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ESSENCE OF HEDGING ACTIVITIES IN THE LIGHT OF POLISH BALANCE LAW AND IAS/IFRS

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Сутність проблеми ризику в діяльності підприємства підвищує зацікавленість до інструментарію, який слугує його зниженню. Одним з таких засобів є похідні фінансові інструменти, які у відповідних умовах можуть бути ефективним інструментом зниження ризику (хеджування). Метою статті є представлення і порівняння основних принципів обліку хеджування відповідно до польського облікового законодавства та МСФЗ, використовуваних в Україні.

Growing risk of business activity of enterprises triggered interest in tools helping limit risk. In conditions of uncertainty derivative instruments can serve as effective instrument of limiting risks (hedging instrument). The purpose of this article is to present and compare basic bookkeeping rules of hedging instrument according to Polish balance law and IAS/IFRS also practised in the Ukraine.

Understanding derivatives and their role in protection against risk. The risk is perceived as one of most important theoretical notions in finance. It is also present in the course of life of man and the business activity carried on by them.

The risk can be defined and classified in numerous ways¹. In business financial risk is present and affects financial standing of enterprises. Financial risk may refer to changes in prices in financial markets and other markets connected with them (e.g. goods). Market risk manifests itself in many ways including risk rooted in changes of exchange rates, interest rates, share prices or prices of commodities².

Among tools that serve limitation of risk we find derivative securities or derivatives in short. In the broadest sense, it is possible to define derivatives as agreements, value of which is depending on value of different so-called base instruments³. Base instruments can be physically existing financial instruments (e.g. shares, debentures, currencies), but also interest rates or share indices. Futures, forwards as well as options and swap contracts are all considered derivatives.

Although derivatives are being used for numerous purposes e.g. speculation or arbitration, the basic aim they are serving is hedging i.e. protecting against financial risk. In economic sense hedging transactions (securing) allow subjects demonstrating aversion to risk to transfer it to companies inclined to accept such risk and make a profit⁴.

Derivative instrument is constructed to hedge against risk. If only unfavourable changes in value of basic instrument (secured title) are compensated with favourable changes in value of derivative instrument

¹ For further reference see: A. Żebruń, *Instrumenty pochodne zabezpieczające w rachunkowości*, Difin, Warsaw

2010, p. 18-19.

² *Zarządzanie ryzykiem*, K. Jajuga (scientific ed.), Wydawnictwo Naukowe PWN, Warsaw 2008, p. 18-19

³ P. Czajor, *Rachunkowość instrumentów finansowych*. MSSF, polskie prawo bilansowe, regulacje podatkowe,.

Ośrodek Doradztwa i Doskonalenia Kadr, Gdańsk 2010, p. 109.

⁴ W. Tarczyński, M. Zwolankowski, *Inżynieria finansowa. Instrumentarium, strategie, zarządzanie ryzykiem. Strategie inwestowania, ryzyko inwestowania*, Agencja Wydawnicza Placet, Warszawa 1999, p. 186.

which is acting in the role of securing instrument. That way open financial title (exposed to risk) is staying secured with the opposite title which is eliminating or lowering risk. One should notice that hedging is enabling to limit (rarely totally eliminating) risks, but is also limiting the possibility of making a profit, if predictions of negative effects of risk resulting from changes in the secured title don't materialize on the market.

Essentials of hedge accounting In Poland principles of bookkeeping of financial instruments (including derivatives) The Accounting Act dated 29 September 1994⁵ (further referred to as Polish Act on Accounting PAA) and the Regulation of the Minister of Finance of 12th of December 2001 on the matter of detailed principles of recognition, methods of the evaluation, ways of presentation of financial instruments⁶ (further referred to as Regulation of financial instruments - RFI). However, some entities don't need to follow RFI in Poland whose financial reports aren't subject to required examination under PAA on condition that it will not lead to distorting the image of assets, financial situation or financial result. Entities obliged to follow RFI find provisions on financial instruments enumerated in more detail including strict sequence of duties relating to classification, evaluation and presentation of financial instruments. Entities obliged to follow PAA provisions only find themselves in a more comfortable position than those who need to follow RFI.

Bookkeeping of financial instruments in the Polish balance law are modelled on international accounting standards, i.e.:

- IAS 39 Financial Instruments: recognition and evaluation,
- IAS 32 Financial Instruments: presentation,
- IFRS 7 Financial Instruments: disclosure⁷.

Hedge accounting is addressed both by Polish balance law regulations (PAA, RFI) and IAS 39⁸.

Hedging is being defined choosing one or more securing instruments, changes in fair value of which are compensating for the change in fair value of the secured title or cash flows connected with secured title⁹. Like Polish regulations also IAS 39 (in article 85) states that changes in fair value of one or more securing instruments will be compensating in whole or in parts, changes in fair value or cash flows of secured title.

Polish balance law, besides definition of hedging introduces for interpretation hedged items and hedging instrument. And so hedged items is defined as assets, liabilities, future liability or planned transaction under risk of change of fair value or future cash flows expected by the unit¹⁰. Hedging instrument is an instrument fulfilling set of requirements whereas in justified circumstances it may be defined as financial assets or financial liabilities that are not derivative instruments whose expected fair value or cash flows connected with it will compensate changes in fair value of secured title or cash flows connected with it¹¹.

Pursuant above quoted definition derivatives are most commonly used hedging instruments. Both Polish regulations (RFI in art. 3 pt. 4), as well as IAS 39 (art. 9) alike are defining requirements a derivative instrument must meet. These are the following:

- value is dependent on the change in value of the base instrument i.e. the interest rate, the price of securities or the price of good, the exchange rate of currencies, of a the price index or the interest rates index, the credit credibility or the credit index or similar, and
- purchased without initial expenses or net value of these expenses is low in comparison to value of different kinds of contracts the price of which the price is depending on the change in market conditions, and
- settled in the future.

⁵ Journal of Laws from 2009 yr, No. 152, item. 1223, as amended.

⁶ Journal of Laws from 2001, No. 149, item 1674, as amended.

⁷ In November 2009 a new standard was passed - IFRS 9 "financial instruments" (still however works on improving him last). This standard is supposed to replace with IAS 39 and 1.01.2013 applied obligatorily to financial statements, for which the financial year is starting will be (optionally it is possible to apply it for reports for the starting financial year 1.01.2009). In the article, according to the legal status he/she is applying to which during his coming into existence, they were based on standards still being in force: IAS 39, IAS 32 and IFRS 7.

⁸ International Financial Reporting Standards, <http://www.mf.gov.pl/index.php?const=1&dzial=487&wysw=2&sub=sub11> (access: 18.01.2012 r.).

⁹ Par. 3 ust. 18 RFI.

¹⁰ Par. 3 pkt. 16 RFI.

¹¹ Par. 3 pkt. 17 RFI.

One should note the difference in understanding of hedging in economic sense and in accounting sense. In economic sense hedging is understood as a shield against unfavourable influence of volatile outside factors (rates of currencies, interest rates, and the like). In accounting securing transactions concentrate on demonstrating joint effects of changes in value of secured and securing titles as if outside factors haven't taken place¹². Hence, securing title in economic sense will not always be treated as such in accounting. Both Polish and international accounting regulations set special requirements to hedging (i.e. connecting the secured title with instrument securing it).

Bookkeeping of hedging activities. Hedge accounting is an exception to standard principles of bookkeeping. It perceived as a privilege not unconditional law and individuals wanting to use bookkeeping of securities have to to comply with regulations and fulfil certain requirements¹³.

General conditions for bookkeeping securities are set by PAA (35a art. sec. 3) stating that financial instruments serving the limitation of risk tied to assets or liabilities of an entity i.e. for securing these assets or liabilities, if at least:

- 1) prior to signing a contract its purpose was established as well as was determined which assets or liabilities were supposed to stay secured;
- 2) securing title and secured title have similar features particularly the face value, the date of maturity, the influence of changes in interest rate or the rate of currency;
- 3) significant degree of confidence in cash flow flows from the contract

Conditions for hedging transactions enumerated in PAA law are considerably more detailed in the light of RFI which enumerates the formal conditions and requirements to be fulfilled for a secured title and securing title.

According to RFI entities wanting to apply principles of securing must beforehand create formalised documentation of securing transaction which contains at least:

- purpose and strategy of risk management,
- identification of securing and secured titles,
- characteristics of connected with the secured title, the future obligation or planned transaction,
- period of protection,
- description of the chosen method of evaluation of hedging effectiveness¹⁴.

As a secured title the following may be an item entered into account books or planned transaction, a group of assets, liabilities or planned transactions. In case of hedging of group of items it is essential that items subjected to securing are exposed to similar risk¹⁵. RFI regulations enumerate items excluded from secured titles. They include derivative instruments and such financial assets which the entity categorised as investment held till maturity¹⁶. The secured title must be identified so it cannot be so-called net base.

The next important condition which securing instrument must be fit for fair value evaluation¹⁷.

The need to evaluate the effectiveness of hedging is clearly addressed by both Polish and international reporting regulations which is sine qua non of hedge accounting.

Effectiveness of securing transaction is being expressed in it, that change in fair value of title secured suitably compensated with changes in fair value or cash flows of securing instrument. One of ways to evaluate effectiveness of hedging¹⁸ is resulting straight from its definition i.e. changes on the securing instrument side with changes on the secured title side, what in literature is referred to as dollar-offset method¹⁹. The dollar-offset compares accumulated changes of value of the securing instrument and the secured title, no matter which we treat as nominator or denominator. The level of effectiveness based on the index should be range from 80% to 125%.

¹² P. Czajor, op. cit., p. 169.

¹³ A. Żebruń, op. cit., p. 57.

¹⁴ Par. 28 RFI.

¹⁵ Though IAS 39 points to exceptions in that matter.

¹⁶ Par. 30 ust. 4 RFI.

¹⁷ Goodwill (Art. of 28 sec. 6 PAA) it is the amount, for which given component of assets could be exchanged and liability settled between well-informed and interested parties in the transaction between them.

¹⁸ Par. 28 ust. 4 RFI.

¹⁹ A. Żebruń, op. cit., p. 75-76.

For example if fair value of secured title grows by 500 whereas fair value of securing instrument grows about 450, effectiveness of the protection will be determined on the level of 111% (500/450) or 90% (450/500) independently of the way of computation and is located in a required range. It is worthwhile adding that fall in fair value of securing instrument doesn't preclude applying principles of bookkeeping securities²⁰. However, the change in fair value secured title must be opposite, that is in this case it would have to grow. Because securing transactions aren't aimed at generating extra profits but safeguarding the company against the loss in a long term. So it possible to reach the situation when predictions of unfavourable market tendencies turn out to be false. On the secured title it will make a profit then, whereas fair value of the securing instrument will fall down which means making loss.

However, among Polish regulations and IAS/IFRS differences exist in moments when one should assess the effectiveness. The Polish directive stresses the need of evaluation the effectiveness the in progress what is most often interpreted as evaluation on time of balance evaluation. In turn, IAS 39 requires evaluation of effectiveness of securing transactions:

- prior to hedging transaction,
- periodically during the protection period.

In case of international regulations of the most controversial issue is evaluating effectiveness prior to hedging transaction because IAS aren't showing ways that would prove the high level of effectiveness of protection. Nevertheless that point to possible situations when it is possible to secure such a high effectiveness upfront for example in case of swap transactions of interest rates where at the same for both titles conditions in relation to amounts, completion dates, dates of exchange of prices, charging base interest remain alike.

Kinds of hedging activities according to the balance law. In the Polish balance law securing transactions are being divided on:

- securing fair value that is limiting of the risk of the influence on the financial result of changes in fair value, resulting from the defined risk connected with assets inserted into an account books and liabilities or their specified part,
- securing cash flows understood as limiting the risk of the influence on the financial result of changes in cash flows resulting from the defined risk connected with assets inserted into an account books and liabilities, future liabilities or planned transactions,
- securing shares in net assets of foreign entities whose activity isn't making for integral part of activity of domestic entity²¹.

In IAS/IFRS solutions securing individual kinds of the transaction differ from Polish solutions in terms of scope. So in protections of fair value in understanding of Polish regulations only the ones which concern secured titles making the element of books are being presented as an element of assets and liabilities. However IAS 39 is expanding this scope by protections of future liabilities, which not-inserted into an account books are subject to recording according to fair value of securities accounting principles. Securing currency risk connected with the future obligation of lent credence to an exception to this rule. In this case entities have choice whether to treat the transaction as securing fair value or securing cash flows.

According to the directive on financial instruments securing future liabilities of lent credence is being treated without exception as securing cash flows.

Situating the transaction in the typology described above is important because securing fair value of securing and secured titles results in their categorisation in ledgers. In this scope Polish and international regulations considerably differ from themselves.

According to the Polish balance law, securing secured titles is treated as financial income/costs. So if parallel change in fair value of secured and an securing title is recorded with opposite sign so in effective part they are compensating each other. So only an ineffective part of the protection is influencing the result.

The essence of transactions securing cash flows consists on securing the flows connected with the future transaction so in the moment of signing a contract the secured title still isn't an element of balance

²⁰ P. Czajor, op. cit., p. 174.

²¹ Par. 27 ust. 1 RFI.

sheet. In case this type of transaction (as well as at securing net assets of foreign individuals) profits or losses from the evaluation of fair value of the securing instrument in part recognised as effective is being transferred to capital (fund) from updating the evaluation. Absolute values of the amount taken back to capital (effective part) cannot however be higher than fair value of accumulated changes of future cash flows connected with secured position (from day one of protection)²².

Ensuing capital from updated evaluation can be recorded in two ways:

- as gross receipts or financial costs of the period, in which the secured title is coming into existence; in effect postponement of the result is achieved on the securing instrument till the time when planned transaction is also having an effect on the result;
- as an element of initial value of an item, purchased and entered into books as assets or liabilities (purchasing price or value differently calculated), provided such an element as a result of planned transaction or liabilities of lent credence is coming into existence.

In international regulations it is possible to find a few substantial differences with respect to Polish regulations. Differences in recording effects of changes in fair value of secured title and securing instrument. Inasmuch as RFI is pointing to the need to account for them into financial cost/incomes directly. IAS doesn't require them to be recorded as gross receipts/costs. However it is usually recorded in remaining operational activity.

According to IAS doesn't allow correction of initial value of ensuing assets and financial liabilities with value of capital from the updated evaluation in case of financial assets. Polish regulations allow corrections in both and non financial assets.

Ending. In the light of the above conducted analysis of securing transactions both resemblances and differences are present in the Polish balance law and IAS/IFRS.

Resemblances include:

- the scope of notions: protection, secured title and securing instrument,
- requirements which instruments must fulfil jointly,
- treating bookkeeping of protections as the special area of the bookkeeping of financial instruments and pointing the conditions conditions to be fulfilled in order to use these principles,
- requirements for hedged items and hedging instruments must fulfil which,
- conditions of applying principles of the bookkeeping of protections by the degree of the effectiveness of securing transaction and demonstrating the scope of effectiveness (80% - 125%),
- division of securing transactions into three kinds: securing fair value, securing cash flows and securing shares in net assets of foreign entities.

Basic differences amongst Polish regulations and IAS it include:

- different determining moments of the measurement of the effectiveness of protections,
- divergences in the subject of scope of protections of fair value and cash flows,
- lack in IAS regulations of pointing at the section of profit and loss account where one should demonstrate effects of changes in value of securing instruments and the title secured (in Polish regulations these are financial cost/incomes).

1. Czajor P., *Rachunkowość instrumentów finansowych. MSSF, polskie prawo bilansowe, regulacje podatkowe, Ośrodek Doradztwa i Doskonalenia Kadr, Gdańsk, 2010.* 2. *International Financial Reporting Standards*, <http://www.mf.gov.pl/index.php?const=1&dzial=487&wysw=2&sub=sub11> (access: 18.01.2012 r.). 3. *Regulation of the Minister of Finance dated 12 December 2001 on the matter of detailed principles of recognition, methods of the evaluation, ways of presentation of financial instruments, Journal of Laws from 2001, No.149, item 1674, as amended.* 4. Tarczyński W., Zwolankowski M., *Inżynieria finansowa. Instrumentarium, strategie, zarządzanie ryzykiem. Strategie inwestowania, ryzyko inwestowania, Agencja Wydawnicza Placet, Warszawa 1999.* 5. *The Accounting Act, dated 29 September 1994, Journal of Laws from 2009 yr, No. 152, item. 1223, as amended.* 6. *Zarządzanie ryzykiem, K. Jajuga (scientific ed.), Wydawnictwo Naukowe PWN, Warsaw 2008.* 7. Żebruń A., *Instrumenty pochodne zabezpieczające w rachunkowości, Difin, Warsaw 2010.*

²² Par. 33 ust. 1 RFI.