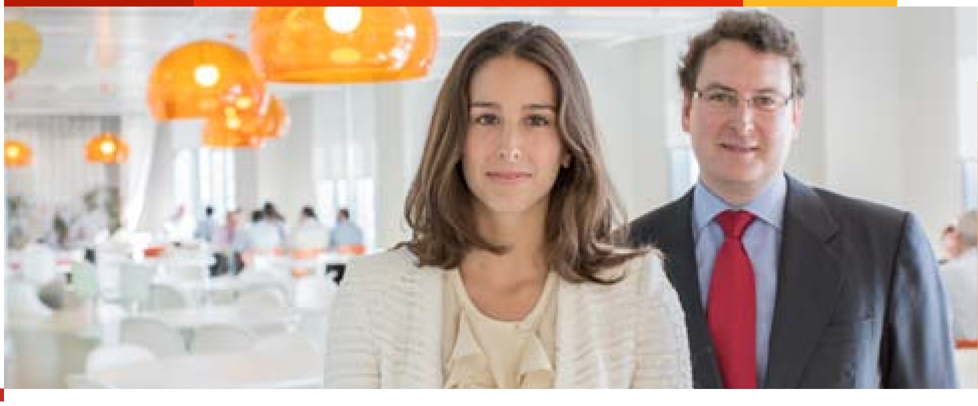
Investor view

Insights from the investment community

Issue 11 - Foreign exchange and hedging



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Giving a clearer picture with improved disclosures of foreign exchange and hedging

Markets have experience significant volatility in foreign exchange with the Indian Rupee depreciating to its all time low. Metal prices are highly unpredictable in recent months due to increasing worry about the impact of slowing economic growth.

Investors want to be able to forecast a business' future cash flows. But they tell us that volatility around foreign currency and hedging makes it challenging for them to disclosure the right information. In this 'Investor view', we look at what improvements to disclosure could be done in this uncertain economic environment that will benefit companies.

What do investors want to know about foreign exchange?

Investors want to understand the extent to which an entity's underlying performance is affected by foreign exchange and any strategy in place to mitigate these risks.

Current financial reporting standards require disclosure of foreign exchange gain and losses being taken through income statement; and only the related derivative losses being booked on account of prudence. Investors tell us that this is not enough.

The foreign exchange information that analysts tell us they are most interested in:

- What are the drivers of the FX gain or loss number reported in the financial statements?
- What are the market risk parameters that are being considered while performing sensitivity analysis?
- Whether FX risk management policy is regulatory compliant in light of changing RBI and other regulatory requirements?
- What are the exposures the entity has to different currencies? And how are they managed?
- What is the entity's approach to managing FX risk? While this is required by IFRS 7 / AS 32, investors tell us management doesn't make the risk management strategy as clear as they would like.
- Was the latest year's FX risk management strategy effective?
- Has management moved production, or made other changes to its business or delivery model, to create a natural FX hedge?

This understanding of the entity's strategy for managing FX exposure gives investors genuine insight into the quality and sustainability of performance.

What do investors want to know about hedging?

Investors want to know about what has been 'economically' hedged. They also need to understand what exposure is being hedged, at what price, in which currency and for how long. They are trying to understand to what extent gains and losses were affected by derivative profits or losses, and how much profit came from maturing hedges versus marked-to-market gains and losses.

They want to know is the current accounting norms of booking losses on derivative based on prudence the real accounting. What about gains? Has the entity adopted AS30 to reflect the economic hedges in accounting with its related disclosures are as per AS 32. Without all this there is never a complete picture as the profits keep on yo-yoing.

How can management improve hedging disclosures?

Many of the items on the investment community's wish-list are already required by accounting standards, but investors tell us management is not explaining these things as clearly as they could.

Management could help investors by making the following clear:

- What are their exposures?
- What has and hasn't been hedged?
- Where has hedge accounting been applied, and what has its effect been?
- In cases where hedge accounting is not applied, how has economic hedging affected the exposures?
- How will gains and losses on derivatives in the income statement match against underlying transactions?
- What are the future cash flows on derivatives?
- Which currencies has debt been swapped from and to?

Current segment reporting is not always helpful

Management might have large exposures in a particular division that are hedged through central treasury. Where segment reporting shows these activities in two different segments, investors do not have a true picture of the entity's results.

Investors are also discouraged that it is hard to link the income statement impact to the cash flow statement.

Contact your local PwC office to discuss these issues and visit:
http://www.pwc.com/in/en/services/IFRS/IFRS-in-India.jhtml
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NJ 348 - July 2012 Investor View 11.indd
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