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FASB Statement No. 52 and Its Implications for Financial Statement Analysis

The Financial Accounting Standards Board's Statement No. 52 on foreign currency translation introduces the concept of the "functional currency" to determine the recognition of foreign currency translation gains, losses and adjustments. According to the criteria set forth in the statement, the functional currency in the case of a foreign subsidiary that is an independent, cash-generating center will be the local currency; in most other cases, the functional currency will be the dollar.

If the functional currency is the dollar, the translation process under Statement No. 52 is essentially the same as under the old Statement No. 8: The "temporal" method is used, and gains or losses resulting from translation are included in income for the period. If the functional currency is the local currency, then the "all-current" method is applied: All assets and liabilities are translated at the current rate; translation gains and losses are not recognized in the income statement, but are included in owners' equity as "translation adjustments"; and income statement items are translated at the rate that prevailed when the revenue or expense was recognized (in general, the weighted average exchange rate for the year).

When the local currency is the functional currency, adoption of Statement No. 52 will lead to smaller fluctuations in operating income and much smaller fluctuations in net income in response to changes in exchange rate. This result should please many critics of Statement No. 8. On the other hand, Statement No. 52 raises its own problems. In particular, the translation at current exchange rates of local-currency-denominated historical cost items may be considered to result in a figure that is neither a meaningful description of past cash flows nor a description of future flows. The statement further confounds interpretation of the effects of translation by requiring that these meaningless balances be consolidated with the parent company's accounts.

IN DECEMBER 1981, the Financial Accounting Standards Board adopted (by a one-vote margin) Statement No. 52 dealing with foreign currencies. This new pronouncement supersedes Statement No. 8, which was undoubtedly the most controversial and contentious statement ever issued by the FASB. Its critics objected most strongly to the requirements that all translation gains and losses be reflected in current income and that foreign currency items be

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translated according to the "temporal method," which resulted in the translation of different items at different rates.

Problems with Statement No. 8

All income statement events and balance sheet items are quantified either in terms of past transactions (e.g., inventory, plant and equipment, common stock, depreciation, cost of goods sold) or in terms of future transactions (e.g., cash, receivables, short-term payables). Under the temporal method of translating foreign financial statements, items quantified in terms of past flows are translated using the exchange rate that existed when the quantifying transaction occurred, whereas items quantified in terms of future flows are translated at the current rate. This method preserves existing accounting logic, which argues that, if it is proper to quantify an item in terms of a past flow, it would also seem appropriate to quantify that item at the exchange rate that existed when the past flow took place. It is hard to see how changes in exchange rates could affect such past flows. Similarly, it would seem logical to translate items quantified in terms of future flows in terms of the current exchange rate.

However, Statement No. 8 combined the temporal method with the immediate recognition in income of translation gains and losses, and this resulted in reported earnings fluctuations that, according to critics of the statement, were unrelated to economic gains and losses accruing to companies owning foreign subsidiaries. In fact, under this standard, economic gains often resulted in accounting losses. For example, the use of the temporal method meant that economically related items such as inventory and accounts payable were translated at different rates (historical and current, respectively), so that a translation gain or loss resulted even though these items in a sense serve as economic hedges for each other.

Translation results in an accounting gain or loss for the period when exchange rate fluctuations during the period alter the net balance of asset and liability accounts. Only those assets and liabilities translated at the current rate will be affected by such fluctuations. Under Statement No. 8, all liabilities were translated at the current rate, whereas major asset groups financed by those liabilities (such as inventory and plant and equipment) were translated at the historical rate. Most companies' foreign subsidiaries were therefore in a net translation liability position, so that devaluation of the dollar resulted in translation losses. The rationalization was that more dollars would be needed to pay off the foreign debt.

Critics pointed out that this concept of exposure presented a limited, and often distorted, view of foreign operation gains and losses. The translation loss would never be realized, for example, if foreign operations generated sufficient foreign cash to retire the debt. Indeed, a U.S. parent actually benefits from devaluation, since dividend payments by the foreign subsidiary yield larger dollar amounts. The critics pointed out that accounting gains and losses should not be recognized if there are no economic gains and losses.

Statement No. 52 was designed to overcome both major objections to Statement No. 8. Whether the cure is worse than the disease remains to be seen.

How Statement No. 52 Works

Statement No. 52 provides a set of criteria that, when evaluated by management, allows determination of the translation method to be used—the temporal method or the "all-current" method. Under the all-current method, *all* assets and liabilities are translated at the current rate. The statement also specifies that, if the all-current method is used, translation gains and losses must be excluded from income and accumulated in a new component of owners' equity, and all income statement events must be translated at the rate that prevailed when the revenue or expense was recognized. This rate can be approximated by using the weighted average exchange rate for the year.

Statement No. 52 introduces the concept of the "functional currency" to determine the recognition of foreign currency translation gains, losses and adjustments. In most cases, the functional currency will be either the local currency of the foreign subsidiary or the dollar. Management must designate a functional currency for each foreign subsidiary, using the criteria suggested in Statement No. 52. If the functional currency is determined to be the dollar, then the translation process is essentially the same as under Statement No. 8—the temporal method is used, and gains or losses resulting from translation are included in income for the period. If the functional currency is the local currency, then the all-current method is applied; translation gains or losses are not recognized in the income statement, but are included in owners' equity as "translation adjustments."

In general, the criteria for choosing the functional currency establish whether or not the foreign subsidiary is an independent, cash-generating center; if it is, then the local currency is considered the functional currency. In coming to this determination, the following factors must be weighed:

(1) the degree to which cash flows related to the foreign entity's individual assets and liabilities are in the foreign currency or affect the parent's cash flows;
(2) the responsiveness of sales prices of the foreign entity's products on a short-term basis to changes in exchange rates;
(3) the existence of an active local market for the foreign entity's product, even though there may be significant amounts of exports;
(4) whether labor, materials and other costs for the foreign entity's products are incurred locally or elsewhere;
(5) the denomination of debt and the extent to which funds generated by the foreign entity's operations are sufficient to service existing and normally expected debt obligations; and
(6) the volume of intercompany transactions and the extent of the interrelationship between the operations of the foreign entity and the parent company.

Statement No. 52 requires, however, that the dollar be used as the functional currency of any subsidiary operating in a "hyperinflationary" economy (i.e., where the cumulative three-year inflation rate exceeds 100 per cent).

A foreign subsidiary's functional currency may turn out to be a foreign currency other than the local currency or the dollar. In this case, the subsidiary's statements must first be translated from the local currency into the functional currency before they are translated into dollars. In all cases, however, a few simple rules for translation method and income statement recognition of translation gains or losses can be applied.

(1) When translating *into* the functional currency, use the temporal method.
(2) When translating *from* the functional currency, use the all-current method.
(3) When translating *into* the functional currency, gains and losses are included as part of income.
(4) When translating *from* the functional currency, show changes as part of stockholders' equity but not as part of income.

Comparing the Statements

The differences between the old and new pronouncements in terms of their effects on reported earnings and financial position are highlighted by considering an example where the functional currency of the foreign subsidiary is identified as the local currency. We'll call this local currency the Grabule, and assume for simplicity, and with no loss in generality, that the exchange rate is fixed at \$1:₢1 until 1/1/X1, the beginning of the current accounting period, and that the dollar devalues during 19X1 so that the exchange rate becomes \$2:₢1 by the end of the period, 12/31/X1.

Balance Sheet Results

Table I illustrates the differences in balance sheet amounts. Only monetary items (cash and payables, in this case) are translated at the same rate under both statements. Statement No. 52 calls for the translation of inventory and equipment at the current rate, whereas Statement No. 8 requires historical rates. Because the cost of goods sold equals the beginning inventory balance (see Table II), the ending inventory value must consist of 100 per cent of the period's purchases. The appropriate historical rate for inventories valued using FIFO is the average rate for the period (1.5), assuming the purchases took place at a constant rate over the period. The retained earnings balances under both methods are, for now, "plugs," hence we will ignore the translation adjustment disclosure required by Statement No. 52.

The application of Statement No. 52 will result in higher (lower) values for assets (hence net worth) if the dollar devalues (revalues) against a foreign currency. The effect of this change on conventional financial ratios may cause some firms to be in technical default of certain indenture provisions, whereas other firms may actually show an improvement in their "paper" financial positions. The dividend-paying ability of a firm may or may not be affected, depending upon whether applicable state law considers the new stockholders' equity account available for dividends.

The balance sheet (and income) numbers provided under Statement No. 52 may be difficult to interpret. Under Statement No. 8, a historical cost in Grabules would be multiplied by the exchange rate prevailing at the time of the transaction to yield a dollar-denominated amount that is easy to interpret: It is simply a description of the actual cash flow that occurred in order to acquire the asset, translated at the dollar equivalent

Table I Balance Sheet Translation

ASSETS		Local Currency 1/1/X1	Local Currency 12/31/X1	Statement No. 52 (Local Functional Currency) 12/31/X1	Statement No. 8 12/31/X1
Cash	₡ or $	100	₡ 150	$ 300	$ 300
Inventory (FIFO)		500	750	1,500	1,125
Property, Plant & Equipment (net)		800	700	1,400	700
Total Assets	₡ or $	1,400	₡1,600	$3,200	$2,125
EQUITIES					
Payables	₡ or $	200	₡ 200	$ 400	$ 400
Common Stock		900	900	900	900
Retained Earnings		300	500	1,900	825
Total Equities	₡ or $	1,400	₡1,600	$3,200	$2,125

Table II Income Statement Translation

	Local Currency 12/31/X1	Statement No. 52 (Local Functional Currency) 12/31/X1	Statement No. 8 12/31/X1
Sales	₡1,000	$1,500	$1,500
Cost of Goods Sold	(500)	(750)	(500)
Depreciation	(100)	(150)	(100)
Taxes	(200)	(300)	(300)
Operating Income	₡ 200	$ 300	$ 600
Translation Gain (Loss)	₡		(75)
Net Income	₡ 200	$ 300	$ 525
Translation Adjustment		$1,300	

of that time period. The same local-currency-denominated historical cost multiplied by the current exchange rate (per Statement No. 52) yields a number that defies interpretation: It is not a meaningful description of past cash flows, nor is it a description of future flows. Because changes in exchange rates are critically affected by comparative changes in prices, fluctuations in the exchange rate probably reflect some change in the underlying structure of asset prices. This, in turn, probably means that the mix and quantity of assets held has changed.

Statement No. 52 further confounds interpretation of the effects of translation by requiring that these meaningless balances be consolidated with the accounts of the parent company. The result is an aggregation of parent company figures representing a history of the cash flows with a number that is neither fish nor fowl.

Income Statement Results

Table II shows how reported net income changes significantly under Statement No. 52 because of the deferral of translation gains and losses, as well as other factors. Under Statement No. 8, cost of goods sold (FIFO) and depreciation are translated at historical rates, whereas sales and other items are translated at the current rate. The leverage provided by the fixed element of expense creates substantial variation in income—200 per cent in our example, compared with the actual average foreign currency fluctuation for the period of 50 per cent.

Under Statement No. 52, on the other hand, all income statement items, including depreciation and cost of goods sold, are translated at the average current rate. The fluctuation in income due to translation is thus 50 per cent. The fluctuation of operating income due to changes in the

Table III Translation Adjustment vs. Translation Gain or Loss

	Local Currency 12/31/X1	*Statement No. 52 (Local Functional Currency) 12/31/X1*	*Statement No. 8 12/31/X1*
Beginning Net Assets	₢1,200	$1,200	$1,200
Ending Net Assets	1,400	2,800	1,725
Difference to be Accounted for	₢ 200	$1,600	$ 525
Operating Income	₢ 200	$ 300	$ 600
Translation Gain (Loss)	—	—	(75)
Net Income	₢ 200	$ 300	$ 525
Translation Adjustment	—	1,300	—
Change in Owners' Equity	₢ 200	$1,600	$ 525

exchange rate will always be less under Statement No. 52 than under Statement No. 8.

Translation Adjustment

As Table III indicates, the total translation adjustment under Statement No. 52 is significantly larger than and in the opposite direction of the translation gain or loss under Statement No. 8. The fluctuation in income is significantly less under the new statement because (1) fluctuation of operating income is reduced (as described above) and (2) translation gains and losses are not reflected in income.

We can predict that the adoption of Statement No. 52 will lead to smaller fluctuations in operating income and much smaller fluctuations in net income in response to changes in exchange rates, but much greater changes in equity because of "translation adjustments." All who use financial ratios and income and equity numbers should be aware of these effects of Statement No. 52.

Systematic Ratio Effects

Table IV summarizes how significant financial ratios will be affected by the application of Statement No. 52, given devaluations or revaluations of the dollar. It assumes use of a FIFO inventory cost flow; LIFO, which is not prevalent for foreign subsidiaries, would result in smaller differences between Statement No. 52 and Statement No. 8 results.

Nearly all the ratios are affected in some way by the change in accounting principles, but the direction of the change cannot always be determined. For example, with devaluation, operating income using the all-current method of Statement No. 52 will be smaller than operating income

Table IV How Statement No. 52 Affects Key Financial Ratios

	$ Devaluation	*$Revaluation*
Current Assets / Current Liabilities	increase	decrease
Cash Flow from Operations* / Assets	decrease**	increase**
Cash Flow from Operations* / Net Worth	indeterminate	indeterminate
Cash Flow from Operations* / Liabilities	decrease	increase
Net Worth / Fixed Assets	indeterminate	indeterminate
Operating Income / Interest	decrease	increase
Sales / Working Capital	decrease	increase
Operating Income / Sales	decrease	increase
Net Income / Sales	indeterminate	indeterminate
Sales / Fixed Assets	decrease	increase
Net Income / Net Worth	indeterminate	indeterminate
Operating Income / Assets	decrease**	increase**
Operating Income / Liabilities	decrease	increase
Debt / Net Worth	indeterminate	indeterminate
Net Income / Assets	indeterminate	indeterminate

*Operating income plus non-cash operating expenses.
**Assuming the numerator of the ratio is less than the denominator.

under Statement No. 8 because all the expenses translated at the current rate are larger. (If revaluation occurs, the opposite result will be produced.) Net income differences, including translation gains and losses, cannot be predicted, however. Although operating income under Statement No. 52 is smaller, a translation loss would probably result under Statement No. 8 if, as is likely, the firm is in a net translation liability position. The change in net income, therefore, will depend upon the relative magnitude of the decrease in operating income under Statement No. 52 compared with the translation loss under Statement No. 8.

All asset categories and net worth will be larger under Statement No. 52, which provides for the translation of all assets at the current devalued rate, than under Statement No. 8, which required that only some of these assets be translated at the current rate. All liability and debt items are translated at the same rate under both statements, hence there will be no change in liabilities and debt. The translation of sales will also be unaffected by the change in accounting principles.

The impact on cash flow will depend upon how cash flows are measured. Obviously, cash receipts minus cash disbursements will be unaffected, since the cash balance is translated at the current rate under both financial accounting standards. However, cash flow is typically calculated in terms of income plus addback of non-cash expenses.

If operating income is used as the starting point, then the derived cash flow under Statement No. 52 will be smaller. Operating income under this statement will be smaller because depreciation and cost of goods sold are greater than they would be under Statement No. 8. Although the decrease due to depreciation will be exactly offset by the increase in the depreciation addback, cost of goods sold is not an addback item; the decrease in operating income due to cost of goods sold will therefore carry over as a decrease in the calculated cash flow number. If net income is used as the starting point for the cash flow calculation, the impact of Statement No. 52 will not be predictable because of the conflicting effects on net income of operating income and the translation adjustment.

Is Statement No. 52 Better?

Does Statement No. 52 represent an improvement over Statement No. 8? In our opinion, it does not represent a theoretically sound or preferable way of dealing with foreign currency translation. For foreign subsidiaries that are independent cash generators, hence use the local currency as the functional currency and apply the all-current method for translation, no method so far suggested adequately describes the risk or exposure due to foreign currency fluctuations. Since these companies are independent cash generators, actual gains or losses attributable to foreign currency fluctuations will depend upon the exchange rates in existence at the time cash transfers to or from the subsidiary take place.

Statement No. 52 contaminates the existing accounting model, which provides for a historical record of cash flows, with a translated number that defies logical interpretation in terms of cash flows. We believe the FASB would have been better advised to silence the critics of Statement No. 8 by retaining the temporal method but allowing translation gains and losses to be excluded from income. In addition, we believe that a record of the volatility of the foreign currency fluctuation for significant foreign subsidiaries should be provided so that users of financial statements can assess the inherent risk. ■