Tips for Managing Foreign Exchange Risk

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Corporate Treasuries need to identify and manage foreign exchange risk. What gives rise to foreign exchange risk and how should this risk be managed? The risk can be an economic risk or accounting risk or both. Economic risk is the degree to which the value of the firm will change due to changes in foreign exchange rates. Accounting risk arises when a firm restates the foreign currency denominated accounts in the parent's financial statement. Both the risks can cause variability of cash flows for the firm or volatility in key financial reporting metrics and hence it may be prudent to hedge the risk.

Economic Risk

Economic risk arises from unanticipated exchange rate changes on the value of the firm. An economic risk exists to the extent that future inflows are denominated in a different currency than future outflows as the inflow currency will need to be converted into the outflow currency. This risk is operational and transactional in nature. Operational risk arises when exchange rates impact a firm's operational forecast (for example, forecasted foreign currency denominated revenues). Economic risk is transactional when a transaction executed today is impacted by exchange rate at settlement (for example, the settlement of a foreign currency denominated receivable). The domestic currency equivalent of the cash received on the date of settlement may be different from the amount expected at the time of contract execution.

Economic risk is directly proportional to volatility in currency markets. Economic risk is valid for multi-national companies as well as domestic firms. A multi-national company that has revenues or expenses in foreign currency is subject to the exchange rate fluctuation. A domestic firm may have economic risk indirectly from foreign exchange rates because stronger domestic currency would make competitor product imports from other countries cheaper which could impact the prices of products or costs of the domestic firm.

Accounting risk

Accounting risk arises from accounting guidance regarding reporting of a firm's revenues, margin, net income, equity, or other reporting metrics in consolidated financial statements. The financial statements are reported in a single currency. If the firm conducts transactions in more than one currency then the accounting guidance requires measurement of those changes in the relationship between different units of currency.

The framework in the accounting guidance requires identification of reporting entity's reporting currency. Reporting currency is the currency in which a firm prepares its financial statements.

The next step is identification of reporting entity's foreign entities. A foreign entity is a distinct and separate operation with a functional currency other than the reporting currency. The functional currency of each of the foreign entity needs to be identified and documented. The functional currency is the currency of the primary economic environment in which the entity (a distinct and separate operation) exists. A foreign currency is the currency other than the functional currency of the entity.

On each reporting date, (1) each entity in the firm needs to measure foreign currency transactions into the functional currency (re-measurement) and (2) the firm needs to translate the financial statements of foreign entities into the reporting currency (translation). Re-measurement is a process by which an entity expresses transactions whose terms are denominated in a foreign currency in its functional currency. Foreign revenues, expenses, equity transactions, and non-monetary assets and liabilities are recorded at the rates in effect at the time the transaction took place. Foreign monetary assets and liabilities are re-measured at current exchange rates. Transaction gains and losses from re-measurement are reported in net income.

Translation is the process of expressing a foreign entity's functional currency financial statements in the firm' reporting currency. Assets and liabilities are translated at current exchange rates while equity and income statement items are translated at historical rates or rates in effect at the time of the transactions. The impact of translation is included in Cumulative Translation Adjustment (CTA) account in Other Comprehensive Income (OCI) in equity.

Which risk should the firm hedge?

A firm needs to manage both economic and accounting risk to be competitive in today's environment. In many cases, though not all, the economic and accounting risks are similar and both can be managed with the same strategy. In order to address both effectively, the firm needs to establish the risk management framework to integrate assessment and management of both risks.

The immediate priority for Corporate Treasury is to eliminate transactional risk. This helps ensure sufficient cash is available on hand to make foreign payments. The firm makes this assessment on an on-going basis.

The firm may also adopt various strategies on an on-going basis to address economic risk. For example, a natural hedging strategy can be adopted where revenue received in a foreign currency is netted against expense borne in that currency. Another example is diversification of production sources and end product markets may provide risk mitigation if there are multiple currencies involved.

The firm can adopt a periodic approach to evaluation of enterprise level accounting risk of re-measurement and translation. As part of the periodic risk management exercise the firm needs to ensure only net exposure is hedged.

A firm can use financial instruments like futures, forwards and options to hedge forecasted transactions, firm commitments and recognized assets and liabilities. This helps reduce the firm's exposure to changes in the fair value or cash flows or fair value associated with recognized balances and future transactions.