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CORPORATE FOREIGN EXCHANGE

International Outlook

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FX Considerations for the New Year

Are you Chasing Budget Rates?

By *David Pierce, Director Business Development*



Many companies undergo much anguish and pain when it comes to setting budgets for their foreign subsidiaries. As the year begins most companies find themselves in the precarious situation of trying to guess where currency rates will be for next year in order to create an accurate budget. Here are some tips and ideas on how to deal with this.

When working with a foreign subsidiary it is not only important to project sales, revenue and expenses to adequately determine the budget in US terms, but predicting where the exchange rates will be at a given time throughout the year is vital as well. Most companies use a combination of factors when determining and setting FX budget rates. These can include the current spot rate, historical average rates, forward rates, bank forecasts, prevailing business sentiment, and technical chartist trends. The actual budget rate is then usually some compromise of all of the above, combined with the desire of the treasury department for a conservative rate and the sales and marketing departments for an aggressive rate.

From a best practice point of view, companies use the following methods of determining budget rates:

Order of Popularity

- consensus forecasted rates
- prevailing spot rates
- forward rates
- historical average rates
- chartist trends

This being said, we would agree with the majority of people that using historical average rates is not the best method, as this involves looking at what has happened in the past, and does not take into account the current economic realities. We also do not like using forecasted exchange rates as they have historically proven very inaccurate.

For instance if continued EUR strength, you may end up with a budget rate that is 15% better than what the current market rate is, and the treasury department would be unable to hedge that exposure, with corresponding rates. If the treasury fails to hedge this exposure, and chases after the budget rates, what are the consequences if the forecast is incorrect; and the currency then moves against you? You have left yourself open to market movements, and the market has gone against you, causing the company to show huge losses. This is not what anyone is looking for, because it can create a situation where people can lose their jobs.

The problem with both of these methods is the rates may simply not be achievable in the market. For instance, you are selling your product in EUR, and the forecast is for a significantly stronger EUR, you may want to lock-in a portion

of your risk with Forward Contracts. This will give you 100% guarantee of a given exchange rate for that portion of your risk. On the other portion, purchase an outright Put Option that allows you to participate in the upside if the currency moves the way you have it forecasted, this also protects the company for any downside moves if the EUR weakens against the dollar.

Historically, the prevailing forward rates have proven to be the most accurate “predictors” of future currency rates. This being said, should companies just simply use an average of the prevailing forward rates to create their forecast? Our thoughts are if you change your methodology by using a combination of tools, you will do a much better job on improving on the average forward rate for the period of the budgeting cycle.

In short best practice for treasurers are to first establish a budget rate that is rational and achievable, and then combine this with an effective foreign currency risk management hedging program. By having these two programs working together, the budgeting process is easy, budgets are attainable, and reporting is manageable.

Balance Sheet Hedging

By *David Pierce, Director Business Development*

In general we view balance sheet hedging for foreign exchange as the building block for a successful foreign exchange risk management policy. Balance Sheet Hedging is a generic term for managing the risk associate with current foreign exchange assets and liabilities. The most common of these would be foreign currency accounts receivable and payable, intercompany loans, or anything that can represent a foreign currency position to the reporting entity.

Companies that are new to this type of hedging often ask why is it necessary? There are a number of reasons balance sheet hedging is so common. Under FAS 52, companies are required to mark to market their foreign assets and liabilities at periodic accounting periods, with the



resulting change in value reported as foreign exchange profit and loss. This creates a no win situation for a treasury department. If in a corresponding period the company shows a large FX currency gain, creditors and analysts tend to discount the value of this as being outside the scope of regular business. However, if a large loss shows up, then analysts and creditors tend to get very excited about the company not doing a credible job of managing its FX risk.

Beyond the risk to the company’s reputation (and maybe your job), is the true cost of cash to the company. As enterprises go about the process of making and selling their products around the world the assumption is they plan on making money! Most companies set prices for their products at the prevailing exchange rates, and extend some term of credit to their clients rather than requiring cash up front. If these positions are left unhedged until settlement, the actual cash flows are at the mercy of the foreign exchange market. By leaving these positions unhedged, the treasury department is in effect taking the corporations cash and speculating with it in the FX market. When you consider that the vast majority of companies with balance sheet risk hedge their exposure, this becomes a very difficult position to defend.

Hedging foreign currency balance sheet positions is a common and widespread best practice in managing a company’s worldwide currency exposures. Balance sheet hedging is very effective in neutralizing volatile foreign exchange rates. A well organized and run balance sheet hedging program is an achievable, practical approach to stabilizing your income statement, and is ever increasingly important in today’s world.