

Replies, 10/29/03

Dear Students,

Here are the replies to your questions. As for the answer to my question (what translation method would you use in a country w/ hyperinflation?) is that according to FAS #52 US subsidiaries in countries where cumulative inflation is above 100% over three years, use the temporal method. The idea is to preserve the value of the assets in investments overseas.

Here are the answers to your questions.

Even if subsidiary's balance sheet is kept in \$, if subsidiary operated in foreign currency, isn't there implicit translation exposure?

I see. So, you are thinking of a situation where the subsidiary would bill in local currency, but for the purposes of the balance sheet, they would keep everything in US\$. In other words, the do "quasi"-consolidation with the parent, keeping the books in US\$. Yes, in this case, they would suffer "implicit" exposure, but it will not be translation exposure – they simply do not keep financial records in the local currency.

What are the benefits of translating at historical rates?

First, you can preserve important accounting ratios based on the balance sheet. Why? Translating at historic rates will not distort the value of the line items when there is a change in the exchange rates. So, why preserving accounting ratios might be important? Because, oftentimes, debt covenants, etc are written based on these ratios. And, because analysts watch closely these ratios too.

Second, from accounting point of view, you do not distort the balance sheet & income statement line items when exchange rates fluctuate.

I think someone might have asked this question, and I forgot, but what is a derivative?

Great question. In fact, I can not give an exact definition, because pretty much every instrument is in a some sense a derivative. If we assume that straight debt & equity are not derivatives, all other financial instruments (claims) are derivatives. Basically, options (put & call, American & European), futures, forwards are the so-called "plain vanilla", or simple derivatives. There are many other derivatives, e.g. barrier options, Asian options, Basket options, etc (and I am sure that many of you have used them in your daily work).

Do we have to know the details of the 2 translation methods on slide 4?

No, of course. Just remember how to translate the equity items under both methods, and also how to translate the non-monetary items under the temporal method. Sounds too much? I know, I also think accounting could be quite boring, sometimes.