

Foreign Currency Translations May Cause Erratic Equity Positions

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Abstract

Financial Accounting Standards Board Statement No. 52 (FASB 52) replaced FASB 8 in 1981 and the new guidelines have been accepted widely for providing noncontroversial and adequate disclosure of foreign currency matters. The nine years since the adoption of FAS 52 have seen erratically fluctuating exchange rates, however, and the equity positions of many firms have responded accordingly. This article provides an investigation into the erratic equity positions that may have been caused by the new guidelines, and recommends actions that may avoid future embarrassments for the accounting profession.

Introduction

The erratic earnings resulting from foreign currency translation gains and losses required by Financial Accounting Standards Board Statement No. 8 (FASB 8) were largely responsible for the passage of FASB 52. Nine years have passed since the new guidelines have been used, and it is now apparent that FASB 52 may result in equally erratic equity positions. The procedures required by the newer statement which reflect the income and resulting cash distributions of foreign enterprises may be conceptually sound, but general acceptance of the standard should be questioned because equity can be significantly eroded by the unrecognized gains and losses.

Foreign currency translations can result in distortions because of (1) an inability to understand long term exchange rate trends and (2) an inability to determine if there are true gains and losses from these trends. The first problem may currently be beyond the FASB's ability to resolve, but the second problem is one which can be confronted and easily rectified. The Board considered recognition of foreign currency gains and losses in their initial consideration of the problem, and evidence now exists that, in special situations, amortization of some gains and losses is necessary.

Foreign Currency Translation (FASB 52)

FASB 52 identifies two methods of translating the financial statements of foreign operations to be included with parent company financial statements. These are the temporal method and the current rate method. The methods are not alternatives, and the Statement explains the circumstances when the two methods should be used.

Under the temporal method, assets are translated at the

current exchange rate at the balance sheet date if they are monetary items, otherwise they are translated at the historic exchange rate at the time of their acquisition. Liabilities, since they are monetary items, are also translated at the exchange rate at balance sheet date. Stockholder equity is brought forward at the historic rate at the date of purchase of the company or issue of the stock plus or minus any changes in the equity since that time. These changes include dividends and earnings. Dividends are translated at the exchange rate at the time of dividends, and earnings are related to historical cost assets. These expenses, such as depreciation, are translated at the exchange rate of the asset being removed from the balance sheet. Any amount needed to balance assets and equities is the translation gain or loss and is included in income.

The temporal method attempts to retain the historical cost aspect of foreign statements by translating the activities of the year as if they took place in the currency of the reporting parent. Accordingly, the method is used when the foreign entity is closely tied to the domestic reporting parent. The functional currency is said to be the currency of the parent, evidenced by a great deal of profit repatriation or the foreign entity conducting much of its business in the currency of the parent company. The temporal method is appropriate for most branches.

Finally, the temporal method is also used, regardless of the functional currency, if the three year inflation rate is greater than 100 percent in the foreign country concerned. This is because the inflation is accompanied by dramatic depreciation of the foreign currency. If the current rate method were used, the shrinkage of foreign assets would be unwieldy. Thus, for practical reasons, the asset shrinkage is reduced by the temporal method; however, it

is recognized in income.

Under the current rate method, all assets and liabilities are translated at the current exchange rate at balance sheet date. The stockholder equity accounts are brought forward at their previous historical cost balances plus or minus changes such as dividends and earnings. Dividends are translated at the rate in effect at the time of the dividend, and earnings are translated at the average rate for the year. Any amount necessary to balance assets and equities is the cumulative translation adjustment and is part of stockholder equity and not part of income. In the year of translation to the current rate method from *SFAS 8* (1982-3), the financial statements were first translated using the temporal method, recognizing a gain or loss, and then translated using the current rate method. This provided the opening balance in the cumulative translation adjustment.

The current rate method is used when the foreign entity is autonomous from the reporting parent. This is evidenced by the foreign entity conducting its business mostly in the foreign currency. Additionally, there is reinvestment of profits in the foreign country and limited repatriation of profits to the domestic parent. Hence, the functional currency is said to be the foreign currency. Under these circumstances, the likelihood of the parent company realizing gains and losses from the translation is much less than that of a closely tied branch, and, accordingly, no gain or loss is recognized in the income statement from exchange rate movements.

The Current Rate Method and the Resulting Equity Erosion

SFAS 52 removes translation gains and losses from the income statement in situations where these gains and losses do not appear to affect net cash flows to the parent. The translation gains and losses of distant or independent operations whose functional currency is the foreign currency are, therefore, not recognized in income. The translation gains and losses are instead charged directly to owners' equity through the cumulative translation adjustment account.

The charges to stockholder equity, through the cumulative translation adjustment (CTA), fluctuate upward and downward due to the movements of exchange rates. In the short term this effect on stockholders equity seems almost trivial, however, in the long term, the CTA can grow to a point where it may raise some concern. One analyst, who asserts that people in his profession are basically profit and loss people, noted that large swings in the CTA might be an issue if stockholders' equity is affected in the same direction three years in a row (1). In the case of a rising dollar, for example, this means a growing debit balance in the CTA (deferred loss) will occur without ever being disclosed in the income statement. The result is equity erosion without any income statement disclosure.

Recent Patterns of Foreign Currency Exchange Rates

The years from 1979 to 1984 and part of 1985 were a period of a rising dollar and, accordingly, a growing CTA debit balance for many U.S. multinational firms. Illustration 1 shows the U.S. dollar rising against some of the currencies of its major trading partners during this period. It can also be seen that during the period between 1985 and 1988 this trend has been reversed to some degree. Since 1972, approximately when currencies began floating against one another, exchange rate movements have moved in the same direction for three or four years before they have changed direction.

The recent reversal of the dollar may be a short term trend or simply a technical correction in the long term trend. The pattern that has developed since 1972 cannot confidently be used to predict the future. The history of exchange rates is simply too short and the knowledge of the conditions that affected those exchange rates too limited to rely upon any models from the data collected so far.

Effects of Recent Exchange Rates on Large U. S. Firms

Illustration 2 displays the effect of the dollar movement over the past few years on some of the largest firms in the U.S. since the adoption of FASB 52. The illustration shows that equity erosion has occurred, and that the erosion as a percentage of stockholder equity or net assets grew through 1984 before beginning a reversing trend in 1985. The rate of erosion of foreign held assets was so large the it out-paced the rate of growth in net assets or equity until 1985. The full importance of this to a U.S. multinational corporation can only be assessed when examining the proportion of overseas business to domestic business. The CTA balance finally dropped for all of the companies shown, because the dollar tended to weaken in 1985. Several companies still have significant negative CTA balances for as many as eight consecutive years.

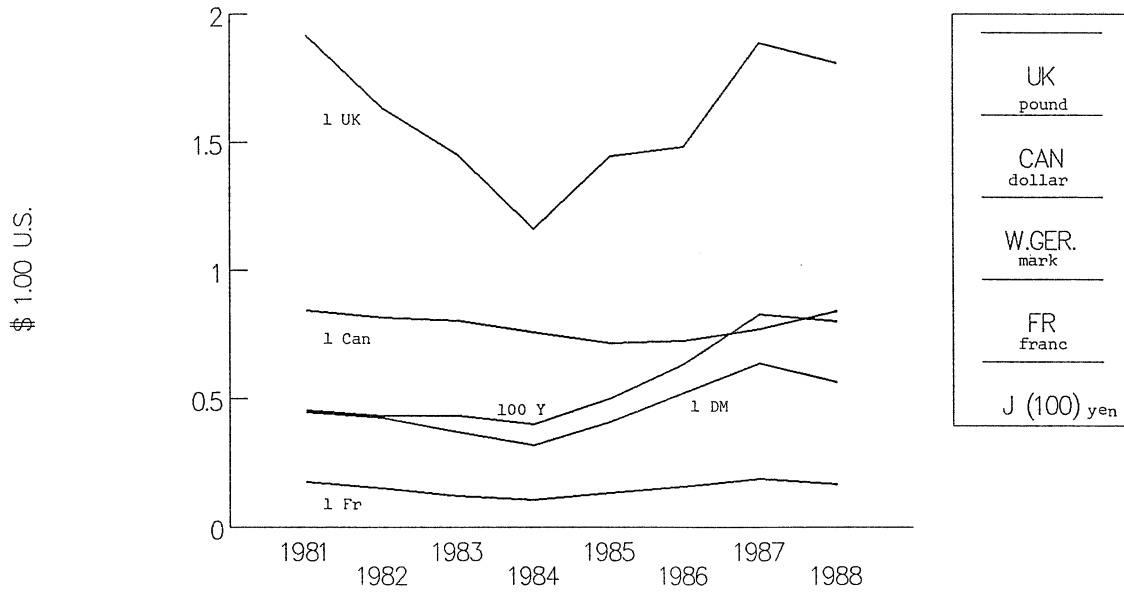
If the strong dollar had continued, the erosion effect on equity would have worsened. At some point, accountants would have been faced with explaining, perhaps somewhat unsuccessfully, what the CTA really is. Lenders might have questioned its effect on key ratios such as debt to equity, and equity investors might have begun to doubt the strength of the parent. At present, these concerns have been reduced due to the 1985-1988 dollar movement. Unfortunately, the current trend cannot be depended upon to continue.

A Proposal to Amend Statement No.52

SFAS 52 seems to be appropriate for entities whose functional currency is the foreign currency during short run exchange rate movements. During these periods the likelihood of there being any realized exchange rate gain or loss is greatly diminished. During long run exchange

Illustration 1

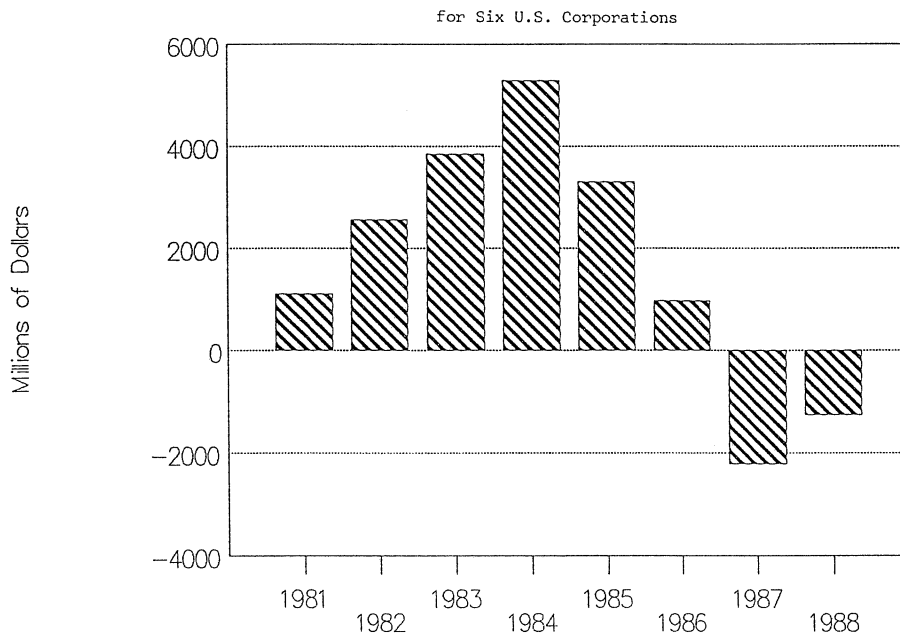
The U.S. Dollar and Foreign Currency



Source: Wall Street Journal
December 31, 1981-1988

Illustration 2

Cumulative Translation Adjustment



rate movements, however, the analyst must be concerned with a permanent impairment in the value of foreign assets. Such an impairment was addressed during initial consideration of FASB 52 when the idea of amortizing the CTA was considered. The Board, however, was persuaded that the CTA net asset valuation could not be recognized in income because actual realization does not occur until liquidation. The CTA gain or loss was therefore considered too uncertain to be recognized in income, and the amortization alternative was abandoned.

In truth, the reasoning applied to the functional currency argument is quite sound from a theoretical standpoint and is ignored, only by necessity, for operations in highly inflationary countries. The remaining problem that accountants face is whether or not the translation gain or loss in extended periods of exchange rate movements should be charged to the income statement in some systematic manner. The large increases that were made in the CTA account for most firms through 1985 were so massive that, even after a period of change in the direction of exchange rates, old CTA balances are often still significant. Ignoring the gains or losses, unfortunately has not made them disappear.

The original option of recognizing foreign currency gains and losses considered by the board during their initial deliberations should be instituted. CTA balances that have been in existence for more than four years should be amortized against earnings of the next five years. The amortization should apply to income from operations, and footnote disclosure should be included that state that the gain or loss is unrealized. Any recovery of previous amortization from a change in the exchange rate movement could be used to offset the current year's amortization and then applied against the CTA balance until the CTA is exhausted.

Conclusion

SFAS 52 has proven to be quite successful at accounting for most of the foreign currency translation problems. It does not, however, go far enough in providing investors and lenders information concerning the potential for equity erosion. FASB should take advantage of the reprieve from the 1985-1988 exchange rate reversal and amend FASB 52 to address the potential problems created by a long term upward or downward exchange rate movement. The amortization alternative already considered by the Board can easily be adapted to provide adequate disclosure for the potential embarrassment that would be brought on by an extended period of exchange rate gains or losses.

References

- 1 David W. Bodenberg, "Foreign Exchange Accounting Transition: An Analyst's View," *International Research*, Merrill Lynch International, May 21, 1982, p.2.