CITIZENS FOREIGN EXCHANGE

Fundamental Concepts in Foreign Currency Risk Management

Introduction

For many businesses that operate internationally, **foreign currency (FX) hedging programs** may reduce risk and limit the impact of currency volatility on future financial performance. Yet smaller companies that have frequent or rising volumes of FX transactions may simply transact in the *current* spot market and may not have a hedging program targeted at protecting margins from fluctuations in *future* exchange rates.

So, when and how does one develop a currency hedging program? How do companies make the leap of faith sometimes necessary to embark on a program targeted at future transactions and complex currency exposures?

The Emergence of Currency Risk

Initially, as companies expand and grow sales in overseas markets, they may prefer to do business in U.S. dollars to minimize concerns associated with foreign currency transactions. Companies typically seek **efficient transaction processing** and accounting reconciliations, which can become more complex with sending and/or receiving payments in another currency. Invoicing in USD may insulate firms from these complexities and provide protection from direct exposure to FX risk.[1]

As businesses grow and move through successive phases of international expansion, however, they may find benefits in departing from transacting solely in USD. Transacting in currencies other than USD may allow firms to take advantage of opportunities to increase market share or to expand into new markets, to broaden and add resilience to supply chains, and to deploy capital and begin manufacturing overseas.

Transacting in foreign currencies introduces new complexities and may expose importers and exporters to currency risk in a variety of ways:

- **Exchange rate fluctuations:** Sudden changes in exchange rates may impact the USD value of export/import activity contracted in a foreign currency.
- **Payment terms:** Foreign currency denominated sales expose companies to the risk of changing exchange rates between the timing of sales and the receipt of payments. Terms negotiated with foreign buyers can affect the magnitude of this exposure to currency risk.
- **Delayed payments:** Delays may result in differences between exchange rates when sales are made and payments are rendered, with resulting gains or losses in the USD value of sales.
- **Economic conditions**: Inflation, interest rates and political developments can affect the variability of exchange rates and exposure to currency risk.
- **Competitor pricing**: If competitors price products in a third currency, exchange rate fluctuations may impact the competitiveness of a U.S.-based business, affect sales volumes and necessitate adjustments in prices.
- **Shipping costs**: Because shipping costs for imports are often paid in foreign currency, exchange rate fluctuations may have an impact on the cost of imported goods.

Managing FX Risk

As companies become committed to operating in international markets, stakeholders may perceive that currency fluctuations present material risks to priority financial performance measures and recommend the consideration of an FX risk management program.

Key motivations for implementing a hedging program include:

- **Protecting revenues, margins and the economics** of capital and other investment transactions, such as an acquisition.
- **Managing foreign currency costs and expenses** across the global supply chain, including raw material costs.
- **Minimizing cash flow volatility** and enhancing working capital management – arguably one of the greatest benefits of FX risk management.
- **Enhancing the evaluation of business unit performance,** enterprise-wide resource allocation and investor confidence by increasing certainty relative to budget and/or other performance benchmarks. Reducing realized variances in forecasted financial metrics may increase stakeholder confidence in management's ability to execute its plans.

[1] Pricing cross-border transactions in USD exposes a firm's customers and vendors to FX risk, and may expose the firm to indirect risks (e.g., delayed payments and credit risk, and fluctuating volumes).

Ways to Hedge Against Variability in Foreign Exchange Rates

A U.S. business growing globally may use a number of techniques to protect its financial performance from the adverse consequences of currency volatility:

- **Netting:** Offsetting payments and receipts in a single currency may reduce exposure to currency fluctuations.
- **Diversification:** Expanding operations in multiple countries may limit the overall business impact of an adverse move in a single currency (or an adverse development in a single location).
- **Incorporating risk-limiting terms in contracts:** Terms negotiated with suppliers, customers and partners may limit the impact of changes in currency values and factors on results. For example, a business might negotiate fixed exchange rate contracts, FX risk-sharing agreements or inflation-adjusted contracts.
- **Actively executing spot transactions:** Strategies such as setting risk limits, using stop-loss orders and monitoring currency values relative to preset market entry levels may help mitigate exposure to currency risk.
- **Financial hedging:** By executing FX derivative contracts with third-party financial institutions, companies may offset the effects of movements in currency exchange rates. Instruments such as FX forward contracts, currency options and swaps may generate offsets to economic exposure resulting from changes in FX rates.

It is important to note that these strategies have advantages and disadvantages, and businesses should carefully evaluate all alternatives before deciding on a strategy to protect against currency risk.

Hedging Considerations

Currency hedging programs should be tailored to the firm's business objectives and limit designated risks to predetermined tolerance levels. When designing an FX risk management program, a number of factors, parameters and constraints should be considered:

- **Risk management objective:** What is the goal?
  - To reduce risk to revenues, operating margin, net income, cash flows, equity or a mix of these and other performance measures? Results at specific entities or on a consolidated basis?
  - To reduce the volatility of results or to reduce risk of shortfalls relative to specific benchmarks?
- **Tenor:** The risk management horizon may be influenced by forecast accuracy, pricing flexibility, transaction seasonality, market liquidity, curve shape and credit.
- **Coverage and cadence:** The breadth, depth and timing of coverage may be affected by the firm's risk management objectives (e.g., smoothing versus mitigating risk to budget), the natures of exposures (e.g., forecast vs. recorded), forecast accuracy and resources.
- **Instruments:** What tools and products (e.g., forwards, swaps and options) are available, most practical and align best with the firm's exposures and risk management objectives?
- **Cash availability:** What is the firm's appetite to incur premium costs for options, comfort with potential cash flows at final exchange of cross currency swap?
- **Financial reporting:** What is stakeholder sensitivity to unrealized gains and losses – recorded in income and not matched by offsetting losses or gains associated with the hedged items – from changes in the values of derivative hedges not designated for special accounting? Alternatively, does the firm have the resources and appetite to adopt special hedge accounting, which may allow better matching of the income statement effects of hedges and the hedged items?

Hedge Accounting

The default accounting for FX derivatives requires that these instruments be recorded on the balance sheet at fair value, with changes in value recorded in current income.

This treatment may be inconsequential for private companies or entities that do not use net income as a key measure of financial performance and instead rely on cash flow measures or some other EBITDA-based measure that adjusts for non-cash items. However, public companies that use earnings-per-share (EPS) as a key performance metric, or those concerned with protecting the income statement from fluctuations in value in their currency hedge portfolio, may find recording changes in values of derivative hedges in current income problematic.

Derivatives may be designated and documented as being in a hedging relationship, and qualifying relationships may benefit from special accounting that results in better matching of the income effects of the hedge and the hedged exposure.

FX derivatives may qualify for special accounting in three types of hedging relationships:

- **Cash flow hedging** enables an entity to defer the recognition of fair value gains/losses on qualified hedging instruments to OCI (Other Comprehensive Income) until such time as when the hedged item occurs. The hedged items are usually forecasted FX transactions, such as revenues or expenses denominated in foreign currency that create risk to the entity's functional currency income.

- **Net investment hedging** mitigates an entity's exposure to changes in the value of net investments in foreign operations due to changes in exchange rates. As a result of the process of FX translation, exchange rate-related changes in the values of investments in foreign operations are recorded in equity – the cumulative translation adjustment (CTA) section of OCI.

  For qualifying net investment hedges, changes in the value of the hedge instrument may also be recorded in CTA, mitigating income statement volatility. The process preserves the reporting-currency-equivalent value of the foreign investment, and consolidated equity, during the life of the hedge. Upon termination of the hedge, the instrument's gain/loss remains in OCI-CTA until the substantial liquidation or sale of the foreign entity, at which time it is reclassified to earnings.

  Also, when an election is made to exclude time value from the hedging relationship, e.g., as in the case of net interest payments on a cross-currency swap, the positive interest rate difference in the respective currencies can be reflected in current earnings.

- **Fair value hedging** allows an entity to change the method of accounting for a hedged item, usually from cost or amortized cost to fair value adjusted for changes in the hedged risk. In the case of a qualifying hedge, changes in the fair value of the hedged item due to the hedged risk are recorded in income each period and may offset gains or losses associated with the hedging instrument.

  This model is used relatively infrequently in currency hedging. One reason is that when the hedged item is a recorded non-functional currency denominated monetary asset or liability (e.g., a foreign currency accounts receivable or accounts payable), U.S. GAAP requires the item to be remeasured into functional currency on each reporting date, with changes in value recorded in income. In other words, the default accounting for recorded monetary assets and liabilities under U.S. GAAP is identical to the accounting that would result from designating hedges for special accounting as fair value hedges, eliminating the need for such designation.

The effective application of hedge accounting requires consistent and correct application of the relevant standards. To qualify for special accounting, risk managers must demonstrate at the outset and on an ongoing basis that the hedging relationship is expected to be effective, and comply with rules and requirements regarding disclosures, documentation and consistency of methods. If you are considering the use of strategies whose performance may be affected by the use of special hedge accounting, we strongly advise you to consult your auditors and accountants.

Conclusion

Currency risk management by multinational companies involves a range of fundamental concepts and methods. These include establishing a policy, analyzing exposures, quantifying risks, considering the adoption of hedge accounting, executing hedging strategies, and implementing processes and systems to document, monitor, assess and disclose hedges.

The concepts discussed above may provide a framework for multinational companies to identify, measure and mitigate currency risk in their global operations, helping them navigate the volatility of foreign exchange markets and protect their financial performance.

Contact

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Important Note