

SESSION 1: FINANCIAL ACCOUNTING AND REPORTING

DATE: SATURDAY, FEBRUARY 24

TIME: 8:30 – 10:00 AM

## **The Valuation-Relevance of the Foreign Translation Adjustment: The Impact of Barriers to Entry and Rigidity of Wages**

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**ABSTRACT:** We examine the economic effects of barriers to entry and rigidity of wages signaled by the foreign currency translation adjustment on multinational firms' stock returns. Specifically, based on economic theories an appreciation (depreciation) of the foreign currency exchange rate could signal (a) an increase (decrease) in the foreign country's economic growth leading to potentially higher future cash flows for firms operating in environments with barriers to entry: innovation-intensive companies and asset-intensive companies, and (b) a decrease (increase) in future profits for firms operating in environments with rigidity of wages: labor-intensive companies. Firms that are research and development (R&D) leaders in their industry are our proxy for innovation-intensive companies. Among the R&D followers, firms with large total assets (employees) to sales ratio are classified as asset-intensive (labor-intensive) firms. Innovation- and asset-intensive firms are our proxy for firms likely to be affected by the barriers to entry and labor-intensive firms are our proxy for firms likely to be affected by the rigidity of wages. We find that the foreign currency translation adjustment is positively associated with abnormal stock returns for R&D leaders and asset-intensive, R&D followers. We also find that the foreign currency translation adjustment is negatively associated with abnormal stock returns for labor-intensive, R&D followers. This shows the importance of assessing the valuation-relevance of the foreign currency translation adjustment by considering the economic contexts of foreign currency fluctuations. Overall, the evidence shows that the accounting rules governing foreign currency translations in general produce results consistent with the economic effects of foreign exchange rate changes.