

Multinational Accounting

- Many companies, large and small, depend on international markets for supplies of goods and for sales of their products and services.
- This chapter and Chapter 12 discuss the accounting issues associated with companies that operate internationally.

Multinational Accounting

- The U.S. entity may incur foreign currency risks whenever it conducts transactions in other currencies.
- For example, if a U.S. company acquires a machine on credit from a Swiss manufacturer, the Swiss company may require payment in Swiss francs (SFr).

Multinational Accounting

- This means the U.S. company must eventually use a foreign currency broker or a bank to exchange U.S. dollars for Swiss francs in order to pay for the machine.
- In the process, the U.S. company may experience foreign currency gains or losses from fluctuations in the value of the U.S. dollar relative to the Swiss franc.

Multinational Accounting

- The topic of foreign exchange markets is one of the most important and often misunderstood subjects in international business.
- The European euro is a relatively new currency, introduced in 1999 to members of the European Union (EU) that wished to participate in a common currency.

Multinational Accounting

- The EU is a dominant economic force, rivaling the United States, and the euro is now as familiar to companies doing international business as is the US dollar.

Multinational Accounting

- MNEs transact in a variety of currencies as a result of their export and import activities.
- There are approximately 150 different currencies around the world.

Multinational Accounting

- Most international trade has been settled in six major currencies that have shown stability and general acceptance over time: the U.S. dollar, the British pound, the Canadian dollar, the European euro, the Japanese yen, and the Swiss franc.

Multinational Accounting

- A growing international trend is the adoption of the ISO 9000 series of standards by companies engaging in international trade.

Multinational Accounting

- These standards, adopted by the International Organization for Standardization (ISO) in 1987, specify the degree of conformance to rigorous quality programs in various product design and production processes.

Multinational Accounting

- Companies undergo a thorough quality control audit during the certification process, and many of these companies see the ISO 9000 series of standards as part of their total quality management programs.

Multinational Accounting

- The value of the ISO certification in the marketplace is that a company's customers are given additional assurance that the certified company focuses on continuous improvement and has a quality focus in all its processes from the initial stages of production through post sale servicing.

Accounting Issues

- Accountants must be able to record and report transactions involving exchanges of U.S. dollars and foreign currencies.

Accounting Issues

- Foreign currency transactions of a U.S. company include sales, purchases, and other transactions giving rise to a transfer of foreign currency or recording receivables or payables which are denominated—that is, numerically specified to be settled—in a foreign currency.

Accounting Issues

- Because financial statements of virtually all U.S. companies are prepared using the U.S. dollar as the reporting currency.
- This process of restating foreign currency transactions to their U.S. dollar equivalent values is termed translation.

Accounting Issues

- Transactions denominated in other currencies must be restated to their U.S. dollar equivalents before they can be recorded in the U.S. company's books and included in its financial statements.

Accounting Issues

- In addition, many large U.S. corporations have multinational operations, such as foreign-based subsidiaries or branches.

Accounting Issues

- The foreign currency amounts in the financial statements of these subsidiaries have to be translated, that is, restated, into their U.S. dollar equivalents, before they can be consolidated with the financial statements of the U.S. parent company that uses the U.S. dollar as its reporting currency unit.

Accounting Issues

- FASB 52 serves as the primary guide for accounting for accounts receivable and accounts payable transactions that require payment or receipt in a foreign currency.
- FASB 133 guides the accounting for financial instruments specified as derivatives for the purpose of hedging certain items.

Direct Exchange Rate

- The direct exchange rate (DER) is the number of local currency units (LCUs) needed to acquire one foreign currency unit (FCU).
- From the viewpoint of a U.S. entity, the direct exchange rate can be viewed as the dollar cost of one foreign currency unit.

Direct Exchange Rate

- The direct exchange rate ratio is expressed as follows, with the LCU, the U.S. dollar, in the numerator:

$$\text{DER} = \frac{\text{U.S. dollar equivalent value}}{1 \text{ FCU}}$$

Indirect Exchange Rate

- The indirect exchange rate (IER) is the reciprocal of the direct exchange rate.
- From the viewpoint of a U.S. entity, the indirect exchange rate can be viewed as the number of foreign currency units that 1 U.S. dollar can acquire.

Indirect Exchange Rate

- The ratio to compute the indirect exchange rate is:

$$\text{IER} = \frac{1 \text{ FCU}}{\text{U.S. dollar equivalent value}}$$

Exchange Rate Mnemonic

- A mnemonic to help remember the difference in exchange rates is to note that the U.S. dollar is the numerator for the direct rate (the foreign currency unit is in the denominator).
- The foreign currency unit is in the numerator for the indirect exchange rate (with the U.S. dollar in the denominator).

Exchange Rate Mnemonic

- The terms currency is the numerator and the base currency is the denominator in the exchange rate ratio. The numerator is the key to identification of the rate.

Spot Rates versus Current Rates

- FASB 52 refers to the use of both spot rates and current rates for measuring the currency used in international transactions.
- The spot rate is the exchange rate for immediate delivery of currencies.
- The current rate is defined simply as the spot rate on the entity's balance sheet date.

Forward Exchange Rates

- A third exchange rate is the rate on future, or forward, exchanges of currencies.
- Active dealer markets in forward exchange contracts are maintained for companies wishing to receive, or deliver, major international currencies.

Forward Exchange Rates

- The forward rate on a given date is not the same as the spot rate on the same date. The difference between the forward rate and the spot rate on a given date is called the spread.

Foreign Currency Transactions

- Foreign currency transactions are economic activities denominated in a currency other than the entity's recording currency.
 - Examples on next slide.

Foreign Currency Transactions

- Purchases or sales of goods or services (imports or exports), the prices of which are stated in a foreign currency.
- Loans payable or receivable in a foreign currency.
- The purchase or sale of foreign currency forward exchange contracts.
- Purchases or sale of foreign currency units.

Import and Export Transactions

- Payables and receivables that are denominated in a foreign currency, must be measured and recorded by the U.S. entity in the currency used for its accounting records—the U.S. dollar.
- The relevant exchange rate for settlement of a transaction denominated in a foreign currency is the spot exchange rate on the date of settlement.

Import and Export Transactions

- At the time the transaction is settled, payables or receivables denominated in foreign currency units must be adjusted to their current U.S. dollar equivalent value.

Import and Export Transactions

- If financial statements are prepared before the foreign currency payables or receivables are settled, their account balances must be adjusted to their U.S. dollar equivalent values as of the balance sheet date, using the current rate on the balance sheet date.

Import and Export Transactions

- An overview of the required accounting for an import or export transaction denominated in a foreign currency, assuming the company does NOT use forward contract, is as follows:
 - See next slide

Import and Export Transactions

- Transaction date.
 - Record the purchase or sale transaction at the U.S. dollar equivalent value using the spot direct exchange rate on this date.
 - Continued on next slide.

Import and Export Transactions

- Balance sheet date.
 - Adjust the payable or receivable to its U.S. dollar equivalent, end-of-period value using the current direct exchange rate.
 - Recognize any exchange gain or loss for the change in rates between the transaction and balance sheet dates.
- Continued on next slide.

Import and Export Transactions

- Settlement date.
 - First adjust the foreign currency payable or receivable for any changes in the exchange rate between the balance sheet date (or transaction date if transaction occurs after the balance sheet date) and the settlement date, recording any exchange gain or loss as required.
 - Then record the settlement of the foreign currency payable or receivable.

Risk Management

- Companies need to manage business risks.
- Derivative instruments are an important tool in managing risk..
- MNCs often use derivative instruments including foreign-currency denominated forward exchange contracts, foreign currency options, and foreign currency futures, to manage risk associated with foreign currency transactions.

Risk Management

- Those companies operating internationally are subject not only to the normal business risks but are typically subject to additional risks from possible changes in currency exchange rates because of their transacting in more than one currency.

Risk Management

- Multinational entities manage their foreign currency risks by using one of several types of financial instruments: Foreign currency denominated forward exchange contract; Foreign currency option; and, Foreign currency futures.

Financial Instrument

- A financial instrument is cash, evidence of ownership, or a contract that both:
 - Imposes on one entity a contractual obligation to deliver cash or another instrument, and
 - Conveys to the second entity that contractual right to receive cash or another financial instrument.
- Examples include cash, stock, notes payable and receivable, and many financial contracts.

Derivative

- A derivative is a financial instrument or other contract whose value is “derived from” some other item which has a value that is variable and can change over time.

Derivative

- An example of a derivative is a foreign currency forward exchange contract whose value is derived from changes in the foreign currency exchange rate over the term of the contract.
- Note that not all financial instruments are derivatives.

Fair Value Hedge

- Fair value hedges are those designed to hedge the exposure to potential changes in the fair value of:
 - (a) a recognized asset or liability such as available-for-sale investments
 - (b) an unrecognized firm commitment for which a binding agreement exists such as to buy or sell inventory.

Fair Value Hedge

- The gains or losses on the hedged asset or liability, and the hedging instrument, are recognized in current earnings on the income statement.

Cash Flow Hedge

- Cash flow hedges are those designed to hedge the exposure to potential changes in the anticipated cash flows, either into or out of the company:
 - (a) a recognized asset or liability such as future interest payments on variable- interest debt
 - (b) a forecasted cash transaction such as a forecasted purchase or sale.
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Cash Flow Hedge

- The gain or loss on the effective portion of the hedging instrument should be reported in other comprehensive income.
- The gain or loss on the ineffective portion is reported in current earnings on the statement of income.

Hedges of a Net Investment

- In the earlier discussions of the use of forward exchange contracts as a hedging instrument, the exchange risks from transactions denominated in a foreign currency could be offset.

Hedges of a Net Investment

- This same concept is applied by the U.S. companies that view a net investment in a foreign entity as a long-term commitment that exposes them to foreign currency risk.

Hedges of a Net Investment

- A number of balance sheet management tools are available for a U.S. company to hedge its net investment in a foreign affiliate.
- Management may use forward exchange contracts, other foreign currency commitments, or certain intercompany financing arrangements, including intercompany transactions.

Hedges of a Net Investment

- Any effects of exchange rate fluctuations between the pound and the dollar would be offset by the investment in the British subsidiary and the loan payable.

Hedges of a Net Investment

- FASB 133 specifies that for derivative financial instruments designated as a hedge of the foreign currency exposure of a net investment in a foreign operation.
- The portion of the change in fair value equivalent to a foreign currency transaction gain or loss would be reported in other comprehensive income.

Hedges of a Net Investment

- That part of other comprehensive income resulting from a hedge of a net investment in a foreign operation shall then become part of the cumulative translation adjustment in accumulated other comprehensive income.

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- Virtually all companies have foreign transactions.
- The general rule is that accounts resulting from transactions denominated in foreign currency units must be valued and reported at their equivalent U.S. dollar values.
- Forward exchange contracts typically use the forward rate for determining current fair value.

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- For fair value hedges, the gain or loss is taken into current earnings.
- For cash-flow hedges, the gain or loss—for the effective portion of the hedging instrument—is taken to other comprehensive income for the period.

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- For cash-flow hedges, the gain or loss—for the ineffective portion of the hedging instrument—is taken into current earnings for the period.
- For a hedge of a net investment, the gain or loss is taken to other comprehensive income for the period.