Accounting Historians Journal

Volume 2
Issue 1 *No. 1/4 Winter-Fall 1975*

Article 4

1975

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Recommended Citation

Kubin, Konrad W. (1975) "Accounting for foreign currency translation: Current problems in historical perspective," *Accounting Historians Journal*: Vol. 2 : Iss. 1 , Article 4.
Available at: https://egrove.olemiss.edu/aah_journal/vol2/iss1/4

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ACCOUNTING FOR FOREIGN CURRENCY TRANSLATION: CURRENT PROBLEMS IN HISTORICAL PERSPECTIVE

Present accounting for foreign currency translation is in a sad state. Several pressing problems have not been covered adequately by authoritative pronouncements; yet, at the same time there exists a multitude of alternative accounting principles which seriously hampers intercompany comparisons. Moreover, present translation procedures largely reflect the economic environment and political conditions that prevailed several decades ago. To overcome these inadequacies the FASB and others interested in accounting for international operations are currently striving to develop new translation standards. It is the purpose of this paper to contribute to these efforts by retracing the evolution of accounting for foreign operations to gain a better understanding of the current problem. Furthermore, such a historical review lends perspective to the need for promulgating standards which are relevant to the significantly increased and still growing international business operations[1] in an era characterized by fairly frequent and material changes in foreign exchange rates.

Historical Perspective of Current Practice

Bulletin No. 92 entitled "Foreign Exchange Losses" was the first official pronouncement on accounting for foreign operations. Issued in 1931 by the American Institute of Accountants, it promulgated what has become known as the "current-noncurrent translation method" with exceptions sanctioned for (1) receivables protected by forward exchange rates, (2) inventory purchased prior to a devaluation of the foreign currency, where the net realizable value of the merchandise exceeds (as a result of inflation in that country) the dollar acquisition cost of the inventory and (3) long-term liabilities if the company has receivables, which are translated at the current rate, particularly where these receivables could be applied to retire the long-term debt.

Reasons for translating fixed assets at historical rates were not given. Presumably the Institute's Committee on Accounting Procedure agreed with Ashdown who states that fixed assets are not intended for sale, but for use in the business of the foreign subsidiary; consequently, the value of these assets to the company does not vary with changes in exchange rates.[2] Since Ashdown, to whose article Bulletin 92 explicitly refers, admitted however that under special circumstances fixed assets might preferably be translated at rates other than those prevailing at the time these assets were acquired, it is unfortunate that the Bulletin did not reveal reasons for requiring—without any exception—the use of historical exchange rates for translating fixed assets.

Also of historical interest is the disclosure that Bulletin 92 was issued in response to numerous and severe fluctuations in foreign exchange rates. Consequently, its accounting principles may not necessarily be the best for translating foreign financial statements during eras of relative stability in the international monetary system.

Moreover, the fact that Bulletin No. 92 was hastily issued in December 1931 (just in time for the preparation of the year-end financial statements) after deliberations for only about one month suggests that the underlying theoretical rationale may not have been investigated thoroughly.

The absence of a sound theoretical basis became all too apparent in 1933, when the application of the current-noncurrent translation method typically resulted in foreign exchange gains instead of losses. The Special Committee on Accounting Procedure settled the widespread uncertainty about the proper treatment of such gains by issuing the "Memorandum on Accounting for Foreign Exchange Gains" (Bulletin No. 117), which introduced the following logical inconsistency: It advocated that *translation gains* are to be *deferred* when the revaluation of the foreign currency, which gave rise to the gain, may reverse. On the other hand, it required that *translation losses* have to be *realized currently*—presumably even if there are indications that the drop in the value of the foreign currency, which caused the loss, is likely to be transitory.

Bulletin 117 is also of historical interest from another point of view. Issued on December 27, 1933, again just barely in time for the preparation of the year-end financial statements, it reaffirms the earlier observation that current translation methods have been developed hastily on an *ad hoc* basis with apparently little regard for a sound theoretical foundation.

The conservative element introduced in this memorandum was stressed even more in ARB No. 4.[3] It cautioned against the con-

solidation of foreign subsidiaries since assets and earnings located abroad stand in some degree of jeopardy, so far as ultimate realization in U. S. dollars is concerned. The solution to this issue was seen in the all purpose remedy of "adequate disclosure." ARB 4 suggested four possible disclosure procedures and left the door open for still other alternatives.

Despite the resulting decrease in comparability, the authors of ARB 4 found powerful support for their warnings and call for conservatism in the SEC. The Commission's Accounting Series Release No. 11 stated that the consolidation of foreign subsidiaries operating in territories affected by war or currency restrictions may be misleading, and it barely stopped short of generally prohibiting the consolidation of such subsidiaries.

In 1941, the Research Department of the American Institute of Accountants reemphasized that greatest care should be taken to ascertain whether foreign earnings are or may be made available in the United States before such earnings are consolidated with those of American companies.[4] It concluded that there may be instances where it is no longer appropriate to even translate separate foreign financial statements into U. S. dollars, so that the only course is to present them in their respective foreign currencies.

The 1949 statement of the Research Department of the American Institute on "Accounting Problems Arising from Devaluation of Foreign Currencies" also deals with a crisis situation. It was issued for the purpose of commenting on foreign exchange problems arising from the ". . . recent wholesale devaluation of currencies by some twenty-five countries." Unfortunately this statement only added to the complexity by recommending various other translation procedures, instead of first clarifying the objective of translation and addressing itself to the question whether the current-noncurrent method is logically sound.

In addition, this statement contradicted itself in parts. Arguing for charging material losses from devaluation to retained earnings in order not to distort net income, the Research Department was very certain that ". . . the recent [1949] devaluations of foreign currencies are such that they cannot be considered recurrent hazards . . .," although its warning against consolidating foreign subsidiaries was based partially on the uncertainty of the international monetary system.

Many of the Research Department's recommendations were later incorporated together with ARB 4 into Chapter 12 of ARB 43, which was modified in 1965 by APB Opinion No. 6. This opinion officially sanctioned the monetary-nonmonetary translation method as an ex-

ception to the current-noncurrent method. Most of the credit for promulgating the monetary-nonmonetary distinction is probably due to Hepworth's 1956 study entitled *Reporting Foreign Operations* and the 1960 NAA research report on *Management Accounting Problems in Foreign Operations,* which attacked the current-noncurrent distinction because it reflects the use of an established balance sheet classification for a purpose to which it is not relevant. The 1971 APB Exposure Draft on "Translating Foreign Operations" and ARS No. 12 dealing with "Reporting Foreign Operations of U. S. Companies in U. S. Dollars" were also very critical of the current-noncurrent translation method.

The most recent official pronouncement affecting accounting for foreign operations is FASB Statement No. 1 which requires the "Disclosure of Foreign Currency Information."[5] It does, however, not supersede, alter, or amend any translation method promulgated previously, and it specifically disclaims any intention to imply that one method is more acceptable than another.

In summary, the historical review of the evolution of accounting principles for foreign currency translation reveals that current practice is based on principles which have been developed during periods characterized by (1) wars and political instability, (2) major upheavals of the international monetary system, (3) run-away inflation with significant differences in the inflation rates of various countries, (4) relatively minor international operations in comparison with today's multitude of significant multinational business linkages, and (5) a perception of international operations as being "foreign"—in the original sense of that word—to U. S. companies. Moreover, it is probably fair to say that the *ad hoc* solution of pressing practical problems had precedence over the development of a logically consistent set of translation standards which are based on a sound theoretical foundation. Thus accounting standards for foreign operations have been developed largely during crisis situations to cope with exceptional circumstances, and—barring the existence of standards for normal international economic and political relationships—their use has been extended to also cover non-crisis situations for which they were not originally intended.

Implications for the Future

Some of the more important implications of this historical review for present and future efforts in developing sound translation standards are as follows:

(1) Resist the temptation to patch up translation problems by hastily promulgating standards in time for the preparation of the year-end financial statements. If such short-stop "solutions" are unavoidable, follow up immediately to determine whether the new standards are logically and theoretically sound.

(2) Clarify the objective or objectives of foreign currency translation before standards are promulgated, since the determination whether an existing or a newly proposed translation method is defensible on theoretical grounds can only be made once agreement in principle has been reached on the objectives of foreign currency translation. The FASB discussion on the objectives of translation represents a significant step in the right direction;[6] however, it partially lost its effectiveness because it was stated in terms of what the appropriate unit of measure should be (Issue Four), and because it was buried in a grocery list of other issues, many of which would automatically cease to exist once the objective of translation is clarified.

(3) State the reasons for adopting certain translation principles and rejecting others. Such a disclosure does not only help in evaluating whether the promulgated translation standards are logically sound, but it also assists in preventing that standards intended for war-time and other abnormal situations become accepted permanently even after these situations ceased to exist.

(4) Develop translation standards for normal economic and political relations among countries and, if necessary, supplement these standards with others designed to cope with unusual situations. Such an emphasis on relatively normal international relations would further prevent the perpetuation and use of accounting standards reflecting the exceptional conditions of decades past.

FOOTNOTES

[1]The book value of U. S. direct investment abroad is currently about $100 billion, compared to only $8 billion at the beginning of 1931.

[2]Cecil S. Ashdown, "Treatment of Foreign Exchange in Branch-Office Accounting." *Journal of Accountancy,* October 1922, p. 269.

[3]Committee on Accounting Procedure, American Institute of Accountants, *Foreign Operations and Foreign Exchange* (Special Accounting Research Bulletin No. 4). New York: Author, 1939.

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[4]Research Department, American Institute of Accountants, "Foreign Operations and Foreign Exchange." *Journal of Accountancy,* January 1941, p. 27.

[5]Additional disclosure provisions for foreign operations can be found in paragraphs 6 and 8, Chapter 12, ARB 43; paragraph 13 in connection with paragraph 12, APB No. 22; paragraph 8, APB No. 19 in connection with APB No. 22; paragraphs 23 and 30, APB No. 30.

[6]Financial Accounting Standards Board, *FASB Discussion Memorandum: An Analysis of Issues Related to Accounting for Foreign Currency Translation.* Stamford, Conn.: Author, 1974.

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