1949

Accounting Problems Arising from Devaluation of Foreign Currencies

American Institute of Accountants. Research Department

ACCOUNTING PROBLEMS ARISING FROM DEVALUATION OF FOREIGN CURRENCIES

By Research Department,
American Institute of Accountants

This statement is issued by the research department to meet urgent requests for advice on certain problems arising from the recent widespread devaluations of foreign currencies. It reflects conclusions reached after extensive consultation with many leading accountants and corporate executives.

THIS memorandum is written for the purpose of commenting on some of the more important foreign exchange problems arising from the recent wholesale devaluation of currencies by some 25 countries in adjusting their respective monetary units downward in terms of the U. S. dollar. These problems are considered herein from the standpoint of expressing the accounts of foreign subsidiaries and branches in terms of U. S. dollars. Many of the problems may be resolved by following the principles stated in Accounting Research Bulletin No. 4. Others will require special attention.

A related problem of primary importance is whether to consolidate foreign subsidiaries and branches at all in view of the uncertain values which must be associated with the assets and liabilities, and the unrealistic statements of income which may result from the translation of many foreign currencies into dollars under existing conditions. With this in mind and in the light of the restrictions on the remittance of funds, which have existed and continue to exist in many countries, there may be many cases in which it will be desirable to exclude certain foreign subsidiaries and branches from consolidated financial statements.

PREVIOUS RECOMMENDATIONS

Whether consolidation of foreign subsidiaries is decided upon or not, adequate disclosure of foreign operations should be made. Four methods of presentation suggested by the committee on accounting procedure in 1939 in Accounting Research Bulletin No. 4 are worth repeating:

"(a) To exclude foreign subsidiaries from consolidation and to furnish: (1) statements in which only domestic subsidiaries would be consolidated; and (2) as to foreign subsidiaries, a summary in suitable form of their assets and liabilities, their income and losses for the year, and the parent company's equity therein. The aggregate amount of investments in foreign subsidiaries should be shown separately, and the basis on which the amount was arrived at should be stated. If these investments include any amount of surplus of foreign subsidiaries and such surplus had previously been included in consolidated surplus, the amount should be separately shown or earmarked in stating the consolidated surplus in the statements here suggested. The exclusion of foreign subsidiaries from consolidation does not make it permissible to include inter-company profits which would be eliminated if such subsidiaries were consolidated.

"(b) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition the summary described in (a) (2) above.

"(c) To furnish: (1) complete consolidated statements, and also (2) consolidated statements for domestic companies only.

"(d) To consolidate domestic and foreign subsidiaries as hitherto, and to furnish in addition parent company statements showing investment in and income from foreign subsidiaries separate from those of domestic subsidiaries."

In general, the underlying principles for stating the results of business conducted in foreign currencies were stated in 1931 by the special committee on accounting procedure as follows:

"BALANCE-SHEET

"Fixed assets should be converted into dollars at the rates prevailing when such assets were acquired or constructed. Where large units are purchased for American dollars the American dollar cost will, of course, be used. If, however, the purchase is made in some foreign currency then the cost of the fixed assets should be the equivalent of the amount of foreign currency in American dollars, at the rates of exchange prevailing at the time payment is made. In consolidated accounts, the depreciation charged on fixed assets should be kept strictly on the American dollar cost, even though for purposes of local taxation it may be impossible to show the full currency equivalent on the foreign statements. . . .

"Cash, accounts receivable and other miscellaneous current assets should be converted at the rate of exchange prevailing on the date of the balance-sheet, unless protected by forward exchange contracts.

"Inventory should follow the standard rule of market or cost, whichever is lower in dollars. Where accounts are to be stated in which the question of foreign exchange enters and the inventory is not treated as an ordinary current asset and converted at the rate of exchange prevailing on the date of the balance-sheet, the burden of proof should be on the client." *

"There are, however, undoubtedly many cases where the cost or a portion of the cost of an article was incurred when the foreign currency was at a substantially higher rate of exchange than existed on the closing day of the financial period. In many cases such an asset could not be replaced for the amount in currency at which it appeared in the records of the local branch or subsidiary company. In some cases the market price in currency would undoubtedly have been increased since the fall in exchange, and it would be inequitable to treat 'the lower of market or cost' as a mere conversion at the closing rate of the currency cost price, where the article could now be replaced only at a much higher amount in currency. Where the market price obtainable in dollars, after deducting a reasonable percentage to cover selling and other local expenses, exceeds the cost price of the article in dollars at the rate prevailing as of the date of purchase, such original dollar equivalent may be considered as the cost price for purposes of inventory.

"Current liabilities payable in foreign currency should be converted into dollars at the rate of exchange in force on the date of the balance-sheet.

"Long-term liabilities should not be converted at the closing rate, but at the rate of exchange prevailing when the liability was actually contracted. This is a general rule, but exceptions might exist in particular cases: for example, where there are assets receivable over a term of years, which are converted at the current rate, particularly where such assets could be applied to the retirement of such liabilities.

"As a case in point, assume a corporation had a series of bonds to be retired in ten equal annual payments in currency and corresponding receipts from assets sold on the deferred-payment system, falling due at or about the same time as the payments due to the bondholders, then such offsetting items might reasonably be carried at the same rate of exchange.

"PROFIT-AND-LOSS STATEMENT

"A loss arising through a fall in foreign exchange is a risk incidental to foreign business, and should be a charge to operating accounts and not a charge to surplus; however, in such a year as the present, the item will be a substantial one in many cases and may be stated separately in the published accounts of a business,

* Possibly emphasis should be placed on *those who wish to follow some other procedure* rather than on *the client.*

present very misleading results if the pre-devaluation exchange rates were used for a large part of the fiscal year, and the loss resulting from the fall in exchange rates were charged to retained income (surplus). Obviously, the charge to income for the fall in exchange should not be less than the loss applicable to the increase in net current assets since the beginning of the fiscal year during which devaluation took place.

Fixed Assets

Generally, the rule for translation of fixed assets at rates in effect when the asset was acquired or constructed should be followed. One exception to the rule might be with respect to current plant additions when income is translated at post-devaluation rates. Another exception might be with respect to fixed assets acquired with foreign capital, to which reference is made later. When, however, fixed assets are purchased with United States dollars, or when they are purchased in foreign currencies presumably out of profits which are not restricted as to withdrawal, the United States dollar cost or the dollar equivalent of the foreign currency at the date of purchase should be recognized as the amount at which such assets should be carried.

Long-term Liabilities

Translation of long-term liabilities presents possibly the greatest deviation from the principles previously stated by the committee. The committee generally has favored translating long-term liabilities at the rates of exchange prevailing when the liability was actually contracted, but recognized that there were exceptions. The purpose was to avoid giving recognition to minor fluctuations in foreign currencies. The argument has been advanced, however, and apparently without satisfactory rebuttal, that long-term bonds will be paid off in post-devaluation currencies and therefore should be translated at post-devaluation rates. This argument may not be compelling in any given instance, but the logic supporting it is convincing for a fall in rates of the breadth and size of the one just witnessed. Accordingly, with respect to long-term bonds, the general rule should be modified to permit translation at post-devaluation rates.

Under certain circumstances, the gain resulting from restating the long-term debt at the lower rates of exchange may appropriately be offset against the loss arising from translation of net current assets.

However, when fixed assets held in the foreign country were acquired with funds obtained in that country, it may be appropriate to restate the fixed assets to the extent of the reduction of the related debt.

Capital Stock

Consideration also should be given to the rates at which capital stocks stated in foreign currencies are to be translated; whether they should be translated at historical rates, or at the average of rates applicable to the net assets, or at the post-devaluation rates, would depend on the circumstances in the individual cases.

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In conclusion, the underlying principles as stated in Accounting Research Bulletin No. 4 and the interpretation and modification suggested in this statement are intended only as guides to those confronted with current and unusual foreign exchange problems resulting from devaluation of foreign currencies. Each problem will have to be resolved according to the best judgment of those responsible for making the decisions, having due regard for the facts and the general rules.

November, 1949