

managing the hedging risk

By Elie Zabal, senior vice president, Treasury and Regulatory Compliance Division, Triple Point Technology

Deferring the financial impact of a derivative hedge transaction to smooth quarterly earnings in line with the FAS 133 and IAS 39 regulations is a perilous task. Recent history is full of examples of the dire consequences suffered by firms that had to restate earnings thanks to errors in their deferred accounting practices. When earnings have to be restated, you lose the trust of the market, forfeit a good portion of your reputation for sound management and see the value of your firm drop.

A company can expect to lose an average of 10 percent of its share price following such a restatement, according to extensive research by accounting professor Nicole Thorne Jenkins. In today's climate, with the still-present specter of toxic assets looming over the markets and an almost complete breakdown in relationship between companies and their investors, firms might consider themselves lucky to escape with just a 10 percent hit on share price.

The current crisis has wiped billions of dollars off the world's stock markets. And yet, through all the turmoil and foment, huge numbers of firms are still trusting billions of dollars of that market capitalization to relatively junior accountants armed with spreadsheets, struggling to come to grips with the complexities of hedge accounting. If this was unadvisable before the credit crunch sparked the latest and most intense round of troubles, it is sheer insanity now.

Hedge accounting is very hard to get right. It seems that no one is immune from hedge accounting mistakes. The Ford Motor Company, Fannie Mae and Freddie Mac were all coming to terms with the effects of errors in their hedged accounts long before their current problems. Freddie took more than 18 months to recommence issuing quarterly statements on a timely basis, following the announcement of accounting distortions in early 2003. It spent hundreds of millions of dollars on the cleanup.

The point is that hedge accounting is not simply a trading problem: The decision to hedge may be made on the trading desk, but it is the finance department that must ensure it is recorded, reported and accounted for appropriately. Nor, despite its name, is it simply an accounting issue.

Indeed, the hedge effectiveness regulations and reporting requirements touch many different aspects of a business, including trading, credit, accounting and risk management. They require adequate documentation for external auditors on an entire gamut of processes. It's a major operational issue.

There are two options.

The first is to abandon hedge accounting completely. That will almost certainly result in dramatically fluctuating income statements. The markets for any number of raw materials, like metals or agricultural products, are now incredibly volatile. If you're one of the rapidly growing club of firms that needs to find sophisticated ways of managing raw materials into and products out of your business, then hedge accounting is an answer. It can make you very appealing to shareholders and market analysts. And in these highly competitive but deeply risk-averse times, that's a significant benefit.

The second, and by far more attractive option, is to abandon the spreadsheets.

If you want to manage risk across your organization, you need the tools to do it. Spreadsheets are not and have never been an effective risk management option. In highly volatile markets they are a liability rather than a solution because they increase the chance that your junior accountants will make dangerous accounting mistakes.

But by using the right tools, you are no longer relying on manual processes or the effectiveness of self-programmed macros. Simple mistakes such as input errors, logic errors, interface errors and



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wrong cell range errors can put decisions and dollars at risk. Indeed, the greatest cost of spreadsheets might be the implicit cost of poor decisions based on faulty data. Research suggests that 20 to 40 percent of spreadsheets have errors, but a recent study by the University of Hawaii found that out of 54 spreadsheets audited, 49 had errors.

However, you can now automate the hedge accounting process and ensure that yours is compliant with the relevant accounting regulation – and, just as importantly, with your own risk parameters and policies on hedging.

If you want the market to have confidence in your company and if you want shareholders to have faith in your management, then they need to be sure that you have the tools to manage your all your risks, including hedge accounting, effectively. Errors in reporting and accounting for your hedges require earnings restatements and breach that trust, sending a terrible signal to the market.

Getting the right tools in place will enable you to balance economic benefits, risk management and stable financial statements. You'll maintain your financial well-being, retain shareholder confidence and even secure your operational future. This is the light in which hedge accounting management needs to be seen.

To find out more about hedge accounting solutions, visit www.tpt.com.