

Exchange rate risks and possible solutions

Accounting advisory

Uncertainty about the euro zone and stability problems of euro countries', as well as Hungary's risk rating and the downgrade of the Hungarian sovereign debt has caused foreign exchange (FX) rates to become highly volatile in the past year. Such extreme volatility can seriously affect the operation of companies which are internationally active or making FX denominated business in Hungary, and might lead to risks and losses hardly foreseeable.



Potential problems	Effects
Appearance of non-realized loss from foreign currency revaluation	Negative effects because of FX denominated loans with weakening forint compared to hard currencies.
Difficulties in planning EBITDA and income before tax	Unexpected positive or negative effects compared to business plans. Shift from EBITDA to FX result is unpredictable
Foreign currency losses not transferable to selling prices	Price increases arising from unhedged purchases may result in declining demand or delayed purchases by the customers.
Non-realized loss on forward, option and swap deals	Loss will be compensated only in the following accounting period, in hedge accounting is not used.
Equity problems due to non-realized FX losses	FX losses might generate loss of equity and recapitalization need.
Loan covenants	Non-compliance because of unfavourable FX rates and FX loss can generate a default event or make financing more expensive.
Non-compliance with tender requirements	Some tenders prescribe positive equity and/or profit after tax. The company may not be able to participate in public procurement due to FX losses.

Possible solutions

There are a number of potential solutions to reduce uncertainty and improve predictability in financial planning, as listed below. In order to choose the best tool or combination of tools one has to consider the advantages and disadvantages, and conduct an in-depth preliminary analysis on the available options suiting the company's business model. Before implementation, financial modeling and a preliminary feasibility study are able to assess the expected outcome and whether the selected solutions are feasible in all aspects.

Solutions	Advantages	Disadvantages
Forward, option and swap deals	Classic tools to effective hedge of risk exposures widely available at the financial markets.	Increases the volatility of profit (without hedge accounting). Requires sophisticated risk assessment and hedging strategy due to the complexity of risks.
Natural hedge strategies and renewal of customer/supplier agreements	Risk handling strategy can be adjusted to the business model of the company.	Requirement is the possibility of transfer of the FX risk to customers / suppliers Might result in falling customer demand.
Increase/decrease of outstanding foreign currency denominated loans	It can be an alternative risk hedging tool of derivatives Favourable in the case of FX denominated overdraft.	It may increase the FX currency risk exposure in the balance sheet Generates liquidity risks.
Hedge accounting	It helps eliminate the negative effects of derivatives closed in line with business purposes. Alignment of accounting treatment with business model can be favourable in taxation.	It requires complex and detailed documentation and (i.e. measurement of effectiveness).
Book-keeping in FX	Decrease the volatility in balance sheet and/or income statement if the business is based on significant FX denominated transactions.	Not always an optimal solution due to the nature of the business model. Significant IT development could be required to operate.
Restructuring the balance sheet	Restructuring of business processes can be favourable to risk exposures in the balance sheet.	Alternatives can be limited by the business model, current and future market conditions.

In addition to the above, for the **optimal solution** – and contrary to past practices focusing only on risk management issues – all the below aspects should be considered when dealing with foreign exchange risk:



How we may help you

- Identification of the best alternatives to reduce risks related to FX rate volatility
- Preparation of a feasibility study
- Advising on the restructuring of the business model
- Advising on the implementation of the designed risk management system

Contact us

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