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The Effect of SFAS on Multinationals' Foreign Exchange Risk Management Policies

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I. Introduction

A major reporting change affecting multinational corporations took place in 1983. For the first time multinationals were required to translate their foreign subsidiaries' financial statements from foreign currencies to the U.S. dollar using the method outlined in the Statement of Financial Accounting Standards (SFAS) 52. SFAS 52, which replaces the widely criticized SFAS 8, is designed for the following purpose:

to provide information that is generally compatible with expected economic effects of an exchange rate change on an enterprise's cash flows and equity and reflect in consolidated statements the financial results and relationships as measured in the primary currency in which the entity conducts its business (Journal of Accountancy, 1982).

In this paper I first briefly discuss the mechanics of SFAS 8 and its effects on financial statements. Next, I analyze the foreign exchange risk management policies implemented by multinational corporations in reaction to SFAS 8. Proceeding with an illustration of the mechanics of SFAS 52, I explain how accounting exposure under the new rule depends upon the designation of the functional currency. In the process I briefly note the distinction between accounting exposure and economic exposure. Finally, I analyze the impact of SFAS 52 on multinationals' hedging practices and debt structure and conclude with an assessment of whether these changes will be beneficial or detrimental to multinational corporations.

II. The Mechanics of SFAS 8 and Its Effects on Financial Statements

The previous standard, SFAS 8, required multinationals to use the temporal method of
translation. Under the temporal method, non-monetary items, such as fixed assets or inventories valued at historical cost in the foreign currency, were translated from the foreign currency to the U.S. dollar using the historical exchange rate (i.e., the exchange rate on the date the transaction took place). On the other hand, monetary items and other items carried at current prices, such as inventory carried at market, were translated at the current exchange rate (i.e., the exchange rate at balance sheet date). Thus, the temporal method was concerned with the exposure of individual monetary assets and liabilities in that the dollar value of the monetary items changed as exchange rates fluctuated.

SFAS 8 often led to distorted profit margins since sales were translated to dollars using current exchange rates, but in most cases inventories were translated to dollars using historical exchange rates. In addition, any translation gains or losses which arose due to the effect of fluctuating exchange rates on the exposed position (i.e., those assets and liabilities translated using current exchange rates) were included in multinationals' consolidated net income. Fluctuating exchange rates caused volatility in consolidated net income due to bookkeeping entries which may not have reflected underlying economic significance. To compound the problem, these translation exchange gains and losses were combined with those gains and losses resulting from foreign exchange transactions, which have actual cash flow implications. The net figure was reported as a simple line item on the multinationals' income statements.

This reporting practice posed difficulties for users of multinationals' financial statements. For example, while ITT's earnings per share for the first quarter of 1980 was 64% higher than a year earlier, 60% was attributable to favorable translation effects and only 4% was the result of an increase in operating profits (Srinivasulu, 1983). For the fiscal year 1981, the application of SFAS 8 contributed to a decrease of 44.5% from 1980 in ITT's earnings before an extraordinary item (Management Accountant, 1982).

III. Foreign Exchange Risk Management Policies Implemented in Reaction to SFAS 8

Evidence shows (Shank and Dillard, 1979) that multinationals implemented foreign exchange risk management policies in reaction to SFAS 8 to offset translation gains and losses and thereby stabilize their “bottom line.” Concern about the effect of volatile translation adjustments on consolidated net income stemmed from the following:

1) the desire to have a steady (or growing) EPS;
2) the need to link corporate incentive and profit-sharing systems with reported profits;
3) a fear (genuine or imagined) that such swings affect stock prices, as well as the firm's ability to raise capital and the attendant costs (Srinivasulu, 1983).

Shank and Dillard found that 68% of the firms which they studied entered the forward markets to cover translation exposures (p. 3). The objective was to cover potential translation losses with corresponding gains on the forward currency contracts. This policy, however, often proved to be detrimental in an economic sense because the firms increased their real economic exposure to exchange rate fluctuations. They risked actual cash flow losses on the forward contracts in attempting to offset potential translation losses which had no cash flow effect. For example, a multinational with a foreign subsidiary with an exposed net monetary liability position (i.e., monetary liabilities which exceed monetary assets) would engage in a forward purchase of the foreign currency if it expected the value of the dollar to decrease relative to the foreign currency. The intent would be for the gain on the forward purchase contract to offset the translation exchange loss on the exposed position. If the value of the dollar actually increased relative to the foreign currency, however, the loss on the forward purchase contract would be offset by the corresponding translation gain on the exposed position. Although the multinational has main-
tained stability of earnings on its consolidated income statement, the firm has suffered in an economic sense in that it has incurred an actual loss of cash on the forward purchase contract.

The Shank and Dillard study also revealed that multinationals changed their preference for local currency debt and U.S. dollar debt depending on their exposure under SFAS 8:

Sixteen percent of the companies indicated that they ... (were carrying) "more local debt at higher interest rates in order to cover monetary asset exposure." Twelve percent indicated that they ... (were carrying) more U.S. dollar debt at higher interest rates to offset monetary liability exposure (Shank and Dillard, p. 28).

Once again, multinationals incurred a higher economic cost in the form of increased cash outflows (to cover increased interest expense) with the objective of protecting their net incomes from translation losses.

IV. The Mechanics of SFAS 52

Two major reporting changes have been implemented by SFAS 52. First of all, the concept of "functional currency" has been introduced as the primary currency of the environment in which the subsidiary generates cash flows. Current exchange rates will be used to translate all of the assets and liabilities of the foreign subsidiary from its functional currency to the U.S. dollar. The equity accounts, however, will be translated at historical rates. Secondly, the bookkeeping gains and losses which arise from this translation process will not flow through consolidated net income. Such gains and losses will instead be accumulated in a special component of owners' equity on the multinational's consolidated balance sheet (Huefner and Largay, 1982).

The designation of the functional currency is to be based on such factors as cash flows, sales prices, sales market, financing and intercompany transactions. In general, foreign subsidiaries which are self-sufficient and relatively independent of the U.S. parent will designate a foreign currency as their functional currency, while those whose operations are closely tied to the U.S. parent will designate the U.S. dollar as the functional currency. These criteria are not absolute, however, and management has been given a degree of discretion so long as the choice of a functional currency is not inconsistent with reality. Nevertheless, in the case of a subsidiary operating in a highly inflationary environment (defined as one in which cumulative inflation over the last three years exceeds 100%), the functional currency must be the U.S. dollar.

The functional currency may or may not be the currency in which the subsidiary keeps its books. When the subsidiary does keep its books in the functional currency, the books are simply translated from the functional currency to U.S. dollars in accordance with the current rate method of SFAS 52. The resulting translation gains or losses are accumulated directly in the special component of owners' equity. If the functional currency differs from the currency in which the subsidiary keeps its books, however, the books must first be translated to the functional currency using a remeasurement process before the current rate method of SFAS 52 can be applied. The remeasurement process is essentially the same method that was outlined in SFAS 8, with the resulting gains or losses flowing through consolidated net income. The books are then translated from the functional currency to U.S. dollars in accordance with the current rate method of SFAS 52. Any further translation gains or losses are accumulated directly in the special component of owners' equity.

I will use a simple example for illustrative purposes. As described in Figure 1. Subsidiary X, a French subsidiary which maintains its books in French francs (the functional currency), translates its books from French francs to U.S. dollars using the current rate method of SFAS 52. The resulting gains or losses go directly to owners' equity, having no effect on consolidated net income.

On the other hand, Subsidiary Y, a Canadian subsidiary which maintains its books in Canadian dollars, must first translate its books to British pounds (the functional currency)
FIGURE 1: Converting Foreign Subsidiaries’ Financial Statements to U.S. Dollars Under SFAS 52

(A) The foreign subsidiary’s books are remeasured from the currency of the books to the functional currency under SFAS 8 rules. The resulting gains/losses flow through consolidated net income.

(B) The conversion from the functional currency to the U.S. dollar is made using the current rate method of SFAS 52. The resulting gains/losses go directly to the special category in owner’s equity and have no effect on consolidated net income.

using the remeasurement process outlined in SFAS 8. Any gains or losses resulting from this step impact consolidated net income. The books would then be translated from British pounds to U.S. dollars in accordance with the current rate method of SFAS 52, with any further gains and losses going directly to owners’ equity.

It is important to note that in cases where the U.S. dollar is designated as the functional currency, SFAS 52 is equivalent to SFAS 8. This case is represented in Figure 1 by Subsidiary Z, a German subsidiary which has as its functional currency the U.S. dollar. Subsidiary Z’s books would be remeasured from Deutschmarks into U.S. dollars using the temporal method of SFAS 8 to reflect the position of Subsidiary Z had its books been maintained in U.S. dollars.

V. Accounting Exposure

Accounting exposure arises from the translation process and pertains to the impact of fluctuating exchange rates on the dollar value of assets and liabilities denominated in foreign currencies. The extent of accounting exposure depends upon which assets and liabilities are translated at current exchange rates and therefore varies with the translation method.

In the case where the U.S. dollar is not the functional currency, SFAS 52 will significantly
alter the definition of accounting exposure. Accounting exposure will pertain to the U.S. parent’s net investment in the foreign subsidiary rather than to the foreign subsidiary’s individual monetary assets and liabilities. The rationale for linking accounting exposure to net investment is based on the concept of functional currency. A functional currency other than the dollar implies that the foreign subsidiary’s operations are relatively self-contained. It is reasonable to assume that the foreign currency cash flows related to individual monetary assets and liabilities are not indicative of the U.S. parent’s exposure, for there is a high probability that these foreign currency cash flows will never be converted into U.S. dollars. Thus, the corresponding effects of fluctuating exchange rates would not have an impact on the subsidiary’s operations and default risk, and the U.S. parent’s exposure would be limited to the effect of fluctuating exchange rates on its net investment in the foreign subsidiary.

On the other hand, when a foreign subsidiary’s functional currency is the U.S. dollar, accounting exposure will still be related to the individual monetary assets and liabilities of the foreign subsidiary. The underlying rationale is once again based on the concept of functional currency. In this case, the functional currency indicates close financial ties between the foreign subsidiary and the U.S. parent. It is very likely that the foreign currency cash flows relating to individual monetary assets will be converted to U.S. dollars or U.S. dollars will be converted to meet liabilities denominated in the foreign currency. The U.S. parent, therefore, is exposed since its own cash flows and default risk may be directly affected by the influence of fluctuating exchange rates on the subsidiary’s foreign cash flows.

Although SFAS 52 has significantly changed the multinational’s accounting exposure in cases where the U.S. dollar has not been designated as the functional currency, changes in accounting exposure have not affected the multinational’s economic exposure (i.e., risk of cash flow impairment). Indeed, economic exposure is a much broader concept than accounting exposure, for economic exposure includes such considerations as the effect of exchange rate fluctuations on competitive factors and price elasticities of demand. Both proponents and critics of SFAS 52 agree that, regardless of how accounting exposure is defined, it cannot accurately measure economic exposure.

VI. The Impact of SFAS 52 on Hedging Practices

Since multinationals’ economic exposure has not been altered by SFAS 52, theoretically there should be no impact on their hedging practices. Multinationals’ foreign exchange risk management policies should therefore be formulated in reaction to economic exposure with the objective of minimizing default risk (Adler & Dumas, 1981).

As was previously illustrated, however, multinationals may not have been managing their exposures correctly in the past. Under SFAS 8 it was implicitly assumed that the functional currency was the U.S. dollar in all cases, without regard to the likelihood of an actual conversion between the foreign currency and the U.S. dollar. All translation gains and losses were treated as if they reflected underlying economic exposure, and multinationals implemented hedging policies in attempts to neutralize the impact on net income. The major strength of SFAS 52 is that it makes a distinction between those situations in which translation gains and losses have economic significance and those that do not. This distinction is made by recognizing that the functional currency may be other than the U.S. dollar.

In cases where a foreign currency is designated as the functional currency, we may see a marked change in multinationals’ hedging practices. In situations where multinationals had previously hedged under SFAS 8 against the effect of translation gains and losses on net income, the hedging should be curtailed, for such gains and losses no longer flow through net income. These firms will be better off in an economic sense because they will no longer be taking on the risk of actual cash flow losses in order to hedge losses that do not affect cash flows. Thus, in this case SFAS 52 should induce
multinationals to manage their foreign exchange risks more rationally since they will no longer be hedging where no economic exposure exists.

On the other hand, in cases where the dollar is designated as the functional currency, we should not expect to see substantial changes in multinationals' hedging practices. Those multinationals which had previously hedged against fluctuations in net income will most likely continue to do so since translation gains and losses still flow through consolidated net income. In addition, multinationals who had previously chosen not to hedge might consider adopting a hedging policy, if they believe that net monetary assets measure economic exposure when the functional currency is the U.S. dollar.

VII. The Effect of SFAS 52 on the Debt Structure of Multinationals

Under SFAS 8, which assumed the U.S. dollar to be the functional currency of all foreign operations, transactions denominated in dollars suffered no accounting exposure. According to SFAS 52, however, when a currency other than the U.S. dollar is the functional currency, dollar-denominated transactions are exposed, since they will produce translation gains or losses in the remeasurement process. As illustrated in Figure 2, dollar denominated debt, receivables, payables and intercompany accounts must be remeasured from U.S. dollars into the designated functional currency using the method outlined in SFAS 8, with the resulting translation gains and losses flowing through consolidated net income. The foreign subsidiary's statements are then translated from the functional currency to the U.S. dollar as outlined in SFAS 52, and any further translation gains or losses go directly to the separate component of owners' equity.

Multinationals whose functional currency is not the U.S. dollar will want to carry as little U.S. dollar debt as possible to avoid translation adjustments to net income. We should expect, therefore, to see an increase in local currency funding to the extent that it is available (Gianotti, 1982). In cases where local currency funding is not available or where the foreign subsidiary has traditionally relied primarily on funding from the U.S. parent, there is a strong indication that the U.S. dollar rather than the foreign currency will be designated as the functional currency to avoid translation adjustments.

VIII. Conclusion

Although much controversy remains concerning SFAS 52 from an accounting standpoint, it is clearly superior to SFAS 8 inasmuch as it will allow multinationals to manage their foreign exchange risk more rationally. In choosing their functional currencies and the treatment of translation adjustments, multinationals will be forced to determine the extent to which their foreign operations are exposed to exchange rate fluctuations in an economic sense. No longer should we see multinationals implementing foreign exchange risk management policies designed solely to protect against unfavorable translation adjustments without regard for the presence or absence of underlying economic exposure.

FIGURE 2: The Treatment of U.S. Dollar Denominated Monetary Accounts Under SFAS 52

When the U.S. Dollar Is Not the Functional Currency.

<table>
<thead>
<tr>
<th>DOLLAR-DENOMINATED MONETARY ACCOUNT</th>
<th>FUNCTIONAL CURRENCY (other than dollars)</th>
<th>U.S. MULTINATIONAL'S CONSOLIDATED STATEMENTS IN U.S. DOLLARS</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) REMEASUREMENT to functional currency under SFAS 8 rules with gains/losses impacting consolidated net income.</td>
<td>(B) TRANSLATION to U.S. dollars under SFAS 52 with gains/losses reported in separate component of owner's equity with no impact on consolidated net income.</td>
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References


