Erratum to: Do sophisticated investors use the information provided by the fair value of cash flow hedges?

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Appendix 1 has been erroneously published in the original article, which is corrected with this erratum.

Appendix 1: Illustration of the implications of cash flow hedge gains/losses for future profitability

This appendix illustrates how cash flow hedge gains/losses provide a signal about future profitability after the hedge has been reclassified into earnings and the firm is fully exposed to the underlying price movements that created the gain or loss.

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Suppose a firm has revenue of \$4 and cost of goods sold (COGS) of \$2. Revenue is constant over the next few years. The firm sells only one product. And taxes are ignored. During year t , the firm hedges its year $t + 1$ inventory costs. After the hedge is in place and the current year's inventory has been purchased, the price of inventory rises by \$1, from \$2 to \$3. Therefore, in year t , the firm has a hedge gain of \$1 in AOCI. However, because the firm had purchased its inventory at \$2, COGS would be \$2 in year t .

In year $t + 1$, the firm benefits from the hedge. It purchases inventory at the “new” price of \$3 but has the offsetting hedge gain of \$1 being reclassified into the income statement. Thus, COGS would again be \$2.

However, after year $t + 1$, there is no hedge, so COGS is \$3 in years $t + 2$ and $t + 3$. Therefore, income is \$2 in t and $t + 1$ but \$1 in years $t + 2$ and $t + 3$.¹ This scenario is illustrated graphically and through journal entries below:

	Year t	Year $t+1$	Year $t+2$	Year $t+3$
Dr. Accounts Receivable (or Cash)	\$4	\$4	\$4	\$4
Cr. Revenue	\$4	\$4	\$4	\$4
Dr. COGS	\$2	\$2	\$3	\$3
Dr. AOCI (hedge gain)	\$0	\$1	\$0	\$0
Cr. Inventory (at cost)	\$2	\$3	\$3	\$3
Dr. Derivative Asset	\$1			
Cr. AOCI (hedge gain)	\$1			
Dr. Cash		\$1		
Cr. Derivative Asset		\$1		

¹ This illustration assumes that inventory costs follow a random walk (and stay at \$3 for the foreseeable future) that the firm only hedges in year t and that it only hedges for the next year. We test the random walk and 1-year-horizon assumptions in Sect. 2. Furthermore, as explained in Sect. 2, even if the firm enters into hedges in year $t + 1$, these hedges will lock the firm into a \$3 cost for its inventory and thus only protect the firm from *additional* cost increases beyond those experienced in year t .