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The effects of SFAS 133 on foreign currency exposure of US-based multinational corporations

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Abstract

This study examines the change in foreign currency exposure of US-based multinational corporations (MNCs) upon implementation of SFAS 133—Disclosure of Derivative Instruments. We attempt to answer the question of whether this accounting requirement, which seeks to eliminate earnings surprises associated with derivatives, actually impacts earnings volatility and hedging strategies of exporting firms. Our results indicate that firms who were hedged prior to SFAS 133, i.e., those which managed their exposure using operational hedges, derivatives, or both, were able to decrease exposure to exchange rates following SFAS 133. However, those that were hedged prior to SFAS 133 and remained hedged following SFAS 133 did so without significantly changing their imbalances, i.e., without using operational hedges. These firms also experienced an increase in earnings volatility and a decrease in earnings predictability, as predicted by critics of the regulation. However, market value does not change following SFAS 133, implying that investors do not equate accounting regulation changes and EPS volatility with changes in cash flow.

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1. Introduction

While innovation in financial markets leads to the creation of complex derivative instruments to meet the hedging needs of multinational corporations (MNCs), financial analysts and investors

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are often presented with a maze of financial statements that are confusing and, some suggest, not fully transparent. In an effort to make the risks faced by derivative users more clearly communicated to investors, the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) issued statements requiring firms to disclose the impact of derivatives on their financial statements. Originally scheduled to be implemented 15 June 1999, the Statement of Financial Accounting Standard (SFAS) 133 suffered from controversy and setback and was not implemented until June 2000. Though intended primarily to improve transparency, the complexity of SFAS 133 may discourage the use of certain derivative instruments such as exchange rate options and cause firms to remain exposed to some risks, including foreign currency risk.[1]

When confronted with the realization that SFAS had become a reality, some firms informed their shareholders of a potential impact on earnings volatility. Others indicated that it was, in their opinion, a non-event. Firms with exchange rate exposure can choose to hedge or to remain unhedged. The perceived potential impact of SFAS 133 on earnings volatility could impact the hedging decision. To the extent that increased volatility faced by the firm is reflected in earnings volatility, and to the extent that investors discount volatile firms, we can expect an impact on market value as a result of SFAS 133.

This study investigates exchange rate exposure and the management of exposure as well as the impact on earnings volatility and predictability of MNCs following the implementation of SFAS 133. Our results indicate that firms who were hedged prior to SFAS 133 are able to decrease exposure to exchange rates following SFAS 133. In addition, firms that were hedged prior to SFAS 133 and remain hedged following SFAS 133 do so without significantly changing their imbalances—that is, without relying on operational hedges, implying that they effectively managed their risk with derivatives. These firms experience an increase in earnings volatility and a decrease in earnings predictability consistent with the hypothesis that SFAS 133 increased the complexity of financial statements. However, market value does not change following SFAS 133, implying that investors do not equate accounting regulation changes and EPS volatility into changes in expected cash flow. The findings suggest that managers should not fear the decreased earnings predictability that may be associated with the complexity of FAS 133. Investors are able to benefit from the disclosures required by FAS 133 without causing the firm to suffer a decrease in market value.

The study is organized as follows: Section 2 reviews the literature relating to the use of derivatives and discusses SFAS 133. Section 3 presents the hypotheses and methodology. Section 4 presents the results and Section 5 concludes.

2. Literature review

2.1. Use of derivatives

Firms facing exchange rate exposure can either remain unhedged or manage the exposure. Exposure management can take place through internal operational cash flow hedges (Pantzalis et al., 2001), such as matching foreign expenses and revenues, funding foreign assets with foreign

[1] This complexity is largely the reason the FASB has set up a special committee to deliberate and explain how to apply FAS 133. This committee is known as the Derivatives Implementation Group (DIG). Despite the special efforts of the DIG, the FASB was forced to delay implementation for 1 year (www.SFAS133.com).