Wake Up Call

Protecting Your Numbers

My company have a significant loan in USD, manufactures good with 40% local content, and sold the entire products in Rupiah. How should we respond to the current exchange rates volatility?

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A wise man said, "If opportunities or threats arise through events, but you do not respond, then you are not smart. If they arise through a trend, and you do not make a plan, then you are not wise. If they arise from certain conditions, but you do not act anything to those, means you are not brave." In the current situation where Rupiah tend to weakening than other currencies, especially US dollar, companies like yours should immediately act to protect its financial performance from exchange rate risk, that is on its fluctuation. A company needs to protect volatility in earnings by transferring those risks to a third party through hedging.

A company may minimize this exposed risk naturally by preparing items opposed to the items where risks arise. This is referred to as a natural hedge. If the debt is in US dollars, a portion of the cash received in Rupiah shall be converted into US dollars as cash, deposits or other monetary items. Thus, foreign exchange losses result of debt in US dollars will be off-set with foreign exchange gains result of monetary assets in US dollars, and vice versa.

Another way in responding to this risk is by setting up instruments with symmetrical pay-off. These instruments can be either non-derivative instruments, such as money market, or derivatives. A set of special accounting rules, in Indonesia Financial Accounting Standards ("IFAS") referred as hedging accounting, shall applies when an entity used those instruments for hedging purposes.

At the outset, it is important to identify and specify correctly the risk to be hedged. This is because an item to be hedged may contain some risks. Risks that qualify for hedge accounting are interest rate risk, foreign exchange risk, price risk and credit risk. For example, a company with Rupiah's functional currency who buys US dollar bonds will be exposed to interest rate risk, foreign exchange risk and credit risk. Incorrect specification of risk to be hedged will increase the probability of hedge ineffectiveness.

A hedged item can be a financial asset or liability with exposures to changes in fair value, a non-financial assets exposed to foreign exchange or price risks (such as, commodities), an unrecognized firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. As an example, based on your question, hedged items could be inventories and loans. They are exposed by foreign exchange risk and interest rate risk (for loans in US dollar).

There are many instruments available for hedging. However, only instruments that qualify as hedging instruments shall be used. Those instruments are designated derivatives with the exception of written option, embedded derivatives, and a designated non-derivative financial asset or non derivative financial liability that hedges the risk of changes in foreign currency rates only.

There are three types of hedge of hedging relationship, fair value hedge, cash flow hedge and hedge of net investment in a foreign operation. As an illustration, in your case, a fair value hedge may appropriate for foreign exchange risk on loans. Then, you will also need to assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to hedged risk. Hedge effectiveness must be evaluated prospectively at the inception of the hedge and retrospectively on an ongoing basis.

Please keep in mind that hedge accounting applies only if a hedging relationship has met the requirements as specified in the IFAS. This is frequently forgotten by the companies. For example, IFAS requires that at the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. If the entity has no such formal designation and documentation, hedge accounting cannot be applied.

KEY POINTS

- Companies need to protect its financials from volatility risks, such as interest rate, foreign exchange, market or credit risks.
- Protecting your financials maybe perform naturally (by natural hedge) or use non-derivatives or derivative instruments.
- Hedge accounting applies only if a hedging relationship has met the requirements as specified in the IFAS.

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