FASB 52: Corporate Response and Related Foreign Exchange Market Effects

U.S. multinational corporations are in the midst of responding to the second major change in foreign exchange accounting rules in the last nine years The first change occurred in October 1975 when the Financial Accounting Standards Board (FASB)[1] issued "Statement of Financial Accounting Standards Number 8" (FASB 8) The FASB had felt compelled to develop a standard set of rules to replace the diverse accounting procedures being used by U.S. corporations following the move to generalized floating exchange rates in 1973.

But FASB 8 almost immediately generated controversy. In particular, it was criticized for producing a distorted picture of a multinational company's underlying economic situation. Thus, after much debate and a thorough review of various alternatives, the FASB adopted in December 1981 a vastly revised set of accounting rules embodied in FASB 52. Corporations were required to implement the new statement for fiscal years beginning on or after December 15, 1982.

To determine how U.S. corporations are responding to the significant changes of FASB 52, corporate treasury personnel at sixteen of the largest U.S. industrial companies and at one of the top ten U.S. diversified service firms were contacted and questioned about corporate foreign exchange hedging practices, borrowing strategies, and other matters related to managing foreign exchange risk. In most cases, corporate respondents did not confine their remarks to activities of their own firms. Instead, based on experience and conversations with their counterparts at other companies, they spoke more generally about their views regarding the reaction of U.S. corporations to FASB 52.

In addition to the corporations, corporate advisory personnel at seven of the top twenty U.S. commercial banks and at one foreign bank operating in New York were contacted Altogether, a total of twenty-seven people were contacted.

Based on these conversations, several findings emerge about the response of U.S. corporations to the adoption of FASB 52.

Most of those asked said that many corporations which had hedged or offset balance sheet exposure under FASB 8 had scaled back, or ended altogether, this practice following the adoption of FASB 52. Balance sheet exposure results from a mismatch between those foreign-currency-denominated assets and liabilities which must be translated into U S dollars at exchange rates prevailing on the date of the balance sheet The majority said that overall corporate activity in the exchanges had declined, although not everyone attributed this to the new accounting rules. But the bulk of respondents thought that the volume of foreign exchange business done by corporations in the forward market had dropped under FASB 52. By contrast, well over half believed corporations had become more active in the foreign exchanges during the time of FASB 8.

Virtually all of those questioned said that some companies, including many deemphasizing or ending the practice of hedging balance sheet exposure, are now focusing more on transaction and/or economic exposure. Transaction exposure results from the possibility that exchange rates might change between the time a transaction is agreed to (*e.g.*, when a sales contract is signed) and the time when it is actually settled (*e.g.*, after the goods are delivered). Economic exposure, a broader and more forward-looking concept, stems from the possibility that the firm's future cash flow will be affected by exchange rate changes.

The change in hedging strategy by many U.S. companies seems to have been accompanied by a shift in corporate borrowing patterns A majority of the respondents thought that under FASB 52 some U.S. firms are more willing, or had moved, to arrange more foreign currency loans than before. About half felt that some corporations had relied more on dollar-denominated and less on foreign-currency-denominated borrowings under FASB 8.

A majority of those asked believed that many U.S. companies had already centralized, or were moving toward centralizing, the management of foreign exchange exposure They felt that many corporations use, or are looking at the possibility of using, a system of netting exposures. Netting involves collecting at a central location information about payments and receipts between the different entities within a corporation The central office calculates a net receipt or payment figure for each entity and issues specific payment instructions, which result in funds flowing from entities with net payments to those with net receipts. Netting lowers transaction costs by reducing the number of payments between entities within the corporation

Most of the contacts reported that corporations also

[1]The FASB is a private rule-making body in the United States with the responsibility of setting forth generally accepted accounting principles

have used, or were considering, foreign exchange options contracts as part of their overall strategy to manage exchange rate exposure better However, actual corporate use of foreign exchange options apparently has not become very widespread as yet And few respondents felt that corporations were using foreign exchange futures contracts as a tool for managing foreign exchange exposure

Statistical evidence to support most of these findings is unfortunately sparse However, the respondents' belief that corporate activity in the forward foreign exchange market has dropped following the adoption of FASB 52 receives support from the latest foreign exchange turnover survey conducted by the Federal Reserve Bank of New York. The survey shows that outright forward transactions reported by U.S banking institutions with nonfinancial customers declined 16 percent to $8 8 billion in April 1983 from $10 5 billion in March 1980 even as total foreign exchange turnover reported by the banks rose about 44 percent. While FASB 52 may not be the only reason for this decline, it seems to have played an important role.

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