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Large swings in currency valuations can play havoc with financial reports. A company — or its subsidiary — may have performed well in the latest quarter in a local currency. But if that currency lost value against the home currency during the period, the translated performance can quickly move from good to lackluster or even into the red. The whole dynamic can work in reverse, of course, and provide the appearance of strong growth where it does not exist.

While many companies do a good job managing currency volatility, reporting it in a meaningful and transparent way that keeps investors and other stakeholders informed, a sizable number appear still to be grappling with the issue.

So, how should companies present bottom-line results when currency volatility distorts the bigger picture? When is it appropriate to explain that a “loss” is not a loss, but simply the result of a — perhaps very temporary — currency movement?

It is a thorny problem that takes on new immediacy with the greater currency volatility brought on by events like the eurozone turmoil and concern over the slowdown in China’s economy, says Catherine Schrand, a Wharton accounting professor. The fluctuations flow right to the bottom line, “and management may be concerned about shareholder reaction.”

More generally, “many investors tend to focus on short-term results, so income declines due to currency fluctuations may disturb them,” Schrand says. “This is so even though currency fluctuations may in fact reverse themselves to the advantage of the company in the next reporting period, minimizing the overall impact to earnings.”

It’s not enough that companies understand the currency dynamic internally and make balanced

decisions. Publicly held companies must communicate financial results to analysts and investors through a variety of methods, including 10-Qs and periodic earnings reports filed with the Securities and Exchange Commission (SEC). This information helps guide investors in making buy-sell decisions and in judging how well management is performing.

Net profit or loss, naturally, is usually the first metric to catch investors’ eyes. But that number packs in many variables, including currency impact, that can leave management looking for ways to explain which variables are “central to a company’s operations and which variables may be slightly less vital,” says Chris Rhodes, accounting advisory partner at PricewaterhouseCoopers (PwC).

Companies that have not been focused on currency reporting policies have been thinking, “Well, it’s never really affected budget; it’s never really moved out of a 2% band. It’s never affected earnings by more than 3%,” Rhodes says. But in today’s environment, all of a sudden something can pop and “they will have to talk about it, and they’re not ready. Other companies that have historically focused on this are ready and may be at an advantage.”

Does Currency Volatility Matter?

One of management's challenges in carefully explaining reporting profit or loss involves the basic issue of reporting sales, for example. In order to give shareholders a more complete picture about revenues reported in financial statements, the SEC sometimes prefers companies to address the distinction between price and quantity, explains Rhodes. The SEC wants investors to know if "you are moving more units through your company or if you are just raising prices." Similarly, retail chains may differentiate between sales from stores open a year or more (same-store sales), and newly opened stores, so investors can make an apples-to-apples comparison of sales progress by factoring out data from the new stores.

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—Chris Rhodes

Currency fluctuations offer a comparable test for transparency. For example, retail price and volume of units sold in a certain country may explain local currency sales better than fluctuations in the U.S. dollar-equivalent of those sales, which adds the variability of exchange rates. Or, take a global company with a Brazilian subsidiary during a period when the U.S. dollar-translated performance was going up or down wildly, but its local currency performance was steadily increasing over three years. "A question may arise whether management should be concerned about that — especially if there are no short-term plans to liquidate that business or to get out of the Brazil market," says Rhodes. "From a management viewpoint, I may be a little less concerned about the dollar equivalent going up or down. Instead, I care about the fact that performance was steady in Brazil and that's what I invested in."

The effect of currency fluctuations on financial reports is certainly widespread, as a 2010 survey by AvantGard — the financial services unit of SunGard Systems — indicates. Fifty-nine percent of study participants reported that currency volatility led to a gain or loss of at least 5% in the 12 months ended March 31, up from 40% in the previous survey. In 2012, for example, the revenues of one global company fell 0.7% one quarter due in part to a 4.2% drop in currency valuations. Other global corporations also cut forecasts because currency effects were hurting reported sales in international markets.

The question is, what, if anything, should companies be doing to address these concerns?

There is no easy answer because stakeholders sometimes find explanations about currency movements too subtle for what is often a very quick, targeted analysis, says Rhodes. And it does not encourage investors to take a more balanced view when some executives want to blame a falling currency for poor results but are quick to claim success when a local currency values rises and pumps up dollar results. What is clear, however, is that since the financial crisis of 2008, rising currency volatility has moved the whole issue to the forefront and intensified the debate over how currency risk should be managed and reported, says Rhodes.

Says Schrand: "Is this something management should be held accountable to?"

Currency volatility has been consistently higher since the financial crisis and continuing through to uncertainty in the Eurozone, Rhodes explains. Given the many uncertainties at the global economic level, "no one's sure what the 'new normal' is going to be." Uncertainty about individual economies adds to the unpredictability, and "now the Street is trying to parse currency risk out of the financials a little more than before" Rhodes says.

All this presents a thorny communications challenge for investor relations: How should a company speak to investors when separating the

effects of currency from overall performance? Currency fluctuations can certainly distort results. Yet, giving the issue too high a profile — when explaining away a nominally poor performance in quarterly analyst calls, for example — can sometimes backfire. While many analysts place fluctuations under careful consideration, others sometimes overlook the nuance involved in such explanations and simply react negatively to any “complexity,” Rhodes points out.

Constant Currency Reporting

Multinational companies (MNCs) experience a variety of risks while operating in foreign territories, including political and regulatory risk, and risks from local competitors and customs

Currency risk is one of the most direct risks. Under Financial Accounting Statement (FAS) No. 52, now Accounting Standards Codification (ASC) section 830, companies that consolidate the results of foreign operations denominated in local currencies must translate the foreign financial statements into the parent company's currency, which for U.S. companies is U.S. dollars. This one-size-fits-all, single currency reporting requirement can mask critical details — strong foreign subsidiary performances can look misleadingly weak in dollar terms and vice versa.

MNCs can turn to a couple of different strategies to deal with this anomaly, notably constant currency treatment and hedging. Neither solution works for all companies and choices depend on many variables, including currency and economic growth trends in different countries, and, of course, individual company circumstances. But constant currency reporting offers one simple and inexpensive way to talk to Wall Street if, say, a U.S.-based company's Brazilian operation had a great year operationally, but a rising exchange rate makes the translated financial results look weak, say Schrand and Rhodes.

Constant currency accounting is a supplemental, non-GAAP (Generally Accepted Accounting Principles) reporting format that usually appears in the Management Discussion and Analysis (MD&A) section of the financial statements. This “as if” reporting method adjusts for the effects of

exchange rate fluctuations, and reports core profit and loss operations more directly by excluding currency rate fluctuations.

In addition to currency translation, some firms also experience a different kind of risk — cash flow fluctuations due to foreign-currency-denominated transactions. To address these cash flow fluctuations, firms use currency hedging strategies, but that can be a time-consuming, labor-intensive operation with costs that can outweigh the benefits, notes Schrand. Hedging often requires setting up a “dedicated department and powerful computer programs to crunch a great deal of information.” The complexity can be particularly burdensome if an MNC operates in many nations. Adding to the complications: the basic nature of MNC operations, which involve labor, plants, equipment and investments — all requiring consideration. Still, many companies enter into derivatives to hedge currency risk, which adds one more layer for investors to consider.

Risks, Exposures and Management Responsibilities

Chad Kokenge, a PwC accounting advisory partner, says that from an analyst's viewpoint, the issue is “figuring out management's motivations and what they can control or not control.... It's important to determine what should be reported or not. It begins with the financial instruments world, but then it permeates the rest of accounting....” The real economic issue is the time horizon, he says. From an economic point of view, whether or not currency fluctuations matter is affected by a company's plans to take money out of the business in the near term vs. reinvesting it locally longer term.

When it comes to internal reporting, however, some firms informally strip out currency fluctuation when they measure business-unit performance, says Schrand. Others take a more active role, either hedging currency at the corporate level, or letting regional or country managers engage in hedging. But these kinds of details are not likely to be disclosed to public stakeholders or analysts. “From the viewpoint

of external reporting, most companies don't disclose this granular kind of information," Schrand notes. "Issues like centralized or decentralized currency management, or the role that currency movements play in evaluation of divisional or other personnel are rarely disclosed in segment reporting."

In addition to currency risks that the market presents, there is also the risk of government action — say a devaluation or capital flow restrictions. These issues can be critical in deciding whether a firm should continue investing in a given country or instead move to a substitute. And such decisions are often aimed at a moving target because they must consider how competitors might game out the alternatives. Each of these risk layers also creates exposure for the firm and presents challenges for investor relations.

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—Catherine Schrand

"There are some companies that are not as concerned about their exposure to currency swings," says Kokenge. "They ask why they should go through a convoluted hedging profile when they can, basically, self-insure, and take their risks and deal with the spot market next year." Schrand concurs. Currencies may go up one year and down the next, but "do you care if it flip flops? How will it affect your value if it does? Maybe fluctuations don't matter to you." She cites one firm that did not hedge currency risk, though all of its competitors did. The reason: it was a highly rated, well capitalized company able to borrow cheaply to maintain cash flows if the currency took a turn for the worse.

Making the Call

In the end, public companies must decide how investor relations will handle the currency issues in financial reports. Schrand says that those kinds of questions go to the heart of the purpose of the income statement: the ability to use historical data to attempt to predict future results.

"One argument for making the effects of currency transactions transparent is that such variations themselves are unpredictable. And since management has no control over them, variations in one time period really aren't a good indicator of future results," she explains. "In contrast, events like labor relations and the probability of a strike may be reasonably ascertained by considering the company's historical experiences, and thus the effects of a strike would be properly reflected in the income statement."

Another issue is the fact that many currency impacts that appear in the financial reports are "unrealized" and are not likely to affect future cash flows, Schrand adds. "One could say that any movement is simply a 'display' issue, especially since those operating cash flows are likely to be reinvested in the local business."

Theoretically, management could report hedging activity in the profit and loss statement, and also increase disclosures about the activity. But Schrand says that could quickly become cumbersome and could confuse investors instead of helping them.

Further, don't expect a constant currency strategy necessarily to satisfy the many investors who simply go straight to the bottom-line results on traditional financial statements, and who don't pay attention to MD&A, footnote and other supplementary disclosure, Schrand says. What's more, "an increasing volume of trading is being done by computerized 'quant' or quantitative programs that may not even recognize supplementary disclosures."

At the same time, addressing currency issues through constant currency methods is increasingly important in other contexts. In due diligence reports that value acquisitions, for example, “constant currency analysis has moved from the back of a 50-page report to the front.... The first thing you’re trying to do is take that complex topic of currency off the agenda because people want to get at, ‘what are the core earnings or what is the quality of earnings?’”

Also worth noting: From a strictly best-practices standpoint, “if something is disclosed and measured, there’s a greater chance that it will be managed,” says Schrand, who points to a *Journal of Applied Corporate Finance* article by Nigel Topping, chief innovation officer at the Global Carbon Disclosure Project as an example. Topping cites a giant retailer that credited a Carbon Disclosure Project questionnaire with spurring its realization that the refrigerants used in its grocery stores accounted for a larger percentage of the firm’s greenhouse gas footprint than its entire truck fleet. Starting to measure output suggested the potential for reducing the firm’s “refrigerant footprint.” Measuring led to insight.

Paying more attention to currency issues could also provide something of a first-mover advantage, says Schrand. “If your firm is one of the early ones to get investors to understand

the issues involved in currency valuations, you’re more likely to gain an edge on your competitors.”

PwC’s Rhodes agrees. “If currency risk has a significant effect on a multinational’s strategic decision making process, it’s important to communicate this to stakeholders in a meaningful way. You can use the MD&A to put many issues into context, but currency fluctuation in particular can be treated in a way that’s very focused and clearly explained to stakeholders. But it’s not a slam-dunk decision.”

Management should carefully review its operations and strategies regarding currencies, and recognize that the market appears to be trending towards more disclosure, Rhodes points out. So even if management is not currently worried about investor reaction, companies may wish to consider reviewing their currency-fluctuation management and reporting policies with these disclosure trends in mind.

“Companies and investors will only benefit from improved communication about how currency risk impacts financial statements, and that leads to more efficient allocation of capital,” Rhodes says. And as Schrand suggests, by thinking through how to communicate better around the issue, companies may also find that they may uncover better ways to manage. #

To have a deeper conversation about how this subject may affect your business, please contact:

Henri Leveque

Partner, Capital Markets and Accounting Advisory Services
US Practice Leader
678.419.3100
h.a.leveque@us.pwc.com

Chad Kokenge

Partner, Capital Markets and Accounting Advisory Services
Accounting Advisory Leader
646.471.4684
chad.a.kokenge@us.pwc.com

Christopher Rhodes

Partner, Capital Markets and Accounting Advisory Services
646.471.5860
chris.rhodes@us.pwc.com

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