Foreign Currency Risk Management Policy Guidelines

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Foreign Currency Risk Management Policy Guidelines

PRICEWATERHOUSECOOPERS

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Foreign Currency Risk Management Policy Guidelines

Introduction

Overview

The purpose of the Foreign Currency Risk Management Policy Guidelines ("Policy Guidelines") is to provide an outline for developing a formal foreign currency risk management policy ("policy") that establishes the key principles that will guide corporate treasuries in the company-wide communication and implementation of foreign currency risk management activities. In addition, treasuries should maintain a procedures manual or "desk book" that translates the policy into daily procedures for personnel executing the foreign currency risk management program.

Purpose and Scope of Policy

The purpose of a well-designed policy is to delineate clearly the parameters within which foreign currency risk will be managed. The policy should outline the role of treasury, as well as the responsibilities of senior management and the other departments and affiliates/subsidiaries involved. Although the policy focuses primarily on the role of the treasury department in foreign currency risk management, the guidelines are also applicable to companies that manage their foreign currency exposure through some other department.

Organization of the Policy Guidelines

The policy guidelines are organized in two sections. This first section defines and discusses the importance of the foreign currency risk management policy, recommends a policy development and approval process, provides guidelines for monitoring compliance, and proposes a process for managing exceptions to the policy. The second section addresses fundamental exposure identification and measurement, as well as hedging strategy and management reporting guidelines for developing a policy that reflects a company's overall risk profile.

The Importance of a Foreign Currency Risk Management Policy

In general, the policy should be used as a tool to achieve overall performance management objectives and ultimately add value to an organization and its shareholders. Furthermore, a well-developed policy is a crucial component of treasury's management of foreign currency risk within established risk tolerance levels. To be effective, a foreign currency risk management program should:

- Provide clear guidance and communication about the definition of risk.
- Ensure linkage to the company's overall business objectives.
- Reduce the possibility of miscommunication and possible errors in the management of the foreign currency program.
- Ensure that the company's risk management objectives are met and that the hedging strategy is well executed.

Policy Development Process

Role of Corporate Treasury in Policy Development

Treasury should be the sponsor and custodian in the process of developing a detailed corporate foreign currency risk management policy. (See Exhibit 1.) However, although treasury plays the lead role, it will require oversight and review by senior management, as well as input from various departments, such as finance, corporate accounting, corporate tax, internal audit, and subsidiaries and affiliates.

Roles and Responsibilities in Developing a Foreign Currency Risk Management Policy

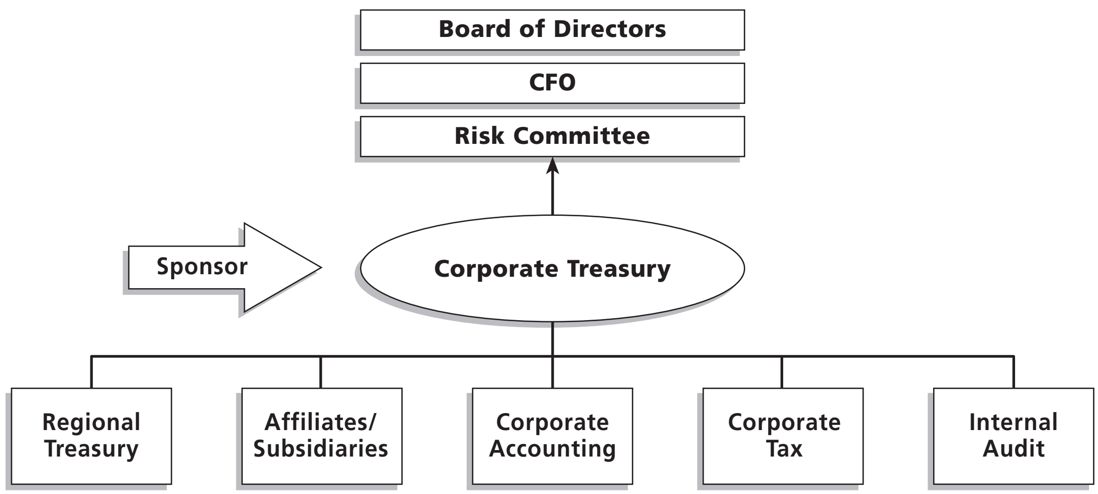
See Exhibit 2, page 107.

Approval of Foreign Currency Risk Management Policy

After treasury develops the policy, the chief financial officer (CFO) should review, comment on and provide the first level of approval of the policy. For some com-

EXHIBIT 1

Foreign Currency Risk Management Policy Development Process



Note: Smaller companies may not have a risk management committee.

panies (e.g., a smaller company), this may constitute final approval.

Larger and more complex companies should have a risk management committee that reviews and provides final approval of the policy. In lieu of such a committee, the board of directors should review and provide final approval of the policy. The individual or group authorized to approve the initial policy and any subsequent revisions should be named in the policy.

Guidelines for Policy Compliance and Effectiveness

Frequency of Policy Validation and Revision

The policy should state who has responsibility for reviewing and updating the policy, and how frequently this should be done. At a minimum, the policy should be reviewed and updated annually to reflect changes in the marketplace as well as other organizational and business changes. Even if the policy does not change from year to year, the effectiveness of the overall program and procedures should be continually monitored and discussed. If the policy needs revision, the changes should be reviewed and re-approved by the party or parties authorized to approve the initial policy to ensure proper oversight and governance.

Compliance

The foreign currency risk management policy can be effective only when there is compliance by all parts of the organization in their daily foreign currency activities. As a **best practice**, the policy should require that someone outside of the immediate foreign currency function, such as internal audit, test compliance annually. Treasury staff should spot check transactions periodically to ensure compliance; the results should be documented and communicated to internal audit during its annual audit.

Amendments, Policy Updates and Revisions

Amendments, policy updates and revisions should be documented and incorporated in the revised policy for approval by senior management. Following approval,

EXHIBIT 2

Roles and Responsibilities in Developing a Foreign Currency Risk Management Policy

ROLE: **Board of Directors**

- Review and provide final approval of the foreign currency risk management policy (in lieu of risk management committee).
- Review and approve any amendments to operating parameters, permissible instruments and limits.

ROLE: **CFO**

- Review and approve the foreign currency risk management policy.
- Ensure compliance with the policy.

ROLE: **Risk Management Committee**

- Review and provide final approval of the foreign currency risk management policy.
- Ensure compliance with the policy.

ROLE: **Treasurer**

- Play lead role in the generation of the policy and act as overall custodian.
- Monitor compliance with the policy.
- Initiate changes to policy as appropriate.
- Distribute policy.

ROLE: **Treasury Staff**

- Monitor foreign currency activity for compliance with the policy.

ROLE: **Affiliates/Subsidiaries**

- Ensure business unit compliance.

ROLE: **Internal/External Audit**

- Ensure compliance with the policy.

the revised policy should be distributed to all parties responsible for executing any of its elements, including compliance testing.

Exception Management

Exceptions to the policy may arise in the course of executing the foreign currency risk management program. The procedures for dealing with exceptions should be clearly spelled out in the policy. There should be a process for handling exceptions that includes written explanations, supporting documentation and approval procedures. The risk management committee or CFO should approve all exceptions to the policy.

Foreign Currency Risk Management Policy Development Guidelines

Policy Heading

The formal policy should be headed by a few key items of information. The person or committee that approved the policy should sign or be noted on the policy itself. The date of approval of the latest policy, including any updates, revisions or amendments, should also be provided. In addition, a version number or company reference number should be assigned that provides an audit trail to ensure that the most recent version is used for all treasury operations.

A unique sequential distribution control number should also be included to ensure that all affected personnel have received the latest version of the policy. A distribution control log managed by treasury should contain the distribution control number, the names and location/department of all recipients, the date the latest version of the policy was issued to each recipient, and the date its receipt was acknowledged by each recipient.

Foreign Currency Risk Management Program Objectives

The policy should clearly state the objectives of a company's foreign currency risk management program. The objectives should specify the overall goal of the program, whether it be minimizing foreign currency risk, reducing hedge costs or hedging to obtain a competitive advantage. An additional factor that should be incorporated in the objectives of the program is the linkage of the hedging program to the company's overall business objectives. It is critical that the objectives of the foreign currency management program are aligned with senior management's strategy and business objectives for the company as a whole.

Risk Management Philosophy of the Company

Within the context of the policy, a company should clearly state its risk appetite and foreign currency risk tolerance levels. Generally, foreign currency risk management is defined as managing foreign currency risk to an acceptable level at an acceptable all-in cost. There are two principal risk profiles:

- *Passive risk management appetite.* Within the approved operating parameters, treasury acts as the company's cost or service center for minimizing foreign currency risk.
- *Active risk management appetite.* Within the approved operating parameters, treasury has much more latitude in foreign currency risk management, and may take a more "speculative" approach. The risk/return ratio, in this case, will be quite different from the passive risk profile. While still mitigating foreign currency risk, the company may take active positions based on a particular viewpoint as to currency movements in order to obtain competitive advantages or realize economic gains.

Management of the Foreign Currency Risk Program

Best practice generally suggests centralizing foreign currency risk management at the parent treasury or among regional hedging centers reporting directly to the treasury. A company can best ensure that its foreign currency management activities are aligned with the company's overall business objectives if they are managed centrally. Centralization also allows for economies of scale by processing foreign currency transactions centrally in a more integrated treasury function, reducing transaction costs, eliminating redundant trading and risk management systems, and having more efficient back office operations. Centralization also allows corporations to leverage specialized expertise and maintain better internal controls. Other benefits include more efficient settlement mechanisms for intercompany transactions, as well as enhanced netting opportunities.

Roles and Responsibilities in the Foreign Currency Risk Management Program

The policy should state the roles and responsibilities of all parties involved in the foreign currency management program. The following provides an overview of the parties typically involved in a foreign currency management program as well as key responsibilities. It should be noted that the structure outlined below may not be suitable for all companies. The required roles and responsibilities for properly managing a company's foreign currency program will differ among companies depending on the scope of foreign currency activity, complexity of the risk management program and the supporting organizational structure.

Role of the Board of Directors

The board of directors' responsibilities may include the following:

- Review and provide final approval of the foreign currency risk management policy
- Approve new hedging strategies.
- Review and approve any amendments to operating parameters, permissible instruments, and exposure limits.
- Monitor policy performance and risk levels.

Role of the Risk Management Committee

A growing number of corporations are taking a broader view of corporate risk management and have developed a more cohesive approach to managing all risks (e.g., business, financial, operational). A trend that has resulted from this more expansive approach is the emergence of the risk management committee, which has oversight of and actively manages corporate risk. In today's environment, the existence of a risk management committee is considered a **best practice**. Typically, a risk management committee is composed of management representatives of treasury, finance, accounting, tax, legal and business unit operations.

With respect to foreign currency management, the general mandate of the committee should be to provide final approval of the policy, and ensure regular monitoring and review of financial exposures, policy, strategy and performance. The risk management committee has responsibility for regular review and approval of treasury's risk-taking activities and strategies, exposures, performance, counterparty credit limits and exceptions to corporate foreign currency policy.

Although the establishment of a risk management committee may be best practice, it may not be appropriate for all companies, particularly in the case of a smaller company that does not have a great deal of foreign currency activity. If a company has no risk management committee, the responsibilities discussed here would typically fall to the board of directors.

Role of the Chief Financial Officer (CFO)

Typical CFO responsibilities include:

- Review and approval of the foreign currency risk management strategy and acceptable risk tolerance levels.
- Recommendations to the board of directors.
- Review and approval of the foreign currency risk management policy.
- Review and monitoring of policy compliance.
- Approval of exceptions to the policy.
- Communicating the foreign currency management program to the investment community.

Role of the Corporate Treasurer

The treasurer typically has direct responsibility for the administration of a company's foreign currency risk management program. Those responsibilities include:

- Monitoring foreign currency management program performance, including hedged and unhedged exposures.

- Development and execution of the foreign currency hedging strategy.
- Discussion and resolution of accounting issues.
- Program performance review.
- Reporting on foreign exchange controls.
- Updating foreign currency policy.

Role of Corporate Treasury Staff

The treasury staff responsibilities should include:

- Supervising the day-to-day operations of the foreign currency risk management program.
- Executing foreign exchange transactions within the boundaries specified in the policy.
- Compiling, reviewing, modifying and issuing all foreign exchange rate forecasts used by a company, including those prepared in conjunction with profit planning.
- Reporting on foreign exchange activities based on the reporting requirements outlined in the policy.
- Maintaining a list of approved foreign exchange trading lines and approved counterparties.

Role of the Regional Treasury

Regional treasury center responsibilities should include:

- Responsibilities similar to those of corporate treasury staff.
- Foreign currency exposure forecasting.
- Coordination with corporate treasury.

Role of the Affiliate and Subsidiary Finance Managers

Affiliate and subsidiary finance managers' responsibilities should include:

- Identifying economic, transaction and translation exposures.
- Reporting foreign currency exposure forecasts to corporate treasury.
- Reporting actual exposure information to treasury and explaining any variances.
- Recording all necessary accounting entries related to the entity's transactions.
- Communicating any extraordinary events in the entity's marketplace.

Role of Corporate Accounting

Corporate accounting responsibilities should include:

- Recording treasury transactions.
- Managing financial/Securities and Exchange Commission (SEC) reporting.
- Providing pro-forma financial disclosure of foreign currency transactions under consideration.
- Providing information and counsel on accounting guidelines relating to foreign currency.

Role of Corporate Tax

Corporate tax responsibilities should include:

- Assistance in development of strategy.

Role of Internal Audit

Internal audit responsibilities should include:

- Monitoring and auditing treasury group's operations, reporting and systems.
- Reviewing compliance with the policy.
- Reporting findings to audit committee.

Exposure Identification

A formal definition of the types of foreign exposure the company faces should be included in the foreign currency policy. Exposure identification provides for consistent organizational definition of exposures and the ability to support foreign currency management strategies by exposure types. Following are definitions of some key foreign currency exposure types.

Transaction Exposure:

Transaction exposure involves the actual conversion or exchange of one currency for another and typically arises when a product or service is sold or purchased in a foreign currency (intercompany and third party).

Explicit exposure arises after a sale, purchase or other transaction has occurred, and is a result of a non-functional currency asset or liability recorded on a company's balance sheet. The associated gain or loss is explicitly stated in the company's accounting records. This exposure is subject to mark-to-market accounting and the currency impact is ultimately reported in the income statement.

Implicit exposure comprises both anticipated transactions, such as projected sales, and firm commitments arising from signed contracts. An implicit exposure's impact is embedded in a company's sales, cost of goods sold and expenses, and is generally not directly disclosed in the accounting records.

Translation or Balance Sheet Exposure:

Translation exposure arises from converting the financial statements of an affiliated entity from the local operating currency to the parent company's base currency for reporting. The resulting gain or loss from this translation is reported in the cumulative translation adjustment (CTA), which is in the stockholders' equity section on the balance sheet.

Economic or Operating Exposure:

Economic exposure is embedded in the net sales revenue, costs and expenses (and cash flow) of the company. It can be further influenced by the company's ability to command a price for its product in the marketplace and retain its market share, as well as the competition's response to changes in exchange rates. The impact is implicit in the company's overall profitability/net cash flow.

Exposure Measurement

This section provides an outline of key components of foreign currency exposure measurement, which should be incorporated in the policy. Measuring exposures allows a company to understand the magnitude and materiality of risk and to identify the potential financial statement impact of foreign currency volatility.

Parties Responsible for Measuring Exposures

Treasury will typically be responsible for reviewing the company's annual budgets, long-term strategic business plans, anticipated cash flow information, and forecasts of future revenues in order to assess the company's exposure to foreign currency risk and determine whether the risk should be managed. Treasury should define and quantify its risk profile in the policy operating guidelines, as well as recommend appropriate foreign currency hedging strategies within the company's agreed upon risk-tolerance levels. However, while treasury monitors overall exposures, affiliates and subsidiaries should play an integral role in collecting, and transmitting data and assuring its integrity.

Use of Foreign Exchange Rates

A foreign currency policy should establish responsibilities for determining and communicating foreign exchange rates to be used for business planning, forecasting, intercompany billing, investment analysis, and currency choice in sales and procurement. Typically, treasury's role in the use of foreign exchange rates involves:

- Forecasting, hedging and setting intercompany billing rates, in accordance with methodology approved by senior management
- Reviewing, modifying and issuing all foreign exchange rate forecasts

Data Requirements and Sources

The policy should state which systems will be used to track, manage and value the derivatives and the underlying business exposures being hedged. Such systems typically have interfaces to pricing vendors in order to retrieve market rates and prices, and to make it possible to mark to market the instruments in the portfolio(s).

Timing and Frequency of Data Delivery

Exposure data should be updated on a regular basis

— at the very least quarterly or whenever there is a major change in exposure. The policy should indicate deadlines for receiving exposure data from affiliates and subsidiaries. In interim periods, treasury should be notified of any significant changes in exposure.

Risk Measurement Tools

The policy should specify the risk measurement tools treasury will use to measure foreign currency exposure. Companies engaged in active foreign currency risk management usually employ a combination of risk measures — such as mark-to-market, value-at-risk, sensitivity analysis and stress testing — depending on their level of sophistication in risk measurement techniques and methodology.

- **Value-at-risk (VaR).** VaR is a measure that represents the maximum expected loss of a portfolio value from adverse market movement within a specified confidence interval level. VaR is usually used to manage portfolio exposures to specific VaR limits set by the company, or as a general risk measure to evaluate future earnings at risk.
- **Stress testing.** Stress tests, such as plus-or-minus 10 percent currency movements and non-parallel shifts in the forward curve, are commonly used in addition to VaR analysis
- **Scenario analysis.** Scenario analysis — e.g., specific market crisis scenario — in conjunction with the parallel or non-parallel shifts in the yield curves used in stress testing, is useful to assess the potential impact of foreign currency volatility on the portfolio.

Foreign Currency Risk Management Program Guidelines

A well-developed foreign currency risk management program will include:

- Risk management strategy by exposure type.
- Approved hedging instruments by exposure type.
- Approved coverage levels and exposure horizons.

Within the foreign currency program framework, strategies may differ by affiliate and/or subsidiary, exposure type, timing and risk appetite.

Strategy by Exposure Type

The policy should specify 1) which exposure types are required to be fully or partially hedged, and 2) the percentage of each exposure type required to be hedged. It is likely that a company may have hedging strategy guidelines that vary by exposure type. This can be attributable to differing impacts on financial statements. The following are examples of strategies for transaction and economic exposures.

Transaction Exposures

Company XYZ's policy will be to hedge a minimum of X percent and a maximum of Y percent of all identified transaction exposures upon their being recognized on the balance sheet. Hedging transaction exposures will apply only to currency pairs that have a quarterly exposure of at least $XXX,XXX or an annual exposure of at least $X,XXX,XXX.

Economic Exposures

The company's identified economic exposures shall be hedged prior to the start of the forecasted time horizon, as follows:

- With maturity through the end of the first quarter, X percent to Y percent of the net economic exposures identified shall be hedged.
- Second quarter, X percent to Y percent of the net economic exposures identified shall be hedged.
- Third quarter, X percent to Y percent of the net economic exposures identified shall be hedged.
- Fourth quarter — Unhedged.
- Once hedges are placed in accordance with the above criteria, subsequent increases or reductions must be made in such manner that the remaining hedge positions do not exceed 100 percent of the revised exposure.

Translation Exposures

Most companies do not hedge translation exposures.

However, if a company decides to do so within its foreign currency management program, the policy should reflect what is to be hedged and the allocation.

Approval of Hedging Instruments

Incorporated in the policy should be a listing of pre-approved hedging instruments. For each hedging strategy, the appropriate instrument should be identified and the policy should clearly indicate how the instrument is to be used. In addition, the policy should outline a procedure for obtaining approval to use new instruments. Some of the instruments that may be included in a policy are:

- Foreign exchange spot contracts
- Foreign exchange forward contracts
- Futures
- Swaps
- Options

Process for Obtaining Approval for New or "Exotic" Instruments

The foreign currency risk management policy should explain the procedure for adding new foreign exchange instruments to the policy, as well as for obtaining approval for more complex derivative instruments.

As a general rule, the use of "exotic" instruments not authorized by the foreign currency risk management policy should require advance review by the tax, legal and accounting groups, and the approval of the risk management committee or the chief financial officer.

As a general rule, prior to entering into any type of derivative contract, a company should be able to value the instrument being considered in order to understand how it will behave under a variety of market scenarios.

Exposure Hedging Horizon

A company's hedging horizon will be based on several factors, including forecast accuracy, the ability of the company to change pricing to incorporate foreign currency rate movements, competitor hedging practices, how hedging costs change over time and the period of time during which the company may want to protect forecasted income and cash flow.

A company's foreign currency risk management process should actively capture and manage exposures for the specified time horizon. Exposures should be periodically updated based on received exposure forecasts.

The hedging time horizon for exposures should be specified in the policy. The time horizons for hedging these exposures are largely company-specific, but typically are 12 to 24 months, depending on the company's hedging needs. Companies that are able to generate reliable exposure forecasts tend to have longer hedging time horizons, as do those that have long product sales lead times or narrow product margins.

Statement on Speculation

Regardless of a company's risk appetite, treasury should monitor forward foreign exchange and interest rate forecasts in light of macro- and micro-economic factors and their impact on the forward foreign currency curves in order to ascertain where foreign currency rates may be moving (e.g., in one month, in three months, in one year and beyond).

Apart from treasury's role in monitoring foreign exchange and interest rate movements, the policy should clearly specify whether treasury is permitted to engage in speculative foreign exchange transactions. Most companies explicitly allow foreign currency risk management to include hedging the underlying financial exposure, but prohibit speculation or active trading in foreign currency spot/forward or derivative instruments. However, some companies may have a more aggressive risk appetite and will choose to speculate. In any case, the policy should clearly state whether speculative foreign exchange transactions are permitted and, if so, should specify the foreign currencies and instruments that are authorized.

Foreign Currency Risk Management Process Controls

This section introduces operating guidelines for controls of foreign currency risk management. It is not meant to be a procedures manual, but rather to provide guidance for companies in implementing proper controls and parameters when executing transactions. The guidelines are best practices that emphasize key activities and controls that are highly recommended if a policy is to be effective.

Authorization to Enter into Foreign Currency Transactions

The policy should include a listing of treasury personnel authorized to enter into foreign currency transactions on behalf of the company. The list of approved individuals and level of authorization should be updated regularly to ensure that changes in staffing are included.

Transaction Limits

The policy should explicitly specify the transaction size and maturity limits for all foreign currency transactions. The following example provides some guidelines:

- Individual hedge transactions, excluding spot, forwards and futures, cannot exceed a U.S. dollar amount of $X million without board approval.
- Individual hedge transactions, excluding spot, forwards and options, cannot extend beyond X number of days from trade date without board approval.
- Spot, forward and options hedge transactions cannot exceed a U.S. dollar amount of $XXX or X number of days from the trade date without approval from the CFO or treasurer.

Segregation of Duties

From a control perspective, key treasury functions must be adequately segregated to prevent possible fraud, operational errors, misappropriation of funds, unauthorized deals, concealment of trades and profit/loss manipulation. As a general rule, personnel involved in risk monitoring should be segregated from risk taking (i.e., executing transactions). See Exhibit 3.

EXHIBIT 3

Segregation of Duties

Activity to be Performed	Segregation Level
Trade Execution	Personnel who are authorized to execute transactions should not be in a position to confirm and settle the trades. Neither should they be allowed to mark-to-market the positions or conduct account reconciliation activities.
Trade Confirmation	Personnel who conduct confirmations should not be authorized to execute transactions.
Settlement – Disbursing and Receiving Funds	Personnel who handle cash settlement on transactions should not be authorized to execute transactions. *Best practices recommend using nostro accounts and net settlement when possible if the trading volume is relatively large.*
Mark-to-Market Positions	Valuation and mark-to-market of position, as well as reporting, must be segregated from trade execution.
Account Reconciliation	Account reconciliation activities must be segregated from trade executiuon activities.

Approved Counterparties

The purpose of this section is to set guidelines for reducing counterparty concentration exposure and credit risk. A company should maintain a list of approved brokers/dealers and initiate hedging activity only with brokers/dealers who meet credit rating requirements at the time of initiation and within the appropriate concentration limit.

Credit/Exposure Limits

A company must establish a minimum acceptable credit rating for approved counterparties provided by a reputable rating agency, (e.g., S & P, Moody's, Fitch). The policy should also set a maximum exposure limit to any one counterparty that is not to exceed a specified dollar amount. Limits should be set and monitored with consideration given to credit exposure across the entire relationship.

Periodic Evaluation/Monitoring Procedures

The maximum concentration limit for each counterparty should be established by the risk management committee or CFO. Treasury should also be responsible for reviewing the credit rating of each counterparty prior to establishing trading limits with the counterparty. Treasury also should monitor current counterparty exposures and report them to senior management on a monthly or quarterly basis.

Procedures for Changing Authorized Brokers/Dealers

The list of authorized credit parties should be maintained and updated by treasury upon approval by the risk management committee or CFO.

Accounting and Disclosure

This section pertains to all foreign exchange hedging transactions that occur on behalf of a company and provides an overview of the requirements for, and disclosure of, hedging instruments in accordance with generally accepted accounting principles (GAAP) and SEC requirements. In addition to a foreign currency risk management policy, companies may maintain a separate accounting policy that provides the accounting guidelines for foreign currency-related activity.

The accounting and related disclosures arising from a company's foreign exchange activity and derivative transactions can be quite complicated. For a typical corporate treasury, three areas of the accounting literature and SEC pronouncements (discussed in detail in Appendix B) will be of particular interest. Financial Accounting Standard (FAS) 52 and FAS 133 cover the GAAP in the area of foreign exchange. Disclosure requirements for foreign exchange activity are addressed in the SEC's Financial Reporting Release (FRR) 48. Any foreign currency risk management policy should be prepared in accordance with these standards to ensure the consistent recording and disclosure of hedging instruments required by GAAP and the SEC.

Performance Management Reporting

Performance management reporting is an important component of an effective foreign currency risk management program. Performance management reporting should serve as a measure of whether the program's objectives are being met and the adequacy of the hedging strategy being used. When developing a performance management reporting package, the following should be assured:

- Performance reporting and the company's overall business strategy are clearly linked.
- Program benchmarks are directly linked to the program objectives and hedging strategies used.
- Information conveyed in management reporting supports decision-making by senior management.

A list of the standard management reports for the foreign currency program should be incorporated in the policy. In addition, the policy should establish responsibilities and procedures for communicating to treasury and senior management the information needed to effectively monitor and assess the performance of the hedging program. Exhibit 4 lists sample reports that may be included to effectively monitor and assess the performance of the foreign currency risk management program.

EXHIBIT 4

Sample Reports and Distribution

Report	Recipients	Frequency
Consolidated exposure report	Treasurer, CFO	Monthly
Exposure forecast variance	Treasurer, CFO, Affiliate Business Managers	Monthly
Performance report (hedge results vs. benchmark)	Treasurer, CFO, Affiliate Business Managers, Executive Committee	Monthly
Currency trend reports and market intelligence	Treasurer, CFO, Business Managers	Monthly

Appendix A: Sample Foreign Currency Risk Management Policy

Policy Title: *Foreign Currency Risk Management Policy for XYZ Corporation*
Established: *March 1, 2001*
Approved: *Reviewed and approved by board of directors February 16, 2001*
Version 1.0: *Reference Number "Treasury 1.0" of XYZ Corp. Finance Policy Manual*

Sample Policy Overview

The purpose of this sample foreign currency risk management policy is to provide a general overview of the key elements the policy should contain in order to effectively manage a company's foreign currency exposure.

While the sample is generic in nature, it is most representative of a medium-sized corporation that has a treasurer, treasury manager and supporting treasury staff. In addition, in this sample policy the company's audit committee serves in place of a risk management committee. Although a risk management committee is typically best practice, many companies may not have sufficient staffing and/or activity to justify its existence.

1.0 XYZ Corporation Foreign Currency Risk Management Policy Overview

1.1. Purpose and Scope

The purpose of the foreign currency risk management policy ("the policy") is to provide clear guidance on the foreign currency management functions and the importance of XYZ Corporation's corporate treasury department ("treasury") in the foreign currency management process, as well as the responsibilities of affiliate and subsidiary personnel involved.

This policy will enable treasury to manage foreign currency exposures on a company-wide basis and facilitate the communication of new and/or revised policies adopted by treasury. The policy will also serve as a tool for training new employees in the approved policies for foreign currency risk management.

This policy is applicable to all employees of XYZ who have responsibility for or interactions with foreign currency risk management activities.

1.2. Organization of the Policy

This policy consists of two sections. Section 1 contains an overview of the policy and guidelines for its maintenance and distribution. Section 2 sets forth the fundamental foreign currency guidelines for managing XYZ's foreign currency risk.

1.3. Distribution of the Policy

The policy shall be distributed to all subsidiaries and affiliates of XYZ Corporation in accordance with the guidelines that have been set by the treasurer. The policy shall not be made available to individuals outside XYZ without written authorization by the treasurer.

1.4. Roles and Responsibilities in Managing and Distributing the Foreign Currency Risk Management Policy

Exhibit 1.4 outlines the roles and responsibilities of all parties involved in the management and distribution of the policy.

1.5 Guidelines for Policy Compliance and Effectiveness

1.5.1. Compliance

As custodian of the policy, XYZ's treasury is responsible for ensuring that foreign currency management activities adhere to the policy. Internal audit

EXHIBIT 1.4

XYZ Policy Role & Responsibility Matrix

ROLE: **Board of Directors**

- Review and provide final approval of the foreign currency risk management policy.
- Review and approve any amendments to operating parameters, permissible instruments and limits.

ROLE: **CFO**

- Review and approve the foreign currency risk management policy.
- Ensure compliance with the policy.

ROLE: **Treasurer**

- Play lead role in the generation of the policy and act as overall custodian.
- Monitor compliance with the policy.
- Initiate changes to policy as appropriate.
- Distribute policy.

ROLE: **Treasury Staff**

- Monitor foreign currency activity for compliance with the policy.

ROLE: **Affiliates/Subsidiaries**

- Ensure business unit compliance.

ROLE: **Internal/External Audit**

- Ensure compliance with the policy.

also will review foreign currency risk management activity annually to ensure compliance with the policy by treasury and the affiliates and subsidiaries of XYZ. The findings of the review will be formally documented and circulated to senior management.

1.5.2 Amendments, Policy Updates and Revisions

The treasurer and CFO will review the policy annually, or more frequently as required, to ensure the continued validity of the company's foreign currency risk management program. As a result, modifications to the policy may be needed to accommodate changes in business requirements. Any amendments, policy updates or revisions must be reviewed and approved by the CFO and board of directors (see Exhibit 1.4 for roles and responsibilities). After adoption of modifications to the policy, a revised policy must be distributed to all parties on the approved distribution list.

2.0 XYZ Corporation's Foreign Currency Risk Management Guidelines

2.1. Risk Management Philosophy and Foreign Currency Risk Management Program Objectives

XYZ Corporation's hedging policy maintains a risk-averse profile. The approach to financial risk management is designed to enhance shareholder value and support the company's financial performance objectives. These goals are accomplished by:

- Reducing earnings volatility due to movements in the foreign currency markets.
- Limiting the risk of loss in the value of foreign-currency-denominated cash flows.
- Preserving the operating margins of XYZ's foreign entities.

2.2. Foreign Currency Risk Management Program Roles and Responsibilities

Exhibit 2.2 outlines the roles and responsibilities of all parties involved in the foreign currency risk management program.

2.3. Exposure Identification

XYZ defines foreign exchange exposure as the risk of realizing reduced operating cash flow and future earnings resulting from movement in foreign exchange rates. The exposures hedged under the policy are limited to transaction and economic exposures. Following are definitions and examples of each exposure type that may be hedged under the policy.

2.3.1. Transaction Exposure

Definition:

Transaction exposure involves the actual conversion or exchange of one currency for another and typically arises when product or service is sold or purchased in a foreign currency (intercompany and third party):

Explicit exposure arises after a sale, purchase or other transaction has occurred and is a result of a non-functional currency asset or liability recorded on a company's balance sheet. The associated gain/(loss) is explicitly stated in the company's accounting records. This exposure is subject to mark-to-market accounting and the currency impact is ultimately reported in the income statement.

Implicit exposure comprises both anticipated transactions, such as projected sales, and firm commitments arising from signed contracts. An implicit exposure's impact is embedded in a company's sales, cost of goods sold and expenses, and is generally not directly disclosed in the accounting records.

EXHIBIT 2.2

Roles and Responsibilities of all Parties Involved in Foreign Currency Risk Management Programs

Role	Responsibilities	Frequency
Board of Directors	• Monitor the performance of the foreign currency risk management program and risk levels.	Quarterly
	• Review and provide final approval of the foreign currency risk management policy.	Annually
	• Review and approve any amendments to operating parameters, permissible instruments and limits.	Quarterly
Audit Committee	• Monitor and review foreign currency risk management policy, strategy and performance.	Quarterly
	• Report on foreign exchange controls.	Annually
CFO	• Review and approve the foreign currency risk management strategy and acceptable risk tolerance levels.	Ongoing
	• Make recommendations to the board of directors.	As Needed
	• Review and monitor noncompliance.	Ongoing
	• Communicate the foreign currency risk management program to the investment community.	Ongoing
	• Ensure compliance with the policy.	Ongoing
Treasury	• Manage exposures under the policy guidelines.	Ongoing
	• Work with affiliates to identify foreign currency exposures, set risk limits and develop hedging strategies.	Ongoing
	• Consolidate exposure information and disseminate company-wide exposure profile.	Monthly
	• Provide recommendations for the program.	Ongoing
	• Perform performance review and distribute management reporting.	Monthly
	• Monitor and report on foreign exchange controls.	Ongoing
	• Manage overall relationships with financial institutions, including commercial and investment banks.	Ongoing
Affiliates	• Identify transaction and economic exposures.	Quarterly
	• Forecast foreign currency exposures to treasury.	Monthly
	• Report actual exposure information to treasury and explain variances.	Monthly
	• Perform all necessary accounting entries related to their entity's transactions.	Monthly
	• Communicate any extraordinary events in their entity's marketplace to treasury.	Ongoing

2.3.2. Economic Exposure

Definition:

Economic exposure is embedded in the net sales revenue, costs, expenses and cash flow of the company and can be further influenced by the company's ability to command a price for its product in the marketplace and retain its market share, as well as the competition's response to changes in exchange rates. The impact is implicit in the company's overall profitability/net cash flow and includes such items as "linked" currency exposures.

2.4. Exposure Measurement

Measuring exposures allows XYZ to understand the magnitude and materiality of risk and to identify the potential impact of foreign currency volatility on the financial statement.

2.4.1. Parties Responsible for Measuring Exposures

Treasury is responsible for reviewing the company's annual budgets, long-term strategic business plans, anticipated cash flow information and forecasts of future revenues to assess the company's exposure to foreign currency risks. This review is needed to determine whether action is required to protect the company from potential adverse movements in foreign exchange rates. Treasury is responsible for monitoring overall exposures; affiliates and subsidiaries have the responsibility for collecting and transmitting data and ensuring its integrity.

2.4.2. Foreign Currency Exposure Reporting

In order to manage exposure risks effectively, treasury will obtain reliable and timely information regarding both the economic and transaction foreign currency exposures. This policy establishes responsibilities and procedures for communication of information necessary for the effective management of foreign exchange exposures. At the beginning of each fiscal year treasury will distribute the timetable of exposure reporting deadlines. (See Exhibit 2.4.)

EXHIBIT 2.4

Summary of Exposure Reporting

Exposure	Data Requirements	Source	Frequency
Economic	Economic exposures in local currency	Business Plan	Quarterly
Transaction	Third-party exposures	Subsidiaries	Quarterly

- **Economic:** Economic exposure reporting will be based on data obtained from the business plan. The data must be reported in local currency by entity. Treasury will use this information to calculate monthly economic exposure and to link economic and transaction exposures for hedging and reporting purposes.
- **Transaction:** Individual subsidiaries will be responsible for the timely dispatch to treasury of information regarding third-party exposures.

2.4.3. Use of Foreign Exchange Rates

Corporate treasury is responsible for reviewing, modifying and issuing all foreign exchange rate forecasts used for profit planning, as well as any rates used internally (e.g., accounting rates). Treasury's role in the use of foreign exchange rates should reflect the following:

- Forecast, hedge and intercompany billing rates should be set by treasury, using methodology approved by senior management
- All foreign currency accounting rates will be provided by treasury
- Treasury is responsible for reviewing, modifying and issuing all foreign exchange rate forecasts

2.4.4. Data Requirements and Sources

Under the guidelines of this policy, treasury will use ABC system as the source of all market data related to pricing derivatives.

2.4.5. Timing/Frequency of Data Delivery

Exposure data should be updated quarterly or any time there is a major change in exposure. Affiliates and subsidiaries should notify treasury immediately of any significant changes in exposure.

2.5. Foreign Currency Risk Management Program Guidelines

The primary objective of XYZ's foreign currency risk management program is to minimize the impact of foreign currency movements on its foreign-denominated cash flows and earnings. Due to the fact that more than 45 percent of XYZ's operations are based overseas, it is critical that XYZ develop and maintain an effective foreign currency risk management program.

2.5.1. Strategy by Exposure Type

The hedge amounts will be identified based on the exposure forecasts received from XYZ's entities. Hedge percentages must be calculated for a total fiscal year, or for the remainder of the current fiscal year. Hedge coverage and exposures are calculated in local currencies and both are converted into dollars at the current spot exchange rate. The following provides hedge strategy guidelines for transaction and economic exposures.

Transaction Exposures:

Forward or option contracts may be used to hedge the company's transaction exposures. XYZ's policy will be to hedge a minimum of 60 percent and a maximum of 100 percent of all identified transaction exposures that are recognized on the balance sheet, or deemed as firm commitments. Hedging transaction exposures will apply only to currency pairs that have a quarterly exposure of at least $250,000 or an annual exposure of at least $1 million.

Economic Exposures:

Option contracts will be used exclusively to hedge the company's economic exposures. Identified economic exposures shall be hedged prior to the start of the forecast year as follows:

- With maturity through the end of the first quarter, 50 percent to 80 percent of the net economic exposures identified shall be hedged.
- Second quarter, 40 percent to 80 percent of the net economic exposures identified shall be hedged.
- Third quarter, 25 percent to 80 percent of the net economic exposures identified shall be hedged.
- Fourth quarter – Unhedged.

Once economic hedges are placed in accordance with the above criteria, subsequent increases or reductions in the hedges must be made in such a way that the remaining hedge positions do not exceed 100 percent of the revised exposure.

Translation Exposures:

Unlike economic and transaction exposure, treasury is not authorized to hedge translation exposure without the consent of the CFO and board of directors.

2.5.2. Exposure Hedging Horizon

Treasury is responsible for actively capturing and managing its exposures for a period of not less than one year. Exposures will be periodically updated based on received exposure forecasts and will be tracked on a rolling 12-month basis. The infrastructure for conducting the forecasting process is at the discretion of treasury.

2.6. Authorized Foreign Exchange Hedging Instruments

As a general rule, speculative foreign exchange transactions are prohibited. Treasury may use the instruments listed in Exhibit 2.6 to hedge foreign currency exposures. If treasury seeks to utilize any instruments not explicitly listed, the procedure for amending/revising the policy must be followed.

EXHIBIT 2.6

Instruments Used to Hedge Foreign Currency Exposures

Instrument	Authorized Activities	Definition
Foreign Exchange Forward Contracts	• Transaction hedging program	Forward contracts will be used to hedge the company's transaction exposures. A forward contract is defined as an agreement to accept or make delivery of the specified currency at a specified future date, for a specified amount, and for an exchange rate determined at the inception of the contract (the outright or forward contract rate) transacted directly with a counterparty.
Foreign Exchange Put or Call Option Contracts	• Transaction hedging program • Economic hedging program	Option contracts may be used to hedge transaction and economic exposures. An option contract is defined as the purchase of an agreement by which the holder has the right but not the obligation to sell/buy a currency at a specified exchange rate (strike), on a specified date (delivery date) for a specified premium to be paid on a specified date. XYZ may purchase either European or American options. These contracts are over-the-counter agreements with a third-party financial institution.

2.7. Controls

2.7.1. Authorization to Execute Foreign Exchange Transactions

The authorizations outlined in Exhibit 2.7 are established to provide segregation of duties and to ensure proper approval of hedging activities. The treasurer will maintain the authorization list. The CFO shall review and approve the authorizations at least annually.

EXHIBIT 2.7

Authorization List for Hedging Activities

Role	Responsibility
Treasurer	Authorize, approve and execute trades ($5M and less)
Treasury Manager	Execute trades ($5M and less)
Senior Treasury Analyst	Trade confirmation and settlement
Treasury Analyst	Valuation and reconcilement

2.7.2 Transaction Size and Maturity Limits

The following guidelines should also be observed with respect to transaction size and maturity limits:

- Individual hedge transactions may not exceed a U.S. dollar amount of $5 million or extend more than 12 months from trade date without approval by the board of directors.

- Individual hedge transactions may not exceed a U.S. dollar amount of $100,000 or extend more than 30 days from trade date without approval by the treasurer or CFO.

2.7.3. Approved Counterparties

This section provides guidelines on managing counterparty concentration exposure and credit risk. Treasury shall maintain a list of approved counterparties for foreign exchange activities. Guidelines for approved counterparties are as follows:

- Treasury is authorized to initiate hedging transactions with counterparties that meet the minimum acceptable credit ratings at the time of initiation without exceeding the maximum concentration per counterparty.

EXHIBIT 2.7.3

Approved Counterparties

Financial Institution	Maximum Exposure	S&P	Moody's	Review Date
Bank A	$5,000,000	A+	A	3/00
Bank B	$5,000,000	A+	A	3/00
Bank C	$3,000,000	A	A	4/00

EXHIBIT 2.7.4

Responsibility for Market Risk Analysis

Role	Responsibility	Frequency
CFO, Controller, and Treasurer	Determine market risk analysis method	Annually
CFO and Treasurer	Review market risk analysis	Monthly
Treasury Staff	Perform market risk analysis	Monthly

EXHIBIT 2.9

Treasury Performance Reporting Package

Report	Recipients	Frequency
Transaction Hedge Balance Analysis	Treasurer	Weekly
Economic Hedge Balance Analysis	Treasurer	Weekly
Consolidated Exposure Report	Treasurer, CFO, Affiliate Business Managers, Executive Committee, Audit Committee	Monthly
Exposure Forecast Variance	Treasurer, CFO, Affiliate Business Managers	Monthly
Performance Report (hedge analysis vs. budget)	Treasurer, CFO, Affiliate Business Managers, Executive Committee	Monthly
Currency Trend Reports and Market Intelligence	Treasurer, CFO, Affiliate Business Managers	Monthly

- Minimum counterparty credit rating of A by S&P or Moody's.
- Maximum exposure to any one counterparty not to exceed $10 million.
- The treasurer is responsible for reviewing the credit rating of each counterparty prior to establishing trading limits with the counterparty. The treasurer shall also monitor and report on current counterparty exposures to the board of directors at least once annually.
- Any exceptions must be approved by the CFO.

Approved counterparties are listed in Exhibit 2.7.3.

2.7.4. Market Risk Limits

Treasury is responsible for performing market risk analysis of XYZ's hedging instrument portfolio (see Exhibit 2.7.4). Under the guidelines of this policy, treasury has the discretion to use any one of the following methods to assess market risk:

- Value-at-Risk (VaR)
- Earnings-at-Risk (EaR)
- Stress testing
- Scenario analysis

2.8. Accounting and Disclosure

Accounting and disclosure requirements for foreign exchange and derivative activities are established and maintained in the XYZ corporate accounting policy manual.

2.9. Performance Management Reporting

To monitor the effectiveness of XYZ's foreign currency risk management program, treasury shall distribute reports periodically to the CFO, treasurer, executive committee and audit committee.

Exhibit 2.9 specifies the reports to be distributed with respect to the foreign currency risk management program, the recipients of each report and the frequency of distribution.

Appendix B: Relevant Accounting and Disclosure Requirements

The following sections describe the relevant accounting and disclosure requirements that may be addressed in a company's foreign currency risk management policy or its accounting policy. These sections are not intended to serve as accounting advice or guidance. Readers of this document should work closely with their internal accounting experts and external auditors to determine the appropriate way to account for foreign exchange transactions. It should also be noted that although this accounting overview is valid at the time of writing, there may be subsequent changes in the standards and interpretations.

FAS 52 – Foreign Currency Translation

Financial Accounting Standard No. 52 (FAS 52), Foreign Currency Translation, provides accounting and reporting standards for both the foreign currency transactions of a reporting entity and the translation of foreign currency financial statements by consolidation, combination or the equity method of accounting under U.S. GAAP. The objectives of FAS 52 are to:

- Provide information that is generally compatible with the expected economic effects of a foreign currency rate change on an enterprise's cash flows and equity.
- Reflect in consolidated financial statements the financial results and relationships measured in the primary currency in which each entity conducts its business (i.e., the "functional currency"). The effect of translation should therefore be to preserve the financial statement ratios as measured in the functional currency statements.

Foreign Currency Approach

Before translation to U.S. dollars, the local currency financial statements must be expressed in the entity's functional currency. The functional currency of an entity is the primary currency of the environment in which it operates. This is normally the environment in which an entity primarily generates and expends cash. Ordinarily, the functional currency is the currency of the country in which the entity is located, but it may also be a foreign currency or the reporting currency of the parent.

The requirement to identify each entity's functional currency is the initial and key feature of FAS 52, affecting the translation process and thereby the reported results and the treatment of exchange gains and losses. FAS 52 provides extensive guidance about how to determine an entity's functional currency.

Translation of Foreign Currency Financial Statements

The purpose of translation is to state foreign currency financial statements in terms of a single reporting currency. The exact procedure for translating an entity's financial statements depends on two factors:

- The functional currency designation for that entity.
- Whether its books and records are maintained in its functional currency.

The two basic methods of translation are the current rate method and the monetary/non-monetary method ("re-measurement"). The basic difference between the two methods lies in which foreign exchange rates are used to translate specific financial statement items and how resulting exchange gains and losses are reflected in the financial statements. FAS 52 provides further insight into each method, and how to determine which is appropriate given the functional currency and the currency in which the entity keeps its books.

Foreign Currency Transactions and Balances

FAS 52 defines foreign currency transactions as "transactions denominated in a currency other than the entity's functional currency." Exchange gains and losses on foreign currency transactions and balances may result from a change in exchange rates between the transaction date and the settlement date. These exchange gains and losses generally should be included in income.

Exchange Rates

FAS 52 contains the following provisions for using exchange rates in translating foreign currency financial statements or foreign currency transactions:

- The rate used in translating a particular foreign currency transaction should be the rate at which that transaction could be settled at that transaction date.
- When translating a foreign entity's income statement, an appropriate weighted average rate for the period can be used.
- When translating a foreign currency balance sheet, accounts should be translated using the current rate at the balance sheet date.

Disclosure Requirements

FAS 52 also requires disclosure of certain items, including:

- The aggregate transaction exchange gain or loss included in determining net income, including gains or losses related to forward exchange contracts.
- A reconciliation of the translation adjustment account including the beginning and ending amount of the cumulative translation adjustment (CTA), the aggregate adjustment for the period resulting from translation adjustments and gains and losses from hedging transactions.

SEC Derivative and Market Risk Disclosures

In response to the concerns of investors about the adequacy of disclosures about derivatives activities and the risk inherent in those activities, the Securities and Exchange Commission (SEC) issued Financial Reporting Release No. 48 (FRR 48), "Disclosure of Quantitative and Qualitative Information about Market Risk." In general, FRR 48 requires enhanced descriptions of accounting policies for derivatives, and both qualitative and quantitative disclosures about market risk inherent in derivatives and other financial instruments outside the financial statements (i.e., off-balance-sheet).

Disclosure of Accounting Policies

To facilitate a more informed assessment of the effects of derivatives on financial statements, FRR 48 requires comprehensive descriptions of the accounting policies used to account for derivatives, including a description of:

- Each method used to account for derivatives.
- The criteria to be met for the accounting method used, such as the criteria to be met to use accrual accounting for interest rate swaps.

Quantitative Disclosures about Market Risk

To allow investors to assess the magnitude of market risk, FRR 48 requires registrants to provide quantitative disclosures outside the financial statements covering market risk of market-risk-sensitive instruments. Registrants may choose any one of the following three disclosure alternatives:

- Tabular presentation of fair value information and contract terms relevant to determining future cash flows.
- Sensitivity analysis expressing the potential loss in future earnings, cash flow or fair value of market-risk-sensitive instruments due to hypothetical changes in interest rates and other relevant market rates or prices.
- Value at Risk (VaR) disclosures expressing the potential loss in future earnings, fair values or cash flows from market movements with a selected likelihood of occurrence.

Qualitative Disclosure about Market Risk

FRR 48 further requires registrants to offer qualitative disclosures about market risk to help users of the disclosure better understand the context of the quantitative disclosures. Key disclosure requirements include information about:

- The registrants' primary market risk exposures.
- How those exposures are managed (e.g., description of objectives, strategies, instruments used).

FAS 133 – Accounting for Derivative Instruments and Hedging Activities

FAS 133, "Accounting for Derivative Instruments and Hedging Activities," is a new, comprehensive accounting standard that provides uniform rules on how companies are to account for their derivative and hedging activity. All companies preparing financial statements using GAAP must adopt FAS 133 by the beginning of the first fiscal year commencing after June 15, 2000. Much like FRR 48, FAS 133 was issued in response to concerns that there was general inconsistency and inadequacy in the ways in which companies accounted for and disclosed derivative activity. Concerned about hidden losses from off-balance-sheet instruments, the Financial Accounting Standards Board (FASB) responded with FAS 133.

FAS 133 differs from previous accounting guidance in four general ways:

- Comprehensive guidance and uniform standards to replace FAS 52, FAS 80 and numerous Emerging Issues Task Force (EITF) consensus opinions and accepted practices.
- All derivatives must be recognized on balance sheet at fair value.
- Offset is either to current earnings or other comprehensive income (OCI) depending on whether the derivative qualifies for hedge accounting and its specific hedge designation type.
- Derivatives must meet specific criteria to apply hedge accounting.

Two aspects of FAS 133 mark a notable departure from previous practice in the foreign currency area: a) an entity's ability to hedge forecast transactions with foreign-currency forward contracts or combination options; and b) an entity's ability to hedge with a tandem currency (proxy hedging) provided that hedge effectiveness (see below) can be demonstrated.

FAS 133 is a very complicated standard and, as of this writing, the exact requirements of the standard and its implementation are not finalized. However, it is clear that FAS 133 will be an important issue for any end-user of derivatives and may require significant changes in how corporate treasuries manage their organizations' risks both from a strategic and operational perspective. It is important that treasurers work closely with their internal accounting staff and external auditors to ensure that they are in compliance with the requirements of FAS 133.

Scope

FAS 133 applies to all derivatives. The standard contains a detailed definition of what is and what is not a derivative instrument. Derivatives are contracts that contain:

- One or more underlyings (e.g., exchange rate, interest rate).
- One or more notional amounts or payment provisions (e.g., a defined quantity such as 100 million yen).
- Minimal initial net investment or none.
- A net settlement provision (e.g., the ability to settle net via a mechanism such as an exchange).

Derivative instruments include such common items as forward contracts, options and futures, but may also apply to more traditional commercial arrangements such as procurement contracts. FAS 133 and the related interpretations provide more detail on how to identify derivatives.

Recognition and Measurement of Derivatives

FAS 133 requires that all derivatives be recognized on the balance sheet and measured, initially and subsequently, at fair value. This applies regardless of whether or not the derivative is designated as a hedge. The income statement recognition of changes in the fair value of a derivative will depend on the intended use of the derivative. If the derivative does not qualify as a hedging instrument, or is not designated as such, the gain or loss on the derivative must be recognized in current earnings. If the derivative qualifies for hedge accounting, the gain or loss will either:

- Also be recognized in income along with an offsetting adjustment that is made to the basis of the item being hedged.
- Be deferred in OCI, a separate component of equity.

Hedge Designation and General Qualifying Criteria

FAS 133 requires that a particular derivative be designated as a hedging instrument in order to qualify for hedge accounting. The accounting treatment of the derivative will depend on the derivative's purpose and designation. Derivatives can be designated as:

- No hedging relationship — trading
- Fair value hedge
- Cash flow hedge
- Foreign currency hedge

Documentation standards required to qualify for hedge accounting are significantly higher than under previous accounting guidance. Risk managers must document the risk management objectives, strategies and tactics used in hedging financial risk exposures. Specifically, the documentation should identify all hedged items and hedging instruments and show how the derivative will serve to meet the defined objectives.

In addition, risk managers must demonstrate, at hedge initiation and on an ongoing basis, that the hedging instrument is "highly effective" at offsetting the hedged risk. Hedge effectiveness is a measure of the degree to which the hedging instrument serves to meet the defined hedge objectives, or its ability to provide an offset to changes in fair value or cash flow associated with the underlying hedged item.

There are numerous methods of determining hedge effectiveness including the "dollar offset" method, regression analysis or other statistical methods. Even if the "highly effective" standard is met, there may still be some hedge ineffectiveness. This must be measured using the "dollar offset" method and reported in current earnings at least quarterly. Alternatively, if the derivative does not meet the effectiveness requirement, hedge accounting is not allowed and the derivative must be accounted for on a fair value basis.

Types of Hedging Relationships and Associated Accounting

If a foreign currency risk represents an exposure to changes in fair value, it may qualify for hedge accounting as a fair value hedge. With a fair value hedge, changes in fair value of the derivative and the firm commitment are recorded on the balance sheet and simultaneously on the income statement. To the extent that the hedge is effective, gains and losses on derivative instruments should offset gains and losses on the underlying hedged item.

Certain other foreign currency risks qualify for cash flow hedge accounting if the anticipated foreign currency transaction is probable and changes in cash flows associated with the underlying will impact earnings. With cash flow hedge accounting, the hedge results are "deferred" in OCI until the underlying transaction impacts earnings. When the underlying transaction impacts earnings, the associated balance in OCI is reclassified to earnings. As is the case with all types of hedge accounting, to the extent that there is hedge ineffectiveness, this will be recorded in current earnings.

FAS 133 also identifies a foreign currency hedge as a discrete hedging type. Foreign currency hedges can be hedges of the foreign currency exposure of:

- An unrecognized firm commitment (fair value hedge)
- An available-for-sale security (fair value hedge)
- A forecast transaction (cash flow hedge)
- A net investment in a foreign operation.

The accounting for a foreign currency fair value and a foreign currency cash flow hedge follows the same principles that apply to the accounting for non-foreign currency hedges. In a hedge of a net investment in a foreign operation, the gain or loss on the hedging instrument is reported in OCI as part of the cumulative translation adjustment.

Disclosure Requirements

The disclosure requirements of FAS 133 are quite extensive. The standard requires disclosures as follows:

- Qualitative information – the entity's objectives and strategies for holding and issuing derivatives, and a description of the items or transactions for which risks are hedged.
- Quantitative information – the net gain or loss recognized in earnings for the period representing aggregate ineffectiveness for all hedges, and the components of the derivatives' gains or losses excluded from the assessment of hedge effectiveness.
- The standard also requires additional disclosure for cash-flow hedges and hedges of a net investment in a foreign operation, as well as quantitative disclosure for certain "failed" hedges.

Appendix C: Glossary

Active risk management appetite. Within the approved operating parameters, treasury may take a "speculative" approach to foreign currency risk management. The risk/return ratio, in this case, will be quite different from the passive risk profile. While still mitigating foreign currency risk, the company may take active positions based on a particular viewpoint as to currency movements in order to obtain competitive advantage or realize economic gains.

Currency spot contract. An agreement to accept or make delivery of the specified currency at the spot foreign currency rate one or two days from the transaction day.

Currency forward contract. An agreement to accept or make delivery of the specified currency at a specified future date, for a specified amount, and for an exchange rate determined at the inception of the contract (the outright or forward contract rate) transacted directly with a counterparty.

Economic exposure. This is embedded in the net sales revenue, costs, and expenses (and cash flow) of the company and can be further influenced by the company's ability to command a price for its product in the marketplace and retain its market share, as well as by the competition's response to changes in exchange rates. The impact is implicit in the company's overall profitability/net cash flow

Foreign currency swap. The simultaneous purchase of a forward with an offsetting spot transaction. A currency swap agreement requires that a principal amount be specified in each of the two currencies. The principal amounts are usually exchanged at the beginning and at the end of the life of the swap.

Foreign exchange put or call option contract. An agreement by which the holder has the right but not the obligation to sell/buy a currency at a specified exchange rate (strike), on a specified date (delivery date) for a specified premium to be paid on the contract trade date. A company may purchase either European or American options. An American option, such as a call or a put, can be exercised on any business day after purchase through the expiration of the option. This contrasts with a European option, which can only be exercised at the end of its life, on its expiration date. These contracts are considered over-the-counter agreements with a third-party financial institution.

Futures contract. Similar to a forward contract except that it is exchange-traded and is resettled at the close of trading each day. At that time, a new futures price is set that resets the present value of the futures contract to zero, and any difference between the successive futures prices is made as a cash payment between the parties. Therefore, if the futures price rises, the difference is received by the buyer and paid by the seller; if the futures price falls, the difference is received by the seller and paid by the buyer.

Nostro account. A bank account held with a bank in another country, usually in the currency of that country.

Passive risk management appetite. Within the approved operating parameters, treasury acts as a cost or service center to the company to achieve the objective of minimizing foreign currency risk.

Risk management committee. A committee of management representatives of treasury, finance, accounting, tax, legal and business unit operations which has oversight of and actively manages corporate risk.

Scenario analysis. A risk management tool that assesses the potential impact of foreign currency volatility on the portfolio as a result of a specific market crisis scenario.

Stress testing. A risk management tool whereby currency movements and non-parallel shifts in the forward curve are commonly used to assess the potential impact of foreign currency volatility on the portfolio.

Transaction exposure. This involves the actual conversion or exchange of one currency for another and typically arises when product is sold or purchased in a foreign currency (intercompany and third party):

- **Explicit exposure** - This arises after a sale, purchase or other transaction has occurred and is a result of a non-functional currency asset or liability recorded on a company's balance sheet. The associated gain/(loss) is explicitly stated in the company's accounting records. This exposure is subject to mark-to-market accounting and the currency impact is ultimately reported in the income statement.

- **Implicit exposure -** This comprises both anticipated transactions, such as projected sales, and firm commitments arising from signed contracts. An implicit exposure's impact is embedded in a company's sales, cost of goods sold and expenses, and is generally not directly disclosed in the accounting records.

Translation exposure. This arises from converting the financial statements of a functional entity from the local operating currency to the parent company's reporting base currency. The resulting gain/(loss) from this translation is reported in the cumulative translation adjustment (CTA) in the balance sheet's stockholders' equity section.

Value-at-risk (VaR). VaR is a measurement that represents the maximum expected loss of a portfolio value, within a specified confidence interval level, from adverse market movement. VaR is usually used to manage portfolio exposures to specific VaR limits set by the company, or as a general risk measure to evaluate future earnings at risk.