

The Case of the Drifting Exchange Rate

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Randy Bozarth loosened his grip on the tiller of his sail boat and let the bow turn slowly into the breeze. Soon the craft nosed into the wind and was virtually dead in the water giving Randy time to think about what had been troubling him for days now. If only he had taken an international finance course rather than wasting his time on “fun” electives when in college. But that was in the past and if he had learned anything so far in life it was you cannot change the past.

Randy had relocated from the Chesapeake Bay area to the west coast of Mexico a couple of years earlier to be able to sail more and also to experience a different culture. So far he was quite happy with his decision although life ‘south of the border’ did present some unique challenges. Most of the challenges came from his housing arrangements. Upon moving south he decided he would forgo living in a single family dwelling and instead opt for a condominium. There were several condo complexes to choose from and most were owned predominately by Canadians, U.S. citizens, and Europeans. Randy chose Bahia Mar Condominiums as his home and in general was very satisfied with his choice.

Given Randy’s educational background (B.S. in accounting) and years spent as a hospital controller it was no surprise that he was called upon by his neighbors to assist in the governance of the homeowners association (HOA). With some reluctance he had allowed himself to be elected treasurer of the Bahia Mar HOA’s Board of Directors last year. This means that he is obligated to review the quarterly financial statements prepared by the management of the HOA. Additionally he is responsible for presenting the proposed budget for the upcoming year to the annual meeting of all 150 condo owners. It is the budget that is troubling him.

The HOA is responsible for building and grounds maintenance, security, maid service (if desired), as well as general administration of the HOA which includes paying taxes, utilities, billing owners, etc. Virtually all costs incurred are denominated in pesos. The current year’s budgeted expenditures are 5,250,000 pesos. Approximately two-thirds of the budget is comprised of salaries for various HOA employees.

The budgeting process is largely driven by the expenditures requested by management. Once those have been justified and agreed upon by the Board of Directors of the HOA, management converts the budget into U.S. dollars. The budgeted expenditures amount is then divided by 150, the number of condominiums, to determine the annual condominium fees. The resulting annual fee is then divided by four as homeowner fees are paid quarterly on the first day of each quarter. Since most condo owners’ primary residences are in the U.S. it was decided that condo fees would be denominated in U.S. dollars rather than the local currency.

During the last few years management used an exchange rate of 10.5 pesos to the U.S. dollar to convert the peso denominated budget into dollars. Actual exchange rates fluctuated between 9.9 and 13.9 pesos per U.S. dollar during that period. The manager of the HOA is insisting on utilizing the same conversion factor as in the past years. His arguments range from “consistency” to “no one can predict the future”. Randy is uncomfortable with this approach. He takes his fiduciary responsibilities seriously and while on his watch as treasurer he wants the budgeting process accomplished in a professional manner.

As the budgeting process moves forward Randy knows he must decide how he wants the currency translation to be handled. He will also need to provide a coherent argument for his position and draft a memo for the HOA’s Board and manager. As Randy contemplates these

exchange rate issues he notices a squall building rapidly a few miles to the west and moving his way. Apparently it's time to make some decisions both financial and navigational.

Appendix A

Depending on the extent of guidance the faculty member desires to provide to students, the following information regarding the current situation (as of Sept. 20X0) may be provided:

The expected interest rate in the US for 20X1 is approximately 0.25%

The expected interest rate in Mexico for 20X1 is approximately 4.50%

The current spot rate is 13.03 pesos/US\$.

A chart of the forward prices offered by a local bank is:

Date	Futures Price: \$/peso
Sept. 20X0	0.076925
Oct. 20X0	0.076400
Nov. 20X0	0.076100
Dec. 20X0	0.076275
Jan. 20X1	0.075775
Feb. 20X1	0.075475
Mar. 20X1	0.075125
Apr. 20X1	0.074975
May 20X1	0.074625
June 20X1	0.074400
July 20X1	0.074225
Aug. 20X1	0.074025
Sept. 20X1	0.073600
Dec. 20X1	0.072800

Questions

1. Assuming Mr. Bozarth would prefer to use external sources for an exchange rate, how would you suggest a rate for converting next year's budget from pesos to U.S. dollars be determined?
2. What alternate methods might Mr. Bozarth propose to the Board for dealing with foreign currency fluctuations?
3. How might Mr. Bozarth go about formulating an estimate of the exchange rate for the upcoming year rather than relying on external quotes?
4. What are the implications for the owners and the HOA manager of using the actual foreign exchange rate as compared to the 10.5 pesos per U.S. dollar rate used in prior years' budgeting process? How might this influence the owners' and manager's preferences regarding the choice of exchange rate for next year's budget?