FAIR VALUE ACCOUNTING AND RISK-HEDGING DECISIONS

Accounting for derivatives and hedging activities is currently governed by International Accounting Standards (IAS) 39 Financial Instruments: Recognition and Measurement in Singapore. IAS 39 requires firms to account for derivatives as assets or liabilities on the balance sheet and initially measure them at fair market value. The derivatives are then marked to market on each financial reporting date, with any fluctuations in fair market value reflected in either the income statement or comprehensive income. Under the current standards, the fair value changes of derivatives (the hedging instrument) can be offset by the corresponding value changes in their underlying assets, liabilities, or future cash flows (the hedged item) only when the strict criteria of hedge accounting are satisfied. If companies fail to apply hedge accounting even though they employed derivatives to hedge their risk exposures, or if hedge accounting was applied but hedging was not perfectly effective because of basis risk, hedging with derivatives will induce additional earnings volatility and balance sheet volatility.

ICPAS Research spoke to Professor Tan Hun Tong, Professor in Accounting at Nanyang Technological University, on a recent study he conducted on 148 experienced accountants on how fair value rules affect their hedging behaviour. The respondents have, on average, 10 years’ working experience. Here are some highlights of the study.

What was your area of interest (in this study)?

Prof Tan Over the past few years, the debate over the current accounting standards for derivatives and hedging activities has become more intense. Some argue that the current fair value-based derivative accounting standards have enhanced the transparency of derivative reporting and promoted prudent risk management, while others believe that the current disclosure regime has induced excessive volatility and distorted managers’ decisions.

We are keen to explore whether there is an unintended dysfunctional effect arising from the use of fair value accounting. We performed an investigation to find out the causal link between the foregoing of economically beneficial hedging opportunities by managers, and the current accounting treatment of derivatives and hedging activities.

Why is this issue important?

Prof Tan Financial controllers often say that making the right risk-management decision – of which the use of derivatives is an integral aspect – is one of the most important corporate decisions. Appropriate use of derivatives will increase shareholder value. Yet, the current fair value-based accounting standards that are intended to lead managers to make better decisions have been alleged to lead managers to avoid these value-enhancing risk management activities. There is no established research evidence in this arena to dispute this allegation.

We invited 148 accountants to participate in our study to find out how the current derivative accounting standards may impede managers’ risk-hedging decisions. Our participants have extensive management experience and sufficient knowledge of derivative accounting and hedging activities. Briefly, they were asked to make hedging decisions after reading the case materials. These case materials included the background information of an oil and gas company, its historical financial data, the description of the risk-hedging decisions faced by the manager, and the company's accounting treatment of derivatives. Some participants were shown only the economic impact (Table 1) of their hedging decisions, while others were shown both the economic and accounting...
What were the key findings of this research?

Prof Tan We found that when participants were shown only the economic impact, they were more likely to undertake an economically desirable hedging opportunity, but when they were also shown the accounting impact, they were less likely to undertake the same decision. Moreover, this effect was magnified when the price volatility was high than when it was low.

These results indicated that participants were concerned about the earnings volatility induced by the fair value reporting, especially when price volatility is high. As such, many were reluctant to use derivatives if the induced earnings volatility was huge, even when the hedging opportunity was economically sound (Figure 3).

What conclusions can be drawn from this research?

Does this mean that we should stop using fair value accounting?

Prof Tan It would be premature to make such a conclusion. Fair value accounting has its benefits and usefulness. What we have done is to provide evidence of some possible unintended consequences of fair value accounting for derivatives. At the moment, these allegations of adverse consequences have been deemed anecdotal in nature, so we hope our study provides some evidence on the current debate on the appropriateness of the current accounting standards for derivatives and hedging activities.