

# CHOICE OF FUNCTIONAL CURRENCY UNDER SFAS NO. 52

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## ABSTRACT

*The purpose of this study is to determine the importance of various factors in the choice of the functional currency used by 400 major multinational corporations. Selection of functional currency is a key feature of SFAS No. 52 because it determines the method used to translate foreign currency financial statements into U.S. dollars and the extent to which changes in exchange rates affect consolidated operating results. The results reveal that cash flows and sales market were the two most important factors, while financing and intercompany transactions were the least important criteria in selecting the functional currency.*

## Introduction

The choice of translation method for consolidated financial statements of multinational corporations (MNC's) has been extensively, though inconclusively, debated in the accounting literature. The primary reason for the continuing controversy over accounting rules is the lack of an established framework that provides criteria for choosing among the alternative methods of translating foreign currency items in financial statements. SFAS No. 52, by adopting the functional currency approach, views the economic environment of a foreign entity as the critical element in the determination of translation method and the disposition of exchange gains and losses. The functional currency can be either the dollar, the local currency of the subsidiary or, the foreign currency of another country.

In the spirit of SFAS No. 52, the functional currency is essentially a matter of fact. Indeed, the statement discussed two broad categories of foreign operations for which the facts were presumed to be clear, and for which the reporting enterprise would easily identify the functional currency: (1) those that are relatively self-contained and integrated within a particular country or economic environment; and (2) those that are primary a direct and integral component or extension of parent's operations. However, many foreign operations do not fit nearly into either of these two broad categories. In those cases, determining the functional currency requires consider-

able management judgement. In making this determination, management should consider all relevant economic facts and circumstances affecting its operating, financing, and investing decisions. The purpose of this paper is to examine the importance of economic criteria suggested by SFAS No. 52 in determining the functional currency and to discuss the relationship between the functional currency and highly inflationary economies.

## Determination of Functional Currency

The functional currency, as defined in SFAS No. 52 (Par. 3a), is the currency of the primary economic environment in which an integrated foreign operation primarily generates and expends cash. Under SFAS No. 52, the procedures for translating a particular foreign entity's financial statement depend upon the functional currency designation for that entity and whether its books and records are maintained in its functional currency. In SFAS No. 52, the Board made a distinction between the terms "remeasurement" and "translation". The former is the process of translating the accounts of a foreign entity into its functional currency and the latter is the process of stating foreign currency financial statements in terms of a single reporting currency. Functional currency designations of a company's foreign operations are, in fact, a key feature of SFAS No. 52 for two main reasons. First, the functional

currency determines the method used to translate foreign operations into U.S. dollar equivalents. Second, the functional currency determines the extent to which changes in exchange rates affect consolidated financial statements.

The functional currency of an entity is not always identical with the currency of the country in which the records and books are kept. If an entity's operations are relatively self-contained and integrated within a particular country, the functional currency generally would be the currency of that country (the local currency) - unless it operates in a highly inflationary environment, in which case the currency of the parent company is considered to be the functional currency. When a foreign currency is the functional currency, the "all current" method of translation should be used and resulting translation gains and losses should be reported in a separate component of shareholders' equity. However, exchange gains and losses from transaction and balances that are receivable or payable in a currency other than the functional currency should be included in the determination of the net income.

If the foreign entity is primarily an integral component or extension of the U.S. parent, its functional currency might be the U.S. dollar. If so, its financial statements would be translated using temporal method and resulting translation adjustments would be made in income. When the U.S. dollar is denoted as the functional currency, the effects of SFAS No. 8 and SFAS No. 52 are essentially the same and the only required restatement is remeasurement of deferred tax accounts using the current rate method.

If dependency is not evident, a foreign entity is considered to have a currency other than the U. S. dollar, accordingly, management judgement is necessary in determining the functional currency. Specially when a foreign subsidiary has more than one distinct and separate operation, each operation may be considered an entity, each with a different functional currency designation. In those instances, management of the parent company is required to choose the functional currency on the basis of several factors set forth by the FASB. These indicators are: (1) cash flow; (2) sales price; (3) sales market; (4) expenses; (5) financing; and (6) intercompany transaction and arrangements. These, and more likely other factors (e.g., influence of parent), should be considered both

individually and collectively in determining the functional currency. Since the FASB did not suggest hierarchy among the factors, management operating, financing, and investment policies may indicate the appropriate functional currency. This study is undertaken to determine the importance of these factors in the choice of the functional currency used by 400 major MNCs.

### **The Questionnaire**

A two page questionnaire consisting of three sections was developed. The first section asked for personal characteristics of the respondents. The second sought background information about MNCs (e.g., annual sales volume, ratio of foreign sales to total sales, types of training programs and hardware used in translating foreign currency transactions). The last section asked for details about participant's practices designated as functional currency, the relationship between the functional currency and highly inflationary economies, and economic criteria that determine the functional currency.

### **Experimental Design and Methodological Issues**

A preliminary survey questionnaire was pretested using personnel of the Detroit area MNCs. The final survey instrument was mailed to international business executives of 400 MNCs selected from Fortune's 1985 list of the 1000 Largest U.S. Companies. These companies were cross-listed in the Dun and Bradstreet's Directory of International Companies. Completed questionnaires were obtained from 109 MNCs, therefore, the response rate was 27 percent. All responses were tested for non-response bias using a cumulative ANOVA test and found to be free of non-response bias. Table 1 provides the occupations and organization levels of the respondents. The results in Table 1 indicate that the questionnaire was answered by relatively well-informed personnel whose responses reflected company-wide situations.

The questions in the survey were yes-no questions and interval scales with four intervals. A 4-point scale was used, with four signifying high importance. Three being important, two being medium, and one being of no importance. The two statistical methods used were percentages and mean ratings. Tables 1-3 present the results in percentages, while Table 4 shows the mean ratings for each of the suggested six economic criteria

TABLE 1  
OCCUPATIONS AND ORGANIZATION LEVELS OF RESPONDENTS

ORG/LEVEL	PERCENT
Controllers of International Operations	36
Treasurers of International Operations	11
Managers of Financial Reporting or Corporate Accounting	22
Managers of International Financial Analysis	22
Accountants Directly Responsible for Translation	9
	100.0

that determine functional currency.

## Results

### *Background Information*

The second section of the questionnaire sought information about MNC's attributes and their accounting systems. The sample companies were relatively large corporations with substantial foreign operations. Table 2, Panel A indicates that 74.3 percent of the respondents reported that their annual sales exceeded \$500 million. Panel B shows that 77.1 percent of the companies had foreign sales which accounted for more than 20 percent of their total sales. Note that in 1976 the FASB issued SFAS No. 14 which dictated an arbitrary cutoff of 10 percent in the disclosure of foreign operations.

SFAS No. 52 revised the accounting and reporting requirements for translation of foreign currency transactions and foreign currency financial statements. MNCs are required to apply the statement for their fiscal years beginning on or after December 15, 1982, almost one year after its adoption by the FASB. However, early adoption was permitted and restatement of prior years was optional regardless of when adopted. This consideration gave MNCs sufficient time to train personnel, to change accounting systems, and to reevaluate existing financial policies. Panel C of Table 3 presents the types of training programs the respondents used for accountants prior to the implementation of SFAS No. 52. About 59 percent of the respondent companies received

necessary training from CPA firms while only one company used university class instruction. Forty percent relied upon informal types of training. This indicates that many MNCs did not find it necessary to provide their accountants with formal training on SFAS No. 52 because of the ease of its application and one year of grace period before its mandatory adoption.

Panel D of Table 2 presents the respondents' reports on the use of computerized programs in the translation process. Seventy-nine percent of the respondents stated that they presently use computerized programs in translating their foreign currency operations into U.S. dollars while 26 percent still translate manually. Panel D shows the types of hardware utilized in translating financial statements by MNCs currently using computerized programs.

### *Functional Currency Designation Practices*

SFAS No. 52 does not specifically require companies to disclose detailed information on their functional currency designations. However, once the functional currency has been established it should not change except for clearly evident significant changes in economic environments or facts. Because functional currency designations can have a significant impact on consolidated income, some knowledge of such designation practices is necessary in evaluating a company's results of operation. Table 3 reveals that 82.0 percent of sampled companies designated the local currency as the functional currency while the U.S. dollar was used as the functional currency for only

TABLE 2

BACKGROUND INFORMATION OF 109 SAMPLE COMPANIES

Panel A: Annual Sales Volume

Sales Volume	Responses	Percent of Responses
Below \$500 million	28	25.7%
\$500 million - \$1 billion	21	19.3
\$1 billion - \$5 billion	47	43.1
Above \$5 billion	13	11.9
TOTAL	109	100.0%

Panel B: Ratio of Foreign Sales to Total Sales

Foreign Sales/Total Sales	Responses	Percent of Responses
Below 10%	25	22.9%
20% - 25%	42	38.5
25% - 40%	29	26.6
Above 40%	13	12.0
TOTAL	109	100.0%

Panel C: Types of Training Programs Used

	Responses	Percent of Responses
Big 8 CPA Firms	61	56 %
Other CPA Firms	3	2.8
University Class Instruction	1	.9
Informal Training	44	40.3
TOTAL	109	100.0%

Panel D: Types of Hardware Used for Translation

	Responses	Percent of Responses
Main Frame	39	45%
PC	26	30
Main Frame and PC	21	25
TOTAL	86	100%

14.7 percent of the cases. Japanese followed by British and France subsidiaries of U.S. firms designated the U.S. dollar as their functional currency most frequently. German subsidiaries followed by Switzerland subsidiaries of U.S. companies denoted the local currency as their functional currency most often. This indicates that the Japanese, France, and British subsidiaries may function principally as foreign branches of the U.S. parent companies and may actually transact their business and operations in the U.S. dollar. On the other hand, German and Switzerland have most self-contained and integrated operations in Germany and Switzerland and they are independent, cash-generating subsidiaries paying little or no dividends to the U.S. parent companies. Table 3 reveals the designated functional currency for only six selected countries. Results for other countries are not presented because of two reasons. First, other countries (e.g., Brazil, Argentina) operate in highly inflationary economies and, therefore, they are required to use the U.S. dollar as the functional currency. Second, the magnitude of foreign operations in the other countries is not significant enough to warrant disclosure under SFAS No. 14.

### *Functional Currency and High Inflationary Economies*

An issue not totally resolved to the satisfaction of financial executives is the question of how to deal with foreign subsidiaries in countries with high inflation. The FASB recognized that translation of operations in highly inflationary economies at the current exchange rate may produce unrealistic results and, accordingly, required that (Par. 11) the financial statements of foreign entity in a highly inflationary economy should be remeasured as if the functional currency were the reporting currency.

Practically speaking, what is considered highly inflationary relative to the reporting enterprise's economic environment is a matter of professional judgement. However, the prescribed test for a highly inflationary economy is "...cumulative inflation of approximately 100 percent or more over a 3-year period". (Par. 11). The prescribed test provided in SFAS No. 52 permits some latitude on management's behalf in order to implement the guidance. The Board did not indicate that MNCs closely monitor inflation rates and

TABLE 3

## FUNCTIONAL CURRENCY DESIGNATION PRACTICES

COUNTRY	LOCAL CURRENCY		U. S. DOLLAR		BOTH		NO OPERATION #	TOTAL RESPONSES
	#	%	#	%	#	%		
Britain	70	77.8	13	14.4	7	7.8	19	109
Canada	77	82.8	12	12.9	4	4.3	16	109
France	63	82.9	11	14.5	2	2.6	33	109
Germany	66	86.8	8	10.5	2	2.6	33	109
Japan	51	77.3	15	22.7			43	109
Switzerland	42	85.7	7	14.3			60	109
TOTAL # of Cases	369	82.0	66	14.7	15	3.3	204	654

Note: Percentages are for relative usage and not for total responses (e.g., local currency 82% =  $[369 - (654 - 204)]$ ).

changes their accounting methods accordingly. However, SFAS No. 70 requires that SFAS No. 52 reports be supplemented by figures for foreign fixed assets adjusted to reflect the effects of inflation on their market value. Many economies such as Argentina, Brazil, Chile, Iceland, Israel, Jamaica, Micaragua, Peru, Somalia, Turkey, Uruguay and Zaire are clearly highly inflationary. For other economies, the decision depends to some extent on management's judgement and management should decide whether a foreign entity's local economy is highly inflationary only after it has decided that the local currency is the functional currency. Many companies with subsidiaries in countries other than those six industrial countries of Table 3 have indicated that their subsidiaries are located in highly inflationary economies and, accordingly, these companies designated the U.S. dollar as their functional currency.

*Functional Currency Criteria*

Determining the functional currency is perhaps the most important decision management has to make because the translation method and the disposition of resulting gains or losses for each foreign entity depend upon its functional currency. Therefore, judgement by management is the key to its determination, so long as that judgement is not contradicted by the facts. SFAS No. 52 discusses two broad categories of foreign operations for which the facts are presumed to be clear, and for which management can easily identify the functional currency (relatively self contained and integral component of the parent's operations). However, in many cases the functional currency

may not be clearly identifiable if a foreign operation conducts significant amounts of business in two or more countries or when foreign operations do not fit nearly into either of these two classes. In these instances, management of the parent company is required to select the functional currency on the basis of several factors set forth by the FASB and presented in Table 4. Once the functional currency for a foreign subsidiary has been determined, it should be used consistently unless the economic criteria used in the initial selection have changed. According to the SFAS No. 52, this requirement is aimed at preventing MNCs from changing functional currencies capriciously in order to manipulate financial statement resulting from applying different translation methods.

The respondents were asked to indicate the degree of importance they assigned to each of the six economic factors that justify the use of either the local currency or the U.S. dollar as an entity's functional currency. Table 4 presents the mean ratings for each of the six economic criteria using a 4-point scale for each of the seven subsidiary--countries. A weighted average was computed for each of the economic criteria over all seven countries and presented in the last row of the Table 4. The results in Table 4 reveal that cash flows (3.22) and sales market (3.05) received the highest ranking orders; these two factors were followed by sales price (2.97) and expenses (2.93); while financing and intercompany transactions received the lowest ranking orders. These results indicate that cash flows and sales market were the two most important factors in choosing the ap-

TABLE 4

ECONOMIC CRITERIA THAT DETERMINE FUNCTIONAL CURRENCY

Subsidiary Country	Cash Flows	Sales Price	Sales Market	Expenses	Financing	Intercompany Transactions
Britain	3.22	3.10	3.09	2.92	2.44	2.31
Canada	3.34	2.92	2.99	2.80	2.34	2.65
France	2.72	2.79	3.12	2.89	2.42	2.12
Germany	3.25	3.08	3.08	2.89	2.38	2.20
Japan	3.17	2.98	2.74	3.06	2.31	2.29
Switzerland	3.25	3.02	3.33	2.86	2.16	2.36
Mexico	3.56	2.89	3.06	3.06	2.47	2.55
AVERAGE	3.22	2.97	3.05	2.93	2.36	2.35

appropriate functional currency while financing and intercompany transactions were the least important factors.

### Conclusion

SFAS No. 52 aims to have consolidated financial statements to reflect the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. Generally Accepted Accounting Principles (GAAP). Thus, the key feature of the statement is the determination of the functional currency since it justifies the choice of translation methods and the disposition of exchange gains or losses. The results reveal that 82% of surveyed companies designated the local currency as their functional currency, while the US dollar was

denoted as the functional currency for 14.7 percent of the cases. A minority of MNCs (14.7%) designated the U.S. dollar as their functional currency because their subsidiaries operate in highly inflationary economies.

The survey also indicates that a majority (59%) of the respondent firms provided formal training programs for their accountants prior to the implementation of SFAS No. 52. Judgement by management was the key to the determination of appropriate functional currency. The primary considerations in management's determination of the functional currency were based on several factors set forth by the FASB. Cash flows and sales market were the two most important factors, while financing and intercompany transactions were the least important criteria in selecting the functional currency.

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