Woman C.P.A.

Volume 37 | Issue 4 Article 2

10-1975

FASB and the Currency Translation Bungle

Irving L. Fantl

The FASB and the Currency Translation Bungle

Dr. Irving L. Fantl, CPA

The author discusses the implications of the FASB's exposure draft on foreign currency translations.

Dr. Irving L. Fantl, CPA, is Professor of Accounting at Florida International University. He has served on the faculty of Baruch College, Rider College, The Wharton School and Seton Hall University.

Dr. Fantl received his B.A. degree from the University of Pennsylvania and his Ph.D. from New York University. He has contributed articles to several periodicals on various aspects of international accounting and has been instrumental in establishing courses on that subject at a number of universities. He is a member of the American Accounting Association, the American Institute of CPAs, and the National Association of Accountants.

The Financial Accounting Standards Board (FASB) has issued an exposure draft on "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements." The very first sentence of this draft asserts that "the expansion of international business activities . . . and the acceptability in practice of significantly different methods of accounting have highlighted the problems relative to foreign currency translation." The introduction further recognizes that there are two types of transaction affecting translation of foreign currency amounts: the one in which purchase or sale of goods or services on credit involve prices stated in foreign currency and the other in which foreign operations involve assets, liabilities, revenues and expenses measured in foreign currencies. In the first instance receivables or payables will involve a conversion from one currency to the other in settlement of the account within a short period of time. In the second example most of the items will be retained in local currency, only requiring conversion when transfers are made from the operating affiliate to one using a different currency.

From these assertions it might be assumed that the FASB recognizes the essential difference between trading operations and the foreign direct investment function. The Board further appears to recognize this variance by defending the two-transaction method of currency translation. Under this concept, the gain or loss of a transaction is recognized at the transaction date, translated at the rate then existing. If settlement of the receivable or payable arising from the transaction is settled at a time when a different rate of exchange applies, any translation gain or loss from holding the account to the date of settlement will reflect an additional translation gain or loss. In relation to short-term activities this facilitates reporting transaction impacts at the transaction date without the need to wait for account settlement to reflect losses or gains.

This concept functions admirably when applied to short-term transactions. Such activities were the most prevalent form of foreign operations when the earliest rulings on currency translation were pronounced. But there has been a shift in emphasis from trading to direct investment in foreign operations. This entails a need to reevaluate the accounting approach to foreign currency translation for purposes of consolidation; however, the FASB persists in considering the recently expanding capital investment process in the same light as the import export type of operation. The irrefutable reality is that capital invested abroad will not be converted into dollars at the imminent conclusion of a buy or sell transaction. Such capital is invested in foreign countries in order to earn foreign currency. It cannot be compared with a two-transaction short-term contract. Like any other corporate entity, the life of the foreign subsidiary is indefinite and its value must be founded not on historical cost in dollars but on its future earning capacity in whatever currency its earnings will be denominated.

Approached from a different view, if the two-transaction method is applied to fixed assets, then net book value can be considered as the present discounted value of future earnings of that asset. An alteration in exchange rate between the reporting currency and the foreign currency must alter that earning capacity in terms of the reporting currency although it would remain the same in the foreign currency (ignoring price-level changes).

Or perhaps the crucial question should be: does historical value mean original cost in terms of the reporting currency or original cost in the currency of the country in which the asset is located, is functioning and is intended to generate revenue? There is no question that the income so generated will be denominated in the currency of the host country and, if it is transferred to the parent country, will be transferred at the exchange rate in existence at the date of transfer, not at the rate existing at the time the asset was acquired.

Therefore, no matter how interpreted, translating fixed assets at historical rates is a distortion of reality perpetrated in the mistaken belief that it conforms with GAAP. While our business enterprises, whose statements we are interpreting, have become global in their perspective, we — the interpreters — have grown more narrow and provincial in our outlook. The inevitable result must be reports that are irrelevant.

In a defense of the temporal method advocated by the FASB, Leonard Lorenson, author of this technique, reveals the fallacious basis on which his reasoning is founded (J of A, Dec. 1974, p. 100). He wants us to believe that a foreign subsidiary "will, in the future buy only a very small percentage of the . . . goods for sale in a foreign country . . . and is therefore not interested in the general purchasing power of the money unit of the foreign country." Apparently Mr. Lorenson chooses to ignore the fact that the foreign subsidiary must draw its work force from the local labor market, must purchase a great portion of its supplies and even raw materials and semi-finished components locally and, generally, is interested in selling its products to local consumers. Additionally, multinational firms are increasingly depending on local money markets for capital expansion. We cannot shut our eyes to these realities and hope to emerge with an equitable solution to the currency translation problem.

A good example of this weakness of reasoning is found in portions of the FASB exposure draft on the subject. Before examining this item it is advisable to establish the importance of the income statement as a guide to investors in preference to the balance sheet. All knowledgeable analysts recognize that LIFO inventory valuation, which is becoming ever more prevalent, has robbed the balance sheet of its claim to validity. It is also widely recognized that the historical cost basis for valuing fixed assets does not reflect fairly a company's worth. These weaknesses have caused greater reliance to be placed on the income statement as a measure of corporate strength. And yet the FASB persists in its preoccupation with balance sheet aspects of translation in preference to income statement implications of the subject.

In its presentation, the FASB has examined various approaches to currency translation. One of these, the situational approach, would grant to the accountant a certain amount of discretion to select the method best suited to the specific conditions prevailing in relation to this client's foreign operations. When they finally turned to examine this approach the authors of the exposure draft apparently panicked. For the situational approach would permit the accountant to exercise judgment which seems to run contrary to the philosophy of the FASB.

The argument evoked in paragraph 106 of this exposure draft is so completely fallacious as to expose a strong prejudice on the part of the Board. At no point in the prior discussion was reference to "current dollar equivalent *value*" mentioned. Surely this concept should be applied to all solutions if it is applied to any one. However, an assumption of application of replacement value theory is completely irrelevant in this exposure draft. Nor is the relationship between an asset and a liability which generated the funds to acquire the asset a realistic reporting concept. It may be possible that the gain from a liability held through a currency devaluation exactly offsets the loss in value of the asset, but this coincidence is too far-fetched to be considered. To discard the situational approach on such patently contrived grounds is highly irregular. If we concede that accounting must be relevant to the conditions it attempts to reflect, then a "situational approach" is the only way to handle any problem. Any other manner of reporting must produce a non-sequitur.

A more valid way of interpreting the information used in paragraph 106 might be explained as follows: A U.S. corporation (call it Parking Lots, Inc.) acquires land in London on which it expects to earn 10 percent for the next 20 years as a parking lot. The year is 1960 and the exchange rate is 1 = \$2.80. Annual income is calculated at £10,000 per year which will be translated into \$28,000, all of which will be transferred to the U.S. parent. The purchase price for the land is £85,140 or \$238,392, the discounted value at 10 percent of the 20 years' earnings. Total receipts are expected to aggregate £200,000 or \$560,000. The British calculations prove to be correct. However, in 1970, after 10 years of operation, the pound sterling is devalued so that £1 = \$2.40. At this point, although the British income continues at £10,000 per year, the U.S. return is now only \$24,000 per year. The central question is whether carrying the land at \$238,392 is a proper reflection of reality or whether it should be reduced to \$204,336 (85,140 × 2.40) to reflect the real earning power of the investment.

Perhaps a more vivid illustration would be created if, assuming that the land will be worthless at the end of 20 years, the cost is written off as a percentage of revenue for depletion purposes each year. In that case, at the end of 20 years the investment would be completely amortized on the British books. At the time of the devaluation of the pound, the discounted value of remaining earnings at £10,000 per year would be worth, at a 10 percent return, £61,450. This would translate to \$172,060 at the historical rate of return. But the present value of a \$24,000 per year flow at 10 percent return should be only \$147,480. That is, the devaluation would have caused a reduction in present value in dollars of \$24,580.

Viewed in another light, the return of \$24,000 per year on an investment with a value of \$172,060 would be the equivalent of 6.588 percent per annum return on investment, a drop of 3.412 percent from the originally anticipated 10 percent dollar income. This reduction, whether in discounted value of the asset or in revenue rate of return on investment, constitutes a loss in earning power and consequently a loss in asset value. The cause of this reduction in value stems directly from the devaluation process and, therefore, the timing of the loss should be reflected by reducing the dollar book value of the asset when the devaluation occurs. Any deferral of such a loss by retaining historical dollar value and recording income at 6.588 percent instead of 10 percent for the ensuing ten years beclouds the facts of the case. In effect, this procedure merely defers the exchange loss, spreading it over the remaining useful life of the asset. Such a posture was rejected when the APB exposure draft on foreign exchange losses was allowed to lapse.

Obviously, the individuals who devised the argument presented in paragraph 106 had not thought out their proposition carefully. It has no more validity than trying to add apples and oranges, for we are not discussing replacement value accounting at this point but merely examining whether historical value should be maintained in one currency or the other. Within our limited knowledge it is impossible to determine the true future earnings capacity of any asset. Only economists can contemplate such theoretical verities. We accountants must function within the limits of facts related to the past and the present. But this should not limit our understanding that an asset is going to generate future earnings in the currency of the country in which its production will be sold and that such earnings will be related to future conditions and not to conditions existing in the past. Unlike the import/export situation in which the transaction has already occurred, direct investment in foreign operations has not realized revenue or expense at a particular point in time. Transactions from which these assets will generate

(Continued on page 30)

The FASB and the Currency Translation Bungle
(Continued from page 6)

earnings or incur expenses will occur in the future and will be reflected on parent company records at translation rates existing then rather than at rates pertinent to the date when the asset was acquired.

Surely the accounting profession must recognize that to the best of our ability a fixed asset should reflect its future earning capacity. This is the foundation for the use of historical cost which implies that purchasers are willing to acquire an asset at a particular price because they believe its future earnings will justify the outlay. By using the proposed temporal translation method for fixed assets the FASB ignores the going-concern principle, one of the basic tenets of our profession. For the Board implies that these assets are readily convertible into currency by the parent company at their original cost, less depreciation. In reality, the going concern has no intention of repatriating these assets but rather intends that they continue to produce in the country of their locus.

Unfortunately, the temporal method is founded on the premise that GAAP is sacred and inviolable, a concept very far from the truth. The defense of the temporal method (par. 97-100) clearly exposes it as an accommodation to whatever current or future changes might occur in GAAP. But this timid approach does not generate a realistic means of reflecting relevant information.

We have somewhere along the way lost sight of the basic fact that a capital investment is not intended to be converted back into cash, regardless of the currency of the country in which it happens to be located. What will be realized in cash is the earnings generated by that investment over its useful life. Therefore, translation at an historical rate for fixed assets serves no useful purpose. In fact, it creates an illusion of value and, rather than being a conservative practice, overstates the asset's value when the foreign currency is devalued. In the above illustration, if the property had ceased to earn £10,000 per year, that would have been cause to reflect a reduction in annual earnings. But since the income remained as projected, the exchange loss should have been reported. The retention of historical value as a principle is applicable only so long as that historical value is expressed in the currency in which the asset is generating income. A discussion of this same principle where the foreign currency is revalued upward against the dollar is illustrated by Dr. Lee J. Seidler in his excellent article, "An Income Approach to the Translation of Foreign Currency Financial Statements," (The CPA Journal, January 1972, pp. 26-35).

The measure of a skilled, independent operator is the ability to exercise judgment. Even plumbers are permitted discretionary latitude in the exercise of their calling. Why then do we seek to deny professional accountants the right to exercise judgment which might be required under the situational approach? The publication of concise guidelines should provide sufficient control to assure the use of relevant translation procedures.

The objective of the FASB should not be to distort reality so that it will conform with GAAPs, but rather to adjust GAAPs so that they produce results more reflective of reality. For at the present time GAAPs are very suspect ensigns. They are not recognized as legally binding by the judiciary nor are their results respected by those who analyze our work. Let us recognize them for what they are — a collection of conventions and compromises — the very shaky foundation of a much criticized process of reporting. If we would improve our image and the confidence of our clientele in the strength of our profession then GAAP must be improved.

Financial Statements
(Continued from page 10)

method of classification of assets that reduced 1974 depreciation by $97 million, this represented 13% of the total charge for the period and approximately 10% of net income.

Tax Provision on Undistributed Earnings of Subsidiaries. Different policies for handling undistributed subsidiary earnings were reported. AM states that income taxes have not been provided on approximately $20 million of earnings permanently reinvested. Chrysler made almost the identical statement relative to $550 million subsidiary earnings. Ford makes provision for taxes payable on portion of retained earnings expected to be remitted as dividends, but states that no tax provision has been made for $1,225 million reinvested. GM makes provision for deferred taxes on unremitted earnings of foreign operations.

Other differences. Only AM treats the *investment tax credit* as a reduction of tax expense in the period the credit arises; others amortize over the life of the related asset. All reports are silent on the policies related to *product recall.* Ford has a footnote labeled *Litigation and Claims* which states in part "Various legal actions, . . . claims . . . class actions . . . are pending . . . which, if granted would require very large expenditures. . . . In the opinion of counsel for the Company, any resulting liability will not materially affect the consolidated financial position of the company." GM's section on *Contingent Liabilities* reads in part "There are various claims and pending actions . . . arising out of the conduct of the business. The amounts of the claims and actions . . . were not determinable but, in the opinion of the management, the ultimate results will not materially affect the consolidated statements . . ." Note that the GM footnote is based on the opinion of management. One wonders what the opinion of counsel was. Neither Chrysler nor AM mention any ligation or contingent liabilities.

Conclusion. The four financial statements are by no means comparable. Nor is sufficient information given to enable the reader to reconstruct the statements so that they could be compared with any degree of confidence. An exercise such as this further convinces me that additional rulings by professional accounting bodies merely make statements more confusing. Hopefully, some of the current FASB projects will eliminate some of the myriad of choices now available that enable managements to "manage income" by the choice of methods acceptable as GAAP.