Risk!

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FX Risk

Foreign Exchange Risk Management

CFOs are worrying about more than just FAS 133

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The financial press is filled with stories where foreign currency exchange (FX) is causing financial executives significant angst.

That's because every CFO dreads having to report: "In the course of finalizing our financial results for 2007, we has been advised by our independent auditor that, in its opinion, our accounting for FX contracts does not comply with the guidelines of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities(FAS 133)."

The combination of Financial Accounting Standard 133 (FAS 133) and adherence to Sarbanes-Oxley Act Section 404 requires financial executives to re-evaluate their accounting methodologies and the gaps they have in meeting hedge accounting requirements. There is more to proactive FX risk management, however, than simple blind adherence to highly complicated, sometimes obtuse, accounting standards.

In a September 2007 industry survey of 200 senior financial executives conducted by HiFX, a global provider of foreign exchange risk management advisory services, a number of areas of major concern emerged with respect to FX risk management. Treasurers, FX managers and controllers at multinational North American companies identified the following issues in order of priority:

- Building FX exposure management strategies
- Market analysis and forecasting
- Monitoring exchange rates
- Checking competitiveness of FX transaction pricing
- Financial instrument review and selection
- Proper hedge accounting
- Exposure identification
- Formalization of a FX policy
- Assistance with setting budget/costing levels

Of the participants in the study, which included both public as well as private companies, only 10% expressed zero tolerance towards risk. The remaining 90% expressed a clear preference for controlling risk in a "highly managed" environment. Only 3% of all respondents categorized themselves as liberal risk-takers. Respondents said a "highly managed" environment needs to include a documented approach that is:

- Systematic in design
- Iterative in usage
- Transparent to all stakeholders
- Uniform in application
- Metrics-driven in terms of performance

Each of these criteria raises a host of relevant questions that must be considered:

Systematic design

- How consistently are risks identified across currencies?
- What information system is being utilized? How solid is the integrity of the exposures data being compiled?
- How is FX risk management policy imbedded into daily treasury operating processes?
- If the entire risk management team were to leave tomorrow, would a new team be able to pick up where the old team left off, in a manner consistent with the firm's FX risk management policy?

Iterative in usage

- Does the company's risk management process operate in a dynamic fashion, where prior experiences are incorporated into subsequent simulations and analytics?

Transparent to stakeholders

- How does the risk management system promote transparency and clear communication to key stakeholders, whether they are shareholders, business unit managers or Wall Street?
- How dynamic is reporting and sensitivity analysis?

Uniformity in application

- How consistently are FX risk management processes being implemented across the organization?
- Are offsetting, netting and other natural hedging programs being effectively implemented across the organization?

Metrics driven in terms of performance

- How are FX risk management activities evaluated?
- What are the metrics for performance: a specific measurement, such as percentage of exposures effectively hedged, or minimization of reported FX gains or loss on financial statements; or broader financial objectives, such as increasing enterprise value?
- Would the current approach to measurement need to be changed under different circumstances, for example, if the company were publicly held and going private through a leveraged buyout? What would need to change and why?
- Would this change better reflect the goals of creating Economic Value Add ("EVA") for your shareholders? If so, what is preventing implementation of these actions today?

For executives at publicly traded companies it may not seem like there is much flexibility to designing a specific FX hedging approach. After all, FAS 133 and International Accounting Standard (IAS) 39 are not going away anytime soon. On the other hand, as Joseph Maurer, former treasurer at Levi Strauss says, "The important thing is to actively communicate what your approach is, and then proactively manage all communication around the results achieved, or that are about to be realized."

Mr. Maurer continues, "While volatility will always remain, you can still capitalize on it. You better be a good communicator, though." And he ought to know, considering his success in managing in excess of $2.0 billion in FX exposures per year, and the substantial EVA he has created for his shareholders. ▲

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