FOREIGN EXCHANGE RISK

What is foreign exchange risk?

Foreign exchange risk is where either the profitability or balance sheet values in your business are impacted when there is movement in foreign exchange rates.

Do I have foreign exchange risk?

If you import or export, then it is most likely that you have a foreign exchange risk.

Foreign exchange risk can also potentially be created by:

> Selling or purchasing capital equipment in foreign currency

> Foreign currency loans – both repayments and interest payments in foreign currency

> Foreign currency income, such as interest receipts, dividends, royalties etc.

> Assets purchased and/or held in international countries – these will need to be revalued back into Australian dollars at balance dates

Here are some numbers to consider

Ryan exports almonds to China. The customer pays for the almonds in US dollars (or USD). Ryan has just shipped USD 500,000 worth of almonds to the customer. On the day of shipment, the Australian dollar (or AUD)/USD exchange rate was 0.8125.

Ryan will be paid by the customer's bank when the almonds arrive at the Chinese port.

The almonds arrive six weeks later and Ryan receives the USD 500,000 into his USD bank account. He needs to use this money to pay the business expenses, so he asks his bank to transfer the USD to his AUD bank account. On this day, the AUD/USD is 0.9350, therefore AUD 534,759.36 is transferred into his AUD account. If he had converted the USD on the day of shipment he would have received AUD 615,384.61.

He has lost AUD 80,625.25 by not managing this risk.

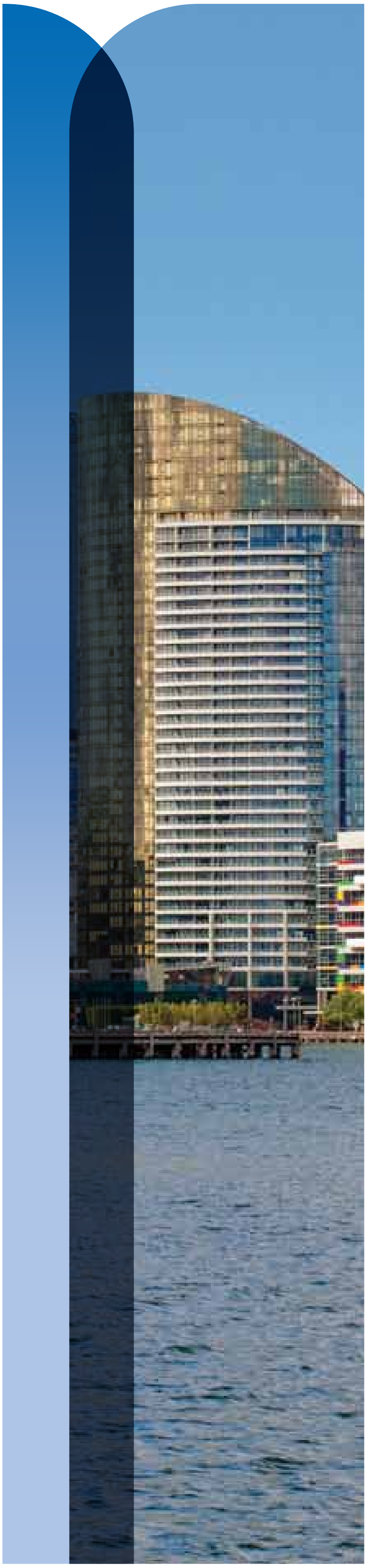
But I pay or receive in Australian Dollars (AUD)

You need to check your agreement with your international supplier or customer. In many cases the agreement will contain conditions that states the AUD price will be adjusted against movements in the USD (or the currency of the supplier or customer). Therefore even if you pay in AUD, the total cost of the goods or services will fluctuate with movements in foreign currency creating a foreign exchange risk.

Do adverse movements in exchange rates only impact my profit?

Adverse movements in the AUD against foreign currencies have the potential to impact:

> Cash flow – for exports or other international receipts you will receive less cash. Where the cost of imports and inputs increase additional cash will be required.



"To assist in identifying, understanding and managing the foreign exchange rate risks in your business, it is best to seek the advice of your CPA or banker."

- Balance sheet values – where foreign currency debt or investments are translated into AUD an adverse movement will affect their value, which can in turn affect balance sheet ratios such as the gearing ratio. This could lead to a greater chance of breaching debt covenants. The cost of servicing foreign currency debt also increases.
- Sales revenue - the cost of your business's product or services becomes more expensive against international competitors.
- Other income - Foreign currency income from investments, such as foreign currency dividends, when translated into AUD may also decline.

What is the potential impact of foreign exchange rates on my business?

To measure the potential impact of foreign exchange rate movements on your business, you first need to understand where the risks lie in your business.

You can ask your CPA and your banker or you can use the points on page one to assist you in this. There are a number of ways to measure foreign currency risk. We will look at two simple methods:

Cashflow Analysis				
	USD Movement			
USD Transaction	Month 1	Month 2	Month 3	Total
Imports	(300)	(300)	(400)	(1000)
Exports	200	200	200	600
Equipment Purchase		(200)		(200)
Net USD position	(100)	(300)	(200)	(600)

The table shows the "net" position at the end of each month and the total for the three month period. It can be used to determine your USD needs. Where foreign exchange rates have low volatility, then this method may be used to identify the foreign exchange risk for your business.

In this cashflow analysis this business both exports and imports in USD, as well as having capital expenditure in USD. The table shows the "net" position at the end of each month and the total for the three month period. Where foreign exchange rates have low volatility, then this method may be used to identify the foreign exchange risk for your business.

How can I minimise my foreign exchange risk?

There are a number of products offered by foreign currency providers and banks that can assist in managing and minimising the foreign currency risks in your business. It is important to understand the different products and how each one works, as the level of protection can vary with each type of product.

Sensitivity Analysis		
AUD/USD $	AUD Received/Required	Variance AUD
0.9350	534,759	0
0.9000	555,556	20,797
0.8750	571,429	36,670
0.8500	588,235	53,476
0.8125	615,385	80,626

This sensitivity analysis shows the variance of AUD received or required to pay USD 500,000. For each various USD exchange rate scenario, the equivalent AUD is calculated and a variance is shown which indicates the fluctuation in AUD received or paid for each USD exchange rate movement against a base of AUD/USD 0.9350. This type of analysis is particularly useful where foreign exchange rates have a high volatility.

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