Risk!

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In the April Risk!

Translation risk can be a particularly difficult risk for corporate treasurers to manage. Kevin Lester and Ward Naughton explore the challenges that this risk presents. FX Columnist Wolfgang Koester discusses questions corporate board members should ask about unanticipated profits from FX, while ERM Columnist Bruce Branson addresses whether ERM enhances shareholder value. Finally, Anthony Scaglione and Pracheer Bansal talk about Earnings Volatility Management and the risks involved.

Risk Analysis

Translation Risk

The relationship between hedging translation and transaction risk

Kevin Lester and Ward C. Naughton

Translation risk, resulting from the conversion of a foreign subsidiary's financial statements into the group reporting currency, can be a particularly difficult risk for a corporate treasurer to manage. The most obvious difficulty in managing translation risk is the fact that, by its very nature, translation risk is an ex-post measure of risk; it measures risk which has already occurred. As such, it does not affect near term cash flows, and attempts to manage this risk using traditional financial hedges like forward contracts often result in cash flow mismatches.

In addition, particularly when looking at the issue of hedging earnings translation, as opposed to balance sheet translation, the accounting standards both in the U.S. and under International Accounting Standards (IAS) do not recognize earnings translation as a qualifying risk for hedge accounting. As such, hedging earnings translation risk directly will often create additional earnings volatility, as the FX effects of several quarters are concentrated into a single reporting period.

The issue of how to manage earnings translation therefore remains a dilemma for many companies, as FX volatility can have a significant impact on consolidated earnings per share. In fact, despite the fact that most companies will focus to a much greater degree on hedging their transaction risk, it can be argued that it is this risk to consolidated earnings per share which actually attracts the attention of the investment community.

So, if a company decides that the effect of FX volatility on earnings translation is something that needs to be managed, but is reluctant to hedge this risk directly due to hedge accounting restrictions, what can they do?

A potential solution to this dilemma is to understand the link between transaction and translation risk. Consider a U.S. company with a profitable European (EUR functional) subsidiary. Assuming that the priority is to protect consolidated U.S. dollar earnings, it is important to consider how a transactional hedging program might affect this objective. For example, if the European subsidiary was to have U.S. dollar receivables, and it was to decide

Continued on page 2

FX Risk Essentials

Black Ink and Red Flags

Questions corporate board members should ask about unanticipated profits from foreign exchange

Wolfgang Koester

As a board member of a multinational corporation, are you being told that the weak dollar has resulted in increased corporate revenues and profits? Today, the multitude of risks associated with foreign exchange exposure has largely been masked by the long-term decline of the U.S. dollar relative to other major currencies. Rather than highlighting flaws in accounting and foreign exchange exposure management processes, U.S. multinationals have regarded these surprises as a "gift." In reality, no surprise is a good surprise when you are talking about accounting practices. While windfalls from the weak dollar have allowed many CFOs to cast a blind eye to irregularities that typically plague multi-currency accounting and foreign exchange risk management, the trend can't continue forever (just ask fellow board members or CFOs of Canadian or Asian multinationals).

Managing foreign exchange risk is harder than you think

"Foreign exchange exposure management is the toughest job in finance," says former Microsoft CFO John Connors—and with good reason. Positing a confident, well-informed response to any of the following FX-related questions is no easy task for any corporate board member, or for any member of their organization:

Continued on page 3

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Translation Risk continued from page 1

to hedge this transaction risk, the overall risk to consolidated U.S. dollar earnings would actually be increased (as the company essentially adds to its eurodollar exposure). Likewise, a decision to hedge U.S. dollar payables would actually decrease risk to consolidated earnings (as the overall eurodollar position is reduced). As such, in this simple example, in can be demonstrated that fine tuning a company's transaction hedging program can be a useful tool in managing the consolidated earnings risk. The additional bonus of this approach is that any hedging activity could also qualify for hedge accounting. Likewise, it should also be noted that in certain cases a transaction hedging program can actually result in an increased risk to consolidated earnings. This is not a reason for a company to ignore transaction hedging however. In fact, it is just the opposite. It just emphasizes the importance of carefully designing and managing a transaction hedging program, with particular consideration to the corporate risk management objectives.

In addition to earnings translation there is the question of balance sheet translation which many CFOs are generally less concerned about since its treatment, via hedge accounting, allows executives to keep the P&L effect off the income statement (at least until the underlying assets or liability are sold, liquidated, or extinguished). With the prolonged weakening of the U.S. dollar over the past few years today's American financial executives in particular must plan for the ultimate reversal of such trends and think longer term how foreign currency assets and liabilities will be managed in the future. For example, if a company is thinking about making a divestiture of such assets in the next 2-3 years it could consider deploying a low-cost options strategy that helps insulate against future adverse currency exchange rate fluctuations.

As is often the case when it comes to managing financial risk, the first step is to first formulate a clear risk management objective, and then devise a strategy to allow that objective to be achieved. If minimizing the risk to consolidated earnings is an important corporate risk management objective, the potential impacts of a transaction hedging program must be carefully considered. A transaction hedging program can be used as a tool to help achieve earnings translation hedging objectives, and even if it is not, the effect of a transaction hedging program on these objectives should be carefully considered. Finally, any hedging strategy should be carefully monitored to ensure it continues to assist in the realisation of the company's risk management objectives, and does not actually result in higher levels of financial risk. ▲

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AFP Seeks Board of Directors Candidates

Interested practitioner members should submit the following information to AFP:

- Biographical sketch containing relevant volunteer experience, especially experience serving on AFP committees, task forces or regional association boards
- Resume, including a brief overview of current responsibilities
- Letter of recommendation from an immediate supervisor, as well as information on the candidate's employer, such as an annual report.

CTP/CCMs are encouraged to apply.

Mail applications to:
AFP Nominating Committee, AFP, P. O. Box 5763, Bethesda, MD 20824.

If you have questions, please call AFP's Executive Office at 301.907.2862 or e-mail driggs@AFPonline.org.

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