

Analysis of the FX risk position

Corporate Treasury

For internationally active companies with correspondingly significant currency risks, a detailed analysis of these risks is of great importance. In addition to examining possible FX earnings effects, the focus should be in particular on the foreign currency exposure, in effect, the starting point of foreign currency management. Once defined, the company can then extrapolate appropriate risk management measures, ranging from exposure management to risk mitigation to hedging strategies.

In practice, the exposure analysis is often reduced to collecting data on foreign currency positions from the day-to-day business. Rarely do companies perform a more in-depth analysis by defining specific measures and detecting optimization potentials. Unfortunately, the consequence of this is obvious: far too often, treasurers are surprised by unexpected FX effects. Frequently, the reasons for this are, for example, that the maturity profiles of foreign currency payments are not precisely planned and that the relevant hedging transactions are therefore imprecise, or that the risk horizon is too short or too long. This results in over-hedging or under-hedging, with the corresponding FX effects.

Analysis and visualization of the currency risk position

So, how can this be redressed? A comprehensive analysis of the risk position is indispensable, as it creates transparency on the type and structure of foreign currency cash flows. It is thus an essential base for determining the risk profile. The following four dimensions should be considered in the analysis:

- *Type of cash flow* (e.g., classifying cash flows into the following categories: Business units or product groups, currency/ies (e.g. by risk; internal/external or sender/receiver),
- *Maturity of payments* (e. g. length of the risk period resulting from a cash flow),
- *Historical development of the company's payment volume* (e. g. whether there were conspicuous events due to a significant increase in recurring exposures over time),
- *Frequency of exposure* (e. g. whether it is a one-off exposure or an exposure of regular frequency).

The number of the dimensions and their definition must be company-specific, designed according to the respective business model as well as external and internal framework conditions (e. g. data availability and possible regulatory changes).

A very descriptive supplement to the analysis of the FX risk position is the so-called currency map or cash flow map. This visualizes internal and external cash flows at specific points in time, differentiated according to currencies in the specific company structure. At one glance, the reader is able to take in a

vast amount of different but structured information. For example, the dimension cash flow type can immediately be visually filtered by internal/external, currency or sender/receiver. In addition, by comparing a current cash flow map with the overviews from previous business periods, historical comparisons of cash flow developments can be presented usefully.

The following diagram shows an example of a cash flow map based on a fictitious company in Germany:



What information can be gleaned from a cash flow map? The chart shows both the external foreign currency payments of the Finnish subsidiary and its inter-company transactions with the German parent company; the results are external cash flows in Norwegian kroner (NOK), Russian roubles (RUB) and Polish zloty (PLN). From the perspective of the Finnish subsidiary, if the corresponding positions are netted, inflows in the amount of NOK 12,100k, RUB 4,300k and PLN 1,600k remain. Liabilities and receivables from transactions with the German parent company are denominated in EUR, NOK and PLN. For example, the netting of all external and internal NOK cash flows for the Finnish company results in a NOK exposure of NOK 100k.

This detailed insight into the Finnish subsidiary's risk position allows the setting up of relevant optimization potentials and alternative strategies to manage and mitigate the company foreign currency risks in a targeted manner. For instance, the newly gained overall perspective could allow the company to analyze to what extent inter-company transactions can be invoiced in EUR instead of a foreign currency in the future. The presentation also shows that the Finnish company is partially paid in EUR by Norwegian customers. In this case, the company could increase the proportion of external EUR inflows from Norwegian customers in order to reduce the risk position in NOK. Both measures reduce currency exposure – notably without the use of expensive hedging instruments.

It is also conceivable to review which currency effects occur in the value chain of a specific product group. To this end, all cross-currency transactions in the value chain can be made transparent for a product group and the associated foreign currency effects can be shown.

Conclusion

The opportunities arising from analyzing a FX risk position are manifold. A high degree of data granularity enables an in-depth analysis of cash flows at various levels (e.g. individual business units or regions). Compared to a purely database-oriented tabular solution, the visualization of cash flows provides a user-friendly overview that allows for a quick identification of anomalies and peculiarities in the structures at an early stage and using this information to define solutions to reduce a company's FX risks. In particular, the visualization of cash flows makes it easier for the Treasurer to communicate with the CFO and other stakeholders (e.g. purchasing, sales, controlling) and thus imparting the benefits of currency management. In addition to operational risk management, a detailed and regular analysis of the currency risk position is essential for determining the specifics of the company's risk profile. Among other things, it enables the Treasurer to derive further management measures, thus reducing foreign currency risks – and significantly lowering the risk of surprises for the Treasurer.

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Liquidity planning

Is the additional effort for a direct liquidity planning justified?

Corporate Treasury

The core competence of cash and liquidity management is to ensure a company's solvency. Furthermore, this process should be as effective and efficient as possible. Liquidity planning is the planning of liquidity inflows and outflows with a time horizon of 3 to 15 months. Usually, the discussion involves two different approaches: the direct liquidity planning where each item is derived directly from source data (e.g. sales, purchasing, payroll) as well as the indirect approach, which is based on cash-flow statements, which in turn is based on the balance-sheet and the P/L.

Two methods, one objective and yet, different results...

Both methods are meant to calculate the operating cash flow. The calculation of the free cash flow, based on the investment cash flow and financing cash flow, is identical in both methods.

In the direct method, each position is calculated separately, such as cash receipts from sales, cash disbursements for vendors or payroll payments. In the indirect method, the result is adjusted for non-cash items, such as write-offs or provisions. However, the quality of the indirect method depends very much on the frequency of the forecasting process by Controlling, the frequency of the planning (i.e. whether planning is annual, quarterly or monthly) as well as the existence of a budget balance sheet which is subject to the same parameters as the budget P/L.

In theory, both approaches should deliver the same results. In practice, however, there will often be deviations between the operating cash flow determined according to the direct and the indirect methods, which can only be explained with great effort. The reasons could be the often complex adjustments of period results around the non-cash transactions, such as the changes in provisions or value adjustments or period closings (sales in period "A" do not necessarily cause an equally high cash flow). This then is the reason why most companies do not bother to reconcile these two methods as the resulting insights are quasi non-existent.

Conversely, the question arises whether a direct liquidity planning is necessary if the budget cash flow is already sufficiently precise to determine capital requirements.

Disadvantages of a direct liquidity planning

The main aspect that speaks against a direct liquidity planning is that it requires an additional and new process as well as a further planning logic, for instance, when determining cash flows from values such as sales or costs. Related to this is the additional expertise required in order to make this process

more meaningful, i.e. so that it provides better results than could have been had through the cash flow statement.

Every planning process also requires a reconciliation between the actual and the planned result in order to improve the quality at line item level. Determining the actual values according to the direct method (through the accounts movements) is quite complex and will bring about results of varying granularity, depending on the system used. The use of virtual accounts for the different liquidity types, automated analyses of the information related to the accounts in the treasury management system or the rules-based research on posting information in the ERP system could be part of the solution.

Advantages of a direct liquidity planning

The arguments speaking for a direct liquidity planning are based mainly on the disadvantages of the indirect liquidity planning, first and foremost its insufficient quality. Why is this?

1. On the one hand, this is usually due to the low frequency of the Controlling forecasts (most of these are quarterly), the infrequency of the budget P/L and budget balance sheet or the non-use of currency forwards, which could lead to an inaccurate monthly view.
2. Another reason is the bias of the budget cash flow statement caused by the Controlling's perspective. In practice, companies do everything to reach the most important KPIs that Controlling requires for the financial year-end so in effect, the planning is really geared towards this. However, in order to reach these KPIs, the company regularly accepts the negative effects on liquidity or working capital, which in turn can have the opposite effect on liquidity planning.
3. There are stumbling blocks in the form of methods and practical aspects in the indirect method that make it difficult to provide a liquidity planning taking into consideration the different currencies for FX management because the P/L and balance sheet are usually only stated in the local currency. A minimum requirement for this would be the determination of inflows and outflows in the transactional currency.

Are new technical solutions the answer to this dilemma?

In the direct method, the calculation of the operating cash flow consists of numerous values with a cash effect. Modern tools are in a position to enhance historic cash flows with other business-relevant information. An example would be the breakdown of cash receipts from sales based on product groups. This provides a higher granularity of historical data and may be used for automated and self-learning predictive analytics. Modern systems these days are capable of processing such mass data. The higher the granularity of historical data, the more meaningful the statistical patterns. Because of this, the origin of algorithms used to extrapolate historical cash flows will become more transparent and reliable in the future.

Conclusion

It is difficult to decide in favor of one or the other option without having made a cost/benefit analysis. Add to this the uncertainty about the quality assessment of existing budget P/Ls and budget balance sheets in view of liquidity.

And don't forget to think of the business model of a company – an influence that cannot be underestimated. Examples here would be mass production versus contract production, seasonality, or even business models that are changing because of the increasing digitalization. In such a case, it is obvious that a direct liquidity planning which is closely based on actual numbers rather than budgets (business planning) is a tool that allows Treasury to act fast.

However, there are also arguments for the indirect method and indeed, in practice, the models are usually hybrids. When using these, the indirect budget cash flow statement is adjusted with predefined procedures based on the direct method to at least enhance Controlling's last extrapolation with current developments and insights.

But maybe these discussions will soon become pointless in the age of predictive analytics.

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Will you become an investment company come 2018?

Corporate Treasury

Do you intend to conclude derivatives contracts based on commodities or energy sources and prefer to be treated like an investment company as far as supervision is concerned? If you answered yes, your wait is now over. As of January 2018, all companies that conclude derivatives contracts for their own account based on commodities or emission certificates will be treated as investment companies. For the company, this entails having to apply for a license and adhere to the relevant regulations, such as the ones on qualification of the company's Executive Board members, its capital endowment, organizational setup and risk management procedures or reporting to the financial regulator.

As an alternative, you could also stop trading in commodity derivatives. Or, you notify each regulatory authority in every member state where you engage in commodity derivatives that you are exempted by 3 January 2018. This notification has to be renewed on an annual basis.

This notification can only be made if you can prove that the conclusion of commodity derivatives is an ancillary activity to your main activity. This proof does not have to be provided immediately but has to be furnished at the financial market regulator's request. Because the conditions for being able to claim this "Ancillary Activity Exemption" must follow certain rules and be based on data from the past three years, the calculations should be as close in time to the submitted notification and not be furnished only at the financial market regulator's request.

In the meantime, the FCA in the UK and the FMA in France have defined a process and the forms to be completed for such an exemption. These regulators require information on the company, the legal entity identifier (LEI), contact information and a declaration requesting an Ancillary Activity Exemption. In fact, completing the form is the least of it –

the real work is in the documentation of the proof, which must be furnished upon demand.

The proof consists of a comparison of the scope of all speculative transactions with the scope of all transactions in a certain class of commodities (oil, gas, etc.). Just as in EMIR, all transactions that do not verifiably serve to reduce the risk arising from an operating transaction or to finance a business transaction are deemed to be speculative. In cases where all of the corporation's derivatives are recorded and documented as risk mitigating transactions during the EMIR process, the proof required for MiFID II will be easy, as the numerator for the threshold calculation will be zero. However, as soon as the corporation also enters into derivatives traded on market places, which are exempted from the duty to clear for EMIR, the calculation has to include these transactions for MiFID II.

For most corporations, the exemption from the duty to register as an investment company is neither a great hurdle to take nor a time-intensive exercise – it just has to be performed on time. So, if you intend to conclude derivatives contracts based on commodities, energy sources or emission certificates also in the coming years, you should circle 3 January 2018 in red in your calendar.

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