

## Chapter 13

### Translation Exposure to FX Risk

- 13.1 Measuring Translation Exposure
- 13.2 Which Translation Method is the Most Realistic?
- 13.3 Corporate Hedging of Translation Exposure
- 13.4 Accounting for Financial Market Transactions
- 13.5 Accounting, Disclosure, and Corporate Hedging Activities
- 13.6 Summary

## A survey of corporate treasurers

**Do you agree or disagree with the following?**

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

1= strongly agree, ... 5= strongly disagree

➤ **Transaction exposure is viewed as the most important currency risk exposure**

## Translation exposure to fx risk

- **Translation (accounting) exposure to fx risk** refers to the impact of fx changes on the parent's consolidated **financial statements**
- Financial accounting strives for two goals: **reliability** and **relevance**
- These objectives can be in conflict when the market values of assets or liabilities are **unobservable**

## The exposure of shareholders' equity

Foreign currency monetary assets (40€)	Foreign currency monetary liabilities (20€)	Net exposed monetary assets (20€)
Domestic currency monetary assets (25€)	Domestic currency monetary liabilities (40€)	
Real assets exposed to fx risk (35€)	Real assets (35€)	Equity (40€)

## Translation accounting methods

- The **current / noncurrent** method
  - in use in the U.S. prior to 1976
- The **monetary / nonmonetary** or temporal method
  - used in the U.S. with FAS #8 (1976)
- The **current rate** method
  - used in the U.S. with FAS #52 (1982)

## The current / noncurrent method in use in the U.S. prior to 1976

- **Current assets and liabilities** are translated at the current exchange rate
- **Noncurrent assets and liabilities** are translated at historical exchange rates
- Most **income statement items** are translated at the average exchange rate over the reporting period
- **Depreciation** is translated at historical exchange rates

### The monetary / nonmonetary or temporal method of FAS #8 (1976)

- **Monetary assets and liabilities** are translated at the current exchange rate
- **All other assets and liabilities** are translated at historical exchange rates
- Most **income statement items** are translated at the average exchange rate over the reporting period
- **Depreciation and COGS** are translated at historical exchange rates

### The problem with FAS #8

- Translation gains or losses were reflected in reported earnings on the income statement
  - Changes in translated balance sheet accounts could overwhelm operating performance, resulting in operating losses even during profitable years
  - This resulted in large swings in reported earnings...swings over which managers had no control

### The current rate method of FAS #52 (1982)

- **All assets & liabilities** except common equity are translated at the current exchange rate
- **Common equity** is translated at historical exchange rates
- **Income statement items** are translated at the current exchange rate
- Any imbalance between the book value of assets and liabilities is recorded as a separate equity account called the **cumulative translation adjustment (CTA)**

### A comparison of translation methods

	<b>FAS #8</b>	<b>FAS #52</b>	
	<b>Current- noncurrent</b>	<b>Monetary- nonmonetary</b>	<b>Current rate</b>
<b>Assets</b>			
ST financial assets	current	current	current
LT financial assets	historical	current	current
Real assets	historical	historical	current
<b>Liabilities and owners' equity</b>			
ST financial liabilities	current	current	current
LT financial liabilities	historical	current	current
Net worth (equity)	historical	historical	historical
Translation gains or losses	flowed thru the income statement	flowed thru the income statement	accumulated as a CTA

### Operating exposures to fx risk

		Revenues	
		Local	Global
Operating expenses	Local	Domestic firms (0)	Exporters (+)
	Global	Importers (-)	MNCs, importers, & exporters in globally competitive markets (?)

### 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

## 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

## Cross-country differences in hedging of translation exposure

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

## Policy recommendations

- **Only hedge economic exposures**
- **Use local sources of capital** whenever possible
- **Performance evaluation and compensation** should be structured to insulate 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 should be hedged internally

## FAS #133 Accounting for Derivative Instruments and Hedging Activities

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