INDOSAT’s Currency Hedging Problems

In mid 2007, some local newspapers reported that PT INDOSAT had booked IDR653 billion in losses on its IDR2.5 trillion's worth (around US$275 million) of derivative transactions. Transactions were made in 2004 and consisted of 17 agreement contracts with several financial institutions.

In Indonesia, such transactions are regulated in the Financial Accounting Standard Statement (PSAK), in Europe in IFRS (International Financial Reporting Standards), and in the US in US GAAP (United States Generally Accepted Accounting Principles). In PSAK No. 55 on Derivative Instrument and Hedging Activities Accounting, it is stated that a derivative transaction requires formal documentation of risk management analysis and transaction effectiveness analysis if such transaction wants to be hedged.

The derivative transactions were made to protect the company against currency risk from its foreign debt. INDOSAT issued USD denominated bonds amounting to USD 550 Million (Guaranteed Notes I & II, each USD 300 Million and USD 250 Million) and also had exposure to Export Credit Facility in the amount of USD 34 Million. To hedge the position, INDOSAT opened an Interest rate swap (pay float/receive fix) and cross currency swap (first leg: sell USD/IDR; second leg: buy USD/IDR). The total contract amount on December 2004 was USD400 Million or 68.5% of its total exposure.

From the transaction, it seems INDOSAT tried to reduce currency risk from fluctuations of USD/IDR by synthesizing its debt to be effectively IDR since its major cash inflow is in IDR. At the same time the company tried to reduce its cost of funds by paying a floating rate, with expectation that the interest rate would get lower in the future.

The problem rose when the level of USD/IDR got lower – meaning a strengthening of the IDR – in 2005 and 2006, as shown in the following graph:
The stronger IDR brought losses on INDOSAT’s derivative/hedging transaction.

For three years in a row (2004-2006), the independent auditor Ernst & Young had reminded the management of INDOSAT to improve its derivative transaction-related risk management formal policy.

The problem arose when the Tax Directorate General revealed that there had been a decrease in the tax deposits from INDOSAT’s revenues during recent years.

Signals of the state's losses due to INDOSAT's tax income and dividend shortfalls amounting to around Rp323 billion were brought up by Dradjad H. Wibowo, a member of the House's Banking and Finance Commission. According to him, the potential income tax losses are Rp196 billion, the potential loss of revenue from dividends Rp65 billion and the potential loss of income tax from dividends Rp62 billion. He stated the losses were due to INDOSAT's mismanagement in carrying out derivative transactions.

Darmin Nasution, Director of Tax Directorate General said that INDOSAT's tax manipulation allegation not to be taken for granted as it must be proved first. “It's really a loss or a manipulation. Those must be differed. If it's a loss, we (Tax Directorate General) can't do anything. But the Capital Market Supervisory Board (Bapepam) might,” he said.

Wong Heang Tuck, INDOSAT's Finance Director, stated he was ready to be checked by Bapepam regarding INDOSAT's loss and tax deposit potential loss due to derivative transactions. However, he denied that the losses were because of mismanagement or foreign currency speculation activities.

“Moreover, derivative transactions are not against tax rules,’’ he said after the annual General Shareholders' Meeting in Jakarta. According to him, INDOSAT's derivative transactions were included in the financial statement submitted to Bapepam and the United States Security and Exchange Commission. INDOSAT will continue carrying out derivative transactions until the end of INDOSAT's Dollar bonds I and II issuing terms.

After the investigation which conducted by Bappepam, Head of Bappepam-LK, A Fuad Rahmany, said his organization has called the management company INDOSAT and auditors to provide clarification and explanation for the company's financial reporting year 2004 to 2006. "Based on the information we have already INDOSAT derivatives transactions is clear.”. INDOSAT's financial assessment has been reviewed by Bapepam carefully and the result does not have a problem,” he said in Jakarta, Wednesday (20 / 6/2007). He added, INDOSAT corporate activity is the business risk borne by the second-largest telecommunications company in Indonesia.

During 2007 INDOSAT booked net income of Rp.2.04 Trillion or grew 56% compare to previous end period. But in 2008, net income fell to be only Rp.1.8 Trillion (eqv.USD151.2 million) due to a weaker IDR and decreasing of business.
The President Director Johny Swandi Sjam explained the losses were mostly due to depreciation of the Rupiah against the USD which contributed to 55% of the overall increase in INDOSAT’s expenses during of the year. Of the total Rp.2.4 Trillion spent in 2008, at least Rp.885.7 billion simply reflected foreign exchange losses.

However, as INDOSAT hedged 52% of its dollar denominated loans and bonds, the company managed to reduce the impact of potential losses and even managed a gain Rp.136.6 Billion from hedging in 2008.