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DISCLOSURE OF FOREIGN CURRENCY RISK AND CORRESPONDING MITIGATING TOOLS BY THE METAL PRODUCING COMPANIES' IN THEIR ANNUAL REPORTS FOR 2014

Abstract: This paper reviews information on foreign exchange risk factors and the corresponding risk reducing techniques, disclosed by 32 largest global steel producing companies in their annual reports for 2014. According to the materiality principle, it is a natural assumption that annual reports disclose the most significant risk factors. Extensive research resulted in identifying 17 risk factors with total frequency of 61. Eleven of these risk factors relate to the transaction risk, with total frequency of 49, which represents 80.3% of risk factors in total. The most significant risk factor refers to purchases of important inputs that are denominated in foreign currencies, with a frequency of 21, which represents 34.4% of risk factors in total. These risk factors are the ones that companies recognize as ones with the most significant impact on their assets, operating costs, earnings and future cash flows, financial result, financial condition, business and future prospects. The analysis of hedging tools used by the companies, reveals that most companies hedge their risk by using financial derivatives. Having in mind that mining is the long-term business, we can conclude that companies mitigate their short and medium-term transaction risk by financial derivatives. Companies do not seem to be concerned with mitigating the long-term translation and economic risks.

Keywords: transaction risk, translation risk, economic risk, risk hedging, mining companies.

1. Introduction

Mining is long-term business, which timescales can run into decades, as "the period from initial exploration to the start of production often exceeds ten years. Then, depending on the nature of the project and market conditions, it may take more than five years of operation to recoup the initial investments." (Antofagasta plc, 2014: 12). Many metal producing companies operate in different geographical locations and market their product worldwide, what makes them exposed to various factors altered by foreign currency fluctuations. Three common forms of foreign currency risk are: (1) transaction risk; (2) translation risk and (3) economic (or operating) risk.

Transaction risk arises from the effect that exchange rate fluctuations have on a company's obligations to make or receive payments denominated in foreign currency in future. Realization of this risk occur when an entity seeks to convert its committed foreign currency cash flows into functional currency, and the rates of exchange at the date of conversion are not known with certainty. According to Dhanani, for most multinational companies, this is the most obvious and easily identifiable form of exchange rate risk, and companies may use financial instruments or employ internal measures, such as leading or lagging payments and receipts, to reduce their overall exposure to this risk (Dhanani, 2003: 39). Consider this statement:

> *"A part of the Company's operating and capital expenditures is denominated in local currencies other than the USD. These expenditures are exposed to fluctuations in USD exchange rates relative to the local currencies. The Company's balance sheet contains various monetary assets and liabilities, some of which are denominated in foreign currencies. Accounting convention dictates that these balances are translated at the end of each period, with resulting adjustments being reflected as foreign exchange gains or losses on the Company's income statement.* (Pan American Silver Corp., 2014: 31)

Translation exchange risk is a result of the restatement of financial statements of foreign entities within the group (subsidiaries, joint ventures and other foreign operations) into group reporting currency terms for the purposes of consolidation. This risk has the non-cash impact on a company's consolidated financial statements. Consider this statement:

> *"The devaluation of the rouble in 2014 has resulted in a significant translation loss of $1,751 million being recorded in the period, which has resulted in our net assets reducing by 59% due to presenting our financial position at the year-end spot rate. Of this amount, $743 million related to mine under development, $646 million to property, plant and equipment and the remaining amounts related to working capital accounts, borrowings, capital construction in progress and other items. This was due to a y-o-y change in the RUB/USD exchange rate."* (Polyus Gold International, 2014: 47)

Economic (or operating) exchange rate risk is concerned with the effect of long-term movements in exchange rates on companies' expected future cash flows and, in turn, their overall market values. Although similar to the transaction risk, "it differs from transaction risk in one fundamental manner. Long term movements in exchange rates may have a more profound effect on the future cash flows since they can actually alter the companies' abilities to generate those cash flows by influencing their level of sales, prices and input costs" (Dhanani, 2003: 40). Consider this statement:

> *"...although a strong U.S. dollar helps Alcoa's near-term profitability, over a longer term, a strong U.S. dollar may have an unfavorable impact to Alcoa's position on the global aluminum cost curve due to Alcoa's U.S. smelting portfolio. As the U.S. dollar strengthens, the cost curve shifts down for smelters outside the U.S. but costs for Alcoa's U.S. smelting portfolio may not decline."* (Alcoa, 2014: 30)

The nature of foreign currency transaction exposure is short-term to medium-term, and of the translation exposure is medium-term to long-term. Economic (or operating) exposure is long-term in nature. (Picardo, internet).

Companies disclose information about their significant exposure to foreign currency risks in their annual reports. Groups prepare annual reports and consolidated financial statements in the reporting currency. In most cases, each entity in a group has its own functional currency, the currency of the primary economic environment in which that entity operates, usually the country in which entity is located. Each entity measures its assets, liabilities, equity, revenues and expenses in its functional currency, and all transactions in currencies other than the functional currency are foreign currency transactions. For group reporting purposes, financial statements of entities within the group are translated into the group reporting currency.

The subject of this article is to review the type of foreign exchange risk and type of hedges used by the 32 biggest metal producers in the mining sector across 16 countries, listed in Appendix 1. For the purpose of this paper, qualitative research and data analysis were carried out by analyzing information on foreign currency risk and related mitigating techniques disclosed in the companies' annual reports for 2014. The compiled data are systematized in the three standard forms of foreign currency risk, transaction, translation and economic (operating) risk factors.

The rest of this paper is organized as follows. Section 2 reviews how companies view effects of foreign currency risk. Section 3 presents the most significant risks which sample companies disclose in their annual reports, and section 4 relating mitigating tools which companies use to manage own foreign currency risks. Short conclusion is at the end of the paper.

2. How companies view effects of foreign currency risk?

For the financial reporting purposes, 23 companies out of the sample of 32 (72%) choose to present their consolidated financial statements for 2014 in US Dollars. Companies believe that this is how international investors analyze the financial statements, and consider US Dollar a common presentation currency in the mining industry. The rest of nine companies present their financial statements for 2014 in other currencies, including China's Renminbi, Australian Dollar, Canadian Dollar, Russian Ruble, Japan's Yen, India's Rupee, South African Rand, Polish Zloty and South Korea's Won.

Considering the way that companies disclose and present their exposure to foreign currency risk, we can see that the most companies disclose information on foreign currency risk as the separate item in their annual report unit related to the risk management, as well as in the financial statements. A few companies classify foreign currency risk into a wider group of risks. Wider group of risk include 'External risk' (Anglo America, BHP Billiton, Glencore Plc. and Rio Tinto), 'Macroeconomic risk' (Newcrest and Polyus gold), 'Financial and regulatory risk' (Barrick), 'Financial risk' (Tata Steel) and 'Market risk' (Vale). In the notes to the financial statement, foreign currency risk is classified either as 'Market risk' or 'Financial risk'. Additional research is needed to understand whether different terminology correlate with different risk factors and/or different risk mitigating approaches.

Although most companies use the term "foreign currency risk", a few companies cite their own definition of risk in terms of factors which expose company to the foreign currency risk and corresponding impacts. According to cited definition, changes in currency risk may impact:
Result and cash flow:

> *We are subject to significant foreign currency risks, which can negatively impact our profitability and cash flows.* (United States Steel Corporation, 2014: 39)

Fair values or future cash flows of the financial instrument:

Currency risk is the risk that the fair values or future cash flows of the Company's financial instruments will fluctuate because of changes in foreign exchange rates. Exchange rate fluctuations may affect the costs that the Company incurs in its operations. (Goldcorp, 2014: 65)

Operating costs and asset valuations, and financial results

*The Group is exposed to currency risk when transactions are not conducted in US dollars. Fluctuations in the exchange rates of the most important currencies influencing our own operating costs and asset valuations ... may materially affect the Group's financial results. (*Anglo American, 2014: 45*)*

*Assets, earnings and cash flows, and f*inancial result:

Our assets, earnings and cash flows are influenced by a wide variety of currencies due to the geographic diversity of the countries in which we operate. Fluctuations in the exchange rates of those currencies may have a significant impact on our financial results. (BHP Billiton, p. 20)

Business, financial condition, results of operation or prospects:

ArcelorMittal operates and sells products globally, and, as a result, its business, financial condition, results of operations or prospects could be adversely affected by fluctuations in exchange rates. (ArcelorMittal, 2014: 210)

Exchange rate fluctuations could have a potential threat on our business, financial position, operational results and future prospects. (Severstal, 2014: 77)

Based on cited examples, the most comprehensive definition of the foreign currency risk shall be one which include impact on assets, operating costs, earnings and future cash flows, financial result, financial condition, business and prospects.

3. Which risk factors are disclosed as the materially significant?

A company faces foreign-currency transaction risk in different ways. According to Comiskey and Mulfor, (Comiskey, 2008: 7), in the first, a company enters into a transaction, like purchasing goods, that is

denominated in a foreign currency. The second way in which a company faces foreign-currency risk is through the anticipated future receipt or payment of foreign currencies. A third manner in which companies face foreign-currency risk is through net investments in unconsolidated foreign entities or consolidated foreign subsidiaries. In addition to these risk factors, all risk factors which relate to the re-measurement of balance sheet items that are originally denominated in foreign currencies, and which should be, by the accounting convention, translated by the current rate of exchange at the end of each reporting period. The analysis of exposures to risks, as disclosed in the annual reports of the sample companies, reveals risks factors presented in Exhibit 1.

The risk management process typically involves identifying particular risk events or circumstances (risk factors) relevant to the organization's objectives (risks and opportunities), assessing them in terms of likelihood and magnitude of impact, determining a response strategy, and monitoring them on a regular basis.

As we worked through the annual reports disclosures, 17 specific risk factors and 9 tools of risk hedges emerged. The specific risk factors and the frequency with which each appeared are provided in Exhibit 1. The nine risk mitigation techniques are provided in Exhibit 2.

Identified risk factors are classified into three categories: transaction risk factors, translation risk factors, operating risk factors. The risk factors are classified according to their presentation in the annual reports, as we want to understand how management perceives and assess own foreign currency risks. For example, a mismatch between the currency of costs and revenues may be also seen as the mismatch between trading asset and trading liability that are denominated in foreign currency balances. The risk factors are classified according to the companies' view on that issue.

The most significant risk factors category relates to transaction risk factors, and, with the frequency of 49, what represent 80.3% of the risk

factors' population. The most significant risk factor relates to purchases of some inputs that are denominated in foreign currencies with the frequency of 21, what represent 34.4% of the risk factors' population. The next risk factor relates to mismatches of company's assets and liabilities that are denominated in foreign currency (Risk 1), with the frequency of 9, what represent 14.8% of the risk factors' population. As six out of these seven companies although face the Risk 1, we can suppose that most of these assets relate to trade receivables in foreign currencies, and most of these liabilities relate to trade payables in foreign currencies. The third risk factor relates to selling of products and services which prices are denominated in foreign currencies, with the frequency of 7, what represent 14.8% of the risk factors' population. Other ten transaction risk factors have a total frequency of 10, what represents 16.4% of the risk factors' population. Translation risk factors are disclosed as significant in 4 cases, what represent 6.6% of the risk factors' population, and operating risk factors in 6 cases, what represent 9.8%of the risk factors' population.

Exhibit 1: Classification of foreign currency risks factors

Classification	In the sample	
	Fre-quency	Per-centage
(a) Transaction risk factors: Cash flows that are denominated in foreign currencies	**49**	**80.3%**
1. Company purchases some important inputs that are denominated in foreign currencies.	21	34.4%
2. Company sells its products and services that are denominated in foreign currencies.	7	11.5%
3. Company has assets and/or liabilities that are denominated in foreign currencies.	9	14.8%
4. Company holds cash and cash equivalents that are denominated in foreign currencies.	1	1.6%
5. Company has borrowings that are denominated in foreign currencies.	2	3.3%

Classification	In the sample	
	Fre-quency	Per-centage
6. Company has to pay dividends that are denominated in foreign currencies.	1	1.6%
7. Company is exposed to currency risk through non-monetary assets and liabilities of entities whose taxable profit or tax loss are denominated in foreign currencies. Changes in exchange rates give rise to temporary differences resulting in a deferred tax liability or asset with the resulting deferred tax charged or credited to income tax expense.	1	1.6%
8. Re-measurement of monetary assets and liabilities by applying the current exchange rate of the foreign currencies versus the base (functional) currency at the end of each period.	4	6.6%
9. Re-measurement of off-balance sheet exposure to currency risk by applying the current exchange rate of the foreign currencies versus the base (functional) currency at the end of each period.	1	1.6%
10. Re-measurement of investments in reporting currency in foreign operations, whose net assets are exposed to foreign currency translation risk.	1	1.6%
11. Company has investments denominated in foreign currencies.	1	1.6%
(b) Translation risk factors: Non-cash gains and losses related to financial reporting purposes	**4**	**6.6%**
12. Translation of financial statements prepared in group entities' functional currency into the	4	6.6%

Classification	In the sample	
	Fre-quency	Per-centage
group reporting currency.		
(c) Operating risk factors	**6**	**9.8%**
13. Exchange controls imposed by governmental authorities in the countries where group companies operate.	1	1.6%
14. Significant currency devaluation is high.	1	1.6%
15. Impact to market price of company's shares denominated in foreign currency.	1	1.6%
16. Impact to competitiveness.	1	1.6%
17. Impact to prospects (asset valuation).	2	3.3%
(d) Foreign currency risk is not significant	**2**	3.3%
Total	**61**	**100,0%**

Fluctuations in the exchange rates of foreign currencies, which relate to transaction risk, influence operating costs and revenues, assets and liabilities valuations and cash flows. In most cases,

> "operating costs are influenced by the countries in which the Group's operations are based, ... as well as those currencies in which the cost of imported equipment and services are determined" (Antofagasta plc,, 2014: 142).

On the other side, risk arises from the revenue that is denominated in the currency that is not the functional currency, as stated in the following example:

> "The group revenue from gold sales is linked to US Dollar, whereas most of the Group's operating expenses are denominated in Russiona roubles." (Polyus Gold, 2014: 38).
>
> "In some cases, companies strength the foreign currency assets and/or liabilities risk exposure, as stated in this example: "The Company also holds cash and cash equivalents that are denominated in foreign currencies which are subject to currency risk. Accounts receivable and other current and non-current

assets denominated in foreign currencies relate to goods and services taxes, income taxes, value-added taxes and insurance receivables." (Goldcorp, 2014: 65).

Three risk factors refer to re-measurement of assets and liabilities at the end of the reporting period, in compliance with accounting standards. Fluctuations in the exchange rates of foreign currencies for the financial reporting purposes materialize as non-cash risk, as a gain or loss in the income statement at the end of each reporting period, and at the moment when they are paid or received, they also have impact on cash flows. Consider this:

> "The Company's balance sheet contains various monetary assets and liabilities, some of which are denominated in foreign currencies. Accounting convention dictates that these balances are translated at the end of each period, with resulting adjustments being reflected as foreign exchange gains or losses on the Company's income statement.." (Pan American Silver Corp., 2014: 44).

Fluctuations in the exchange rates of foreign currencies, for the purpose of preparing consolidated financial statements materialize in the translation risk. Consider this statement:

> "Changes in foreign exchange rates affect the Group's financial results and performance. Foreign exchange losses recognised in the Consolidated Income Statement predominantly arise on the re-translation of US Dollar-denominated external loans in Rouble functional currency entities and represent a non-cash loss. The Group's net assets have also reduced with a US$618 million non-cash loss arising in reserves relating to the translation of the Russian Rouble and Kazakh Tenge denominated Balance Sheets into the US Dollar presentational currency." (Polymetal, 2014: 102).

4. Which risk mitigating tools are disclosed by the companies?

Extensive research of type of hedging and the management of foreign currency risk presented in Exhibit 1 reviled that company use various hedging techniques to pre-amp or mitigate these risks. As presented in Exhibit 2, companies apply financial derivatives, natural hedges, quasy-natural hedges and operational hedges.

Exhibit 2: Classification of foreign currency transaction risk mitigating tools

Classification	In the sample	
	Frequency	Percentage
Hedging with financial derivatives	18	45.0%
1. Regular use of financial derivatives	13	32.5%
2. Use of financial derivatives on occasion	5	12.5%
Natural hedge	2	5.0%
3. Offestting foreign-currency assets and liabilities	1	2.5%
4. Offsetting receivables and payables	1	2.5%
Quasy-natural hedge	7	17.5%
5. Foreign currency debt is matched with foreign currency revenue	3	7.5%
6. Maintaining foreign-currency cash balances 3,12	2	5.0%
7. Assuming liability positions to offset financial assets subject to currency risk	2	5.0%
Operational hedge	3	7.5%
8. Manufacturing or sourcing goods in the currency of the country of sale	1	2.5%
9. Correlation of commodity prices and foreign/functional currencies exchange rate	2	5.0%
No hedging activities	10	25.0%
Total	40	100.0%

The most common tool is the use of financial derivative, as almost half of the companies use financial hedges, either on the regular basis (32.5 percent) or on occasion (12.5 percent). Financial hedges are financial instruments that qualify for hedge accounting in accordance with the accounting standards.

The second most frequent type of hedge relates to quasi-natural hedges. Quasi-natural hedge is a derivative that is not designed as accounting hedge, but which economically offsets the risk. For hedging purposes, companies usually "employ actively-created asset or liability positions to offset the risk associated with outstanding foreign currency balances" (Comiskey, 2011: 11). A few of the sample companies designate foreign currency asset to offset naturally incurred foreign currency liability, or assume a trade liability or debt to offset foreign currency risk of an asset.

Only 5 percent of the sample population employs pure natural hedges to address foreign currency risk. Pure natural hedge is a simple by-product of a company's normal business or operational activities. A pure natural hedge in a foreign currency context is one that offsets exposure in a foreign currency. (Comiskey, 2008: 8). A narrow definition of pure natural hedges would include symmetrically opposite positions, e.g., both accounts receivable and accounts payable in the Euro, that are simply the product of the nature and operation of the business (Comiskey, 2008: 6).

Three companies also disclosed that they employ operational hedging strategies for mitigating foreign currency risk. Operational hedging refers to "mitigating risk by *counterbalancing actions* in a processing network that do not involve financial instruments." (Van Mieghem, 2003, as quoted in Boyabatu, 2004: 9). These operational hedging utilizes "the global supply chain network design" to mitigate exchange risk. Two of these three companies combine operational hedges with financial hedges. Recent research on exchange rate exposure and risk management of Japanese' exporting firms also confirms that the risk is reduced by

combination of financial hedging and operational hedging such as choice of invoicing currency (Takatoshi, 2015: 14).

Finally, 10 companies, which represent 25 percent of the sample population, stated that they do not hedge the foreign currency risk at all. Having in mind that mining is the long-term business with the long pay-back period of invested funds, and that financial hedges are effective in the short and medium term, conventional wisdom is that these companies rely on operational hedging. Moreover, operational hedgings are often viewed as the function incorporated in the value chain and supply chain processes (Dhanani, 2003: 49). Hoberg and all. also state that firms are more likely to use operational hedging, which entails economic activity that has its own net present value, in the form of external input when the efficacy of financial hedging is poor. (Hoberg, 2015: 4, 30). Also, as quoted by Ito (Ito, 2015: internet), investigation by Kim, Mathur and Nam (2006) on relationship between operational hedging and financial hedging confirms "that although operational and financial hedging strategies are complementary, firms using operational hedging are less dependent on the use of financial derivatives". Moreover, "management of economic currency risk is often categorized as a general management issue, one that involves various organizational factors, and not merely a technical issue" (Dhanani, 2003: 41).

5. Conclusion

This paper investigates how 32 largest metal producing companies, which spread their operations amongst a wide range of global locations, disclose foreign currency risk factors and the corresponding risk hedging methods in their annual reports for 2014. We identified 17 risk factors with total frequency of 61. Eleven risk factors, with total frequency of 49, relate to transaction risk, what represent 80.3% of risk factors' population, and five risk factors, with the frequency of 6, what represent 9.8% of the risk factors' population, relate to operating risk. Four companies, what represent 6.6% of the risk factors' population, disclosed that they are exposed to translation risk. The most significant risk factor refers to purchases of some important inputs that are denominated in

foreign currencies, with a frequency of 21, what represent 34.4% of the risk factors' population.

These are risk factors, which companies recognize as the factors with the most significant impact on their assets, operating costs, earnings and future cash flows, financial result, financial condition, business and prospects.

Out of the sample of 32 companies, 22 hedge their foreign currency risks. Financial derivatives are used by 18 companies, which most of them use on the regular basis and a few of them on the occasion. Other hedging tools are not used widely. Ten of the sample companies do not hedge their foreign currency risks at all.

Having in mind the fact that the mining is long-term business, and that the financial derivatives are usefull for short to medium term, we can conclude that mining companies hedge their short-term risks, mainly transaction risk. Companies did not express any concern related to hedging of translation risk. Two companies expressed the concern for hedging economic risks, one by manufacturing or sourcing goods in the currency of the country of sale, and the other one relies on the correlation of of commodity prices and foreign/functional currencies exchange rate.

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APPENDIX 1: COMPANIES IN THE SAMPLE

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Obelodanjivanje deviznog rizika i odgovarajućih sredstava zaštite od strane kompanija za proizvodnju metala u njihovim godišnjim izveštajima za 2014.

Apstrakt

U ovom radu razmatraju se informacije o faktorima deviznog rizika i odgovarajućih tehnika za umanjenje tog rizika, koje su 32 najveće globalne kompanije za proizvodnju metala obelodanile u svojim godišnjim izveštajima za 2014.g. Shodno principu materijalnosti, prirodna pretpostavka je da su u izveštajima obelodanjenji najznačajniji faktori rizika. Postupak ekstenzivnog istraživanja rezultirao je utvrđivanjem 17 faktora rizika koji se u uzorku javljaju 61 put. Jedanaest od tih faktora rizika odnosi se na transakcioni rizik, sa učestalošću javljanja od 49 puta, što predstavlja 80,3% populacije faktora rizika. Najznačajniji faktor rizika odnosi se na nabavku značajnih inputa koji su nominirani u stranoj valuti, sa učeššstalošću javljanja od 21-og puta, što predstavlja 34,4% populacije faktora rizika. Ovo su faktori rizika koje kompanije prepoznaju kao one sa najznačajnijim uticajem na njihovu imovinu, operativne troškove, zaradu i buduće tokove gotovine, finansijski rezultat, finansijski položaj, poslovanje i buduće izglede. Analiza sredstava za zaštitu od rizika koje kompanije primenjuju, pokazuje da se najveći broj kompanija štiti od rizika upotrebom finansijskih derivate. Imajući u vidu da je poslovanje rudarskih kompanija dugoročnog karaktera, može se zaključiti da se kompanije štite od kratkoročnih i srednjoročnih rizika putem finansijskih derivate. Kompanije ne poklanjaju pažnju zaštiti od translacionog i ekonomskog rizika, koji su dugoročnog karaktera.

Ključne reči: Transakcioni rizik, translacioni rizik, ekonomski rizik, zaštita od rizika, rudarske kompanije