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Executive Summary

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A Currency Affair: Venezuelan Vagaries

Venezuela isn't famous just for its oil exports and flamboyant leaders. It's also been a self-contained producer of inflation, with consequent unpleasant effects on its populace. It's also going to have unpleasant effects on the financial statements of U.S. multinational firms doing business in Venezuela. Starting in 2010, the consolidated financial statements of the parents will have to take into account the highly inflationary economy of Venezuela. That means a change in accounting methodology that will result in the recognition of remeasurement gains or losses directly in earnings. Before, translation gains/losses didn't affect earnings: they were tucked into stockholders' equity. No more.

The results of the change in accounting are not always straightforward. Hampering intercompany comparability for investors: there are several different exchange rates that may be used in remeasuring financial statements, and one answer is not the right one for all companies doing business in Venezuela. Estimating changes in the reporting of foreign operations is not a "do it yourself" exercise that investors can prepare for themselves, leaving them at the mercy of the firms making disclosures about their Venezuelan exposure.

- Venezuela has an inflation rate that recently crested 100% on a cumulative basis for the last three years. The country has also experienced a serious devaluation of its currency, and aside from the official currency exchange rate, there is a more costly "parallel" exchange rate available for firms engaging in foreign currency transactions.
- For firms possessing Venezuelan subsidiaries and reporting on a U.S. GAAP basis, that "highly inflationary economy" means a switch in accounting methods for translating the subsidiaries' financial statements into U.S. dollars before consolidating them with all other units. The method of accounting to which the firms are switching will reflect foreign currency gains and losses in earnings. Before switching to the "highly inflationary economy" accounting, translation gains and losses were reported in stockholders' equity.
- A handful of companies have been reporting their anticipated effects from the switch in accounting methods since late fall. There are at least 177 publicly-traded firms with subsidiaries that are either organized in Venezuela or have Venezuela in the subsidiary's name. Of those firms, 88 of them are in the S&P 500. Most of the firms are in the industrial, consumer staples, information technology, consumer discretionary and health care sectors.
- There could be more shoes to drop. Given that the government has devalued the Venezuelan bolivar by half since the beginning of 2010, previously less material changes in financial reporting may now become more significant.
- Investors will need ample help from firms to understand how the difference in accounting and the change in exchange rates will affect comparisons of operations in 2010 compared to prior years. Other areas of concern: how remeasurement gains and losses that were previously not recognized in earnings are currently affecting earnings; how exchange rates may affect impairment testing for long-term investments; and how a firm will hedge its net monetary asset/liability exposure to Venezuelan currency fluctuations.

Venezuelan Connections?

S&P 500	Sector	Total
15	Industrials	35
14	Consumer Staples	20
13	InfoTechnology	26
13	Consumer Discretionary	22
11	Health Care	14
8	Energy	25
6	Materials	21
5	Financials	9
2	Utilities	2
<u>1</u>	Telecom	<u>3</u>
88		177

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