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Cosméticos de España, S.A. (A)

On October 7, 2009, Ana Pérez, the chief executive officer of Cosméticos de España S.A., a Spanish cosmetics firm headquartered in Madrid, Spain, with extensive operations in Latin America, was reviewing the September 30, 2009 "flash report" on the company's 2009 latest quarter and year-to-date operations and period end balance sheets.[1] As she read the report, Pérez became concerned about two aspects of the company's accounting policies related to the process by which the Bolivar-Fuertes ("BsF") denominated financial statements of the company's profitable Venezuelan subsidiary, Cosméticos de Venezuela C.A., were translated[2] for incorporation into the parent company's Euro ("€") denominated consolidated financial statements.

Exhibit 1 presents the Cosméticos de Venezuela nine-month, year-to-date income statement included in the flash report.

Specific Concerns

Pérez's specific concerns related to the consolidation of the company's Venezuelan subsidiary were:

- Should the subsidiary's functional currency[3] continue to be the BsF as it was now, or should it be the € or the U.S. dollar (US$)?

Exhibit 2 presents the definition of "functional currency" and guidelines for identifying an entity's functional currency included in International Accounting Standards Board (IASB) International Accounting Standard 21, "The Effects of Changes in Foreign Exchange Rates" ("IAS 21").

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[1] The company was listed on the Madrid Stock Exchange. It was subject to regulation by the Comisión Nacional del Mercado de Valores. The flash report was routinely produced at the end of each month by the company's accounting department. It was available to Pérez within seven days of the close of the fiscal period covered by the report. The report presented summary total company performance statistics. Flash reports also included summary income statements in their local currency for each of the company's major operating subsidiaries.

[2] Foreign currency translation is the process of expressing in the reporting currency of an enterprise those amounts that are determined or measured in a different currency.

[3] In accounting, the € is referred to as Cosméticos de España's "reporting currency". Similarly, the BsF is Cosméticos de Venezuela's reporting currency. Since the reporting currency of the subsidiary is different than the reporting currency of the parent, the reporting currency of the subsidiary must be translated into the parent reporting currency for consolidation purposes.

Professor David F. Hawkins prepared this case. The company mentioned in the case is fictional. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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- Should the subsidiary's financial statements continue to be translated into the parent's reporting currency using a BsF-€ exchange rate based on the Venezuelan government's official BsF-US$ exchange rate (BsF2.15=US$1) or should a switch be made to using the semi-legal parallel rate (BsF6=US$1)?

Typically, the exchange rate of the BsF with currencies other than the US$ was computed as a cross rate through US$. The case follows this practice. It focuses on the BsF-US$ exchange rate, rather than the BsF-€ exchange rate.[4]

In Pérez's view, the decision as to which BsF = US$ exchange rate to use to translate the Venezuelan subsidiary's financial statements into € for inclusion in the company's consolidated financial statements was a complex one. As noted above, there were two possible exchange rates. One based on the government's official BsF-US$ rate. The other on a semi-legal BsF-US$ parallel rate. The decision between these rates involved business, quality of earnings, and International Financial Reporting Standards (IFRS) considerations.

Pérez was certain that sometime during the current quarter, she would have to conclude that the Venezuelan economy for IFRS accounting purposes was a "hyperinflationary economy."[5] This designation would require the Venezuelan subsidiary's financial statements to be restated to reflect the changing purchasing power of the BsF before being translated into €'s. Pérez wondered how this expectation might influence, if at all, the resolution of her functional currency and translation exchange rate concerns.

Beyond her two concerns listed above, Pérez was pleased to note the flash report indicated that the Venezuelan subsidiary had continued to achieve a high rate of sales growth measured in BsF's. According to the flash report, Cosméticos de Venezuela's latest quarter BsF sales were 22% higher than the comparable 2008 period. It also showed year-to-date BsF sales were 21% higher than the comparable 2008 period.

Economics and Politics[6]

In October 2009, the Venezuelan economy was characterized by price and exchange controls, strong growth in government spending financed by public debt, recession, an overvalued official exchange rate, a high inflation rate, various distortions in the domestic economy, and an acceleration in the rate of nationalizing "strategic industries". On the political front, the potential for widespread social unrest was high due to increased local resistance to many government policies and actions and polarization of the body politic. A decline in the price of oil, the country's principal export, was expected to virtually wipe out the country's large current–account surplus by year-end 2009. The country's September 2009, average lending rate was 18%; the average deposit rate was 14%. Among the Latin American nations, Venezuela had the second-highest gross domestic product per head expressed in US$ measured using market rates.[7]

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[4] If the U.S. dollar-Euro exchange rate is US$1.47=€1, and the Bolivar Fuertes–U.S. dollar exchange rate is BsF2.15=US$1, the Bolivar Fuertes–Euro exchange rate is BsF3.16 = €1. (3.16=2.15x1.47).

[5] As described later in the case, International Accounting Standard's Board International Accounting Standard 29, "Financial Reporting in Hyperinflationary Economies" ("IAS 29") set forth the IFRS accounting requirements for company's operating in hyperinflationary economies.

[6] The Economist Intelligence Unit, "Venezuela," September, 2009.

[7] The Economist Intelligence Unit, "Venezuela," September, 2009.

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Exhibit 3 presents Venezuela's recent inflation rate, average price in US$ received for a blend of its oil product exports, and other selected economic data.

Currency

In 2003 the Venezuelan government officially pegged the Venezuelan Bolivar to the US dollar at a fixed exchange rate and instituted new foreign currency exchange controls. In 2005, the Ministry of Finance established a new official exchange rate. Following a change in the nation's currency from Bolivar to Bolivar Fuertes (BsF) in 2008,[8] the new currency equivalent of the 2005 fixed rate was BsF 2.15 =US$1. This official exchange rate was still in effect in September 2009.[9]

Approval by the Foreign Exchange Administration ("CADIVI") was required to buy US$ at the BsF2.15=US$1 official rate. This approval was reserved for such transactions as dividend repatriations, imports of essential products, and government agency payments for imported services and products. In practice, as a result of the government's attempts to limit the amount of capital outflows and encourage development of local industries, some companies had to wait in excess of 180 days to exchange BsF's for US$'s at the official exchange rate, assuming they could get approval at all.[10]

In order to obtain US$ readily, a semi-legal parallel BsF–US$ currency market developed. Purchases of foreign currency in the parallel market were made through a series of transactions arranged by brokers. A typical transaction might involve a company seeking US$ buying a BsF denominated government bond which it swapped for a US$ denominated security which it then sold in the international securities market for US$. The swap and subsequent sale of the US security were performed outside of Venezuela.[11]

The parallel market US$ exchange rate was approximately BsF 6 = US$1 in early October, 2009. While it had fluctuated within a small band, the BsF – US$ exchange rate had averaged about BsF 6 = US$1 since January 1, 2009.

Cosméticos de Venezuela, C.A.

Cosméticos de Venezuela, C.A. was a direct marketer of a relatively narrow line of reasonably priced cosmetics. The company's products benefited from a strong brand recognition and a consumer perception that its brands were reliable and of good quality.

In contrast to its competitors, who used the one-on-one direct marketing model. Cosméticos de Venezuela employed the network marketing form of direct selling. It was modeled after the direct marketing structure used by Mary Kay, Inc., a well-known North American direct marketer of cosmetics. This approach sold cosmetics to customers invited to attend a "party" at the home of a company sales consultant or a customer.[12]

[8] The change consisted of the government eliminating three zeros from the currency.

[9] In September 2009, the €–US$ exchange rate was €1=US$ 1.47. Thomson Reuters Datastream, accessed 3/11/10.

[10] Northcoast Research, Accounting and Tax Research, January 6, 2010.

[11] PriceWaterhouseCoopers, CFO direct network, 2010-4, January 20, 2010.

[12] For more information on the Mary Kay Cosmetics network marketing model, see HBS case No. 9-583-068, "Mary Kay Cosmetics, Inc.," by Professor John A. Quelch and Research Associate Alice MacDonald Court; and HBS case Nos. 9-190-103 and 9-190-122, "Mary Kay Cosmetics: Sales Force Incentives (A)" and "(B)," by Professor Robert Simons and Hilary Weston.

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Cosméticos de Venezuela's sales force consisted of three levels of independent contractors—individual cosmetic consultants, senior cosmetic consultants who managed a team of 20 individual consultants, and national cosmetic consultants who managed a team of 10 senior cosmetic consultants.

Promotion from one level of consultant to the next was based entirely on sales volume and recruitment of new cosmetic consultants.

New consultants had to purchase for BsF 1,200 in cash a basic "starter kit" of cosmetics priced at a 45% to 55% discount from retail. A minimum wholesale order of BsF 1,000 payable in cash had to be placed every six months for a cosmetic consultant to be considered active.

Consultants at all three levels could earn commissions on the wholesale prices of products purchased by every consultant they recruited. In addition to monetary rewards, top performing consultants at each level were eligible to earn substantial non-monetary incentives and rewards.

Consultants were encouraged, but not required, to receive cash upon delivery of items ordered by customers.

Cosméticos de Venezuela supported its direct marketing sales force with advertising, training sessions, manuals, and workshops.

All of the cosmetic products Cosméticos de Venezuela sold were imported from the parent company's Miami, Florida, manufacturing facility.[13] Cosméticos de Venezuela, like its parent's other Latin American subsidiaries, was required by the parent company to pay for its purchase from the Miami facility in U.S.$'s at time of shipment.[14]

The US$'s used to pay for the imported cosmetics were purchased in the parallel market.

Cosméticos de Venezuela did not own any tangible assets. It leased, through operating lease arrangements, all of its warehouses, distribution and marketing system assets (such as forklifts, trucks, and automobiles), office space, office equipment (such as computers), and its telecommunication network. Its lease rentals were indexed to the general inflation rate.

The company was financed by local vendor trade credit, local bank loans, retained earnings, and equity capital provided by its parent.

The management sought to operate with minimal corporate overhead.

The performance of Cosméticos de Venezuela's key manager was evaluated on the basis of the subsidiary's BsF financial statement revenue and net income results.

As a percent of local BsF net sales, Cosméticos de Venezuela's gross margin averaged 65%. Its selling, general, administrative costs averaged 20% of BsF net sales.

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[13] Cosméticos de España was founded by the Pérez family after it fled to Spain to escape the Cuban Revolution. Prior of the revolution, the family had operated similar businesses in Cuba. They were expropriated by the Cuban Government after the family fled Cuba. When the new business was started, the family adopted a policy of not locating valuable company assets in countries where they would run the risk of asset expropriation. As time passed, the "Fabricado en EE.UU." ("Made in USA") source of manufacturing listed on the company's Spanish language product labels became a powerful marketing tool. Consumers regarded it as a guarantee that the company's product ingredients, product handling, and product manufacturing processes had met the highest quality safety and health standards in the industry. In some Latin American countries, such as Brazil, high duties and extra entrance costs, assessed against cosmetic imports made it difficult for the company to compile against locally manufactured cosmetic products.

[14] The transfer price was set at the full cost of manufacturing plus the cost of transportation and a small manufacturing profit.

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Cash Balances

Cosméticos de Venezuelan held a significant BsF denominated cash balance at local banks waiting CADIVI approval to obtain US$ at the official rate to repatriate as dividends to the parent.

During the first half of 2009, CADIVI volume of approvals for use of the official rate to purchase US$ was down significantly on a year-to-date basis. CADIVI had not only delayed approval, but had removed many items from priority lists, which had further delayed approvals. CADIVI appeared to be giving priority to US$ transactions related to the purchase of food and medicine.

Each year since 2005, when the current version of the official foreign currency exchange control policies was adopted, Cosméticos had applied to the CADIVI to buy US dollars using BsF at the official exchange rate to fund dividend payments to its parent. Approval had not been granted since 2006.[15] Currently, BsF 70 million representing the cumulative dividends declared but not paid since 2005 were being held in a Venezuelan interest bearing bank account awaiting CADIVI action.[16]

To ensure a continuing supply of product from the Miami plant, Cosméticos de Venezuela maintained in Miami a US$ 2 million denominated short-term certificate of deposit with a leading Miami bank.

Direct Selling Market

Over the years, direct selling in Venezuela has benefited from a long tradition of usage, convenience and the social structure. Cosmetics and toiletries accounted for approximately 80% of the total direct market selling, market, which was projected to be about BsF 2.4 billion in 2009 and BsF 2.5 billion in 2010. [17]

There were no major domestic direct selling cosmetic companies in Venezuela. Multinationals dominated the market. Avon Cosméticos de Venezuela, C.A., a subsidiary of U.S.-based Avon Products, was the leading direct selling cosmetic company.

Accounting for Cosméticos de Venezuela

As required by European Union ("E.U") Directives, in its consolidated financial statements, Cosméticos de España accounted for its Venezuelan subsidiary using International Financial Reporting Standards ("IFRS") as approved by the E.U.[18]

Cosméticos de España's consolidated financial statements were stated in Euros ("reporting currency"). As required by International Accounting Standards 27 "Consolidated and Separate Financial Statements" ("IAS 27"),[19] since Cosméticos de Venezuela was controlled by Cosméticos de

[15] Cosméticos de Venezuela's experience since 2006 with requests filed with CADIVI for US$ at the official exchange rate to remit dividends to its parent was not unusual

[16] Even though Cosméticos de España had not received these dividends, to be conservative, it had accrued €3 million in taxes that it anticipated paying to Spanish taxing authorities when the BsF 70 million dividends balance was received in Euros in Madrid. The debit recording the accrued tax expenses was accompanied by a credit to a deferred tax liability account.

[17] Retail value excluding sales tax.

[18] IFRS are issued by the International Accounting Standards Board. It succeeded the international Accounting Standards Committee (IASC), which issued International Accounting Standards (IAS). The IASB retained the "IAS" designation of the predecessor body for standards issued prior to 2001.

[19] In 2008, US GAAP consolidation accounting rules were amended to bring them more in line with IAS 27.

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España, it was included on a fully consolidated basis in Cosméticos de España consolidated financial statements. Consolidated financial statements are the financial statements of a group presented as though the group is a single economic entity. Consolidated financial statements exclude in full all intergroup balances, transactions, income and expenses.

Cosméticos de España translated Cosméticos de Venezuela's BsF denominated financial statements into € using the official rate of BsF 2.15 = US$1 expressed in terms of the current €–US$ exchange rate.

Cosméticos de España's choice of the official rate, rather than the parallel rate to consolidate Cosméticos de Venezuela's financial statements was motivated by two principal considerations. First, to signal to the CADIVI that it had not given up seeking U.S. dollars at the official exchange rate to repatriate dividends. Second, a strong belief by Pérez that investors would rate the quality of Cosméticos de España's accounting policies higher if they were similar to those employed by the industry leader Avon Products, Inc. (NYSE:AVP). For consolidated statement purposes, Avon Products was required by US Generally Accepted Accounting Principles (US GAAP) to translate its foreign subsidiaries' financial statements using the exchange rate applicable to the foreign subsidiary's dividend repatriations to its parent company. The U.S. accounting authorities had concluded this was the official BsF 2.15 = US$1 rate. IFRS allowed management more flexibility in determining the appropriate translation exchange rate.

IAS 21

Cosméticos de España followed the process laid out in IASB International Accounting Standard 21, "The Effects of Changes in Foreign Exchange Rates" ("IAS 21"), to translate its Venezuelan subsidiary's BsF denominated financial statements into €.

IAS 21's basic translation process for an entity's financial statements whose functional currency is not the currency of a hyperinflationary economy is:

- Assets and liabilities in each statement of financial position presented are translated at the closing rate at the date of that statement of financial position (i.e., last year's comparatives are translated at last year's closing rate).

- Income and expenses in each statement of comprehensive income or separate income statement presented are translated at exchange rates at the dates of the transactions (i.e., last year's comparatives are translated at last year's actual or average rate).

Cosméticos de España used the official BsF/US$ exchange rate to determine the BsF/€ exchange rate to translate its Venezuelan subsidiary's BsF denominated financial statements into €.

Hyperinflation Accounting

Different translation accounting rules go into effect when a country's economy is designated for accounting purposes as a "hyperinflationary" economy. IAS 29 "Financial Reporting in Hyperinflationary Economies" does not establish an absolute "bright line" rate at which hyperinflation is deemed to arise. According to IAS 29, judgment is required as to when the application of IAS 29 is necessary. IAS 29 suggests hyperinflation is indicated by characteristics of the economic environment of a country which include, but are not limited to, the following:

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- The general population prefers to keep its wealth in nonmonetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;
- The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;
- Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short;
- Interest rates, wages and prices are linked to a price index; and
- The cumulative inflation rate over three years is approaching, or exceeds, 100%.[20]

Translation Gains and Loses

Typically, under IFRS, the translation process results in translation gains or losses. In economies that are not considered to be hyperinflationary, translations gains and losses are other comprehensive income adjustment to owners' equity. If an economy is classified as hyperinflationary, translation gains and losses are a direct adjustment to net income.

Translation gains and losses arise because certain balance sheet account, such as invested capital, are translated at exchange rates other than period end exchange rates. Up to and including September 2009, Cosméticos de Venezuela's translation gains and losses were always taken directly to owners' equity.[21]

Venezuela–IFRS

With the exception of bankers, as required by local accounting authorities, Venezuelan companies had adopted either Venezuela's version of International Financial Reporting Standards ("Ven–IFRS") or the International Accounting Standards Board's version of IFRS for small and medium sized enterprises ("SMEs–IFRS").[22] For statuary purposes, Cosméticos de Venezuela was required to adopt Ven-IFRS for its local accounting records and reports.

Question

1. How would you respond to Pérez's two concerns? Explain your answer.

[20] For U.S. GAAP purposes, a hyperinflationary economy is one that has cumulative inflation of approximately 100% or more over a three-year period.

[21] This case does not deal with detailed translation mechanics.

[22] Luis W. Montero, "The adoption of IFRS in South America," *IFRS News*, Issue 82, PriceWaterhouseCoopers, March 2010. U.S. GAAP does not have a separate financial reporting standard for SMEs.

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Exhibit 1 Cosméticos de Venezuela Nine-month Year-to-Date 2009 Income Statement (BsF thousands)

Sales	144,000
Cost of Goods Sold	50,400
Gross Profit	93,600
Selling, general and administrative	43,200
Operating Profit	50,400
Interest—BsF accounts	8,925
Interest—US$ account	30
Profit Before Taxes	59,355

Source: Casewriter.

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Exhibit 2 IAS 21 Functional Currency Definition and Identification (guidance paragraphs 9-12, inclusive)

9. Functional currency [is the currency of] the primary economic environment in which an entity operates [which] is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:
   a. The currency
      i. That mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and
      ii. Of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
   b. The currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).
10. The following factors may also provide evidence of an entity's functional currency:
   a. The currency in which funds from financing activities (i.e., issuing debt and equity instruments) are generated.
   b. The currency in which receipts from operating activities are usually retained.
11. The following additional factors are considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity (the reporting entity, in this context, being the entity that has the foreign operation as its subsidiary, branch, associate or joint venture):
   a. Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.
   b. Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.
   c. Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.
   d. Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.
12. When the above indicators are mixed and the functional currency is not obvious, management uses its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. As part of this approach, management gives priority to the primary indicators in paragraph 9 before considering the indicators in paragraphs 10 and 11, which are designed to provide additional supporting evidence to determine an entity's functional currency.

Source: Excerpted from IAS 21, "The Effects of Changes in Foreign Currency Rates."

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Exhibit 3 Cosméticos de España—Venezuela: Selected Economics Statistics (2007–2009 quarterly data)

	2007	2008				2009		
	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr
Output								
GDP at constant 1997 market prices (BsF)[a]	15,302	13,094	14,322	14,673	15,838	13,160	13,975	14,008
Real GDP (% change, year on year)	7.2	4.9	7.2	3.8	3.5	.5	-2.4	-4.5
Prices								
Consumer prices (2007=100)	96.5	105.2	112.1	119.5	127.7	135.6	142.4	151.5
Consumer prices (% change, year on year)	20.2	25.4	29.7	33.6	32.3	28.9	27.0	26.8
Producer prices (% change, year on year)	18.6	22.6	27.6	29.2	26.6	21.7	19.2	20.9
Venezuelan crude basket (US$/barrel; spot)[b]	81.3	89.0	110.5	109.9	48.6	38.4	51.4	63.8
Venezuelan crude basket (% change, year on year)	58.8	77.6	83.6	63.9	-40.2	-56.9	-53.4	-41.9
Financial Indicators								
Exchange rate BsF:US$ (avg)	2.15	2.15	2.15	2.15	2.15	2.15	2.15	2.15
Exchange rate BsF:US$ (end-period)	2.15	2.15	2.15	2.15	2.15	2.15	2.15	2.15
Deposit rate (avg; %)	11.6	13.2	16.6	17.5	17.4	17.7	16.5	n/a
Lending rate (avg; %)	19.2	22.7	22.7	22.2	22.0	21.2	19.9	n/a
3-month money market rate (avg; %)	14.0	9.2	10.7	5.8	18.7	14.6	5.6	n/a

Source: Adapted from The Economist Intelligence Unit Limited, Venezuela.

[a]In September 2009, 8.4% of the labor force was unemployed.

[b]Oil basket is comprised of 70% crude oil and 30% oil products, such as gasoline.

Exhibit 4 Cosméticos de España—Euro/U.S. Dollar Exchange Rate (1/31/2009–9/30/2009)

1/31/2009	.7803
2/27/2009	.7874
3/31/2009	.7532
4/30/2009	.7547
5/29/2009	.7065
6/30/2009	.7129
7/31/2009	.7054
8/31/2009	.6969
9/30/2009	.6842

Source: Thomson Reuters Datastream, accessed 3/11/2010.

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