FACULTY OF ECONOMICS

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<u>THESIS</u>

The Effect of Hedging Practices toward Earnings Volatility and the Implementation of Hedge Accounting

(A Study at PT. Bank Negara Indonesia Tbk)

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ABSTRACT

Banks are financial industries which dealing with the financial instrument. They use financial instruments especially derivatives for trading and hedging purposes. The use of financial instrument significantly affects their risk management decisions. Hedging practices become the most common ways in reducing some risks in order to prevent earnings. However some previous researches indicate that the improper planning and some types of transactions on hedging practices might increase the risk itself. This research analyzes the implementation, disclosure and its affect toward earnings volatility of hedge practices and its accounting treatment in PT. Bank Negara Indonesia (BNI).

The study result shows that the hedging practices in BNI from year of 2006 - 2010 have proved that hedging practices reduces the earnings volatility. BNI also disclose their hedge accounting treatment based on the PSAK (Pernyataan Standar Akuntansi Keuangan) no. 55 revision of 2006. BNI hedging practices is one of the strategies to minimize the risks. All of the critical terms related to the hedging practices in BNI are already matching with principle based on the standards.

Keywords: *Hedging Practices, Hedge Accounting, Earnings Volatility, PSAK no.55, Risk Management.*

CHAPTER I

INTRODUCTION

1.1 Background

For decades, accounting profession has been striving to achieve greater accuracy, transparency and user friendliness in financial reporting data (Schroeder, et.al, 2005). Consistent efforts have been taken to reduce judgmental bias and subjective estimates. By doing so, data are easily and accurately comparable among companies and facilitating investor in making decisions.

Nowadays, investors are no more restricted by geographical boundaries of their own countries in the search for investment alternatives. On the other hand, companies seeking for financial resources both in the form of equity and debt. Companies can now use international capital markets which offer a large choice of alternatives compared to local capital market. In such case the financial data should be comparable not only among different national industries but also on international scale.

Regarding this issue, Indonesia is trying to adopt the International Financial Reporting Standard (IFRS). Indonesian accounting standard board or *Dewan Standar Akuntansi Keuangan (DSAK)* of *Ikatan Akuntan Indonesia (IAI)* keeps moving with the revision of the standards. Since 2009, IAI required the companies and industries in Indonesia to apply *Pernyataan Standar Akuntansi Keuangan (PSAK)* No.55 (2006 revision), as the adoption of the International Accounting Standard (IAS) number 39 related to the recognition and measurement of financial instruments.

Banks are financial industries which dealing with the financial instrument. They use financial instruments especially derivatives for trading and hedging purposes. The use of financial instrument significantly affects their risk management decisions. As the business entity, banks have major concern in their earnings performance. The risk management decision is expected to be able to organize and control their earnings over the year.

The earning is not only important as the performance evaluation but also as the recommendation to the investors' information for their investment decision. There are several ways to evaluate the earning performance of a company, for example by analyzing the volatility of earnings. The volatility of earnings gives the future predictions based on the past performance. It is one of the important points in analyzing the profitability of company. It provides the management and third party the information about whether or not the company has got stable earnings development (Weston, et.al, 2005).

IAI required companies to implement the PSAK no. 55 (2006 revision) since 2009. Furthermore, Bank of Indonesia (BI) pronounced that all banks that operate in Indonesia should follow the standards started on January 2009 (Antaranews.com, 2010). However, the execution of the standard is complained by the banks because of the resources and some technical reasons. Therefore, the standard is effectively applied started from the year of 2010.

One of the scopes in PSAK No.55 is about hedge accounting. The standards require the companies and industries report and disclose their hedging activities. Since this standard is linked to the other standards about fair value measurement, which explained in PSAK No.50, the financial instruments should be measured at fair value. So that, companies use the hedge accounting to prevent their earnings from the risk resulted from the change of fair value measurement.

Based on the previous research, the hedging activities will reduce the earning variability and earnings volatility (Francis, 1990). The argument supported by Hill and Schneeweels (1984) cited in Barton (2001), find large reductions in variability in the presence of hedging. Kopenhaver (1983) cited in Francis (1990) reports 80 percent reductions in the variability of hedged versus un-hedged profits.

Unless there are so many studies conducted with the positive result, some of them also argued the opposite opinion (Benston and Krasney, 1989). In response to the different opinions, the writer intended to conduct a research titled: **“The Effect of Hedging Practices toward Earnings Volatility and the Implementation of Hedge Accounting (a Study at PT. Bank Negara Indonesia Tbk)”**. The research will review the hedge accounting implementation in a financial institution, analyze the reasons and factors that contribute to the hedging activities and examine the relationship between the hedging implementation and the earnings volatility.

1.2 Problem Definition

Based on the background that explained above, there are some problems to be analyzed:

1) How is the disclosure of hedge accounting implementation in banking sector?
2) Does the hedging implementation is effective or not?
3) Does the hedging practice affect the bank’s earnings volatility?
4) What factors contribute to the hedging activities which lead to the changes of earning volatility?

1.3 Research Objectives and Benefits

The objectives of this research are:

1) To describe the disclosure of hedge accounting implementation in PT. Bank Negara Indonesia Tbk.
2) To analyze the effectiveness of hedge accounting implementation
3) To analyze the effect of the hedging practices to the bank earnings volatility.
4) To explain and interpret the indicators behind the hedging activities that lead to the earnings volatility changes.

The benefits of this research are:

a. To the companies

To give recommendation about hedge accounting implementation, disclosure, and its contribution to the earnings volatility.

b. To the writer

To get better understandings about hedge accounting implementation, disclosure and the advantages of hedge accounting in risk management, especially in banking sectors.

c. To the other parties

As a document to support study and also provide some sources related to the hedge accounting implementation.

1.4 Writing Systematic

Section 1 describes the background, problem definition and the purpose of the study. The variables will explain in the section 2, as well as explanation of the concept and theoretical frameworks. Section 3 consists of research method and data collection. This section also describes the type of research conducted. Section 4 indicates and explains the company profile. The result and analysis of data will be explained in section 5. At last, the conclusion and advice will be served at section 6, with the description of the finding summaries, final suggestion and the limitation of the research.

CHAPTER VI
CONCLUSION

6.1 Conclusions

Based on the problem definition, the writer conclude some point from the result and discussion analysis about the effect of hedging practices to the earnings volatility and the hedge accounting implementation at PT. Bank Negara Indonesia Tbk, as follows:

1) PT. Bank Negara Indonesia Tbk or BNI using the derivative financial instruments in its business. BNI enters into hedging policy and practices in order to minimize the interest rate risk and currency risk.
2) BNI already disclose its hedging practices based on the requirement. The formal documentation, assessment effectiveness and obtain the hedge relationship is done by BNI in applying hedge.
3) BNI hedging practices followed by the implementation of hedge accounting based on the standards. From the year of 2006 until 2009, BNI report its hedging activities based on PSAK no.55, 1999 revision. For the year of 2010 BNI applied the revision of 2006 of PSAK no.55 prospectively and reporting it in the consolidated financial statement.
4) The analysis of BNI earnings data from 2006 until 2010, showing the low value of volatility. The earnings volatility conclude from the statistical analysis of Return on Assets (ROA), Return on Equity (ROE) and Net interest Margin (NIM) of BNI from 2006 until 2010.

5) The earnings volatility of BNI is measured from the calculation of each proxy's standard deviation. All of the proxies show the low value of volatility, ROA is 0.00579, ROE is 0.06808 and NIM is 0.004802. this result can be seen in page 62
6) The effect of hedging practices to the earnings volatility at BNI show the positive relationship. The BNI hedging practices as the strategy to minimize the risks. The risk management derives from the BNI objectives in order to prevent its earnings and develop its earning performances.
7) The assessment of hedge effectiveness at BNI based on critical terms comparison is conducted in this study. All of the critical terms related to the hedging practices are already matching with principle based on the standards. The decision of BNI management to enter into the hedging decisions is effective according to the result of risk assessment. The risk control system for interest rate risk and currency risk show the satisfactory result.
8) Based on the analysis page 64, risk management is become the important factors in applying hedge and give contribution to reducing the earnings volatility in BNI.

6.2 Suggestions

Based on the study and analysis conducted, the writer would like to give some suggestions:

1) The hedging practices should be recognized based on the standards applied, in order to give more available information and disclose about the management decision and strategy. The implementation of PSAK no.55 (2006 revision) should follow by the related institution.
2) The implementation of hedge accounting should be realized by the companies as the option and strategy to manage their risk and earnings performance.

3) In applying hedge accounting, bank should analyze the risk factors and identify the suitable hedge relationship that must be obtained. The formal documentation must be provided in the reporting.
4) For the further research, it is needed to expand the discussion to include hedging alternatives for foreign exchange risk in the banking sector. Then, this study can be analyzed from the quantitative method sides to assess the significance of hedge accounting implementation in broader sample. The analysis of hedge effectiveness can assess using the regression analysis for the quantitative method of study.

8.3 Limitations

Since the method of this study is based on the literature surveys and using the secondary data only, there are some constraints on this study:

1) This study is not discussing the compliance of BNI hedging policy according to the regulations of PSAK no.55 (2006). This study only reviews the implementation generally.
2) The revision of PSAK no.55 of 1999 become 2006 is not considered in analyzing the hedge accounting applied at BNI.
3) The data is analyzed based on the annual report only, so the writer analysis is limited to the hedging policy and earnings result only.
4) Since the data disclose for assessing the BNI effectiveness of hedge accounting is limited, this study only measure it from the critical term comparison approach.

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