

17.3: Accounting in International Business

Learning Objectives

1. Describe what consolidated financial statements are.
2. Understand the risk of currency fluctuations.
3. Explain two methods that firms use for currency translation.

Financial Statements in International Business

Multinational firms often organize as separate legal entities (i.e., companies) in different countries to gain advantages, such as limiting liability or taking advantage of local corporate tax regulations. Also, many countries mandate that companies that do business in their country set up a separate company in that country. As a result, a multinational company may have numerous foreign subsidiaries, all owned by the parent. A **consolidated financial statement** brings together all the financial statements of a parent and its subsidiaries into a single financial statement. The consolidated financial statement must reconcile all the investment and capital accounts as well as the assets, liabilities, and operating accounts of the firms. Consolidated financial statements demonstrate that firms—although legally separate from the parent and each other—are in fact economically interdependent. Most of the developed nations require consolidated statements so that losses can't be hidden under an unconsolidated subsidiary. The International Accounting Standards Board (IASB) standards mandate the use of consolidated financial statements.

Consolidating financial statements of subsidiaries located in different countries poses problems because of the different currencies used in different countries. Companies must decide on what basis they will translate those different currencies into the home currency of the parent company.

Currency Risk

Currency values fluctuate from day to day relative to each other, which poses a risk for firms that operate internationally. Currency risk is the risk of a change in the exchange rate that will adversely affect the company. Companies face this risk because they typically price their products and services in the local currency of each country in which they operate, to make it easy for local customers to understand the pricing and make the purchase. This practice exposes companies to currency risk. For example, the US dollar fluctuated from 1.501 dollars per euro in October 2009 to 1.19440 in June 2010. "Historical Exchange Rates," OANDA, accessed October 28, 2010, http://www.oanda.com/currency/historical-rates?date_fmt=us&date=10/26/09&date1=02/25/09&exch=EUR&exch2=EUR&expr=USD&expr2=USD&format=HTML&margin_fix=0. This means that if a US company were selling a product for 1,000 euros, the company would receive \$1,501 dollars for it in October 2009 but only \$1,194 for it in June 2010. To preserve profits, the company might raise the euro-denominated price of its products, but the company would risk a drop in sales due to the increased price.

In a simple example, currency fluctuations mean that if a US-based company sold its product in Germany at a 10 percent profit and the currency value of the dollar dropped 10 percent relative to the euro, then the profit would be wiped out.

Companies can mitigate currency risk by engaging in hedging. **Hedging** refers to using financial instruments to reduce adverse price movements by taking an offsetting position. Specifically, a firm can lock in a guaranteed foreign exchange rate through a forward contract. In the **forward contract**, the firm agrees to pay a specific rate at the beginning of the contract for delivery at a future date. Thus, the firm will pay the agreed-on exchange rate regardless of what the current exchange rate is at the date of the final settlement. There are costs associated with using these instruments, such as premium pricing, bank fees, and interest payments. But companies often prefer to protect themselves against a potential larger downside loss, even if they have to pay extra to avoid that bigger loss.

Currency Translation

When multinational companies consolidate their subsidiaries' financial statements, they must translate all the currencies into the currency used by the parent company in its home country. There are two methods which a company can use for currency translation—the current-rate method or the temporal method.

Current-Rate Method

The **current-rate method** is a method of foreign-currency translation in which items in the subsidiaries' financial statements are translated into the currency of the parent corporation at the current exchange rate (i.e., the rate on the date when the statements are prepared). In this case, the current value may be different on the day it's translated than on the date when the assets were originally purchased. Although this difference is only a paper gain or loss, it nonetheless affects the valuation of the firm. This method is the most widely used currency-translation method.

Temporal Method

The **temporal method** is a method of foreign-currency translation that uses exchange rates based on the rate in place when the assets and liabilities were originally acquired or incurred. The temporal method avoids the paper gains or losses problem of the current-rate method. But because subsidiaries purchase assets at different times throughout the year, the multinational firm's balance sheet may not balance if the temporal method is used.

Currency Fluctuations

When the Chinese government announced in 2010 that it would allow its currency, the yuan, to float more freely in relation to other world currencies, US CFOs knew that the change would affect their currency-risk picture. When the yuan was pegged to the dollar (from 2008 to 2010), China's currency had less value, which gave China an advantage in global trade. China's goods were cheaper in world markets. Once the yuan floats more freely, it's expected to appreciate against the dollar.

The yuan's appreciation against the dollar will most likely bring two results. First, it will bring Chinese consumers' purchasing power closer to parity around the world. Second, manufacturing in China will be more expensive than it was in the past, which brings about two results of its own. Foreign firms may move their manufacturing operations out of China (or not open them there in the first place) as they search for the lowest costs elsewhere, and the yuan's value appreciation in the long term means that Chinese products will become more expensive for other countries to buy, which will force China to move from manufacturing lower-margin products like toys and shoes to higher-end businesses. These higher-end areas will bring China into more direct competition with the United States and Europe. Kate O'Sullivan, "Freeing the Yuan," *CFO*, June 23, 2010, accessed October 28, 2010, www.cfo.com/article.cfm/14506658.

Forward Exchange Rate

One way to deal with the problem of currency fluctuations is to use the forward-exchange-rate method. The **forward exchange rate** is the rate at which two parties agree to exchange currency and execute a deal at some specific point in the future, usually 30 days, 60 days, 90 days, or 180 days in the future. The firms agree up front on the rate at which they'll exchange currencies, although the actual delivery of the foreign currency will be at a future specified date. For example, a multinational firm based in Spain might sign a contract with a US bank to buy US dollars for euros 90 days from now at a specified exchange rate. The Spanish corporation would use the forward exchange rate as a way to reduce exchange-rate risk if the value of the euro decreases substantially relative to the US dollar.

If two subsidiaries of the same multinational firm do a currency exchange, then they can use an internal forward rate. The **internal forward rate** is a company-generated forecast of future **spot exchange rates**. The internal forward rate may differ from the forward rate quoted by the foreign exchange market. The advantage of this agreement between the parent and foreign subsidiaries is that if the exchange rate changes, the subsidiary will not be blamed or credited for the change.

KEY TAKEAWAYS

- Multinational firms often organize as separate legal entities (i.e., companies) in different countries to gain advantages such as limiting liability or taking advantage of local corporate tax regulations. A consolidated financial statement brings together all the financial statements of a parent and its subsidiaries into a single financial statement. Consolidating financial statements of subsidiaries located in different countries poses problems because of the different currencies used in different countries.
- Currency values fluctuate from day to day relative to each other. Companies can mitigate currency risk by engaging in hedging. Hedging refers to using financial instruments to reduce adverse price movements by taking an offsetting position. Specifically, a firm can lock in a guaranteed foreign exchange rate through a forward contract. In a forward contract, a firm agrees to pay a specific rate at the beginning of the contract for delivery at a future date.
- Companies must decide what method they'll use to translate different currencies into the home currency of the parent company. Under the current-rate method of currency translation, items in the subsidiaries' financial statements are translated at the current

exchange rate (i.e., the rate on the date when the statements are prepared) into the currency of the parent corporation. Under the temporal method, firms use the exchange rate based on the rate in place when the assets and liabilities were originally acquired or incurred.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Why do most developed nations require consolidated financial statements?
2. What does currency risk mean?
3. What are some ways that companies can reduce the currency risk they face?
4. Compare the current-rate method of currency translation with the temporal method.
5. Explain the difference between the foreign exchange rate and the internal forward rate.

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