Chapter 11 Managing Translation Exposure and Accounting for Financial Transactions

Learning objectives

- ✓ Accounting for translation exposure
  Current rate method of ASC 830-30 & IAS 21
- ✓ Hedging translation exposure
  Who, when, and why
- ✓ Accounting for financial transactions
  ASC 815 Derivatives and Hedging

11.1 The current rate method

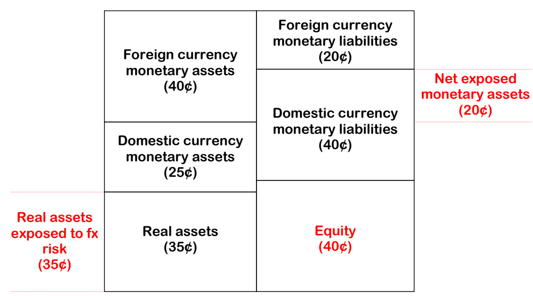
- Translation exposure defined
- Translation exposure to currency risk refers to the impact of exchange rate changes on the parent's consolidated financial statements
  - In its consolidated financial statements, the parent company must translate its foreign operations into the home country currency using the home country's generally accepted accounting principals (GAAP)
  - Translation exposure to currency risk is also called accounting exposure

11.1 The current rate method

- Balance sheet translation exposures
- Foreign assets and liabilities translated at the current exchange rate have a translation exposure to currency risk
  - Foreign currency assets are positively exposed to the foreign currency value
  - Foreign currency liabilities are negatively exposed to the foreign currency value
- Foreign assets and liabilities translated at historical exchange rates do not have a translation exposure to currency risk

11.1 The current rate method

Equity's translation exposure



11.1 The current rate method

Translation accounting

- Financial accounting strives for two goals
  - Reliability: verifiable & neutral in application
  - Relevance: timely & predictive in nature

These objectives can be in conflict when the market values of assets or liabilities are unobservable

11.1 The current rate method

Current rate method of ASC 830-30 & IAS 21

- All assets & liabilities except common equity are translated at the current exchange rate
- Common equity is translated at historical exchange rates
- Most income statement items are translated at the average fx rate over the reporting period
- Any imbalance between the book value of assets and liabilities is recorded as an account in the equity portion of the balance sheet

11.1 The current rate method

The current rate method

Account	Observable market values?	The current rate method translates accounts at…
Assets		
Monetary assets	Yes	Current exchange rate
Nonmonetary assets	Seldom	Current exchange rate
Liabilities & owners' equity		
Monetary liabilities	Yes	Current exchange rate
Equity	Sometimes	Historical exchange rate

Any imbalance between the translated values of assets and liabilities is recorded as a cumulative translation adjustment (ASC 830-30) or as a cumulative exchange difference (IAS 21) in the equity portion of the parent's balance sheet.

11.2 Corporate hedging of translation exposure

A survey of U.S. treasurers…

Do you agree or disagree with the following?
[1= strongly agree, ... 5= strongly disagree]

Managing transaction exposure is important	1.4
Managing operating exposure is important	1.8
Managing translation exposure is important	2.4

Translation exposure appears to be less important than transaction or operating exposure to U.S. financial managers

Jesswein, Kwok & Folks, "Adoption of Innovative Products in Currency Risk Management: Effects of Management Orientations & Product Characteristics," *Journal of Applied Corporate Finance*, 1995.

11.2 Corporate hedging of translation exposure

There are cross-country differences in the perceived importance of translation exposure to currency risk

- Surveys of industrial firms outside the United States indicate a greater willingness to hedge on the part of non-U.S. companies
  - Finland
  - Germany
  - United Kingdom

11.2 Corporate hedging of translation exposure

Hedging translation exposure

- The firm should only consider hedging risk exposures that are related to firm value
  - Hedging can increase firm value by reducing expected taxes, costs of financial distress, or agency costs
  - There is no value in hedging non-cash transactions that do not cost or risk cash
- Translation exposure may or may not involve cash flows

11.2 Corporate hedging of translation exposure

There are also information-based reasons for hedging translation exposure

- Costly or restricted access to information on the part of investors or information providers can provide value-related justifications for hedging
  - Satisfying loan covenants
  - Meeting profit forecasts
  - Retaining a credit rating

11.2 Corporate hedging of translation exposure

Policy recommendations

- Only hedge economic exposures, unless there is an economic reason for hedging translation exposure
- Use local sources of capital whenever possible
- Performance evaluation and compensation should be structured to insulate line managers from fx risk
- If hedging translation exposure is deemed necessary, treasury should quote market prices
  - Net transaction or operating exposures can be hedged in external financial markets
  - Noncash exposures may be hedged internally, but typically should not be hedged externally

11.3 Accounting for financial transactions

Accounting for derivative transactions with ASC 815 and IFRS 9

- **Derivatives** should be reported in the financial statements
- **Fair (market) value** is the most relevant measure of value
- Only assets and liabilities should be reported as such. Income & expenses should be reported on the income statement
- **Special hedge accounting rules** should be limited to qualifying hedge transactions

11.3 Accounting for financial transactions

The reason for hedge accounting rules

Assets	Liabilities and equity
Foreign currency monetary assets (40¢)	Foreign currency monetary liabilities (20¢)
	Domestic currency monetary liabilities (40¢)
Domestic currency monetary assets (25¢)	
Real assets (35¢)	Equity (40¢)

Consider a firm with net exposed monetary assets of 40¢ – 20¢ = 20¢

After multinational netting, a net of 20% of this firm's assets have a transaction exposure to currency risk

11.3 Accounting for financial transactions

The reason for hedge accounting rules

Assets	Liabilities and equity
New domestic currency monetary asset (20¢)	New foreign currency monetary liabilities (20¢)
Foreign currency monetary assets (40¢)	Foreign currency monetary liabilities (20¢)
	Domestic currency monetary liabilities (40¢)
Domestic currency monetary assets (25¢)	
Real assets (35¢)	Equity (40¢)

Suppose the firm engages in a **currency swap** with a notional principal of 20¢

In particular, swap into 20¢ of foreign currency liabilities and swap out of 20¢ of domestic currency liabilities

Exposed monetary assets (40¢) now equal exposed monetary liabilities (40¢)

If capitalized on the balance sheet, this swap would increase the apparent **debt ratio** from D/V = 60/100 = 0.60 to D/V = 80/120 = 0.67

11.3 Accounting for financial transactions

The reason for hedge accounting rules

Assets	Liabilities and equity
New domestic currency monetary asset (20¢)	New foreign currency monetary liabilities (20¢)
Foreign currency monetary assets (40¢)	Foreign currency monetary liabilities (40¢)
Domestic currency monetary assets (25¢)	Domestic currency monetary liabilities (20¢)
Real assets (35¢)	Equity (40¢)

If these offsetting positions **qualify as a hedge**, then they are merely footnoted and are not capitalized on the balance sheet

The net effect of the currency swap is to balance the firm's net transaction exposure to currency risk

11.3 Accounting for financial transactions

Special hedge accounting rules

- Three types of currency hedges can qualify
  - **Cash flow hedge** of a forecasted transaction
  - **Fair value hedge** against changes in the fair value of an asset, liability, or commitment
  - Hedge of a net investment in a foreign operation
- In order to qualify, a hedge must be **clearly defined**, **measurable**, and **effective**
- Both IASB and FASB **recognize derivative gains or losses** - along with the offsetting losses or gains on the underlying exposure - **in earnings**