THE IMPACT OF FOREX CHANGES ON THE VALUATION OF MULTINATIONAL SUBSIDIARIES

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ABSTRACT

This paper provides a simulated numerical example of the impact of a change in the foreign exchange (FOREX) rate on the cash flow in dollars for a multinational subsidiary (MNS). The ultimate effect of a change in the FOREX rate on the cash flow in dollars for an MNS is determined by the impact that the FOREX rate change has on sales units, sales price, and total costs. If an MNS can maintain prices and costs in foreign currency, the value of the MNS may even increase with a negative FOREX rate change. This results because the MNS may reduce the effective price of its product after the FOREX rate change. This is the rationale behind the concept of competitive devaluation.

Keywords: *Foreign exchange rate changes, FOREX gains and losses, multinational subsidiary valuation*

1. INTRODUCTION

The changes in foreign exchange (FOREX) rates have a significant impact on the valuations of multinational subsidiaries (MNS) directly and also on the valuations their parent corporations indirectly. There are three types of FOREX exposures experienced by multinational subsidiaries: transaction exposure, translation exposure, and economic exposure. Transaction exposure results from the needs of the MNS to carry out its business activities related to its payments and receipts through the foreign exchange interface. That is, the MNS must exchange one currency for another currency either when the MNS receives a payment from a customer for goods and services or when the MNS must make a payment to a supplier for goods and services. Between the time when the transaction exposure is created and the time when the transaction exposure is completed, if the FOREX rate changes, the MNS may realize some FOREX gains or may incur FOREX losses, depending on the direction of FOREX rate changes.

Translation exposure is the result of the year-end accounting consolidation process carried out by all publicly traded Multinational Corporations (MNC) which are required to report their annual results to the shareholders. Since MNCs operate in different countries, their subsidiaries are exposed to different accounting systems, since almost all countries have their own rules and regulations for recording and reporting the financial results of the companies operating in their boundaries. The International Accounting Standards Board (IASB) is moving toward a more uniform set of Generally Acceptable Accounting Principles (GAAP) between countries through the International Financial Reporting Standards (IFRS). For a detailed discussion of the IASB and IFRS, see https://www.ifrs.org/content/dam/ifrs/about-us/legal-and-governance/constitution-docs/due-process-handbook-2023.pdf (Last logged on April 17, 2024)

2. FOREX GAINS AND LOSSES

Economic exposure measures the impact of FOREX gains and losses, denoted by FX (+/-), on the valuation of multinational subsidiaries (MNS) and the parent MNCs. Obviously, the gains and losses are directly dependent on the amount of FOREX exposure of the MNS and the change in the future spot rate, denoted by ΔFSR, experienced by the subsidiary. Of course, FOREX exposure may be a gain or a loss depending on whether the ΔFSR is positive or negative as shown schematically in Figure 1.