Foreign Currency Translation Rate Risk

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Introduction

Exchange rate risk has been added to the Managerial Finance syllabus for the first time in 2014/15. This article considers one particular type of exchange rate related risk, translation risk and the management thereof.

Translation Rate Risk

This is the risk posed to an organisation that has assets/liabilities denominated in foreign currencies (meaning denominated in a currency other that its reporting currency). The assets/liabilities may take any form for example:

- property assets e.g. investment properties, factories, land, buildings
- subsidiary companies or businesses
- financial assets/liabilities e.g. cash deposits, investments, medium and long term borrowings

If these assets/liabilities are of an enduring nature, meaning they are likely to be held for a period in excess of one year then translation risk is posed when the organisation translates the value of these foreign assets/liabilities into their domestic/reporting currency value at the closing rate applicable at the year- end reporting date.

For organisations with foreign assets the risk is that the domestic/reporting currency will have strengthened against the foreign currency in which the assets are denominated. In which case the reported value of the foreign asset will have suffered a diminution in value between successive year ends purely due to adverse currency exchange rate movements between the year end dates. This may be illustrated as follows:

Illustration

M Limited is an Irish registered company with a 31 December year end date. In late 2013 M Limited purchased as an investment a land bank in Oslo, Norway. The land cost M Limited 800 Million Norwegian Krone. It is hoped that this land will be rezoned for commercial use in the future.

M Limited obtained a euro loan of €100 Million to finance the acquisition of the Norwegian land. At the date of purchasing the land the rate of exchange was 8 Norwegian Krone = 1 Euro. This was also the 31 December 2013 rate of exchange. A summary Statement of Financial Position for M Limited as at 31 December 2013 reads as follows:

M Limited			
Summary Statement of Financial Position as at 31 December 2013			
Detail	NK (Ms)	FX RATE	EURO (Ms)
Non-Current Assets			
Domestic			185
Norwegian Land	800	8	100
Total Non-Current Assets			285
Net Current Assets			15
TOTAL ASSETS			**300**
Equity			
Issued Share Capital			150
Retained Profits			50
			200
Liabilities			
Domestic			100
Norwegian			0
TOTAL EQUITY & LIABILITIES			**300**

During the year ended 31 December 2014 M Limited reported neither a trading profit or loss i.e. breakeven with no resulting movement in net assets. At the 31 December 2014 the exchange rate had moved to 10 Norwegian Krone = 1 Euro (Norwegian Krone has “weakened” against the Euro). A summary Statement of Financial Position as at 31 December 2014 would then read:

M Limited			
Summary Statement of Financial Position as at 31 December 2014			
Detail	NK (Ms)	FX RATE	EURO (Ms)
Non-Current Assets			
Domestic			185
Norwegian Land	800	10	80
Total Non-Current Assets			265
Net Current Assets			15
TOTAL ASSETS			**280**
Equity			
Issued Share Capital			150
Retained Profits			50
Translation Loss			-20
			180
Liabilities			
Domestic			100
Norwegian			0
TOTAL EQUITY & LIABILITIES			**280**

You will note that net assets have reduced by €20 Million between the two year-end dates. This is as a result of the change in the Norwegian Krone to Euro exchanges rates between the successive year- end dates .

Conversely, organisations with foreign liabilities face translation risk if the domestic/reporting currency weakens against the foreign currency in which the liabilities are denominated. In this case the reported value of the foreign liability will increase in value between successive year ends purely due to adverse currency exchange rate movements between those year-end dates

Managing Translation Risk

The most straightforward hedge against exposure to translation risk is known as a matching strategy whereby an organisation that has foreign investments borrows the funds to finance these investments in the same foreign currency as the investment. In effect when both the assets and liabilities are translated into year-end domestic currency values if the foreign currency has weakened against the reporting currency then the decrease in the domestic value of the foreign asset is offset by the decrease in the domestic value of the foreign borrowings.

This hedge is often referred to as a perfect hedge due to its simplicity and ability to match exactly the translation risk exposure. It is best illustrated by adjusting the M Limited example above. Assume all the facts are the same except that M Limited borrowed 800 Million Norwegian Krone to invest in the land bank rather than acquire the finance in Euros. In which case M Limited's Statement of Financial Position as at 31 December 2013 would read as follows:

M Limited			
Summary Statement of Financial Position as at 31 December 2013			
Detail	NK (Ms)	FX RATE	EURO (Ms)
Non-Current Assets			
Domestic			185
Norwegian Land	800	8	100
Total Non-Current Assets			285
Net Current Assets			15
TOTAL ASSETS			**300**
Equity			
Issued Share Capital			150
Retained Profits			50
			200
Liabilities			
Domestic			0
Norwegian	800	8	100
TOTAL EQUITY & LIABILITIES			**300**

M Limited's onward Statement of Financial Position as at 31 December 2014 would then read as follows:

M Limited			
Summary Statement of Financial Position as at 31 December 2014			
Detail	NK (Ms)	FX RATE	EURO (Ms)
Non-Current Assets			
Domestic			185
Norwegian Land	800	10	80
Total Non-Current Assets			265
Net Current Assets			15
TOTAL ASSETS			**280**
Equity			
Issued Share Capital			150
Retained Profits			50
Translation Loss			n/a
			200
Liabilities			
Domestic			
Norwegian	800	10	80
TOTAL EQUITY AND LIABILITIES			**280**

You will note that there is no change in net assets between year ends and there is no reported translation loss to be explained to (perhaps irate) shareholders.

Conclusion

It is important that students understand foreign currency related risks. In particular students should appreciate when an organisation may be exposed to translation risk and be able to advise on how best to hedge this exposure.