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Statement of Position on

74-5 (FASB)

Accounting for Foreign Currency Translation

May 17, 1974

Responses to Issues Raised in FASB Discussion Memorandum, February 21, 1974 (FASB File Reference 1005)

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

Notes

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

ACCOUNTING FOR FOREIGN CURRENCY TRANSLATION

The Accounting Standards Executive Committee of the American Institute of Certified Public Accountants has considered the Discussion Memorandum, Accounting for Foreign Currency Translation, dated February 21, 1974, and has formulated on behalf of the Accounting Standards Division this Statement of Position on the issues raised in that document.

MAJOR CONCLUSIONS

This Statement of Position has been prepared within the frame of reference of existing accounting principles concerning the nature of assets and liabilities, revenues and expenses. The major conclusions are summarized below.

(1) The two-transaction perspective should be used to resolve the translation accounting issues arising from the import and export of goods, services and capital. Accordingly, exchange adjustments that may result from the foreign currency risk related to such transactions should be accounted for as gains or losses which should, in general, be immediately recognized in the income statement.

(2) The parent company perspective should be used to resolve the accounting issues arising from the need to translate financial statements of foreign entities. This perspective should be implemented through use of the monetary-non-monetary translation method. Translation adjustments should be accounted for as gains or losses, with immediate recognition in income.

The remainder of this Statement of Position presents the Division's comments on the individual issues set forth in the

The Division's comments on Issues Four through Eleven are based on the view that the parent company perspective and monetary-nonmonetary translation method should be adopted. This view is not shared by a significant minority of the Accounting Standards Executive Committee, who favor using the current exchange rate for all assets and liabilities of at least some foreign entities. This Statement of Position does not set forth that minority's comments on those issues.

TRANSLATION OF FOREIGN CURRENCY TRANSACTIONS

ONE: What is the Nature of the Exchange Adjustment That may Result From the Foreign Currency Risk on a Purchase or Sale Denominated in a Foreign Currency?

The Division endorses the two-transaction perspective in considering the exchange adjustment issues resulting from the import and export of goods, services and capital. The nature of these transactions is the same for companies which take steps to change or eliminate the related foreign currency risk as for companies which choose to assume that risk. In order to achieve comparable reporting of purchase or sale transactions by companies engaged in the same basic business activities and to report separately the effects of assumption of the foreign currency risk, the results of import/export transactions should be distinguished from the results of foreign exchange changes which affect related foreign currency obligations arising in the transaction. Exchange adjustments that result from the foreign currency risk on a purchase or sale denominated in a foreign currency should, therefore, be accounted for as an exchange gain or loss, not as an adjustment of an inventory or sale account.

TWO: What is the Nature of the Exchange Adjustment That may Result From the Foreign Currency Risk on a Loan Receivable or Loan Payable Denominated in a Foreign Currency?

This type of exchange adjustment should also be accounted for as an exchange gain or loss for the reasons set forth above.

THREE: When Should Exchange Adjustments be Recorded?

In general, the Division believes exchange adjustments should be recorded when exchange rate changes occur in order to record exchange gains or losses in the period of the event -- the exchange rate change -- rather than at the date the account balance is settled. Delaying recognition of rate changes which are less than a specified percentage is inappropriate; in certain situations a "minor" rate change may have a material effect on the financial statements of a company due to the magnitude of its foreign currency position.

In the case of an import or export transaction, the exchange adjustment should be measured from the date of a firm purchase or sale commitment to the payment date. Net exchange gains and losses should be charged to operations immediately, except for net exchange gains related to unconsummated import or export transactions. In order to be consistent with present income realization concepts, these should be deferred until the goods are received or shipped, as applicable.

TRANSLATION OF FINANCIAL STATEMENTS OF FOREIGN ENTITIES

FOUR: What is the Appropriate Unit of Measure for Financial Statements of Foreign Entities When Included in the Financial Statements of the Parent Company?

The Division endorses the reporting currency of the parent company as the appropriate unit of measure for financial statements of all foreign entities included in the financial statements of the parent company, and recommends implementation through use of the monetary-nonmonetary translation method.

The Division acknowledges that support for a local perspective has grown in recent years. That perspective is based, in varying degrees, on the presumed separability or independence of the foreign entity. However, many foreign entities are in fact no more than an extension of the parent company. The Division also observes that many, if not most, foreign entities enter into transactions with their parent company or affiliated companies which make it difficult to support a presumption of separability or independence. Even if such a presumption could be supported, the practical problems in applying different perspectives to different entities and segments of entities would involve many subjective determinations which could lead to the reporting of noncomparable results in similar situations. Such problems would not arise if the monetary-nonmonetary translation method is applied.

Use of the monetary-nonmonetary method recognizes that the primary financial statements of an entity, at least in the United States, are based on the historical cost concept. Translation of nonmonetary assets and liabilities at the current rate would result in the consolidation of some accounts stated on the historical cost basis with others adjusted to some degree for changes in the general

price level or other factors affecting currency value. The Division believes this is undesirable in the framework of present generally accepted accounting principles. Furthermore, measurement of exchange gains or losses for financial statement purposes by reference to monetary assets and liabilities is more consistent with the way in which exchange rate exposure risks are managed.

FIVE: Which of the Assets and Liabilities of Foreign Entities Should be Adjusted for Changes in Exchange Rates Between the Local Currencies of the Foreign Entities and the Reporting Currency of the Parent Company?

In accordance with the monetary-nonmonetary translation method recommended by the Division, some of the assets and liabilities of all foreign entities should be adjusted for changes in exchange rates.

SIX: At What Rate Should Inventory be Translated?

Inventory, whether acquired locally or imported, should be translated at the historical rate to preserve its historical cost basis.

SEVEN: At What Rate Should Property, Plant and Equipment (Fixed Assets) be Translated?

These accounts should also be translated at the historical rate. The Division did not take a position as to the proper application of a "lower of cost or market" test for fixed assets translated at the historical rate in circumstances in which there has been a weakening of the local currency of a foreign entity.

EIGHT: At What Rate Should Long-Term Liabilities be Translated?

The current rate should be used to translate long-term liabilities. The Division believes the arguments for this position are persuasive, and notes that use of the current rate is supported by present translation practices.

NINE: At What Rate Should Deferred Income Taxes be Translated?

The Division believes that all deferred income tax charges and credits should be translated at the historical rate, which is consistent with present concepts of tax allocation accounting. There is, however, some support within the Division for an exception to this concept which would permit the translation of deferred income taxes related to monetary items at the current rate.

TEN: At What Rate Should Preferred Stock be Translated?

The Division recommends that preferred stock should be translated at the historical rate if it is classified as such in the balance sheet under present generally accepted accounting principles.

ELEVEN: How Should Revenue and Expense Accounts be Translated?

Revenue and expense accounts should be translated under the transaction approach. This approach necessarily follows from the Division's endorsement of the parent company perspective.

TWELVE: If the Local Currency of a Foreign Entity is Used as the Unit of Measure, What is the Nature of a Translation Adjustment?

If the local currency of a foreign entity were selected as the unit of measure, the Division would recommend that translation adjustments be immediately recognized as gains or losses.

THIRTEEN: If the Reporting Currency of the Parent Company is Used as the Unit of Measure, What is the Nature of a Translation Adjustment?

The Division supports accounting for all translation adjustments as gains or losses, with immediate recognition in income in order to recognize the gain or loss in the period of the event -- i.e., the exchange rate change.

FOURTEEN: When Should Translation Adjustments be Recorded?

The Division believes translation adjustments should be recorded when exchange rate changes occur. This position is consistent with that expressed on Issue Three.

OTHER ISSUES

FIFTEEN: Which Currency Should be the Reporting Currency?

The Division agrees that there should be a primary reporting currency and that the choice of reporting currency can have a significant impact upon reported results of operations. For this reason, considerable care and attention must be given to the selection of that currency. Arbitrary rules will not suffice.

The Division does not believe that any of the possibilities presented (source of capital, location of principal operations, country of incorporation), standing alone, are adequate determinants of the reporting currency. All of the factors listed in the Discussion Memorandum, and possibly others, must be considered to make the proper choice.

While there should be a primary reporting currency, many transnational companies must translate their financial statements into other currencies for statutory or business reasons. The issues related to this aspect of accounting for foreign currency translation have been specifically excluded from consideration in the Discussion Memorandum. The Division believes that this is an important topic in need of resolution and urges that it be added to the FASB agenda.

SIXTEEN: What is the Current Exchange Rate?

The Division believes that the buying rate should generally be considered the appropriate current exchange rate. The Division does not believe that when separate exchange rates exist for dividend remittances such rates should be used for translation purposes.

SEVENTEEN: Should the Rate in a Forward Exchange Contract Rather Than the Spot Rate be Used to Establish the Amounts Payable or Receivable for Imports or Exports?

The Division recommends that the spot rate should be used to establish amounts payable or receivable for imports or exports. The difference between the spot rate and the forward exchange contract rate is of a financing nature and should be charged to income when the forward exchange contract is purchased.

EIGHTEEN: Should Gains and Losses be Accrued on Forward Exchange Contracts Entered Into to Eliminate the Risk on Assets and Liabilities of Foreign Entities?

Forward exchange contracts are negotiable at any time at a price which should reflect the gain or loss on the contract and protect the holder against loss on his foreign assets or transactions.

Accordingly, the Division has concluded that gains and losses on forward exchange contracts should be accrued. They should be netted against translation or exchange gains or losses. They should be charged or credited to operations immediately, except for any amount related to (but not more than) a deferred exchange gain on an unconsummated import/export transaction (see Issue Three).

NINETEEN: Should Price-Level Adjusted Financial Statements of Foreign Entities be Included in Parent Company Financial Statements, if the Latter are not Adjusted for Price-Level Changes?

Under the monetary-nonmonetary method of translation, statements of foreign entities included in the financial statements of the parent company should not be restated for changes in the general price level before the statements are translated. This is consistent with the parent company perspective and maintains the historical cost basis of the accounts.

TWENTY: Should the Translation of Accounts be Affected by Changes in Exchange Rates Subsequent to the end of a Period, but Prior to the Issuance of the Financial Statements?

In general, changes in exchange rates subsequent to the end of a reporting period but prior to the issuance of the financial statements should not affect the translation of accounts. The Division was influenced in this decision, among other things, by the variations in the exchange rates for the U.S. dollar after December 31, 1973. These variations demonstrate that subsequent exchange rate changes are not necessarily indicative of more stable rates appropriate for translating financial statements as of an earlier date.

Exceptions to this position should be rare and would arise only when the end of period rate was clearly inappropriate. For example, subsequent rates should be used when exchange rates at the end of a period are being artificially supported, a significant volume of currency exchanges at the end of period rate is not occurring or is subject to major restrictions, and support is discontinued after the end of the period causing a change to a more realistic exchange rate. In this case, the subsequent rate essentially assists in the determination of the appropriate rate as of the end of the period.

TWENTY-ONE: When Should the Effect on Foreign Income Taxes of an Exchange Gain or Loss on a U.S. Dollar Asset or Liability in the Financial Statements of a Foreign Entity be Accounted for in U.S. Dollar Consolidated Financial Statements?

The Division believes that foreign income taxes on the exchange gains or losses referred to in this issue should be included in the U.S. dollar statements in the period in which the gain or loss is included in the foreign currency financial statements.

TWENTY-TWO: Does the use of Historical Rates to Translate Cost of Goods Sold and Depreciation Expense Require Interperiod Tax Allocation?

The use of historical rates to translate cost of goods sold and depreciation expense may result in an unusual relationship between the translated amounts of foreign pretax income and foreign income taxes included in the U.S. dollar consolidated financial statements. However, in the Division's view, this does not give rise to a timing difference as defined in APB Opinion No. 11 and interperiod tax allocation is therefore not appropriate.

The Division does believe that the effect of the U.S. dollar equivalent of foreign income taxes should be considered when translation of inventories and fixed assets at historical rates after a decline in the exchange rate raises questions as to the appropriateness of such historical cost basis in light of after-tax net realizable value or recoverable cost as expressed in U.S. dollars.

TWENTY-THREE: Should U.S. Taxes be Provided for Exchange Gains or Losses Resulting From Translation of Financial Statements of Foreign Entities Into U.S. Dollars?

Since U.S. taxes on exchange gains and losses not currently includible in taxable income would be payable only upon remittance, the Division believes that the applicable provisions of APB Opinions No. 23 and 24 should govern these situations.

TWENTY-FOUR: What Disclosures Regarding Accounting for Foreign Currency Translation Should be Required?

The Division believes that disclosures of the type required by FASB Statement of Financial Accounting Standards No. 1 with respect to accounting policies and the effect of exchange adjustments on the results of operations are appropriate and adequate.

Disclosure in the statement of changes in financial position, as outlined in the Discussion Memorandum, would be difficult to determine and would appear to be of doubtful value, particularly if the parent company perspective with the monetary-nonmonetary translation method were adopted.

Determination and disclosure of the effect of exchange rate changes on sales and earnings would not be an appropriate financial statement disclosure because other direct and indirect results of the exchange rate changes on operations, which are difficult to quantify, would make such determinations very subjective.

ACCOUNTING STANDARDS EXECUTIVE COMMITTEE

May 17, 1974

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