Accounting for Foreign Currency Transactions

Why worry about foreign transactions? Why shouldn’t a company simply insist on trading in US dollars. Particularly if one is a small business in Kansas, why expose oneself to the risks imposed by all these foreign countries and their economies?

Think of a small business in Kansas that buys goods from a supplier in the UK. Could just buy some pounds right now and pay the supplier with that when the bill comes due. No risk.

But .. do you want to keep your money locked up in pounds? Suppose you don’t have the money? Will you borrow it? If so, you are paying interest and also holding currency. Of course you could put the currency in a British/Indian/Japanese bank and that would offset your US expense. Are interest rates the same? If not, what does the formula on page 10-6 of Fischer say?

Also you will have transactions costs at each stage and by the time you put transactions costs together, do-it-at-home arbitrage is more costly than what the banks can sell you. That’s what they are good at. Hence better off hedging with a professional.

The discussion of transactions costs is a good place to think about the Enron saga: Enron was fine as long as its customers had higher transactions costs (lack of knowledge, lack of access to counterparties, lack of
standardized contracts). Once customers became savvy and competitors came up (e.g. Dynegy), Enron lost its edge, started to lose money and started parking those losses in SPEs. In sum, they lost their transactions cost edge, started losing money and didn’t want to admit it. Does fraud/financial skullduggery get any more basic than this? Story as old as the hills…

Coming back to the main story line, what options does this small business have?

1. Buy currency and hold
2. Hedge
3. Go naked (do nothing).

This is what the day’s readings are all about.
Accounting for Foreign Transactions.

MBA version of SFAS 52. This is a very useful guide to how to present these issues to a managerial audience. Also to get some insights into examples that capture the essence of the problem.

Understand the four methods on p. 6 of the HBS case.

Note how each method works. Test your understanding. E.g. What class of assets is treated differently under the current method and the monetary-non-monetary methods?

Leave details of FAS 52 for a later class.

Sneak preview: The key elements of FAS52 are definition of functional currency, the use of the current rate method and remeasurement. Illustration B provides information used to identify the functional currency and Illustration C the correct rate to be used on different components. We get into all this in more detail in a later class.
The interesting stuff starts with the material on p.126-129. First try to understand what is going on conceptually.

We have a sale/purchase transaction.

- These are recorded and any changes in value are essentially financing (holding) gains or losses.

We have receivables or payables.

- These will change value over time till they are realized.
- We need to mark these to market using spot rates at each future reckoning date.

Finally we have the hedge. The hedge is the FC receivable/payable.

- We need to mark this to market at the forward rate at future reckoning dates.

All gains or losses are Income Statement items.

Now we can discuss the problems for today.