ATLASFX
Leaders in FX Risk Management

white paper

The Definitive Guide to FX Risk Management

FX risk management is a crucial piece of every multinational company's business strategy. Get it right, and your business is that much closer to hitting its financial goals. Get it wrong, and your company could lose anywhere from thousands to billions—with seemingly no explanation of what went wrong.

Given how complex FX risk management can be, getting it right is no small feat. According to a recent Global Treasury Survey conducted by Deloitte,

> ***FX volatility** is among the top challenges facing treasurers today.*
>
> *Source: Global Treasury Survey, Deloitte

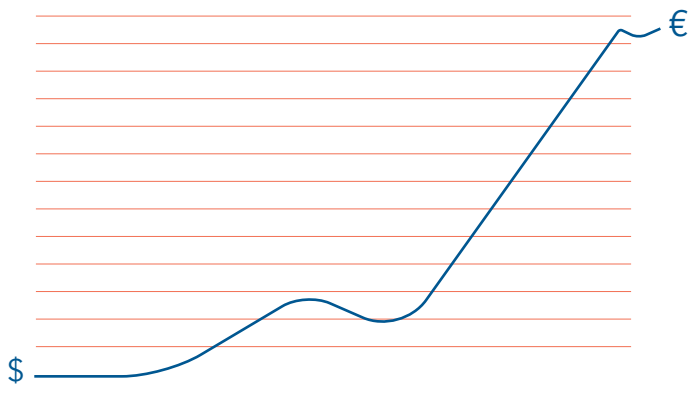
The big-picture objectives for most companies are usually the same when it comes to FX risk management. They want to minimize the impact of FX volatility on their earnings per share and meet all their financial targets and external guidance—regardless of the FX environment. *No CFO wants to have to discuss currency volatility as a reason for missing their objectives on a quarterly earnings call.*

While the primary responsibility for achieving this objective may fall on the treasurer and his or her FX risk management team, there needs to be an understanding throughout the organization of how FX can impact everything from a long-term strategic plan to the smallest of transactions. Among the key FX risk management challenges facing treasury teams, 59% report a lack of understanding by business units as a barrier.

It's not realistic to have *everyone* in the company become an expert in FX risk management, but it is crucial to properly integrate FX impacts into the metrics that drive behavior in the company. After all, you can't manage what you don't measure.

Treasurers know all too well why FX risk management matters. But there are multiple approaches companies can take to mitigate this risk. According to Deloitte, 76% of survey respondents hedge using derivatives instruments, many also in tandem with natural hedging techniques. Only 9% of respondents claim not to practice any FX risk management.

We'll address two FX risk management hedging topics and their accountability factors: balance sheet hedging and cash flow hedging.



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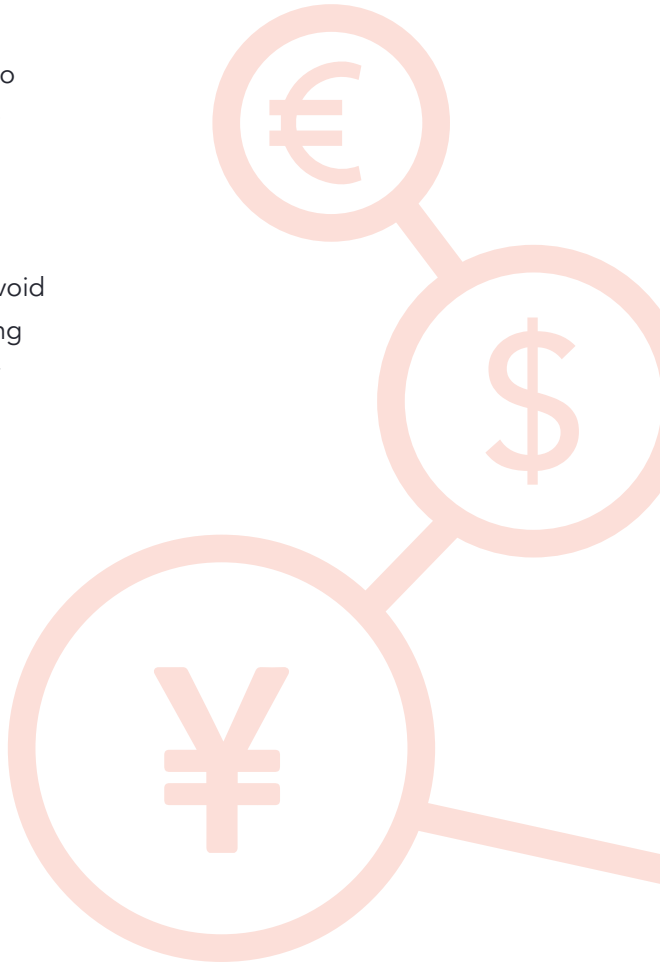
Balance Sheet Hedging vs. Cash Flow Hedging

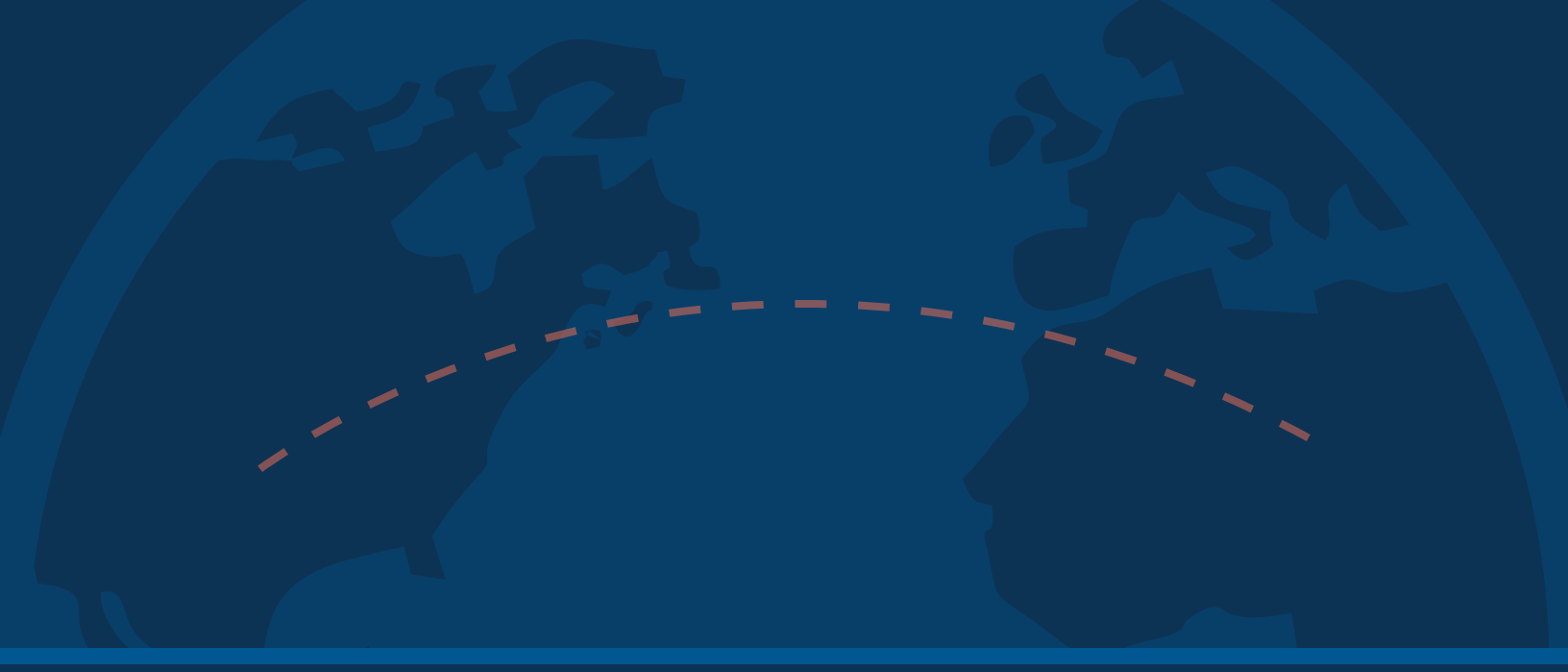
Before we dive into these two hedging methods, let's quickly define how each works.

Balance sheet hedging focuses on the impact of FX rate changes on the balance sheet, where the transaction currency of the assets and liabilities differs from the functional currency of the entity where they reside. The aim of balance sheet hedging is to stabilize the financial position of the company by reducing the volatility of reported assets and liabilities due to FX fluctuations.

On the other hand, **cash flow hedging** is aimed at managing the impact of currency fluctuations on future cash flows, such as those from exports, imports, or intercompany expenses or revenues. This type of hedging is typically focused on managing the FX risk of the income statement where the transaction currency differs from the functional currency of an entity. The goal of cash flow hedging is to minimize the impact of FX rate changes on the company's income statement and earnings.

Both techniques are important for companies that engage in international business to manage their FX risk effectively and to avoid potential financial losses due to currency fluctuations. Keep reading to learn more about each hedging method to learn how they may apply to your organization.





Balance Sheet Hedging

Companies often focus on managing balance sheet risk first. This is because there are no longer any internal mechanisms a company can use to protect itself from the FX volatility of items that are already on the balance sheet.

Future non-functional revenues and expenses may be influenced by local currency pricing changes, negotiated discounts, or other mechanisms. But once a receivable or payable is on the balance sheet, the volatility of that asset or liability will have a direct impact on the bottom line if not hedged.

Specifically, when there are assets and liabilities in currencies different than the functional currency of the entity where they reside, their value must be re-measured (back into functional currency terms) at the end of every month. This remeasurement gain or loss can be substantial, and the goal of a balance sheet hedging program should be to offset this impact as much as possible.

The net impact of currency remeasurement combined with an offsetting balance sheet FX hedges provides the company feedback each month on how well they are managing this risk. However, without the ability to break down the potential sources of variance, the company is just left with an unexplained delta between the underlying balance sheet exposure and the balance sheet hedge.

The FX risk manager hopes this difference is not large and that they will not have to scramble to try and explain where the noise is coming from during a tight month-end close window. *Hope, however, is not a strategy.*

As forward-looking companies seek to evolve their balance sheet hedging approach, it is important to understand the underlying factors driving this variance.

Balance Sheet Hedging Sources of Variance

To move past hope as a strategy, it is crucial to understand the potential sources of hedging variance and have the right technology and processes in place to capture and understand this information in a timely manner.

Seeing that variances exist and understanding why they exist are very different. The true value lies in being able to identify the relative impacts from the list below.

1 Forward point cost or benefit

The forward point cost or benefit is purely a function of the interest rate differential between the currencies being hedged, reflecting the difference between the spot rate and the relevant forward rate to the hedged date. This may be a cost or a benefit to the company, depending on whether they are sellers or buyers of the higher interest rate currency to a future date. This will be part of the hedge while there is no offset on the remeasurement side.

2 Spot trading impact

This is the difference between the spot rate of any hedges and the relevant accounting rate those hedges are meant to protect. This might be small for companies that use a daily accounting rate and hedge daily but can be large if there is a longer gap between the rate used for balance sheet activity and the corresponding hedges. This impact could be favorable or unfavorable.

3 Forecast deviation

Ultimately, there will be a difference between a forecast that a hedge is based upon and the actual exposure that is remeasured. This impact can also either be favorable or unfavorable. For companies that use a daily accounting rate, calculating and tracking this impact can be very complex (without the right technology).

4 Remeasurement inconsistencies

Identifying the inconsistencies between the theoretical remeasurement impact and the actual remeasurement impact is often a major pain point in FX risk management. These inconsistencies may arise from manual booking adjustments (of which treasury is often not notified) or from FX rate booking errors or "ghost balances" that are difficult to locate (again, without the right technology to help spot the issue).

If your current FX risk management program isn't able to identify those sources for you today, your company may be experiencing less-than-ideal hedging results. Understanding the challenges your program is facing is the first step in mitigating risk.

Balance Sheet Hedging Challenges

For treasury teams to effectively manage risk, they need to be able to understand where variances are occurring. Without an effective system in place, it can feel like finding a needle in a haystack.

Unfortunately, there are several challenges companies face that keep them from being able to put together this kind of analysis of their balance sheet variances, which can lead to poor hedging results.

1 Complex ERP environment

The ERP environment can vary quite broadly between companies. Ideally, the entire company uses the same up-to-date version of a single ERP platform for all their entities. Some companies, perhaps due to numerous acquisitions, have an environment of several different ERP platforms and potentially different charts of accounts throughout the company. This can lead to missing information and general confusion when there is no single source of truth for accounting.

2 ERP data lacking transactional currency detail

The out-of-the-box reports that are typically available from the ERP systems often contain information that is missing the transactional currency detail needed to understand the exposures on the balance sheet. The data in the reports have already been converted to the functional currency of the entity or the reporting currency of the company.

3 Poor forecasting processes

Many companies rely on forecasts that are not particularly well thought out and do not take into consideration the main drivers of balance sheet fluctuations. Too often, companies use the latest known balance sheet actuals as a forward forecast, or, for some larger items, they might use a simplistic trend analysis. These companies often fail to leverage existing income statement forecasts that can help them make more predictable, more accountable future balance sheet forecasts. This is mostly a problem for companies that use a month-end accounting rate methodology.

4 Poor liquidity management

Companies can create unnecessary spot trading volatility through their cash conversion process. Whether they are converting excess local currency to a functional currency or needing to purchase a non-functional currency for funding needs, these spot conversions typically have an offsetting impact on the balance sheet. Therefore, the spot trade should have an equal and opposite forward trade (balance sheet hedge adjustment) to reflect the reduction of the asset or liability, eliminating the "spot noise" from this activity.

5 Inability to interrogate remeasurement data

Since the goal of the balance sheet hedging program is to offset the remeasurement impact, not being able to find discrepancies in the remeasurement data is a problem. Discrepancies can show up from manual entries in the remeasurement account, rate errors, ghost balances, and other reasons. Being able to find these "needles in the haystack" during a tight window of the month-end close process is nearly impossible without help from the right technology solution.

How to Make Balance Sheet Hedging More Successful

To overcome the common challenges faced in balance sheet hedging, companies can invest in technology solutions to automate and streamline hedging activities. Automating hedging processes can reduce errors, increase efficiency, and improve accuracy. This may involve using software solutions that offer real-time market data, automated trade execution, and risk reporting and analysis capabilities.

By putting solutions in place that address common balance sheet hedging challenges, you can mitigate the impact of FX volatility and protect your bottom line.

If overcoming these challenges seems like a daunting task, AtlasFX can help. To learn how AtlasFX can dramatically improve your balance sheet analysis and help save your company from costly mistakes,

Schedule a demo today.

Cash Flow Hedging

Cash flow hedging is the hedging method most widely associated with FX risk management programs that seek "hedge accounting" treatment.

The term "cash flow hedging" is actually a bit of a misnomer; often, the maturity of a cash flow hedge will be before the date of any associated cash flows from the underlying hedged item. In the revenue hedging example, the maturity may go to the revenue date, while the receivable associated with the revenue may not get paid for another few months (and potentially be covered by a balance sheet hedge).

As noted previously, with balance sheet hedging there is no need to delay the mark-to-market gains or losses of the balance sheet hedges from impacting the income statement at the end of the month since the remeasurement/revaluation of the balance sheet (the underlying risk they are hedging) is also impacting the income statement immediately.

Meanwhile, the goal of cash flow hedging is to delay the impact of the hedges to match the timing of the underlying risk they are hedging.

Example: *If FX revenue forecasted six months from now is the hedged item, the company will want to postpone the mark-to-market impact of the associated cash flow hedges for six months and ultimately have the entire gain or loss of those FX hedges impact the income statement during the same month that the FX revenue is recognized. During these six months, the mark-to-market gains/losses of cash flow hedges get parked in an equity account called other comprehensive income (OCI).*

As opposed to balance sheet hedging results, which are often kept centralized and not allocated to various business units, cash flow hedging impacts are often allocated throughout the company by geography and/or business unit. Though there are a variety of corporate structures that can influence how or whether this is done, there is ultimately going to be someone responsible for the USD equivalent (post-hedge) results for the various FX exposures that permeate the company's income statement.

In order for cash flow hedging to be successful, companies must build the right internal structures that will help maximize the efficacy of the hedges.

Considerations when Cash Flow Hedging

Coming up with the proper FX risk management approach for cash flow hedging can be challenging. Most companies have a once-per-year financial planning exercise that can be made more complicated by the desire to lock down the USD equivalent value of forecasted revenues and expenses for the following year. This annual plan often becomes the basis for key performance metrics throughout the company.

Because of this, it may be tempting to hedge the following year's revenues and/or expenses all at once when the company needs to put a "line in the sand" about what FX rate assumptions to use for their internal plan. While this may be the easiest approach from an internally focused administrative perspective, it's definitely not the best way to hedge against FX volatility when considering the potential impacts on your suppliers and customers.

Companies must take into consideration a broad set of perspectives and potential impacts. Hedging an entire year's worth of exposures at once and repeating the process one year later will likely distort the financial picture from one year to the next if the FX exposure is at all significant.

That approach would create a "staircase" effect on the FX risk, as the FX rates locked in for one year would often make a dramatic step in the rates locked in for the following year.

Instead, companies should consider a **layered hedging approach.**

What is a layered hedging approach?
Let's say a company targets an ultimate cash flow hedge of 80%. They achieve that by hedging in 20% layers for the four consecutive quarters prior to the period in question. The ultimate hedged rate will be a blend of prior period rates and will more steadily increase or decrease over time in response to currency shocks. How far out to go and what percentage to hedge will relate to the company's ability to respond to these FX shocks in other ways, and may differ by business and/or geography.

Cash Flow Hedging Challenges

Having an effective cash flow FX risk management approach from the perspective of all impacted parties is a difficult goal to achieve, and success requires overcoming numerous challenges.

1 Merely providing constant currency guidance

Some companies decide to not hedge their cash flow exposures and instead provide their investors with information on how their financials would have looked based on the prior year rates (i.e., in "constant currency"). While this data point might be somewhat interesting in trying to figure out underlying growth rates, not hedging material FX risks does a disservice to your investors, as they are not able to manage this risk themselves.

2 Poor forecasting

This was a challenge for balance sheet hedging and not surprisingly, one for cash flow hedging as well. Forecasting future revenues and expenses in total is difficult enough but determining the necessary FX breakdown in order to hedge makes it even tougher. Because of this, the percentage of forecasted exposures hedged will often be less than 100%, as frequent over-hedging may jeopardize the desired hedge accounting treatment.

3 Dealing with attempted "market timers" or those with "20/20 hindsight"

If the FX risk manager is allocating cash flow hedging gains and losses to the business units, he or she may receive unwanted feedback on when or whether to hedge certain currencies. Attempting to time the market based on an individual's guess or even a "bank consensus" estimate is a bad idea. In fact, if most banks agree on a direction for a currency, this is more likely to be a contrary signal, as it is likely an indicator of how the majority are already positioned in the market. A cash flow hedging process needs to have specific parameters for percentages hedged and the window when the hedging will take place, removing subjectivity.

4 Trying to maximize upside

While it relates to market timing and hindsight, **the main goal of a cash flow hedging program should be to minimize the downside, not to maximize the upside.** How to do this can be very specific to the nature of the exposures and requires an in-depth understanding of how your business can respond to various currency shock scenarios (price changes, changing location of certain activities, etc.). Besides, those that may occasionally succeed in maximizing the upside may find themselves with a very difficult year-over-year comparison the following year!

5 Poor cash flow hedging metrics

It is difficult for a cash flow FX risk management program to be successful if the results don't help tie back to a plan that is meaningful to the people who are getting allocated the gains and losses. The sources of variance need to be understood, and where they are significant, a feedback loop needs to exist to make well-understood adjustments when necessary.

Having an understanding of the challenges and complexities of creating a cash flow hedging program is a great start, but it's equally important to measure the impact your approach has when put into action.

Cash Flow Hedging Metrics

When it comes to any performance metrics, you get what you measure, and cash flow hedging is no different. It can be challenging to bridge the results of a layered cash flow hedging program back to metrics that may be based on a single FX rate assumption for the entire year for any given currency. The potential sources of variance that the cash flow hedging analytics need to explain include all the potential volume drivers (where hedged volume differs from the actuals) and rate drivers (where the hedged rates differ from the relevant planning rates).

1 Actual vs. Planning rates (AvP)

In order to understand the results of cash flow hedging, the FX risk manager needs to first identify the impact on the business before incorporating the hedging results. This requires calculations of how the related FX revenues and expenses convert to USD at the actual accounting rates during the period in question, compared to how they would have converted to USD using the planning rates (or budget rates) for the period in question.

This Actual vs. Planning Rate (AvP) calculation quantifies the impact (either positive or negative) of the actual rate environment in which the business had to operate compared to the planning assumptions. To the extent that the cash flow hedge does not perfectly offset this impact (essentially bringing these results back to the planning or budget rate), the variance should be broken out and explained.

2 Rate drivers

This metric reflects the difference between the hedged rate and the planning rate for the period in question. If the company only uses a single planning or budget rate for the year, this may differ significantly from the ultimate hedged rates realized with a layered approach, especially late in the year. The FX risk manager should work with the planning team as closely as possible to eliminate any unnecessary variance here.

This can be accomplished by helping to determine the planning rates used each year, which should ideally be a weighted average of the hedges that are already in place for that period, combined with the most up-to-date forward rates to use as an estimate for what is unhedged at the time of planning.

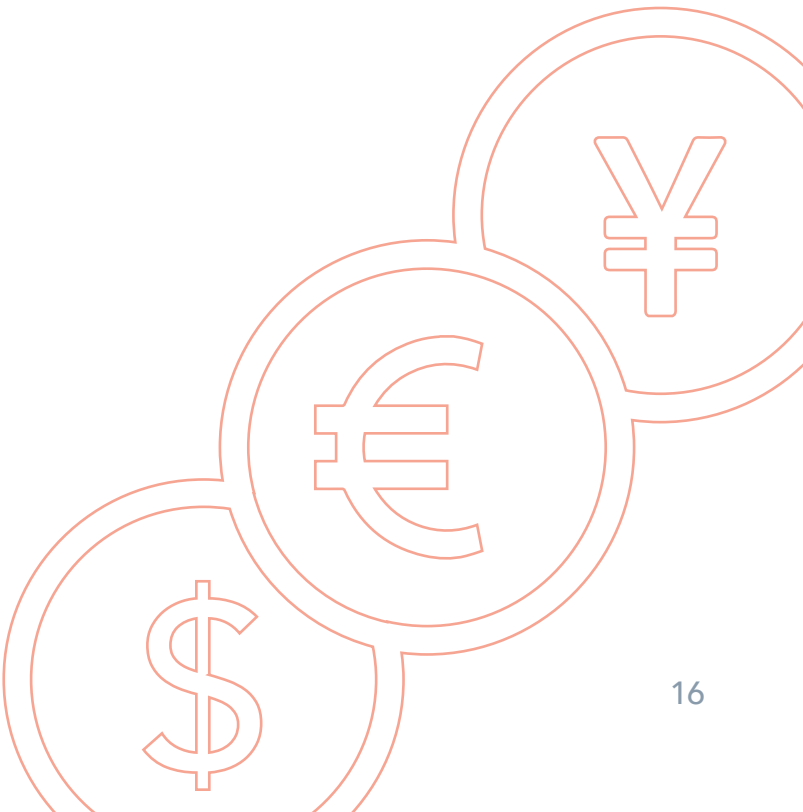
Ideally, the FX risk manager also introduces more frequent planning rates throughout the year (quarterly is better than annually) that more closely mirror the hedges as they are layered on, which need to be reflected in the metrics for those responsible for the USD equivalent results. While this may be administratively more difficult, it more closely ties the company to the FX market realities and keeps certain plans from either becoming too difficult or too easy to achieve based on FX headwinds or tailwinds compared to a single planning rate for the year.

Tracking these metrics will help businesses gain a better understanding of the success of their cash flow hedging program and find opportunities for improvement.

3 Volume drivers

This metric represents the mismatch between the hedge (based on a forecast) and the actual. This will usually have two components, one based on policy (target hedge percentage) and the accuracy of the forecast itself.

> **Example:** If the target hedge only gets to 80%, the policy impact of deciding not to hedge 20% of the exposure needs to be isolated from the true forecast deviation. Feedback on the accuracy of the forecasts needs to be provided back to the individuals providing the forecast, preferably in a dashboard that highlights large percentage misses (the "name and shame" approach)



How to Achieve Cash Flow Hedging Success

When implementing the cash flow hedging strategy, it's critical to focus on these best practices for continued success.

1 **Take a layered approach:**
Achieve the ultimate cash flow hedge percentage by hedging in layers for the consecutive quarters prior to the period in question, so the ultimate hedged rate will be a blend of prior period rates.

2 **Consider a broad set of perspectives & potential impacts:**
Cash flow FX risk management strategies must consider the potential pricing impacts on suppliers and customers, not just the company's internal financial plan.

3 **Understand the company's ability to respond to FX shocks:**
How far out to go and what percentage to hedge will depend on the company's ability to respond to these FX shocks in other ways and may differ by business and/or geography.

4 **Deliver insightful analytics to those who are impacted by FX:**
For those that are measured on USD-based results, understanding the FX rate and volume-related impacts that build a bridge back to the plan they are measured against is crucial.

Ready to evolve your cash flow hedging program? AtlasFX can help with our powerful, flexible, end-to-end SaaS platform.
Schedule a demo today.

Hedging Your Company's FX Future

Effective risk management is critical to the success of any business operating in today's global economy. Currency fluctuations can have a significant impact on a company's bottom line, making hedging an essential tool for mitigating this risk.

Both cash flow and balance sheet hedging are important techniques that companies can use to manage their currency exposure. By automating and optimizing their FX risk management workflow, companies can improve their ability to manage currency risk and achieve their financial objectives.

When it comes to FX risk management, time is not on your side. Find out how you can get started with the industry's only all-in-one FX platform with the superior analytics you need to implement a successful hedging program.

Schedule a demo today.

Atlas Risk Advisory was founded in 2010 to help treasury and finance teams intelligently scale and optimize their FX and commodities hedging strategies. At the core of our offering is the AtlasFX platform, the treasury's most comprehensive analytics software engine. By providing access to exposure data and real-time analytics, the cloud-based solution enables corporations to achieve a holistic approach to managing and improving their balance sheet and cash flow hedging programs. To learn more, visit atlasfx.com.