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Foreign Exchange

Hedging currency risk for foreign assets and liabilities

It's fairly common for multinational corporations to have assets or liabilities that are denominated in currencies other than their functional currencies—payables or receivables or foreign denominated debt or investments. And when this happens, the income statement of that company will generally be subject to currency exchange rate risk. That is, the balance sheet carrying values of those assets or liabilities must be adjusted at the end of each accounting period to reflect the latest exchange rate conditions. This effect is considered a transaction gain or loss in the language of accountants, and it generally gives rise to an adjustment to reported income.

Two critical exemptions apply to the above general rule:

- When the balance sheet item is an intra-entity foreign currency transaction where settlement is not planned or anticipated in the foreseeable future
- When the source of the currency exposure is designated as a hedge of a net investment in foreign operations.

In the first case, when the balance sheet item is an intra-entity foreign currency transaction and settlement is not planned or anticipated in the foreseeable future, the transaction gain or loss is recognized in the currency translation adjustment in stockholders' equity, rather than in current earnings. The second exception is an election commonly made by those having net investments abroad along with debt denominated in that same currency. With this election, rather than posting the currency transaction gain or loss to current earnings, these results are recognized in shareholders' equity—consistent with the geography for recognition of the currency impact affecting the net investment.

Barring these two exceptions, the transaction gain or loss from re-measuring the balance sheet item would go to earnings. Most companies, however, tend to view this currency effect as being extraneous to their core business, and as such, it is a candidate for hedging. Although a number of hedging instruments could serve this purpose, the most popular hedge choice is the currency forward contract—at least in connection with exposures of non-interest bearing instruments (i.e., for payables or receivables).

An obligation to buy or sell A currency forward is simply an obligation to buy or sell a specified volume of currency units at a specified date for a specified price (exchange rate). For asset exposures, the company would sell the non-functional currency forward. For liabilities, the company

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would buy the non-functional currency forward. In either case, the size of the forward position would correspond to the number of currency units associated with the asset or liability being hedged. Considerable discretion applies to the choice of the forward value date, but it's not uncommon to select the last day of the accounting period.

One convenient feature for this kind of hedge is that it doesn't call for any special hedge accounting treatment. That is, the normal accounting treatment recognizes the change in the asset or liability's value to current earnings coincidentally with the derivative's gain or loss. Special hedge accounting accomplishes this coincident earnings recognition, as well, but it's only necessary to seek special hedge accounting—requiring satisfying some rather onerous qualifying conditions—if the associated earnings from the derivative and the hedged item wouldn't otherwise get reported concurrently. In these circumstances, the contemporaneous earnings recognition from the currency transaction's gain or loss, and the derivative's gain or loss, obviates the need to go through the pain of qualifying for special hedge accounting.

In structuring these hedges, the idea is to generate a gain or loss on the forward contract that would be commensurate with the re-measurement effects relating to the asset or liability being hedged. That is, you'd hope to gain on your forward contract when the exchange rate fosters a transaction loss on the asset or liability being hedged, and conversely, you'd expect to lose on your forward contract when the re-measurement effect enhances earnings. These two offsetting outcomes won't be perfect, however, as the forward's result will pertain to the change in the forward exchange rate, while the earnings impact on the balance sheet item depends on changes in the spot exchange rate.

Ultimately, spot and forward rates have to converge as time passes and the forward value date and the spot value date finally coincide. As a consequence, hedgers should appreciate that the forward's gain or loss will differ from the currency transaction gain or loss throughout the hedge by an amount corresponding to the starting forward points (i.e., the difference between the forward price initially stipulated on the forward contract and the prevailing spot price at the time for forward contract is executed, times the number of currency units in the contract).

Four possible cases could occur:

1. Selling a forward contract at a premium over the spot price (to hedge an asset) is a benefit
2. Selling a forward contract at a discount (to hedge an asset) is a cost
3. Buying at a premium (to hedge a liability) is a cost
4. Buying at a discount (to hedge a liability) is a benefit.

These above cases debunk the notion that hedging necessarily imposes a cost. Specifically, in cases 1 and 4, the forward points effectively serve to reward companies that are able to hedge under these conditions. For the major currencies, where forwards actively trade, forward points (i.e., the difference between the forward exchange rate and the spot exchange rate) are determined by arbitrage, as a function of interest rate differentials. Forward points may either work for you or against you, but you're stuck with what the market presents. It's sort of a "take-it-or-leave-it" proposition.

Are exposure volumes static?

Beyond the forward point issue, another consideration pertaining to this kind of hedging has to do with

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the fact that the volumes associated with the exposures may not necessarily be static. For example, consider the case of a company that has payables denominated in a foreign currency. Throughout the month, they may settle some payables and replace them with other payables. Each currency exchange, however, represents a discrete economic risk. When a forward contract serves as a hedge of an aggregation of exposures, as is typical, the forward value date may not explicitly match each occasion at which currency is exchanged.

This mismatch fosters at least some incremental uncertainty about how the intended hedge will perform. One might hope that this concern would be inconsequential when the value date on the forward contract is close to the various currency exchange dates being hedged, but there's no guarantee. A sharp adjustment in exchange rates during the interval between the physical currency exchanges and the value date of any forward hedge contract could yield unanticipated effects – possibly profitable; possibly not.

One further point is that some currency transactions that give rise to income effects happen not to involve economic risks. In such cases, any effort to immunize the income statement volatility actually introduces an economic risk to the hedging entity. Consider the case of a consolidated entity consisting of a USD-denominated parent company and a EUR-denominated subsidiary and assume the sub borrows from the parent under a EUR-denominated note—one that is expected to be settled in the foreseeable future. Thus, the parent has a EUR-denominated loan on its balance sheet.

The debt and the loan are eliminated from the balance sheet in consolidation, as are all of the EUR-denominated cash flows between the parent and the subsidiary. The transaction gain or loss in the parent's income statement, on the other hand, is not eliminated, and this effect passes through to the consolidated income statement. In our example, the loan is a EUR-denominated asset on the parent's books, so a stronger euro would create a currency transaction gain. Conversely, a weaker euro would foster a transaction loss. It should be understood, however, that these earnings effects are a consequence of accounting rules as opposed to being a reflection of any real economic change.

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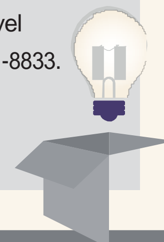

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Economically, any contract made between the entities of a consolidated group will have no effect on the performance of the consolidated entity as a whole. One component of the group simply stands to benefit at the expense of another. In such cases, any earnings impact that arises from the internal contract will necessarily foster a compensating gain or loss that would be recognized in equity through the cumulative translation adjustment. Focusing on the income effect without consideration of the equity effect gives a false impression of the underlying economics affecting the firm.

These accounting requirements create a dilemma for the consolidated group with inter-company loans between the related entities. Should companies hedge income volatility that arises when no when no economic risk is present? In effect, hedging this income statement exposure introduces an economic risk to the enterprise where there otherwise was none. Economically, entering into such a hedge would seem inappropriate. On the other hand, when earnings per share is perceived to be a primary driver of stock prices, an effort to mitigate the volatility of reported earnings could provide an overriding justification for entering into this kind of hedge.

Making the decision

In any case, the decision about whether to hedge currency transactions gains or losses should fully appreciate the distinction between exposures that arise from transactions between members of a consolidated group, versus those that derive from transactions with external, unrelated parties. Both transactions affect reported earnings, but only the latter pertains to a bona fide economic exposure.

Any hedge designed to address the gains or losses from transactions with related entities should be understood to be "protecting" the income statement by introducing an economic risk to the consolidated entity. Companies may reasonably elect to hedge such income exposures, but they should do so with their eyes open, recognizing the fact that they would be hedging an accounting exposure, rather than a true economic one.

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