Foreign currency risk research paper example

Business, Company

Accounting Exposure

Accounting exposure also known as translation exposure which refers to the effects of foreign currency fluctuations on the value of assets and liabilities of subsidiary that report in a currency other than the parent company. XYZ, Inc. may face sensitivity if there is any change in the real domestic currency value. If there is any change in the exchange rates it would affect the assets and liabilities of the company which may affect foreign sales in the other countries. XYZ Company may encounter risk in terms of the translation of the subsidiary's assets if it change through the dominated foreign currency to domestic currency in the financial statements

Operating Exposure

It refers to the effects of foreign currency fluctuations on the company's future cash flows and its market value. Such exposure is related to the long term position of the company. The unexpected fluctuation in the currency rate may adversely affect company's future cash flow and market value. The currency exchange rates are influenced by real exchange rate which mainly affects gains and losses from XYZ company's overseas sales impacting future cash flows of the company .

Transaction Exposure

Transaction exposure evolves from mainly outstanding nominal foreign currency financial receivables or payables. Hence, in the financial statement XYZ Company the impact of transaction exposure is evident in terms of gains and losses. It mainly affects the accounts payable and account receivables of the company due to which the current cash flow as well as future cash flows of the company would be affected .

Hedging Strategies

Hedging strategies are the substitution option that are adopted by the company to overcome the open future exchange rate. There are two hedging strategies that could be used by the company including currency swaps and currency futures.

The two hedging strategies that the XYZ Company may adopt are as follows.

Forward/future market hedge

The forward market hedge can be used by the company

Money Market Hedge

Money market hedge is based on the matching principle in which the asset are substitute against liabilities. Sales in the overseas may create liabilities against the asset which is result from goods and services.

For receipts

It is suggested that the company borrow cash in foreign currency to reduce the deposit and interest income.

The deposits can be made in the home currency banks to earn interest

The company can make use of sell procedures and convert them into home currency to mitigate the risk.

For payments

It is suggested that the company should buy foreign currency from the cash in the home currency

Methods of Translation

In order to mitigate risk arising from translation exposure XYZ, Inc. can make use of the following translation methods:

The company can make use of the Current Method as the gains and losses of the company which are translated can be reported in the reserve account. It will allow the company to reduce the losses emerging from volatility of consolidate earnings.

The other suggested method for translation exposure is Temporal Method. XYZ, Inc. can made use of temporal method in which the assets and liabilities of the company are acquired or incurred based on the exchange rates. In other words, the assets and liabilities of the company are valued at current cost and use of historical exchange rates is used to value the historical costs. It eventually reduces the losses that the company would face if there is change in the exchange rate. However, it only mitigate nominal losses which would emerge, as the historical costs do not accurately projects the future costs.

Both IFRS and GAAP require foreign currency transactions to be reported at the exchange rate on the date of transaction. Both support temporal method and any difference that occurs due to exchange rate is reported as profit or loss in the financial statement.

Inflation Exposure

One of the company’s subsidiary is located in a country that is experiencing high inflation rate. It needs to be addressed through Temporal Method to deal with translation exposure. It is suggested that the XYZ Company should make use of cumulative three year inflation for its projections.

However, under the current rate method the revenues and expenses of the company are translated according to the date of accounting recognition. The use of weighted average exchange rate is an effective way to overcome the losses emerging from the exchange rate, as well as the depreciation and amortization expenses. In the case of hyperinflationary economy, the IFRS requires the company to report all financial items are stated at the current exchange rate. On the other hand, GAAP allows alternative to report financial items are non-inflationary rate as well.

Worked Cited

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