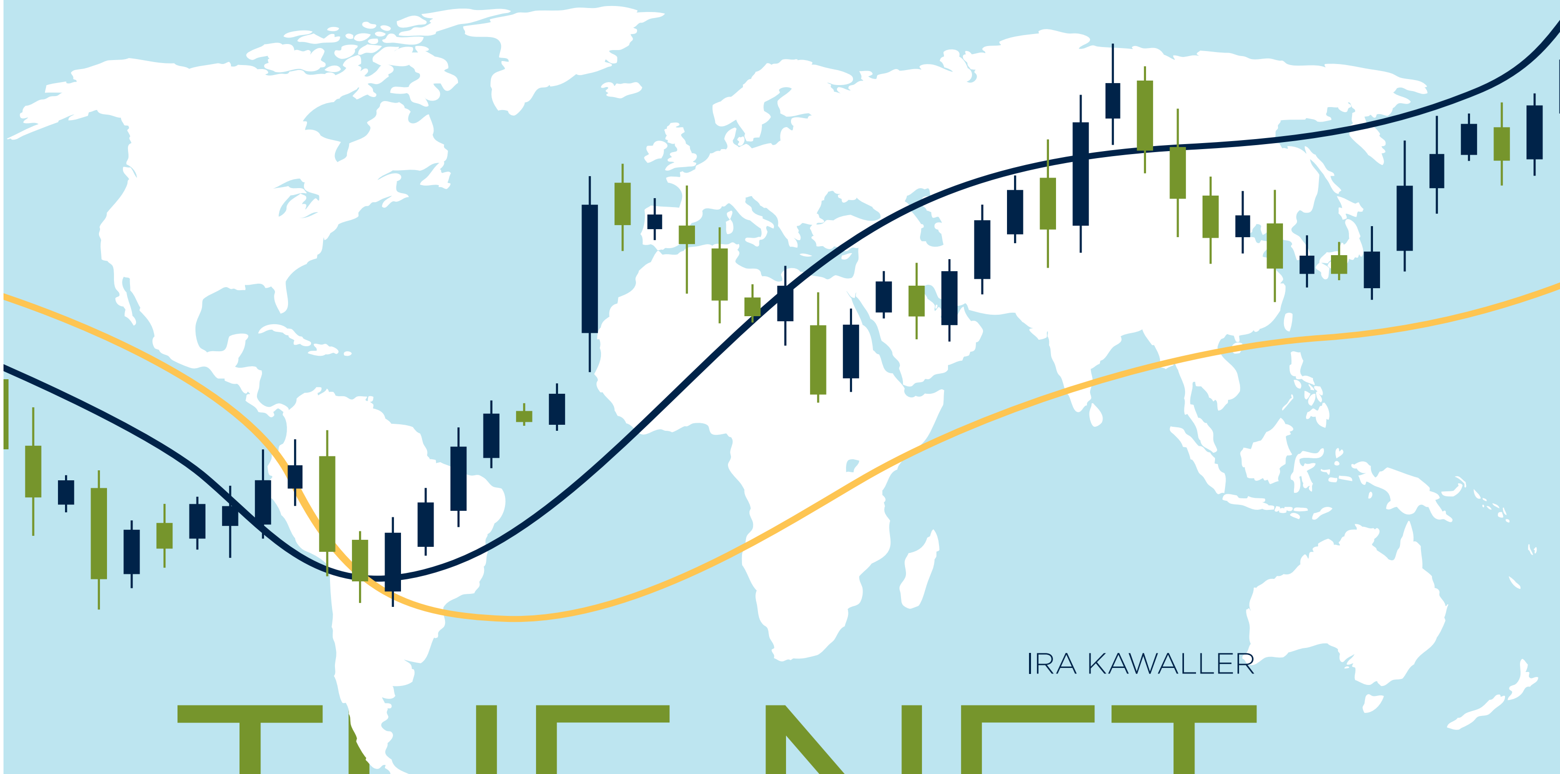

IRA KAWALLER

THE NET EFFECT

Considering net investment hedges

Firms that have net investments in foreign operations generally bear a foreign exchange exposure. In these cases, however, rather than showing up in reported earnings, net investment value changes are reflected in the cumulative translation account (CTA), which is a component of stock holders' equity.

The qualifier above ("generally") reflects the fact that many such net investments are financed with debt issued with the same currency denomination as the net investment. And in the special case when the net investment project is completely financed with debt of the same currency denomination, the respective currency exposures for the net investment and the debt would fully offset. However, the default accounting treatment may obscure this economic reality because the two offsetting currency effects post to different line items in financial statements. That is, net investment changes go to CTA, while the re-measurement effects on the debt are posted to current income.

This default treatment notwithstanding, accounting guidance provides an override by allowing the debt to be designated as a hedge of the net investment. With this designation, the gain or loss due to re-measurement of the debt is recorded in the cumulative translation account in other comprehensive income, i.e., the same line item that applies to the gain or loss on the net investment, rather than current earnings.

Of course, it's unlikely that many companies *fully* fund their net investments, such that at least some residual economic exposure would likely remain. In those cases, it's reasonable to reassess whether it make senses to mitigate the currency risk inherent in this residual exposure on an ongoing basis. A derivative instrument of some type could serve as the preferred hedging vehicle, but which derivative?

Accounting treatments

One consideration underlying this decision is the accounting treatment. Specifically, if the net investment were to be hedged, it would seem preferable to report the gains or losses of the hedging derivative in the CTA account, just like the treatment permissible for debt designated as a hedge. This treatment arises if and when hedge accounting is applied. Qualifying for this treatment, however, requires satisfying a variety of prerequisites, including appropriately documenting the hedge relationship and satisfying effectiveness assessments.

Generally, any derivative that can be expected to be "highly effective" in offsetting the change in the value of the net investment due to currency exchange rate movements will qualify for hedge accounting. Futures, forwards, and options fall into this category—with some semantic gymnastics required in the hedge documentation. The potential difficulty arises because such instruments generate gains or losses from changes in either forward points (for futures or forwards) or option time values (for options, caps, floors or collars), having nothing to do with the value changes of the net investments. Thus, some component of the hedging derivatives' results could foster seemingly disqualifying results. However, the accounting rules allow us to evaluate the offsets independent of these forward point or time value effects, thus allowing us to view the hedge results as being "perfect," as long as the currency underlying the derivative is identical to the currency of the net investment being hedged. This election to exclude forward points or option time values from the hedge effectiveness assessment must be explicitly stated in the hedge documentation.

Besides futures, forwards, and options, the accounting rules specifically sanction the use of certain cross-currency interest rate swaps as acceptable hedging derivatives, as well. Cross-currency interest rate swaps typically serve to transform a financial instrument denominated in one currency to a synthetic instrument having a different currency denomination. For example, a company might start with fixed rate debt denominated in US dollars (USD), but by entering into a cross-currency interest rate swap, they could synthetically replicate the cash flows of debt in an alternative currency—either fixed or floating.

To qualify for hedge accounting, these cross-currency interest rate swaps would need to have standard features—interest rates pertaining to the respective currencies of the swap, with common accrual periods and payment dates on both legs of the swap. Additionally, the accounting prerequisites for applying hedge accounting specifically require the intended cross-currency interest rate swap to convert from fixed-to-fixed interest rate settlements or floating-to-floating interest rate settlements, i.e., fixed-to-floating, or vice versa would not be eligible for hedge accounting. Moreover, the notional amounts of these swaps would have to correspond to the notional value of the net investment being hedged. (See ASC 815-20-25-67 and 815-20-25-69.)

Despite the allowance to apply hedge accounting to these types of cross-currency interest rate swaps, economically, the rationale for using such derivatives seems dubious. These contracts generate periodic cash flows that foster earnings impacts that are unrelated to the currency exposures of the net investment. That is, whether fixed-to-fixed or floating-to-floating, at least some portion of the cross-currency interest rate swaps' gain or loss will derive from variability of functional currency interest rates, and these value changes would be wholly independent of any net investment value changes.

Given this independence, demonstrating that a cross-currency interest rate swap will reliably offset changes in the value of the net investment is, to say the least, problematic. Presumably, the explicit authorization for using these types of contracts as hedging derivatives supersedes any concerns about hedge effectiveness—until it doesn't. Auditors have clearly accepted these contracts as allowable hedging derivatives, but it's not clear that this determination will be able to stand up to scrutiny, over time.

Challenging a rationale

This article wouldn't be complete without challenging a fairly common rationale held by many companies for not hedging net investment exposures. That is, many companies that have no intention of liquidating their net investments in foreign operations or repatriating those funds often chronically leave this exposure unhedged as a matter of company policy. This stance is often justified by (a) the fact that the currency effect is not reflected on the income statement, and (b) management's sense that currency exchange rates will likely fluctuate such that, over the long run, these gains and losses will tend to even out.

The argument in favor of hedging is that, even though the effect isn't reflected in reported income, it is a bona fide economic exposure. And it would seem categorically indefensible to ignore these exposures under any and all circumstances. Clearly, some situations will arise from time to time where it would be a prudent business decision to mitigate this economic risk, based on a serious assessment as to the prospects of an adverse exchange rate move, as well as the pricing of possible hedging derivatives.

It's also appropriate to challenge the second assumption. Secular trends do develop, and when they do, unhedged net investments would either result in a windfall gain or a windfall loss, depending on the direction of the exchange rate move. The presumption that exchange rates can be expected to revert to the mean has myriad counter examples in history.

Still, prospective hedgers need to appreciate that, with the imposition of a derivatives hedge, the firm faces an asymmetry with respect to cash requirements.

While there may be an expectation that the hedging derivative will serve to offset the gain or loss that arises on the net investment, one side of this hedge relationship has to be monetized while the other does not. It's easier to digest a loss on the net investment and a win on the derivative, but it could be painful if currency exchange rates moved in the other direction. That is if you win on the net investment, you'll need to scrape up the cash to settle on the losing derivative. This consideration could easily serve to impose some limits on the amount of the net investment exposure that the firm might seek to address; but the idea that net investment exposures should forever and always remain unhedged seems irresponsible.

At some point, hedging at least some portion of a net investment will inevitably be the prudent action to take, but you have to be paying attention.

Ira Kawaller is managing director at HedgeStar.