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Accounting for Foreign Currency Translation Gains and Losses: A Comparison of the Temporal Method FASB #8 and FASB #52

Richard J. Lee

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A COMPARISON OF THE TEMPORAL METHOD FASB #8 AND FASB #52

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A Digest Presented to the Faculty of the Graduate School of the Lindenwood Colleges in Partial Fulfillment of the Requirements for the Degree of Master of Science

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DIGEST

A culminating project in accounting is somewhat different than one that might be undertaken in other disciplines. While accounting is generally considered to be about numbers and therefore straightforward in application, there exist prescribed principles, procedures, and statements that must be adhered to by accountants. Viewing the discipline from this perspective the door is opened to vast areas of discussion and interpretation of accounting methods.

This paper compares three methods of treating foreign currency translation gains and losses, and the effect on reported earnings. It was written to accomplish three objectives.

1. To present sufficient background to establish a need for discussion of the problem of foreign currency translation gains/losses and the effect on earnings.
2. To demonstrate that the application of three different methods of foreign currency translation to the same data results in three different results.

3. To compare how the determined results affect earnings.

The conclusions found in this paper should aid the reader in understanding some of the basic problems facing multinational companies. The reader should also gain insight into understanding the effect of currency exchange rates on the balance sheet of multinational companies.

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Part I

GROWTH OF MULTINATIONAL ENTERPRISES

Since the end of World War II, there has been a dramatic increase in the growth and activities of corporations outside their national boundaries. While the rate of growth has been most keenly demonstrated in recent years, the idea of the multinational business entity can be traced back to the days of colonialization. The late nineteenth and early twentieth century saw many of today's leading ME's establish their foreign subsidiaries.[1] The transfer of resources, skills, and capital in the early ventures normally took the form of independent buyers and sellers. It was not until the mid-twentieth century that these resources began being transferred within the same firm.[2]

Obviously, the vast improvements in transportation and communication technology made it easier for a New York company to open a branch operation in London. Not only did the changes in the methods of transportation and communication aid in the development of the ME, but additional aid resulted from changes in the type of business being conducted itself. As business became more complex, firms became larger and more diversified. Better protection by government over innovations and trademarks, and increasing advantages of large scale production aided in the development of foreign branches. International production was found to be a sound way to capture the proprietary rights of technology, capital, and management skills.[3]

By the 1950's, the Britton Woods agreement had laid the economic foundation for international business. A vast number of problem issues such as tariffs, quotas, shortage of currency in the host country, and manufacturing capabilities forced firms to serve their foreign markets through local production.

Government policies of host countries had a major impact on ME expansion. With governments becoming more nationalistic, a conflict developed over resource allocation. As the need for economic independence and self-reliance became more intense, the governments became more guarded to ensure that their resources were used in such a way as to be consistent with their goals.

Throughout the 1960's and 1970's tensions between ME's and governments continued to grow. Such issues as control of technology, failure to adopt the technology to the needs of the host country, reluctance by ME's to employ local labor in senior management positions, and many other concerns heightened the growing tensions.[4]

In the 1970's, as a combined action by host governments and ME's, a trend developed indicating a more open willingness to transfer resources. Methods of licensing, turnkey operations, and management contracts became more commonplace. During this time the rate of growth of ME's began to slow down as the conditions for internalizing resource flows became less attractive.[5]

The 1960's was a time of rapid growth for the ME, while the 1970's was a time of maturation. The future should see a time of adjustment to the changing institutional technological and environmental needs.

Part II

DEFINING A MULTINATIONAL ENTERPRISE

While the growth rate of foreign operations has leveled off indications are evident that total growth of multinational companies will continue. For about 200 major U.S. companies, foreign operations represent more than 25% of total activity.[6] On a larger scale this tendency towards foreign operations is not unique to U.S. businesses.

With the increase of business activity conducted by companies outside the home country, there is a shift in the type of business being conducted. Typically there is a much higher proportion of manufacturing operations and decreased export activity.[7] This trend towards manufacturing increases the complexity of business operations. The increasing number of foreign operations and the higher degree of complexity of the businesses are creating new financial reporting problems as well as making existing problems more critical.

Companies operating abroad are often referred to as multinational companies or multinational enterprises. This study will use the term multinational enterprise or simply ME.

As with any phrase or term it is difficult to find agreement on an absolute definition. However, in this study the term multinational enterprise represents a concept and not necessarily a particular company. There is no one characteristic that must be present to determine what is an ME, but rather several characteristics in combination. One of the more significant characteristics usually present to a large degree for companies considered multinational is that top management have an attitude of globalism which makes the company as concerned with its world operations as its domestic operations.[8]

The ME is usually large in total size and conducts a large part of its business abroad. These operations are usually located in several countries and not just in one or two. The fact that most U.S. multinational enterprises have a large proportion of their business in the U.S. may be considered an accident of origin and not a necessity for the continuation of the business.[9]

The ME considers the world as its market; not just in terms of production abilities or consumer tendencies, but also in terms of capital. Borrowing, lending, purchasing assets, and trading money on a world basis are just a few transactions an ME may undertake to maintain an advantageous position.

The ME must operate in a myriad of political, cultural, and regulatory environments. It is imperative to the survival of the ME that top management decisions be made with a clear understanding of the implications in relation to prevailing restraints.

The operation of an ME's headquarters and affiliates is an interchange of economic, technological, financial, and human resources between countries. Although this interchange is usually mutually beneficial, it may involve a degree of conflict between the home and host country as related to economic and control terms. Each country is interested in gaining a maximum return for the resources used by the ME. While both countries want to gain economically from the ME, the home country wants to maintain control over the utilization and exportation of its resources, and the host country wants to control local operations to ensure they serve the national interest. This resource-allocation conflict may be viewed in terms of national sovereignty, independence, economic imperialism, and foreign identity.[10]

With the continued growth of ME's it is probable that these conflicts will become more apparent; in part due to the lack of recognized international law governing the relationship between an ME and the country in which they operate.[11]

Part III

PROBLEM ENVIRONMENTS FACING MULTINATIONAL ENTERPRISES

The results promulgated by the conflict over resource allocation often take the form of restrictions placed on the ME by the host country. These restrictions may be political in nature, legal restrictions, or cultural habits.

Political risk has long been a familiar term in matters of international business. Yet a recent survey of major ME's concluded that few companies undertake a systematic evaluation of political risk "involving their identification, their likely incidence, and their specific consequences for company operations."[12]

The mention of political risk brings to mind the business environment characteristic of newly independent or less developed countries. While these countries may warrant certain concern in this area, political risk may be found in any country.

U.S. companies doing business in South Africa have experienced political boycotts and harassments in the U.S. from groups opposed to the racial policies of South Africa.[13] In 1965, the Firestone Tire and Rubber Company terminated negotiations for a contract to design and equip a synthetic rubber plant in Romania due to unanticipated political pressure from a conservative youth organization opposed to expanded U.S. business relations with Soviet-bloc countries.[14] In Sweden, ASEA, a large electrical firm became the target of intense leftist criticism for its proposed participation in an international power plant project in the Portuguese colony of Mozambique. The Swedish opposition argued that the project would serve the objectionable Portuguese colonial power and weaken opposition movements.[15]

The previous examples point out an expanding company's vulnerability to political ideology. However, in order to assess and forecast the influence of political risk it is necessary to develop an operational definition of political risk. Stefan Robock states political risk exists in international business when discontinuities occur in the business environment; when they are difficult to anticipate; and when they result from political change.[16] These changes must have the potential to significantly affect the profit and goals of the business. It is important to differentiate between the political changes which prescribe to Robock's definition, and those changes which occur in a gradual and progressive manner reflecting more political fluctuations in government policies than the clash of political forces. An example of such political changes are tax laws and tax requirements. These burdens are changing constantly; however, for the most part the changes do not represent an abrupt departure from past trends and cannot be considered political risk.

It is difficult at times to distinguish between a political risk and normal economic risk. Government decisions are all political; however, the forces dictating the decisions may be economic. As an example, the "political-risk insurance offered by the U.S. government to domestic firms investing abroad includes inconvertibility of currency as a political risk. Yet currency inconvertibility can occur for predominantly economic reasons."[17]

A multinational enterprise may encounter both macro and micro types of political risk. Macro risk occurs when politically motivated environmental changes affect all foreign enterprises. Micro risks are those environmental changes which are intended to affect specific foreign activity.[18]

Macro risk can be illustrated by the takeover of private enterprise in 1959-60 by the Castro government in Cuba. All enterprises, both foreign and domestic, were seized. This confiscation was the result of a change in political philosophy brought about by the Cuban revolution. This change was a shift from private enterprise to a communist system.[19] Macro political risks are dramatic in nature, where micro political risks are selectively directed toward specific fields of business. The ME is more likely to be affected by micro risks as they are generally more prevalent. Such political risk may take the form of tariffs, tax laws, ownership requirements or boycotts. After the 1967 war with Israel, the Arab countries boycotted any companies that had branches in Israel, any permanent investment in the country, or any long-term agreements such as licensing arrangements.[20]

While political risk may be the most far reaching in the effect upon multinational companies, legal restrictions and cultural habits constantly present dynamic environments in which the ME must operate.

Fruehauf, a large U.S. truck manufacturer, became embroiled in an international political and legal dispute for failing to properly investigate and comply with U.S. export controls. Fruehauf's French subsidiary sold truck bodies to Berliet, an independent truck manufacturer, who then sold the finished trucks to Mainland China. Fruehauf was judged in violation of the "Trading with the Enemy Act" by the U.S. government. U.S. export controls exerted a restraining impact on the foreign licensor.[21] The foreign licensor is responsible to see that their overseas licensees do not ship product or disclose direct technical data to certain prohibited areas.[22] As Fruehauf had control over their subsidiary, the U.S. government contended Fruehauf was responsible for not preventing the sale. The French government contended that Fruehauf France would be in violation of French law if it did not honor and fulfill the sales contract to Berliet. As a result of Fruehauf's insufficient investigation, the French court temporarily took control of the subsidiary. Substantial money was lost in the French suit filed by Berliet for default of contract, and Fruehauf U.S.A. was caught in a political web between the U.S. and French governments.[23]

ME's operate within many different cultures. What may be desirable in the home country may not be so highly regarded in the host country. The efficient operation of an ME may depend upon a clear understanding of local customs and habits.

Eastern Airlines opened a new promotional campaign in Brazil highlighting the advantages of their rendezvous lounges on board their new luxury jets. Unfortunately, Eastern's people did not realize that rendezvous in Portuguese is a "room for love making" and the promotion was a great failure.[24]

Pepsodent's promise of white teeth was especially inappropriate in certain regions of Southeast Asia where betelnut chewing was an elite habit and black teeth a symbol of prestige.[25]

Whether it is the threat of political takeover, complicated legal requirements, or a needed understanding of local cultures, the environment in which a multinational company must operate is complex and ever changing. Restrictions placed on the ME's to protect host resources can interfere with efficient operations. To offset these restrictions, the ME may go to great lengths to demonstrate concern for the economic growth of the region in which it is located. Such action may include the development of sophisticated information systems to demonstrate the balance of payments effect of a foreign subsidiary's operation in order to gain political favor.[26]

Part IV

WORLD MONETARY FUND: IMF

One of the most significant differences between domestic and international operations is that international operations involve the use of different currencies. This intercurrency activity contributes to a number of accounting problems. One of the foremost problems is accounting for changes in rates of exchange.

The International Monetary Fund was established in 1944.[27] It was the outgrowth of a gathering of nations at Bretton Woods in which the Monetary Agreement established an international monetary fund for the purpose of regulating the world monetary system and to act as the mechanism for exchange stability.[28] The International Monetary Fund (IMF) set forth the following objectives.[29]

1. To provide the tools for consultation and collaboration on international monetary problems;
2. To aid with the growth of international trade;
3. To promote exchange stability and maintain orderly exchange markets;
4. To assist in the establishment of a multilateral system of international payments for current transactions;
5. To lend currencies to members to assit them in the correction of balance-of-payments maladjustments;

6. To shorten the duration and lessen the degree of balance-of-payments disequilibria.

While the Monetary Agreement was a valid attempt to obtain currency convertibility in an orderly exchange market, criticisms of the plan were voiced at the time. An article appeared in The Economist on July 29, 1944, stating the IMF would only work in a world in which major countries could avoid unemployment crisis, tariffs were lowered, creditors behaved as creditors, and debtors did not default.[30] Specifically certain criticisms of the plan had major impacts on ME's.

Prior to the establishment of the IMF the gold standard was in use. The gold standard maintained a rigid link between currencies. The IMF was somewhat less rigid yet similar means were adopted to obtain universal convertibility. The U.S. dollar was given a fixed rate of exchange against gold. This meant the U.S. could not revalue its currency without causing a pro rata adjustment to all currencies.[31] While the IMF attempted to achieve full convertibility of currencies for current transactions, it allowed its members to restrict convertibility for capital transactions. In practice, however, a great many countries utilized currency restrictions for both current and capital transactions. These restrictions often severely encumbered the financial operations of ME's.

The IMF established a system of fees to be levied against those members exchanging their own currency for other currencies to the extent that the IMF held a larger quantity of that member's currency than its quota.[32] It was believed that these fees would serve as a deterrent to maintaining an unfavorable balance of payments over a long period of time.

To better understand the workings of the IMF, the following example brings into perspective the major shortcomings of the agreement.

England is in need of short-term credit from the International Monetary Fund. The IMF enables a debtor country to borrow dollars by extending purchasing rights. It allows England to buy the Fund's own dollars using British pounds. After the British balance of payments has improved, Britain is supposed to buy back its currency with gold or U.S. dollars. Should the Fund end up holding more British pounds than their quota allows, then a fee would be levied against England. If England repaid the IMF then the system worked as it was intended. However, if England chose not to repay the IMF then there would be little recourse by the Fund.

The impact of failure of the fees to act as a deterrent contributed to the failure of countries to devalue on a timely basis. Moreover, the predictability of devaluations was decreased nurturing an already established speculative market.[33]

In principle the Bretton Woods agreement of 1944 was an admirable start in attempting to meet the objective of currency conversion in an orderly exchange market. As pointed out the system had numerous shortcomings. To correct these shortcomings three structural changes were made to the agreement. In 1968 an agreement was made to halt the ability of the private sector to buy U.S. gold indirectly. The United States would no longer exchange gold for dollars held by foreign nongovernment entities.[34] The effect of this change was to enable the U.S. to delay the realignment of the dollar with other currencies until 1971.

In 1970 a change created Special Drawing Rights (SDR's). These SDR's enabled governments to delay devaluations for longer periods of time. They also created a wider disparity between official exchange rates and currency market values.

The third change took place in 1971 at the Smithsonian Institute in Washington, D.C. The IMF cancelled the convertibility of the dollar for gold. Although it was not until 1975 that the IMF abolished the official price of gold, the Smithsonian agreement in effect marked an end to the Bretton Woods agreement.

In the period from 1944 to 1971, the IMF attempted to secure the advantages of the gold standard without the disadvantages. Specifically, the IMF attempted to maintain relatively stable exchange rates. To do this, the IMF defined the parities of currency in terms of gold and dollars. In 1944 the equivalent was 1/35 ounce of gold to a dollar. The U.S. Dollar was to be the "intervention currency."[35] Just as there were methods to peg parities of currency, there were also ways to unpeg parities that represented clear undervaluation or overvaluation. This ability and willingness to change parities created a speculative market for those currencies which could be identified as overvalued. Additional strain was put on the agreement throughout the 1950's and 1960's as it became clear that exchange rates could not be fixed in a world where cost and demands changed disproportionately between regions. The agreement became impossible to defend as it became evident that the U.S. dollar, the intervention currency, was becoming progressively overvalued in the 1960's.[36]

As Bretton Woods proved to be based on invalid assumptions, the post World War II monetary system did not work as it was intended. The result was a different monetary system involving black markets, extensive government market intervention, and supranational money markets.[37]

With the demise of the IMF in 1971 as the official profile of currency exchange rates no new single world monetary system emerged establishing parities between currencies. By the early 1970's, the increased growth of ME's combined with the failure of the IMF resulted in the question of translation being widely debated.

Issues brought to the forefront concerned not only determining exchange rates but also how to account for the resulting translation gains or losses in the financial statements. In the United States the debate on accounting for translation gains and losses was so great that the Financial Accounting Standards Board decided to take the issue under advisement and issue a statement. Rather than clarify the issue, the Board's statement only added more fuel to the debate. Before examining the decision by the Board it is necessary to understand the climate which surrounded this issue.

Part V

METHODS OF ACCOUNTING FOR FOREIGN CURRENCY TRANSLATION GAINS AND LOSSES

An amount stated in foreign money in the financial statements of a foreign subsidiary must be translated into the same currency of the headquarters company. In the case where the headquarters are located in the U.S., the foreign subsidiary's financial statements must be translated into U.S. dollars. A major problem in this translation process is determining the appropriate translation rate from among rates that vary at different times.

Translation has been defined as a measurement conversion process.[38] Translation changes a unit of measure from one type of unit of measure to another. It does not change the attribute of the unit. If for example, a foreign subsidiary's financial statements are prepared according to accounting principles generally accepted in the foreign country but not in the U.S., the translation process cannot be used to justify changes in principles. Any accounting principles that do not conform must be changed prior to translation. Translation is only a process of converting one unit of measure to another.

Accounts in foreign subsidiaries and branches are kept in local currency. While headquarters' management may have limited need or use for financial reports done in local currency, these reports must be translated into parent company currency for the following reasons.[39]

1. Since the U.S. parent company's investment is in dollars, the operations of the foreign subsidiary must be expressed in dollars to evaluate the return produced by the dollar.
2. The objective of business operations abroad is profit which benefits shareholders of the U.S. parent company through an increase in dollar values of the shareholder's equity. Translation of local currency to dollars is necessary to determine the periodic gain or loss resulting from the movement in exchange rates.
3. Management is accustomed to thinking in terms of dollars rather than foreign currency units.
4. Translation is necessary in order to consolidate the foreign financial statements with domestic statements.

While it is not too difficult to understand the need for currency translation, it can be quite difficult to develop a procedure for translation that would be consistent and achievable by all ME's. One of the earliest attempts to establish such a procedure occurred with the issuance of <u>Accounting Research Bulletin No. 4</u> (ARB 4), "Foreign Operations and Foreign Exchange" published in 1939. It recommended the use of the current-noncurrent method of translation. Under this method, assets and liabilities classified as current are translated at the foreign exchange rate in effect at the balance sheet date. The noncurrent assets and liabilities are translated at the rates in effect at the dates on which they were acquired or recorded in the accounting records of the subsidiary.[40]

After World War II, ARB 43 "Foreign Operations and Foreign Exchange" was issued. It was essentially a restatement of ARB 4, supplemented by modifications in the treatment of long-term receivables and payables.

In the early 1950's, another method of translation was being developed. The monetary-nonmonetary method translates those assets and liabilities considered monetary at the foreign exchange rate in effect at the balance sheet date, while assets and liabilities that are nonmonetary are translated at the rates in effect at the dates they were acquired or recorded in the accounting records of the foreign subsidiary.[41] Professor Samuel Hepworth published his monetary-nonmonetary method of translation in 1956. Over the next 15 years this method was studied and revised many times resulting in the proposal of a new method of translation. The Temporal principle stems from key conclusions about the nature of accounting and the translation process.

As previously stated the nature of translation is a measurement conversion process that requires assets and liabilities of foreign subsidiaries be translated such that their attributes be measured the same after translation as before. This objective is accomplished for those assets and liabilities measured at foreign money prices by using the fair value principle.[42]

The Accounting Principles Board Statement 4, states:

> Fair value is the approximation of exchange (money) price in transfers in which money or money claims are not involved. Similar exchanges are used to approximate what the exchange (money) price would have been if an exchange for money had taken place.[43]

Put another way the fair value principle states the money price that would be the basis of the exchange if money was actually exchanged can be determined by approximating the fair value of the consideration given or the fair value of the product received whichever is more evident.[44] The central point of the fair value principle is to establish a specific value at a specific time. This principle can be used to approximate the domestic money price of an exchange that does not involve domestic money, but does involve foreign money and goods or services. The domestic money would be the basis of the exchange; the foreign money would be the consideration given. At the date of the exchange or would be exchange, the fair value in terms of domestic money of the consideration given (foreign money) is determined by the foreign exchange rate for the two moneys at that date.[45] A domestic money price can be determined by multiplying the foreign money price by the foreign exchange rate prevailing at the time of the exchange. Using the fair value principle the historical cost, current replacement price, and current selling price of an asset can be translated from the foreign money price to a domestic money price. Historical cost in domestic money would be the historical foreign money price multiplied by the exchange rate prevailing at the time the asset was acquired. The current replacement price and current selling price in domestic money could be approximated by multiplying the foreign money current replacement price and current selling price by the current foreign exchange rate.

The Temporal Principle applies the fair value principle in measuring assets and liabilities stated at foreign money prices. It is possible to determine the domestic money price of an asset or liability by multiplying it by the exchange rate in effect at the time of the transaction date. In keeping with the definition of currency translation, the historical cost, current replacement price, and current selling price are retained. Foreign money receivables and foreign money payables cannot be translated as easily as other assets and liabilities. These moneys represent unit values that are promised at some future date. Nevertheless, these values must be translated and done so in such a way as to retain their attributes. The Temporal Principle states these assets should be translated by multiplying the foreign money price by the exchange rate in effect on the balance sheet date. The foreign exchange rate in effect at the balance sheet date is the clearest evidence of the relationship of a foreign money price to a specific domestic price. To apply an exchange rate from any other date would contradict the fair value principle and jeopardize the temporal characteristics of the unit measured.

In summary, the Temporal Principle states money, receivables, and payables measured at the amounts promised should be translated at the foreign exchange rate in effect at the balance sheet date. Assets and liabilities that are measured with a money price should be translated at the foreign exchange rate in effect at the date to which the money price pertains.

The following chart lists major classes of balance sheet assets and liabilities and the rates at which they are translated using the Temporal Principle.[46]

	Translation Rates	
Assets	Past	Current
Cash		X
Marketable Securities (Stocks, Bonds)		
Stated at Cost	X	
Stated at Current Market Price		X
Accounts and Notes Receivable		X
Allowance for Bad Debts		X

Assets	Translation Rates Past	Current
Inventories		
Stated at Cost	X	
Stated at Current Replacement Cost		X
Stated at Net Realizable Value		X
Stated at Contract Price		X
Prepaid Insurance, Rent, Taxes	X	
Investments in Subsidiary Companies		
Stated at Cost	X	
Property Plant and Equipment	X	
Depreciation (Translated at the rates that apply to the translation of the related Property, Plant, and Equipment)	X	
Deferred Charges	X	
Patents, Trademarks, Licenses	X	
Liabilities		
Accounts and Notes Payable		X
Bonds Payable		X
Discount on Bonds Payable		X
Obligation under Capitalized Leases		X
Accrued Pension Cost		X
Deferred Income (Measured at a money price in effect when recorded, and translated at the rate in effect at that date)	X	

Past rates are foreign exchange rates in effect before the balance sheet date, and current rates are those exchange rates in effect at the balance sheet date.

Net income (net loss) is "the excess (deficit) of revenue over expenses for an accounting period."[47] Revenue is made up of the gross increases in assets or gross decreases in liabilities; expenses are gross decreases in assets or gross increases in liabilities recognized and measured in conformity with generally accepted accounting principles.[48] Translating the net income of a foreign subsidiary requires translating gross increases and decreases in its assets and liabilities that are reported as revenue and expenses.[49]

The Temporal Principle translates revenue and expenses recognized as a result of receiving or paying money, or accruing receivables or payables at the foreign exchange rate in effect at the date of recognition because money owned and receivables and payables are translated at that rate at that date.[50]

Revenues or expenses that include large numbers of receipts or payments can be successfully translated using approximated rates such as an average rate. If the rate changes during a period are not significant, a single average figure can be used to translate the revenues and expenses. However, if there are wide ranges in the rates within a given period the revenues and expenses may be grouped by subperiods to accommodate the rate fluctuations. Inventories can be translated using average rates; particularly inventory stated at average cost. Depreciation expense can also be translated by approximated rates by translating depreciation on assets acquired during each year at a single yearly rate.

Summarizing the Temporal method as it pertains to the income statement sales and cash operating expenses are translated at the average current exchange rate, cost of goods sold and depreciation are translated at the historic rate of exchange appropriate for each category.[51] The following chart lists the major categories of the income statement and the rates at which they are translated.

Item	Translation Rate
Sales	Current Average Rate
Cost of Goods Sold	Historic Rate
General and Administrative Expenses	Current Average Rate
Depreciation Expense	Historic Rate
Total Operating Expenses	
Operating Profit	
Income Tax Expense	
Net Income (Loss)	

Under the Temporal method of translation gains or losses do not flow through the income statement. Prior to 1976 common U.S. practice was to record net foreign exchange gains for any year in an equity reserve account such as "reserve for future foreign exchange losses."[52]

Net foreign exchange losses for any year were subtracted from any existing reserve created by prior year's net gains. If the amount in the reserve was not great enough to take the loss, the remaining net loss was subtracted from annual income for that year.[53]

To further illustrate the Temporal Principle consider the following examples.

Case 1 U.S. parent company owns shares of a German subsidiary. Parent does not own any assets, no depreciation, no other complications. Exchange Rate = 2.00 DM = 1 Dollar

Balance Sheet - Beginning Period 1

	Sub		Parent	Consolidated
	DM	$	$	$
Fixed Assets	3,200	1,600	1,000	1,600
Inventories	800	400	--	400
Cash	--	--	--	--
TOTAL	4,000	2,000	1,000	2,000
Current Liabilities	1,000	500	250	750
Long Term Debt	1,000	500	250	750
Owner's Equity	2,000	1,000	500	500
TOTAL	4,000	2,000	1,000	2,000

Period 1 Events-Income Statement

Exchange Rate Year End = 1.80 DM - 1 Dollar

Average Exchange Rate = 1.90 DM = 1 Dollar

Historic Exchange Rate = 2.00 DM = 1 Dollar

	Sub		Parent	Consolidated
	DM	$	$	$
Revenues	4,000	2,105.26	210.52	2,105.26
Expenses	3,200	1,684.22	50.00	1,734.22
Pre-Tax Profit	800	421.04	160.52	371.04
Taxes (50%)	400	210.52	--	210.52
After Tax	400	210.52	160.52	160.52
Dividends	200	105.26	25.00	25.00
△ RE	200	105.26	135.52	135.52

Balance Sheet - End Period 1

Exchange Rate Year End = 1.80 DM = 1 Dollar

Average Exchange Rate = 1.90 DM = 1 Dollar

Historic Exchange Rate = 2.00 DM = 1 Dollar

	Sub		Parent	Consolidated
	DM	$	$	$
Fixed Assets	3,200	1,600.00	1,105.26	1,600.00
Inventories	800	400.00	--	400.00
Cash	200	111.12	30.26	141.38
TOTAL	4,200	2,111.12	1,135.52	2,141.38

	Sub		Parent	Consolidated
	DM	$	$	$
Current Liabilities	1,000	555.55	250.00	805.55
Long-Term Debt	1,000	555.55	250.00	805.55
Owners Equity				
Capital	2,000	1,000.00	500.00	500.00
R/E	200	105.26	135.52	135.52
Total		2,216.36	1,135.52	2,246.62
Reserve for Future Foreign Exchange Losses		105.24		105.24
	4,200	2,111.12	1,135.52	2,141.38

The balance sheet accounts Fixed Assets and Inventories are translated at the historic exchange rate of 2.00 DM = 1 dollar. The asset cash is translated at the rate of exchange at the balance sheet date or 1.80 DM = 1 dollar. Long term debt and current liabilities are translated at the closing rate of exchange 1.80 DM = 1 dollar, and owners equity is translated at the historic rate of 2.00 DM = 1 dollar.

On the income statement revenues, expenses and dividends are translated at the average exchange rate of 1.90 DM = 1 dollar.

The translation gain or loss is determined by reconciling the net income figure with the change in retained earnings on the balance sheet. In the previous example, the beginning balance sheet had owner's equity valued at $1,000. The ending balance sheet valued owner's equity at $1,105.26, a difference of $105.26. At this point the balance sheet is out of balance. Total assets should equal total liabilities plus owner's equity. In this example, ending balance sheet assets total $2,111.12 (translated dollars). Total liabilities and owner's equity equals $2,216.36 (translated dollars). The difference between assets and liabilities plus owner's equity is $105.24. This figure represents the translation loss. It is the amount necessary to reconcile the net income figure with the change in retained earnings. To bring the balance sheet into balance, the equity account reserve for future foreign exchange losses will be debited $105.24. In this example there were no prior year gains in the equity account, so the entire $105.24 would be deducted from the income for the period. This would be done by including the $105.24 in the Non-Operating Income/Loss account on the income statement. Under the Temporal method, had there been sufficient prior year's translation gains in the equity account to deduct the exchange loss of $105.24, then no entry would have been made to the income statement.

The Temporal Principle was developed in an attempt to bring consistency and reliability to translated financial statements. The roots of this method can be found in Samuel Hepworth's monetary/nonmonetary method of translation. Leonard Lorenson stated in his study, Reporting Foreign Operations of U.S. Companies in U.S. Dollars, "the monetary/nonmonetary method can perhaps be best described as an incomplete version of the temporal principle."[54]

At the time the Temporal method was put forward there were several other methods being used by ME's. However, unlike other methods, the Temporal Principle was developed from a definition of translation as a measurement conversion process in which a unit of measure is changed from one defined in terms of foreign money to one defined in terms of U.S. dollars, and was not developed from a definition based on the characteristics of assets and liabilities. This is an important concept as it is imperative that a method of translation not affect the attributes of the asset or liability being translated.

Under the Temporal method monetary assets (such as cash, marketable securities, accounts receivable, long term receivables) and monetary liabilities (current liabilities and long term debt) are translated at the current exchange rate. Other assets and liabilities are translated at historical rates. Most income statement items are translated at the average exchange rate for the period. Those items such as depreciation and cost of goods sold which are directly associated with non-monetary assets or liabilities are translated at historic rates. Resulting translation gains are reported separately and accumulated in a separate equity account such as reserve for future foreign exchange losses. Translation losses are reported separately and are subtracted from prior year gains accumulated in the equity account. Unless the balance in the equity account is not sufficient to cover the losses net income for the period is not affected and no entry is made to the income statement. However, if losses are greater than prior year gains, then the equity account is reduced to a zero balance and the remaining losses deducted from the income for the period. It is important to note that in most circumstances net income for the period is not affected by translation gains or losses.

The strength of the Temporal Principle is that by using this method, the measurement bases of the assets and liabilities measured are the same after translation as before. Any measurement bases such as historical cost, current replacement cost, or current selling price based on exchange prices can be accommodated.[55]

At the time the Temporal method was introduced there was no single method of translation currently in use. This situation remained until October 1975 when the Financial Accounting Standards Board issued <u>Statement of</u>

Financial Accounting Standards Number 8, commonly referred to as FASB #8. The Financial Accounting Standards Board consists of seven members who have the responsibility and authority to determine accounting policy for U.S. firms and certified public accountants. With the issuance of FASB #8, the monetary/nonmonetary method of translation was given a precise set of rules. U.S. multinational enterprises now had a specific method of translation to follow.

The translation procedures that apply to FASB #8 are generally the same as the Temporal method. The two methods are often referred to interchangeably. David Eiteman stated in his book, Multinational Business Finance, that the Temporal method in the United States was renamed FASB #8.[56] The following chart shows the translation rates to be used following the FASB #8 method of translation.[57]

Rates Used to Translate Assets and Liabilities

	Translation Rates	
	Current	Historical
ASSETS		
Cash on hand	X	
Marketable equity securities:		
Carried at cost		X
Carried at current market price	X	
Accounts and notes receivable and related unearned discount	X	
Allowance for doubtful accounts and notes receivable	X	

	Translation Rates Current	Historical
Inventories:		
Carried at cost		X
Carried at current replacement price or current selling price	X	
Carried at net realizable value	X	
Carried at contract price (produced under fixed price contracts)	X	
Prepaid insurance, advertising, and rent		X
Advances to unconsolidated subsidiaries	X	
Property, plant, and equipment		X
Accumulated depreciation of property, plant, and equipment		X
Cash surrender value of life insurance	X	
Patents, trademarks, licenses, and formulas		X
Goodwill		X
Other intangible assets		X
LIABILITIES		
Accounts and notes payable and overdrafts	X	
Accrued expenses payable	X	
Deferred income		X
Bonds payable or other long-term debt	X	
Unamortized premium or discount on bonds or notes payable	X	
Convertible bonds payable	X	
Accrued pension obligations	X	
Obligations under warranties	X	

While the translation rates applied to assets and liabilities are generally the same for the Temporal and FASB #8 methods, there is a significant difference in the reporting of translation gains (losses) and their impact on net income for the period. As stated previously under the Temporal method, translation gains are reported in an equity account and losses are deducted from prior year gains accumulated in the equity account. No entry is made to the income statement and net income for the period is not affected. Under FASB #8 translation gains and losses are "included in determining net income for the period in which the rate changes."[58] The requirement that gains and losses pass through the income statement meant that translation gains and losses would have a direct effect on quarterly and annual net income. This requirement existed in the late 1970's, at a time when the value of the U.S. dollar was fluctuating widely. Businesses were faced with a whipsaw effect on reported quarterly earnings. The resulting unstable appearance of these earnings made FASB #8 very unpopular with the business community.[59]

The effect of this flow through requirement can be shown using the same income statement used to demonstrate the Temporal method.

In the previous example there was an exchange loss of $105.24. Under FASB #8 this $105.24 loss would pass through the income statement for the period.

Period 1 Events - Income Statement

(From Previous Example page 32)

Revenues	$2,105.26
Expenses	1,684.22
Pre-Tax Profit	$ 421.04
Taxes (50%)	210.52
After Tax	$ 210.52
Dividends	105.26
Retained Earnings	$ 105.26

The translation loss of $105.24 is a non-operating expense and would be recorded as follows.

Period 1 Events - Income Statement

Revenues		$2,105.26
Non-Operating Expense	$ 105.24	
Other Expenses	1,684.22	
Total Expenses		1,789.46
Pre-Tax Profit		$ 315.80
Taxes (50%)		157.90
After Tax Profit		$ 157.90
Dividends		78.95
Retained Earnings		$ 78.95

As the example demonstrates, the effect of gains and losses on net income can be dramatic. If the income statement in this example was reporting first quarter activity, and second quarter activity resulted in a translation gain of $105.24 the results would be as follows:

Non-Operating Revenue	$ 105.24	
Other Revenue	2,105.26	
Total Revenue		$2,210.50
Expenses		1,684.22
Pre-Tax Profit		$ 526.28
Taxes (50%)		263.14
After Tax Profit		$ 263.14
Dividends		131.57
Retained Earnings		$ 131.57

First quarter net income was $157.90 and second quarter net income was $263.14. It is not difficult to imagine the "whipsaw" effect on earnings when gains and losses flow through period income statements.

A major criticism of FASB #8 is that in periods of wide fluctuations in the value of the U.S. dollar, "multinational firms' foreign exchange risk management policies became dominated by the cosmetic desire to manage quarterly earnings so that they appeared stable and rising."[60]

This criticism was not overlooked by members of FASB. Mr. Robert E. Mays wrote at the time the decision was issued that he believed "that exchange differences arising from translation should not, in all cases, be treated as current gains or losses."[61] The outcry from the business community and the accounting profession was so great against FASB #8, that the FASB committee once again undertook the task of establishing revised standards of financial reporting for foreign currency translation. Their efforts resulted in the issuance of FASB #52, Foreign Currency Translation, in December 1981.

FASB #52, also referred to as the current rate method, calls for "all assets and liabilities to be translated at the current rate of exchange, i.e., the rate of exchange in effect at the time of the balance sheet date. Income statement items including depreciation and cost of goods sold are translated at either the actual exchange rate on the dates the various revenues, expenses, gains and losses are incurred or at an appropriately weighted average exchange rate for the period. Dividends paid are translated at the exchange rate in effect on the date of payment. Existing equity accounts are translated at historical rates."[62]

Under FASB #52, gains or losses resulting from translation are not included in the calculation of net income. These gains or losses are reported separately and accumulated in a separate equity account such as equity adjustment from translation. When the foreign affiliate is sold or liquidated the gain or loss in the equity account is reported as net income or loss for the time period in which final disposition takes place. By taking the gains or losses out of the period net income calculation, the FASB committee removed a major criticism of the previous translation method.

In order to demonstrate the effect of FASB #52, the previous example used to explain the Temporal method and FASB #8 is translated using FASB #52.

Balance Sheet - Beginning Period 1

Exchange Rate = 2.00 DM = 1 Dollar

	Sub		Parent	Consolidated
	DM	$	$	$
Fixed Assets	3,200	1,600	1,000	1,600
Inventories	800	400	--	400
Cash	--	--	--	--
Total	4,000	2,000	1,000	2,000
Current Liabilities	1,000	500	250	750
Long Term Debt	1,000	500	250	750
Owners Equity	2,000	1,000	500	500
Total	4,000	2,000	1,000	2,000

Period 1 Events - Income Statement

Exchange Rate Year End = 1.80 DM = 1 Dollar

Average Exchange Rate = 1.90 DM = 1 Dollar

Historic Exchange Rate = 2.00 DM = 1 Dollar

	Sub		Parent	Consolidated
	DM	$	$	$
Revenues	4,000	2,105.26	210.52	2,105.26
Expenses	3,200	1,684.22	50.00	1,734.22
Pre-Tax Profit	800	421.04	160.52	371.04
Taxes (50%)	400	210.52	--	210.52
After Tax	400	210.52	160.52	160.52
Dividends	200	105.26	25.00	25.00
RE	200	105.26	135.52	135.52

Balance Sheet - End Period 1

Exchange Rate Year End = 1.80 DM = 1 Dollar

Average Exchange Rate = 1.90 DM = 1 Dollar

Historic Exchange Rate = 2.00 DM = 1 Dollar

	Sub		Parent	Consolidated
	DM	$	$	$
Fixed Assets	3,200	1,777.78	1,105.26	1,777.78
Inventories	800	444.44	--	444.44
Cash	200	111.12	30.26	141.38
Total	4,200	2,333.34	1,135.52	2,363.60

	Sub		Parent	Consolidated
	DM	$	$	$
Current Liabilities	1,000	555.55	250.00	805.55
Long Term Debt	1,000	555.55	250.00	805.55
Owners Equity				
Capital	2,000	1,000.00	500.00	500.00
R/E	200	105.26	135.52	135.52
Total	4,200	2,216.36	1,135.52	2,246.62
Reserve for Future Foreign Exchange Losses	--	116.98	--	116.98
Total	4,200	2,333.34	1,135.52	2,363.60

Under FASB #52 assets and liabilities are translated at the current exchange rate of 1.80 DM to 1 dollar. The owner's equity capital account is translated at the historical rate of 2.00 DM to 1 dollar. Revenue and expense accounts are translated at the average exchange rate of 1.90 DM to 1 dollar.

When FASB #8 was applied to this example there was an exchange loss of $105.24; under FASB #52 there is an exchange gain of $116.98. While there is no difference in the numbers being translated the resulting gain or loss is dependent upon the translation method used.

The net income figure highlights another difference between the two methods. Under FASB #8 net income was

$157.90; under FASB #52 net income was $210.52. According to FASB #8 procedures translation gains or losses must flow through the period income statement whereby net income is increased or decreased by the amount of the translation gain or loss. FASB #52 requires the gains or losses to be accumulated and reported on the balance sheet in a special equity account. In this example, net income of $210.52 is correct and the gain of $116.98 is reported on the period ending balance sheet in the account reserve for future foreign exchange losses. If the FASB committee had continued to require the gains and losses to flow through the income statement then net income under FASB #52 in this example would have been $327.50 instead of $210.52.

With the issuance of FASB #52, the Financial Accounting Standards Board attempted to correct the two most often mentioned fallacies of FASB #8. The committee had called for comments on FASB Statements 1-12, and of the more than 200 letters received most were concerned with changes to FASB #8.[63] Changes were suggested both in the method used in translating financial statements, and in the method of disposition of the resulting translation adjustments. To this end the committee recommended that the current rate of exchange be used for translating all elements of financial statements. For assets and liabilities, the exchange rate to be used is the rate at the balance sheet date. For revenues and expenses, the exchange rate to be used is the rate at the dates on which those elements are recognized or the appropriately weighted average exchange rate for the period.[64] It was felt by the committee that using the current exchange rate "would better reflect the underlying economic reality of foreign operations."[65]

By removing the requirement that translation gains and losses flow through the period income statement, the committee attempted to satisfy the second point of contention referenced in the responses to FASB #8.

Under FASB #52 there was no longer a need by management to attempt to manage translation gains or losses. Since these gains/losses were no longer required to flow through period income the short term rate fluctuations no longer appeared on the period net income statements. This decision by the committee was based on respondents' beliefs that transitory rate changes are subject to "misinterpretation because short term rate changes are poor indicators of long term trends."[66]

While FASB #52 has not completely satisfied all concerned parties, the statement has been adopted and can be viewed as a continuing refinement of a method of dealing with a diverse and complex area of accounting. Further refinement may be necessary in the future as those factors affecting currency translation continue to change.

Part VI

CONCLUSION

The problem of foreign currency translation of financial statements is not a recent one. However, the rapid growth of multinational companies has brought this problem to the forefront. Throughout the world the methods used to translate foreign currency vary significantly. The results may also vary dramatically depending only on which method of translation is used.

In the United States the Financial Accounting Standards Board has established a translation method to be used by all U.S. multinational companies. The process of selection was not an easy one and did not occur overnight. Rather the development of a standard translation method can be seen as an evolution of hybrid methods to one single accepted method.

Pronouncements from the accounting world in the 1930's made popular the current/noncurrent method of translation. It was not until the 1950's that the expansion of multinational enterprises brought this method to practical significance. Under this method, all current assets and current liabilities are translated at the current exchange rate. Noncurrent assets and liabilities are translated at historic rates.[67] During the 1950's and early 1960's most important currencies had fixed parities against the dollar and there was little worry about devaluations against the stronger dollar. In the 1970's "fundamental changes in world financial strengths led to dollar devaluations against foreign currencies and foreign revaluations against the dollar."[68] With parities no longer set, and widely fluctuating exchange rates, there was increased acceptance by multinational firms towards the monetary/nonmonetary method of translation. This method, also known as the Temporal method, requires that assets and liabilities valued on a current basis in foreign currency should be translated at the current exchange rate, and assets and liabilities valued at historical cost in foreign currency should be translated at historical rates. By definition the Temporal method is a conversion process, translating one unit of measure to another without changing the attributes of the unit. This principle was highly supported in the dynamic foreign currency environment. Such was the support for this method that the Financial Accounting Standards Board adopted it in 1975. Known as FASB #8, it was selected as the required method of translation in the United States.

While the accounting profession was ready to accept a standard method of translation, FASB #8 ran into noteworthy opposition. This opposition was not essentially directed towards the structural following of the monetary/nonmonetary method, but rather towards the requirement that translation gains or losses must be included in determining net income for the period rather than held in an equity reserve account. At a time when exchange rates were subject to broad fluctuations the flow through requirement created an up and down effect on quarterly earnings. As a result, management attempted to control exchange risk factors in order that quarterly earnings would appear stable and rising. Under FASB #8, foreign currency translation was no longer a measurement conversion process, but rather became a management tool to be used to influence the appearance of short term earnings.

Dissatisfaction with FASB #8 led to the adoption of FASB #52 in December 1981. FASB #52 not only put translation gains and losses back into an equity reserve account and out of period net income, but also departed from the monetary/nonmonetary method. Under FASB #52 assets and liabilities are translated at the current rate of exchange. Income statement items are translated at either the actual rate on which they were incurred or at an appropriately weighted average exchange rate for the period. Through its commentary process, the FASB committee recommended the current rate method over the monetary/nonmonetary method in an attempt to "provide information that is generally compatible with expected economic effects of a rate change on an enterprise's cash flows and equity."[69]

The problem of accounting for translation gains and losses has not disappeared with the issuance of FASB #52. Questions remain and much discussion continues regarding the treatment of gains and losses and their relationship to net income. Treatment of long term debt is another area for further study. FASB #52 reflects fully at the present time any change in currency value of foreign currency long term debt. The underlying assumption "is that any present change in exchange rate is permanent in direction rather than a fluctuation that may in time go in the opposite direction. Thus the full gain or loss should be recorded at the present time."[70] Another school of thought assumes that exchange rates might continue to fluctuate in both directions and that any assumption now that these new rates reflect a permanent change in value is premature.[71] Consequently, the historic rate should be used to translate long term debt, resulting in only the final year, when the debt is repaid, feeling the effect of a translation gain or loss. The interim years would be free of any portion of the change in value.

Questions such as accounting for long term debt are difficult to answer. Currently in the United States FASB #52 supplies the answers to many questions so that the work of currency translation can be done consistently from one multinational firm to another. But FASB #52 should be looked at as the current point of an evolutionary process; a refinement of accounting experience and consensus of accounting opinions. There is no reason to believe that further refinement is not possible and that new approaches may answer old questions.

FOOTNOTES

[1] Leonard Lorenson, Reporting Foreign Operations of U.S. Companies in U.S. Dollars, p. 19.

[2] Ibid., p. 19.

[3] Ibid., p. 19.

[4] Ibid., p. 19.

[5] Paul A. Samuelson, Economics, p. 19.

[6] Vincent Massaro, "Corporate Experience with FASB #8," New York Conference Board, p. 15.

[7] Ibid., p. 62.

[8] Lee Radebaugh, "FASB Position on Translation," American Accounting Association Collected Papers of the Annual Meeting, August 1975, p. 6.

[9] George Scott, "An Introduction to Financial Control and Reporting in Multinational Enterprises," Bureau of Business Research Graduate School of Business University of Texas at Austin, p. 5.

[10] Ibid., p. 9.

[11] Ibid., p. 10.

[12] Stefan Robock and Kenneth Simmonds, International Business and Multinational Enterprises, p. 355.

[13] Ibid., p. 355.

[14] Ibid., p. 356.

[15] Ibid., p. 356.

[16] Ibid., p. 356.

[17] Ibid., p. 357.

[18] Ibid., p. 359.

[19] _Ibid._, p. 359.

[20] _Ibid._, p. 360.

[21] David Ricks, Marilyn Y. C. Fu, Jeffrey S. Arpan, _International Business Blunders_, p. 54.

[22] _Ibid._, p. 54.

[23] _Ibid._, p. 55.

[24] _Ibid._, p. 11.

[25] _Ibid._, p. 15.

[26] Scott, p. 10.

[27] Virgil Salera and Joseph Towle, _Multinational Business_, p. 16.

[28] John H. Dunning, _Economic Analysis and the Multinational Enterprise_, p. 210.

[29] Salera and Towle, p. 13.

[30] _Ibid._, p. 15.

[31] _Ibid._, p. 62.

[32] _Ibid._, p. 64.

[33] _Ibid._, p. 67.

[34] _Ibid._, p. 86.

[35] Samuelson, p. 612.

[36] _Ibid._, p. 667.

[37] Scott, p. 16.

[38] _Ibid._, p. 16.

[39] National Association of Accountants Research Report #36, _Management Accounting Problems in Foreign Operations_, p. 11.

[40] Lorenson, p. 6.

[41] _Ibid._, p. 6.

[42] *Ibid.*, p. 17.

[43] AICPA, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," *Accounting Principles Board Statement No. 4*, paragraph 181.

[44] AICPA, "Business Combinations," *Accounting Principles Board Opinion No. 16*, p. 67.

[45] Lorenson, p. 17.

[46] *Ibid.*, p. 21.

[47] AICPA, APB No. 4, paragraph 134.

[48] *Ibid.*, paragraph 134.

[49] Lorenson, p. 122.

[50] *Ibid.*, p. 22.

[51] David Eiteman, *Multinational Business Finance*, p. 174.

[52] *Ibid.*, p. 162.

[53] *Ibid.*, p. 162.

[54] Lorenson, p. 47.

[55] Financial Accounting Standards Board, "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," *Statement of Financial Accounting Standards No. 8*, p. 56.

[56] Eiteman, p. 160.

[57] FASB No. 8, p. 20.

[58] *Ibid.*, p. 8.

[59] Eiteman, p. 162.

[60] FASB No. 8, p. 162.

[61] *Ibid.*, p. 16.

[62] Eiteman, p. 169.

[63] FASB No. 8, p. 71.

[64] Ibid., p. 5.

[65] Ibid., p. 71.

[66] Ibid., p. 73.

[67] Eiteman, p. 161.

[68] Ibid., p. 180.

[69] Financial Accounting Standards Board, "Foreign Currency Translation," Statement of Financial Accounting Standards No. 52, p. summary.

[70] Eiteman, p. 180.

[71] Ibid., p. 180.

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