

Statement of Financial Accounting Standards No. 8

Note: This Statement has been completely superseded

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Accounting for the Translation of Foreign
Currency Transactions and Foreign
Currency Financial Statements

October 1975



Financial Accounting Standards Board
of the Financial Accounting Foundation
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Statement of Financial Accounting Standards No. 8

Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements

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CONTENTS

	Paragraph Numbers
Introduction	1– 5
Standards of Financial Accounting and Reporting:	
Objective of Translation.....	6
Foreign Currency Transactions	7– 8
Foreign Statements.....	9–15
Exchange Gains and Losses	16–17
Income Tax Consequences of Rate Changes.....	18–21
Forward Exchange Contracts	22–28
Use of Averages or Reasonable Approximation	29
Exchange Rates	30–31
Disclosure.....	32–34
Effective Date and Transition.....	35–37
Appendix A: Translation of Certain Accounts.....	38–52
Appendix B: Background Information.....	53–64
Appendix C: Need for Translation	65–76
Appendix D: Basis for Conclusions	77–242
Appendix E: Glossary	243

FAS 8: Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements

INTRODUCTION

1. The expansion of international business activities, extensive currency realignments—including two U.S. dollar devaluations—that followed the recent major revision of the international monetary system, and the acceptance in practice of significantly different methods of accounting have highlighted problems concerning **foreign currency translation**. (Terms defined in the glossary in Appendix E are in boldface type the first time they appear in this Statement.) Appendix B presents background information for this Statement.

2. This Statement establishes standards of financial accounting and reporting for **foreign currency transactions** in financial statements of a **reporting enterprise** (hereinafter *enterprise*). It also establishes standards of financial accounting and reporting for translating **foreign currency financial statements** incorporated in the financial statements of an enterprise by consolidation, combination, or the equity method of accounting. Translation of financial statements from one currency to another for purposes other than consolidation, combination, or the equity method is beyond the scope of this Statement. For example, this Statement does not cover translation of the financial statements of an enterprise from its **reporting currency** into another currency for the convenience of readers accustomed to that other currency.

3. To incorporate foreign currency transactions and foreign currency financial statements in its financial statements, an enterprise must translate—that is, express in its reporting currency ¹—all assets, liabilities, revenue, or expenses that are *measured in foreign currency or denominated in foreign currency* ² and that arise in either of two ways:

Foreign currency transactions—an enterprise (a) buys or sells on credit goods or services whose prices are stated in **foreign currency**, (b) borrows or lends funds and the amounts payable or receivable are denominated in foreign currency, (c) is a party to an unperformed forward exchange contract, or (d) for other reasons, acquires assets or incurs liabilities denominated in foreign currency.

Foreign operations—an enterprise conducts activities through a **foreign operation** whose assets, liabilities, revenue, and expenses are measured in foreign currency.

The need for translation is discussed further in Appendix C.

4. This Statement supersedes paragraphs 7 and 10-22 of Chapter 12, "Foreign Operations and Foreign Exchange," of *ARB No. 43*; paragraph 18 of *APB Opinion No. 6*, "Status of Accounting Research Bulletins"; and *FASB Statement No. 1*, "Disclosure of Foreign Currency Translation Information." It also amends the last sentence of paragraph 5 of *ARB No. 43*, Chapter 12, to delete "and they should be reserved against to the extent that their realization in dollars appears to be doubtful," and paragraph 13 of *APB Opinion No. 22*, "Disclosure of Accounting Policies," to delete "translation of foreign currencies" as an example of disclosure "commonly required with respect to accounting policies."

5. Standards of financial accounting and reporting for the translation of foreign currency transactions and foreign currency financial statements (*foreign statements*) are presented in paragraphs 6-37. Those paragraphs deal in sequence with the following: objective of translation, foreign currency transactions, foreign statements, exchange gains and losses, income tax consequences of rate changes, forward exchange contracts, use of averages or reasonable approximations, exchange rates, disclosure, and effective date and transition. The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix D.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Objective of Translation

6. For the purpose of preparing an enterprise's financial statements, the objective of translation is to measure and express (a) in dollars and (b) in conformity with U.S. generally accepted accounting principles the assets, liabilities, revenue, or expenses that are measured or denominated in foreign currency. Remeasuring in dollars the assets, liabilities, revenue, or expenses measured or denominated in foreign currency should not affect either the measurement bases for assets and liabilities or the timing of revenue and expense recognition otherwise required by generally accepted accounting principles. That is, translation should change the **unit of measure** without changing accounting principles.

Foreign Currency Transactions

7. The objective of translation requires that the following shall apply to all foreign currency transactions of an enterprise other than forward exchange contracts (paragraphs 22-28):

- a. At the **transaction date**, each asset, liability, revenue, or expense arising from the transaction shall be translated into (that is, measured in) dollars by use of the exchange rate (*rate*) in effect at that date, and shall be recorded at that dollar amount.
- b. At each balance sheet date, recorded dollar balances representing cash and amounts owed by or to the

- enterprise that are denominated in foreign currency shall be adjusted to reflect the current rate.³
- c. At each balance sheet date, assets carried at market whose current market price is stated in a foreign currency shall be adjusted to the equivalent dollar market price at the balance sheet date (that is, the foreign currency market price at the balance sheet date multiplied by the current rate).
8. Although paragraph 7 refers to foreign currency transactions of an enterprise whose reporting currency is the dollar, the conclusions expressed therein also apply to a foreign operation that has transactions whose terms are stated in a currency other than its **local currency**.

Foreign Statements

9. The objective of translation requires that the assets, liabilities, revenue, and expenses in foreign statements be translated and accounted for in the same manner as assets, liabilities, revenue, and expenses that result from foreign currency transactions of the enterprise. Foreign currency transactions of an enterprise involve amounts denominated or measured in foreign currency, but the assets, liabilities, revenue, and expenses from foreign currency transactions are initially measured and recorded in dollars, and in conformity with U.S. generally accepted accounting principles, following the procedures in paragraph 7(a). In contrast, assets, liabilities, revenue, and expenses in foreign statements are initially measured and recorded in foreign currency and may not be in conformity with U.S. generally accepted accounting principles. Since translation cannot transform the results obtained under dissimilar foreign accounting principles into acceptable measurements under U.S. accounting principles, special procedures are necessary to ensure that the translated statements are prepared in conformity with U.S. generally accepted accounting principles.
10. Accordingly, before translation, foreign statements that are to be included by consolidation, combination, or the equity method in an enterprise's financial statements shall be prepared in conformity with U.S. generally accepted accounting principles. Those financial statements shall then be translated into dollars following the standards in this Statement.⁴
11. In preparing foreign statements, balances representing cash and amounts receivable or payable that are denominated in other than the local currency shall be adjusted to reflect the current rate between the local and the foreign currency.⁵ Those adjusted balances and other balances representing cash and amounts receivable or payable that are denominated in the local currency shall be translated into dollars at the current rate.
12. For assets and liabilities other than those described in paragraph 11, the particular measurement basis used shall determine the translation rate. Several measurement bases are used in financial accounting under present generally accepted accounting principles.⁶ A measurement may be based on a price in a past exchange (for example, historical cost), a price in a current purchase exchange (for example, replacement cost), or a price in a current sale exchange (for example, market price). Foreign statements may employ various measurement bases. Accordingly, amounts in foreign statements that are carried at exchange prices shall be translated in a manner that retains their measurement bases as follows:
- a. Accounts carried at prices in past exchanges (past prices) shall be translated at historical rates.

b. Accounts carried at prices in current purchase or sale exchanges (current prices) or future exchanges (future prices) shall be translated at the current rate.

13. Revenue and expense transactions shall be translated in a manner that produces approximately the same dollar amounts that would have resulted had the underlying transactions been translated into dollars on the dates they occurred. Since separate translation of each transaction is usually impractical, the specified result can be achieved by using an average rate for the period. However, revenue and expenses that relate to assets and liabilities translated at historical rates shall be translated at the historical rates used to translate the related assets or liabilities.

14. The procedures specified in paragraphs 10-13 generally result in translated statements in which the assets, liabilities, revenue, and expenses are measured in dollars in the same manner as those resulting from foreign currency transactions of the enterprise. Occasionally, however, translation of foreign statements in strict conformity with those paragraphs does not result in dollar measurements required by U.S. generally accepted accounting principles. For example, the test of *cost or market, whichever is lower*, must be applied *in dollars* to ensure that inventory in the translated statements conforms to that rule—a procedure that can result in dollar measurements that are sometimes different from translating inventory in foreign statements in the manner described in paragraph 12. Similarly, timing differences that affect deferred tax accounting sometimes increase or decrease *in dollars* even though their amounts measured in foreign currency remained unchanged.

15. Appendix A, "Translation of Certain Accounts," (paragraphs 38-52) explains and illustrates certain applications of the procedures set forth in paragraphs 11-13. It also describes and illustrates ways to ensure that amounts in translated statements conform to U.S. generally accepted accounting principles in those situations indicated in paragraph 14.

Exchange Gains and Losses

16. A change in the rate between the dollar and the foreign currency in which assets and liabilities are measured or denominated can result in an exchange gain or loss if the translation method uses the dollar as the unit of measure. Exchange gains or losses are a consequence of translation, that is, of remeasuring in dollars. They result from the procedures specified in paragraphs 7(b) and 11-13 (see paragraphs 167-169). Exchange gains or losses also result from the **conversion** of foreign currency or the settlement of a receivable or payable denominated in foreign currency at a rate different from that at which the item is recorded.

17. Exchange gains and losses shall be included in determining net income for the period in which the rate changes. Exchange gains and losses are gains and losses as those terms are used in paragraph 15(d) of *APB Opinion No. 28*, "Interim Financial Reporting," which states: "Gains and losses that arise in any interim period similar to those that would not be deferred at year end should not be deferred to later interim periods within the same fiscal year."

Income Tax Consequences of Rate Changes

18. Interperiod tax allocation is required in accordance with *APB Opinion No. 11*, "Accounting for Income Taxes," if taxable exchange gains or tax-deductible exchange losses resulting from an enterprise's foreign currency transactions are included in income in a different period for financial statement purposes than for tax purposes. Partial or complete elimination of a foreign operation's exchange gains or losses through translation of its statements into dollars shall not alter current inclusion in the dollar income statement of the effects, if any, of the exchange gains or losses on foreign taxes (see paragraph 200).

19. The use of historical rates to translate certain revenue or expense items may result in an unusual relationship between the translated amounts of foreign pretax income and foreign income taxes. However, that effect of a rate change is not a timing difference as defined in *APB Opinion No. 11*, and interperiod tax allocation is not appropriate.

20. To the extent that exchange gains or losses arising from translating subsidiaries' and investees' foreign statements into dollars are not included currently in U.S. taxable income, the need for deferred taxes shall be determined in accordance with the provisions of *APB Opinion No. 23*, "Accounting for Income Taxes—Special Areas," and *APB Opinion No. 24*, "Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method (Other than Subsidiaries and Corporate Joint Ventures)."

21. Deferred taxes shall be recorded in accordance with *APB Opinion No. 11* for exchange gains or losses that are timing differences arising from including the operations of foreign branches of U.S. companies and certain foreign subsidiaries and investees in determining U.S. taxable income. Since various methods are allowed to measure exchange gains or losses for tax purposes, the determination of whether exchange gains or losses are timing differences or permanent differences must depend on the circumstances in each situation.

Forward Exchange Contracts

22. A forward exchange contract (*forward contract*) is an agreement to exchange at a specified future date currencies of different countries at a specified rate (the *forward rate*). The purpose of a forward contract may be to hedge either a foreign currency commitment or a foreign currency **exposed net asset position** or **exposed net liability position** or to speculate in anticipation of a gain.

23. A gain or loss shall be included in determining net income for the period in which the rate changes if the gain or loss pertains to a forward contract that is intended to be a (a) hedge of a foreign currency exposed net asset or net liability position, (b) hedge of a foreign currency commitment that does not meet the conditions described in paragraph 27, or (c) speculation.

24. A gain or loss shall be deferred and included in the measurement of the dollar basis of the related foreign currency transaction if the gain or loss pertains to a forward contract that is intended to be a hedge of an identifiable foreign currency commitment that meets the conditions described in paragraph 27. Losses on a forward contract shall not be deferred, however, if deferral could lead to recognizing losses in later periods.⁷

25. A gain or loss on a forward contract that is intended to be a hedge (paragraphs 23(a), 23(b), and 24) shall

be determined by multiplying the foreign currency amount of the forward contract by the difference between the **spot rate** at the balance sheet date ⁸ and the spot rate at the date of inception of the contract (or the spot rate last used to measure a gain or loss on that contract for an earlier period). The discount or premium on the forward contract (that is, the foreign currency amount of the contract multiplied by the difference between the contracted forward rate and the spot rate at the date of inception of the contract) shall be accounted for separately from the gain or loss on the contract and shall be included in determining net income over the life of the forward contract. If a gain or loss is deferred under paragraph 24, however, the forward contract's discount or premium that relates to the commitment period may be included in the measure of the dollar basis of the related foreign currency transaction when recorded.

26. A gain or loss on a forward contract that is a speculation shall be determined by multiplying the foreign currency amount of the forward contract by the difference between the forward rate available for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). No separate accounting recognition is given to the discount or premium on a forward contract that is a speculation.

27. There shall be the presumption that the intent of entering into a forward contract is described in paragraph 23. However, a forward contract shall be considered a hedge of an identifiable foreign currency commitment (paragraph 24), provided *all* of the following conditions are met:

- a. The life of the forward contract extends from the foreign currency commitment date to the anticipated transaction date ⁹ or a later date. ¹⁰
- b. The forward contract is denominated in the same currency as the foreign currency commitment and for an amount that is the same or less than the amount of the foreign currency commitment.
- c. The foreign currency commitment is firm and uncancelable.

A forward contract is not a hedge of an identifiable commitment to the extent that its amount exceeds the amount of the commitment or its life extends beyond the transaction date of the commitment. Consequently, a gain or loss pertaining to an amount of a forward contract in excess of the related commitment or pertaining to a period after the transaction date of the related commitment shall not be deferred.

28. If a forward contract previously considered a hedge of a foreign currency commitment is sold or otherwise terminated before the transaction date, the deferred gain or loss, if any, shall continue to be deferred and accounted for in accordance with the requirements of paragraph 24.

Use of Averages or Reasonable Approximations

29. Since literal application of several of the standards in this Statement would require a degree of detail in record-keeping and computations that might be burdensome as well as unnecessary to produce reasonable approximations of the results desired, the use of averages or other methods of approximation is appropriate, provided the results obtained do not differ materially from the results prescribed by the standards. For example, the propriety of average rates in translating certain revenue and expense amounts is noted in paragraph 13.

Likewise, the use of averages and other time- and effort-saving methods to approximate the results of detailed calculations will often prove useful in translating certain inventory, deferred income tax, and other accounts that involve translation of numerous individual elements at historical rates.

Exchange Rates

30. The exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. For purposes of applying this Statement, the *current rate* is the rate in effect at the balance sheet date (see paragraph 34), and the *historical rate* is the rate in effect at the date a specific transaction or event occurred.¹¹ The following shall apply if multiple rates exist:

- a. *Foreign Currency Transactions.* The applicable rate at which a particular transaction could be settled at the transaction date shall be used to translate and record the transaction. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date.
- b. *Foreign Statements.* In the absence of unusual circumstances, the rate applicable to conversion of a currency for purposes of dividend remittances shall be used to translate foreign statements.¹²

31. If a foreign operation whose balance sheet date differs from that of the enterprise is consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise, the current rate is the rate in effect at the foreign operation's balance sheet date for purposes of applying the requirements of this Statement to that foreign operation.

Disclosure

32. The aggregate exchange gain or loss included in determining net income for the period shall be disclosed in the financial statements or in a note thereto.¹³ For the purpose of that disclosure, gains and losses on forward contracts determined in conformity with the requirements of paragraphs 25 and 26 shall be considered exchange gains or losses.

33. Effects of rate changes on reported results of operations, other than the effects included in the disclosure required by paragraph 32, shall, if practicable, be described and quantified. If quantified, the methods and the underlying assumptions used to determine the estimated effects shall be explained (paragraphs 223-225).

34. An enterprise's financial statements shall not be adjusted for a rate change that occurs after the date of the financial statements or after the date of the foreign statements of a foreign operation that are consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise. However, disclosure of the rate change and its effects, if significant, may be necessary.

Effective Date and Transition

35. This Statement shall be effective for fiscal years beginning on or after January 1, 1976,¹⁴ although earlier application is encouraged. Thereafter, if financial statements for periods before the effective date, and financial

summaries or other data derived therefrom, are presented, they shall be restated, if practicable, to conform to the provisions of paragraphs 7-31 of this Statement. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each period restated.

36. If restatement of financial statements or summaries for all prior periods presented is not practicable, information presented shall be restated for as many consecutive periods immediately preceding the effective date of this Statement as is practicable, and the cumulative effect of applying paragraphs 7-31 on the retained earnings at the beginning of the earliest period restated (or at the beginning of the period in which the Statement is first applied if it is not practicable to restate any prior periods) shall be included in determining net income of that period (see paragraph 20 of *APB Opinion No. 20*, "Accounting Changes").¹⁵ The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a period in which the cumulative effect is included in determining net income shall be disclosed for that period, and the reason for not restating all of the prior periods presented shall be explained.

37. Financial statements for periods beginning on or after the effective date of this Statement shall include the disclosures specified by paragraphs 32 and 33 of this Statement. To the extent practicable, those disclosures shall also be included in financial statements for earlier periods that have been restated pursuant to paragraph 35 or paragraph 36.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Mays dissented.

Mr. Mays dissents for two principal reasons: (1) he believes that the method adopted by the Board (which he views as essentially the temporal method) is generally inappropriate for translating financial statements of foreign operating entities; and (2) he believes that exchange differences arising from translation should not, in all cases, be treated as current gains or losses.

Mr. Mays would apply the current rate method in translating financial statements of foreign subsidiaries whose operations are largely conducted in foreign currency and whose assets and liabilities are exposed to foreign currency exchange risk. He believes that only that method meets two requirements which he deems essential: (1) that the translation process should preserve the essence of the foreign currency statements in terms of financial position and results of operations and (2) that it should produce results that are generally consistent with the economic effects of exchange rate changes. Mr. Mays disagrees with the objective of translation as stated in paragraphs 6 and 9 because it does not recognize the two requirements mentioned above, and because, in his opinion, it mistakenly views the assets of a foreign subsidiary as if they had been purchased individually by the domestic parent and recorded in dollars. Typically, however, the parent's dollar investment cannot be identified with individual assets acquired by the subsidiary and, from the parent's standpoint, all assets of the subsidiary are equally at risk in the same foreign exchange environment. In Mr. Mays' view, the temporal method, the selection of which automatically flows from the objective as stated, meets neither of the two

requirements referred to above which he believes constitute important elements of the objective of translation. Translating inventories and fixed assets at historical rates, while translating the short- and long-term debt incurred to finance them at the current rate, causes the translated results and relationships, under the temporal method, to differ significantly from those reflected by the foreign currency statements. In addition, under that method, an exchange loss will be recognized when the economic effect of a rate change is considered beneficial and, conversely, an exchange gain will be recognized when the economic effect of a rate change is considered adverse. Mr. Mays believes that the use of the temporal method with the immediate recognition of the resulting exchange differences as gains and losses will, in the present environment of fluctuating exchange rates, cause erratic changes in the reported results of companies with significant foreign operations, especially for interim periods. In his opinion, these variations will depart markedly from economic results and, accordingly, will be misinterpreted by investors. He also has concern that current recognition in income of translation differences produced under the temporal method may induce uneconomic actions by companies to protect against what may be viewed as an accounting exchange exposure, as contrasted with the actual exchange exposure.

Mr. Mays contests the arguments that the temporal method is conceptually superior because it is compatible with generally accepted accounting practice, including the concept of historical cost, whereas the current rate method is not. He believes that assets acquired for local currency by a foreign subsidiary have no historical dollar costs; their historical cost exists only in local currency, and translation at the current rate does not change that basis. Translation of foreign statements is an accounting convention necessary for the preparation of consolidated financial statements. If use of the current rate with respect to nonmonetary assets introduces valuation into the translation process, as some contend, it may be equally contended that use of the current rate for debt and other monetary items as embraced by the temporal method also introduces valuation. Further, recognition of exchange differences from translation as current gains and losses is, per se, an acknowledgement of valuation. Thus, Mr. Mays concludes that the conceptual superiority claimed for the temporal method is illusory, but its practical deficiencies, as he sees them, are real.

Mr. Mays regards exchange differences arising from translation as unrealized gains and losses. He believes that generally accepted accounting principles, including the principle of conservatism, require the deferral of unrealized exchange gains to the extent they exceed unrealized exchange losses. An excess of unrealized exchange losses should, in his view, normally be recognized in the period in which the excess occurs.

In Mr. Mays' opinion, the nature of foreign operations of U.S. companies is sufficiently diverse and complex that no single accounting treatment for foreign currency translation, whatever its conceptual merits, can be universally applied without producing irrational results in many instances. The practical problems cited in Appendix D in identifying those situations in which the use of the current rate method would be appropriate, would require for their solution some latitude in the Statement for the use of judgment on the part of managements and auditors. Mr. Mays believes that these problems, while real, are of lesser magnitude than those inherent in the mandatory application of a single method to widely divergent situations.

Members of the Financial Accounting Standards Board:

Marshall S. Armstrong, *Chairman*
Oscar S. Gellein
Donald J. Kirk
Arthur L. Litke

Robert E. Mays
Walter Schuetze
Robert T. Sprouse

Appendix A: TRANSLATION OF CERTAIN ACCOUNTS

38. Paragraphs 11 and 12 distinguish those balance sheet accounts in foreign statements that shall be translated at either current or historical rates. The table below indicates the rates at which certain common balance sheet accounts in foreign statements shall be translated. In addition, the following paragraphs discuss certain additional aspects of translating foreign statements. Two topics included in the discussion—applying the rule of cost or market, whichever is lower, to inventory and applying *APB Opinion No. 11* to deferred income taxes—require procedures not described in paragraphs 11 and 12 (see paragraph 14).

Holdings of Debt Securities

39. Debt securities held that are essentially equivalent to notes receivable shall be translated at the current rate. An example is a bond that is intended to be held to maturity and is carried at an amount that is the present value of future interest and principal payments based on the effective rate of interest at the date of purchase (that is, at maturity amount plus or minus an unamortized premium or discount). A debt security held that is not essentially equivalent to a note receivable shall be translated (a) at the current rate if carried at current market price or (b) at the historical rate if carried at cost.

Translation After a Business Combination **16**

40. The method an enterprise uses to account for the acquisition of a foreign operation affects certain aspects of translation. If a business combination with a foreign operation is accounted for by the *pooling-of-interests method*, the assets and liabilities of the foreign operation shall be translated as if the foreign operation had always been a subsidiary of the enterprise. Therefore, assets and liabilities that are translated at historical rates shall be translated at the rates in effect at the date the foreign operation recognized the specific transactions or events.

41. If a business combination with a foreign operation is accounted for by the *purchase method*, assets and liabilities that are translated at historical rates shall be translated at the rates in effect when the enterprise acquired its interest in the assets or liabilities. Thus, assets and liabilities of a foreign operation at the date of its acquisition shall be adjusted to their fair values in local currency and then translated at the rate in effect at the date of acquisition. A difference between the translated net assets and the dollar cost of acquisition by the enterprise is *goodwill* or *an excess of acquired net assets over cost* as those terms are used in *APB Opinion No. 16*. Translation at the date of acquisition, as described, establishes the dollar measures of the assets acquired and liabilities assumed as of the date of acquisition that are translated at historical rates in subsequent balance sheets.

Rates Used to Translate Assets and Liabilities

	<u>Translation Rates</u>	
	<u>Current</u>	<u>Historical</u>
ASSETS		
Cash on hand and demand and time deposits	X	
Marketable equity securities:		
Carried at cost		X
Carried at current market price	X	
Accounts and notes receivable and related unearned discount	X	
Allowance for doubtful accounts and notes receivable	X	
Inventories:		
Carried at cost		X
Carried at current replacement price or current selling price	X	
Carried at net realizable value	X	
Carried at contract price (produced under fixed price contracts)	X	
Prepaid insurance, advertising, and rent		X
Refundable deposits	X	
Advances to unconsolidated subsidiaries	X	
Property, plant, and equipment		X
Accumulated depreciation of property, plant, and equipment		X
Cash surrender value of life insurance	X	
Patents, trademarks, licenses, and formulas		X
Goodwill		X
Other intangible assets		X
LIABILITIES		
Accounts and notes payable and overdrafts	X	
Accrued expenses payable	X	
Accrued losses on firm purchase commitments	X	
Refundable deposits	X	
Deferred income		X
Bonds payable or other long-term debt	X	
Unamortized premium or discount on bonds or notes payable	X	
Convertible bonds payable	X	
Accrued pension obligations	X	
Obligations under warranties	X	

Translation of an Investment Accounted for by the Equity Method ¹⁷

42. The foreign statements of an investee that are accounted for by the equity method first shall be translated into dollars in conformity with the requirements of this Statement; then the equity method shall be applied.

Minority Interests

43. The minority interest reported in an enterprise's consolidated financial statements shall be based on the financial statements of the subsidiary in which there is a minority interest after they have been translated according to the requirements of this Statement.

Preferred Stock

44. Preferred stock that is essentially a permanent stockholder investment shall be translated in the same manner as common stock, that is, at historical rates. However, if preferred stock not owned by the enterprise is carried in the foreign operation's balance sheet at its liquidation or redemption price, and liquidation or redemption is either required or imminent, that preferred stock shall be translated at the current rate. If translation at the historical rate would result in stating a preferred stock above its stated liquidation or redemption price in foreign currency translated at the current rate, the preferred stock shall be carried at the lesser dollar amount.

Revenue and Expense Transactions

45. Paragraph 13 permits the use of average rates to translate revenue and expense transactions that do not relate to balance sheet accounts translated at historical rates. Average rates used shall be appropriately weighted by the foreign currency volume of transactions occurring during the accounting period. For example, to translate revenue and expense accounts for an annual period, individual revenue and expense accounts for each quarter or month may be translated at that quarter's or month's average rate. The translated amounts for each quarter or month should then be combined for the annual totals.

Applying the Rule of Cost or Market, Whichever Is Lower

46. To apply the rule of *cost or market, whichever is lower* (as described in Statement 6 of Chapter 4, "Inventory Pricing," of *ARB No. 43*), *translated historical cost* shall be compared with *translated market*. Application of the rule *in dollars* may require write-downs to market in the translated statements even though no write-down in the foreign statements is required by the rule. It may also require a write-down in the foreign statements to be reversed before translation if the translated market amount exceeds translated historical cost; the foreign currency cost shall then be translated at the historical rate.¹⁸ Once inventory has been written down to market in the translated statements, that dollar amount shall continue to be the carrying amount in the dollar financial statements until the inventory is sold or a further write-down is necessary.¹⁹

47. Paragraphs 48 and 49 illustrate two different situations.

48. A foreign subsidiary of a U.S. company purchases a unit of inventory at a cost of FC500 when the rate is FC1=\$2.40. At the balance sheet date the *market* (as the term is used in Chapter 4 of *ARB No. 43*) of the item is FC450 and the rate is FC1=\$3.00. Thus, the item's historical cost is \$1,200 (FC500 X \$2.40) and its market is \$1,350 (FC450 X \$3.00). If inventory is written down to FC450 in the foreign accounting records, translation of

that amount at the current rate would not result in the lower of cost or market measured in dollars. Therefore, the write-down should be reversed in the foreign statements before translation. After translating the foreign currency cost at the historical rate, the inventory will be properly stated in the dollar financial statements at its historical cost of \$1,200.

49. A situation different from the one in the preceding paragraph could also exist. For example, a foreign operation purchases a unit of inventory at a cost of FC500 when the rate is FC1=\$2.40. At the balance sheet date the *market* of the item is FC600 and the rate is FC1=\$1.80. Thus, the item's historical cost is \$1,200 (FC500 X \$2.40), its market is \$1,080 (FC600 X \$1.80), and a write-down of the inventory to market in the translated financial statements is necessary.

Deferred Income Taxes

50. Present accounting for income taxes is governed by *APB Opinion No. 11*, which requires the *deferred method* of interperiod tax allocation. Consistent with the requirements of *APB Opinion No. 11* and paragraph 9 of this Statement, deferred taxes in the translated balance sheet of a foreign operation shall be stated the same as would the deferred tax effects of timing differences from foreign currency transactions of the enterprise that are subject to foreign taxes but measured and recorded in dollars. Accordingly, the following procedures shall apply:

- a. Deferred taxes that (1) are determined by the *gross change* method (*APB Opinion No. 11*, paragraph 37(a)) and (2) do not relate to assets or liabilities translated at the current rate shall be translated at historical rates.
- b. Deferred taxes that (1) are determined by the *net change* method (*APB Opinion No. 11*, paragraph 37(b)) and (2) do not relate to assets or liabilities translated at the current rate shall be measured in dollars by adding to or subtracting from the dollar balance at the beginning of the period the amount determined by translating (in accordance with paragraph 13 of this Statement) the foreign currency deferred tax expense or credit included in the foreign operation's income statement for the period. (Paragraph 51 illustrates that procedure.)
- c. Deferred taxes that relate to assets or liabilities translated at the current rate shall be translated at the current rate. (Paragraph 52 illustrates that procedure.)

Applying the current rate to the balance of deferred taxes in (c) above complies with the objective of translation. Translating at the current rate the item in the foreign statements that gave rise to a timing difference remeasures the timing difference in dollars, and, therefore, the tax effect *in dollars* of the change in the timing difference should be recognized.

Illustrations of Applying Paragraph 50

51. A foreign subsidiary of a U.S. company uses the net change method of deferred tax allocation for timing differences from using an accelerated depreciation method on plant and equipment for tax purposes and the straight-line method of depreciation for financial statement purposes. The dollar measure of the deferred tax credit at the beginning of the year is \$100,000 (determined in conformity with the requirements of paragraph 50(b)). The current year's deferred tax expense is FC50,000, and the average exchange rate for translating

income tax expense is $FC1 = \$0.50$. Accordingly, the dollar amount of deferred taxes in the translated balance sheet is \$125,000 [$\$100,000 + .50(50,000)$].

52. A foreign subsidiary of a U.S. company accrues warranty obligations for financial statement purposes but is on the cash basis for tax purposes. The accrued warranty obligation at the beginning and end of the year is FC900. No warranty claims are paid during the year. The deferred tax charge using the net change method is FC450 (determined at the 50% local tax rate) at the beginning and end of the year. The exchange rate at the beginning and end of the year is $FC1 = \$1$ and $FC3 = \$1$, respectively. The dollar measure of the deferred tax charge at the beginning of the year is \$450. Accordingly, the dollar amount of the deferred tax charge in the translated balance sheet at year end is \$150 ($FC450 \times 3$). The warranty obligation measured in dollars has decreased \$600 during the year; therefore, the deferred tax charge should be decreased by \$300.

Appendix B: BACKGROUND INFORMATION

53. Before this Statement was issued, existing accounting pronouncements on foreign currency translation (summarized in paragraphs 60-64) dealt only with translating foreign statements and not with foreign currency transactions. Since publication of the basic existing pronouncement, the international business activities of U.S. companies have expanded rapidly. In addition, the international business environment has been affected by recent, significant changes in the world monetary system, exemplified by the U.S. dollar devaluations of 1971 and 1973 and the current prevalence of *floating* rather than *fixed* rates in most foreign exchange markets.

54. Because of those factors and the acceptance in practice of several different methods of accounting for foreign currency translation, the FASB in April 1973 placed on its technical agenda a project on "Accounting for Foreign Currency Translation."

55. A task force of 14 persons from industry, public accounting, the financial community, and academe was appointed in May 1973 to counsel the Board in preparing a Discussion Memorandum analyzing issues related to the project.

56. In the meantime, because a variety of methods of determining and accounting for exchange gains and losses existed in practice and not all companies completely disclosed their translation methods or their accounting for exchange gains and losses, the Board issued in October 1973 an Exposure Draft of a proposed FASB Statement on "Disclosure of Foreign Currency Translation Information." After considering the comments received on that Exposure Draft, the Board issued *FASB Statement No. 1* on that topic in December 1973.

57. The Board issued the Discussion Memorandum, "Accounting for Foreign Currency Translation," on February 21, 1974, and held a public hearing on the subject on June 10 and 11, 1974. The Board received 90 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum. Fifteen presentations were made at the public hearing.

58. In 1972, the AICPA and the Canadian Institute of Chartered Accountants both published research studies

on this subject.²⁰ While the Discussion Memorandum was being prepared, the Financial Executives Institute completed a survey of the translation practices of 45 major U.S. companies.²¹ In addition to the availability of those studies, pronouncements of other professional accounting bodies, and other published research studies and articles that are cited in the Discussion Memorandum, the FASB staff prepared a *Financial Statement Model on Accounting for Foreign Currency Translation*.²² Its purpose was to aid in identifying possible implementation problems related to adopting a particular method or combination of methods from among those that had been proposed or that were currently used in practice. The FASB staff also reviewed the disclosure of translation practices in recent annual financial statements of 77 companies engaged in foreign activities.

59. The Board received 190 letters of comment on its Exposure Draft of a proposed Statement on "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," dated December 31, 1974.

SUMMARY OF PAST PRONOUNCEMENTS AND PRACTICES

60. Chapter 12 of ARB No. 43, as modified by paragraph 18 of *APB Opinion No. 6*, was the basic authoritative pronouncement on accounting for foreign currency translation before this Statement. Chapter 12 called for translation of current assets and liabilities at the current rate and translation of noncurrent assets and liabilities at historical rates, that is, the *current-noncurrent* method. Under Chapter 12, exchange losses and realized exchange gains were included in net income, and unrealized exchange gains were preferably deferred, except that unrealized exchange gains might be included in net income to the extent that they offset exchange losses previously included in net income.

61. Chapter 12 of ARB No. 43 provided certain exceptions to those general rules. Under special circumstances, inventory could be stated at historical rates. Long-term debt incurred or capital stock issued in connection with the acquisition of long-term assets shortly before a substantial and presumably permanent change in the rate could be restated at the new rate. If the debt or stock was restated, the difference was an adjustment of the cost of the assets acquired.

62. A research report ²³ published in 1960 described the current-noncurrent distinction as one that "seems to reflect the use of an established balance sheet classification for a purpose to which it is not relevant." In addition, the report described the *monetary-nonmonetary* method, which had been proposed earlier.²⁴ Under that method, inventory is translated at historical rates because it is a nonmonetary asset, and both current and noncurrent receivables and payables are translated at the current rate because they are monetary items.

63. Translating all payables and receivables at the current rate received official recognition with the issuance in 1965 of *APB Opinion No. 6*. Paragraph 18 of *APB Opinion No. 6* stated, without specifying the circumstances, that "translation of long-term receivables and long-term liabilities at current exchange rates is appropriate in many circumstances." That modification of Chapter 12 of ARB No. 43 in effect permitted use of the monetary-nonmonetary method of translation.

64. Because of extensive currency realignments in 1971, the APB considered the problem of foreign currency

translation and issued an exposure draft proposing that companies using the monetary-nonmonetary method defer exchange gains and losses to the extent they did not exceed those attributable to long-term debt. Amounts deferred were to be accounted for in a manner similar to debt discount.²⁵ That draft in effect created another method of accounting for exchange gains and losses. *ARS No. 12* was in process at the time, and the U.S. dollar was devalued during the exposure period. The APB deferred action on the exposure draft and announced that companies should disclose how they accounted for exchange gains and losses. The APB also noted that some companies had adopted the recommendations of the exposure draft, thus achieving somewhat the same effect as translating long-term receivables and payables at historical rates.²⁶

Appendix C: NEED FOR TRANSLATION

FOREIGN CURRENCY TRANSACTIONS

65. If an enterprise engages in a transaction that requires later settlement in a currency other than the one in which its accounts are maintained, translation is required to record the transaction.

66. An enterprise may be involved in various types of transactions that require settlement in foreign currency, including:

- a. Operating transactions (importing, exporting, licensing, etc);
- b. Financing transactions (borrowing and lending);
- c. Forward exchange contracts.

67. Foreign currency transactions may involve three stages:

- a. Translation to record the transaction at the transaction date;
- b. Subsequent adjustments of the unsettled portion of the transaction (the amount owed by or to the enterprise), if any, to reflect the current rate at balance sheet dates between the transaction date and the **settlement date**;
- c. Conversion of one currency into the other at settlement date.²⁷

Unit of Measure

68. At the transaction date it is necessary to measure and record in a particular currency (a unit of measure) the amount of the goods or services purchased or sold or the amount of the loan received or granted and the corresponding amount owed by or to the enterprise. Once the amount of the goods or services purchased or sold is measured and recorded in dollars,²⁸ it is not subject to further *translation*.

69. Because the dollar amount of any unsettled portion of the transaction (the amount to be paid in an import or borrowing transaction and the amount to be collected in an export or lending transaction) will be affected by a change in the rate between the dollar and the foreign currency (paragraphs 71 and 72), a potential for gain or

loss exists.

70. If a foreign currency transaction is not settled when the transaction occurs, the question arises whether the amount receivable or payable should be presented in the financial statements of the enterprise until the settlement date at the dollar equivalent established at the transaction date or whether it should be adjusted at each intervening balance sheet date for the rate changes that may have occurred in the meantime. Paragraph 7(b) of this Statement states the Board's conclusion regarding that question, and paragraphs 112-115 and 161-166 give the Board's reasoning.

Effect of a Rate Change

71. An exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged (converted) at a particular time. For example, a spot rate of \$1 = FC2 means that one dollar presently can be exchanged for two foreign currency units of money. A change in rate means that more or fewer units of one currency can be subsequently exchanged for a unit of another currency. For example, if the spot rate changed from \$1 = FC2 to \$1 = FC1, it would take \$2 to obtain the same FC2 that \$1 could have obtained at the old rate. Therefore, rate changes have a direct economic effect on transactions that require exchanges between a particular unit of money (for example, the dollar) and another unit of money.

Unsettled Foreign Currency Transactions

72. The effect of a rate change on foreign currency held is measurable in dollars. A rate change has a similar effect on an unsettled foreign currency transaction that was entered into before the rate change and involves the future payment or receipt of a fixed number of foreign currency units.

Future Foreign Currency Transactions

73. Once a rate changes, all subsequent exchanges between the two currencies are effected at the new rate until another rate change occurs. Therefore, a rate change may also affect the future earnings of an enterprise that has foreign currency transactions. For example, the future revenue in dollars of a U.S. company that exports its domestically manufactured product for sale to customers in a foreign country at a price stated in foreign currency may be affected by a rate change. Whether or not the translation process should consider the future effect of a rate change is discussed in paragraphs 96-111.

FOREIGN STATEMENTS

Unit of Measure

74. Foreign statements are derived from accounting records that are not kept in dollars. The unit of measure in foreign statements is usually the local currency of the foreign country, but another foreign currency may be chosen as the unit of measure in particular circumstances. Either way, transactions of a foreign operation are not measured in dollars but in another currency. The foreign currency transactions of a foreign operation require the same translation process as foreign currency transactions of a U.S. company.

75. The need to translate foreign statements arises because an enterprise's financial statements cannot be prepared in dollars directly from accounting records kept in a different currency. The major issue raised in translating foreign statements is whether or not the statements should be translated, either for some or all foreign operations, in a manner that changes the unit of measure from the local currency to the dollar. Paragraph 6 states the Board's conclusion on that issue, and paragraphs 83-95 give the Board's reasoning.

Effect of a Rate Change

76. Paragraphs 72 and 73 mention the possible effects of a rate change on an enterprise's unsettled foreign currency transactions and future foreign currency transactions. That discussion applies equally to foreign currency transactions of U.S. and foreign operations. A rate change between the local currency of a foreign operation and the dollar may also affect the accounting results measured in dollars of future local currency transactions of that operation. For example, the measurement in dollars of future revenue and expenses of a French company whose transactions are solely in French francs may be affected by a rate change. Paragraphs 96-111 consider that possible consequence

Appendix D: BASIS FOR CONCLUSIONS

77. This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others. Some Board members gave greater weight to some factors than to others.

OBJECTIVE OF TRANSLATION

78. The Board determined that the first step toward conclusions regarding the unique problems of translating foreign currency transactions and foreign statements should be to identify the objective of the translation process.

79. Letters of comment received, personal views of Board and task force members, and thoughts expressed in various writings on the subject suggested the following objectives which were considered by the Board.

- A. To present the financial statements of the enterprise in conformity with the U.S. generally accepted accounting principles that would apply had all assets, liabilities, revenue, and expenses been measured and recorded in dollars.
- B. To retain in the enterprise's financial statements the accounting principles that are accepted in the foreign country for assets, liabilities, revenue, and expenses measured and recorded in foreign currency.
- C. To have a single unit of measure for financial statements that include translated foreign amounts; that is, not only to express in dollars the assets, liabilities, revenue, or expenses that are measured or denominated in foreign currency, but also to measure them in dollars.
- D. To retain as a unit of measure each currency in which assets, liabilities, revenue, and expenses are measured; that is, to express in dollars the assets, liabilities, revenue, and expenses that are measured in foreign currencies but to retain the foreign currencies as units of measure.
- E. To produce an exchange gain or loss that is compatible with the expected economic effect of a rate change on business activities conducted in a currency other than dollars.

U.S. or Foreign Accounting Principles (Objective A v. Objective B)

80. Unless the same accounting principles are generally accepted in both the U.S. and the countries in which foreign operations are located, Objectives A and B are mutually exclusive. The translation process cannot retain both if the principles are different. One view is that the only meaningful foreign statements for translation purposes are those based on accounting principles generally accepted in the foreign country. Thus, if an **attribute** of an asset is measured on a basis not in conformity with U.S. generally accepted accounting principles, that measurement basis should, nonetheless, be retained in the translation process.

81. The opposing view is that U.S. generally accepted accounting principles have been developed and are well known. Accordingly, readers of dollar financial statements, although perhaps not cognizant of all the

principles used to prepare the statements, generally understand what the statements represent. Therefore, it is inappropriate to combine in an enterprise's financial statements assets and liabilities that are measured by different accounting principles.

82. After considering the alternatives, the Board concluded that it should require the concept that has been implicitly understood and applied in practice, namely, that all financial statements included in consolidated financial statements should be prepared in conformity with U.S. generally accepted accounting principles. The Board concluded that consistency of accounting procedures and measurement processes between foreign and domestic operations is desirable in the consolidation of foreign and domestic financial statements. Therefore, foreign statements prepared for purposes of combination, consolidation, or equity accounting should be prepared in conformity with U.S. generally accepted accounting principles, and translation should not change the measurement bases used in those foreign statements. The Board, therefore, accepted Objective A and rejected Objective B.

Single or Multiple Units of Measure (Objective C v. Objective D)

83. Objectives C and D are also mutually exclusive because after a rate change the translation process can either retain two or more currencies as units of measure or have a single unit of measure, but it cannot do both. For example, if an asset is acquired either by a foreign operation or a domestic operation for FC100 when the rate is FC1 = \$1, its historical cost measured in either foreign currency or dollars can be expressed as \$100 in the dollar financial statements. However, if the rate changes to FC1 = \$2, the historical cost of the asset would be expressed as \$200 (translated at the current rate) in the dollar financial statements to retain the foreign currency as the unit of measure. Expressing the cost as \$100 after the rate change measures the historical cost of the asset in dollars, not in foreign currency.

84. The desire to retain the foreign currency as the unit of measure stems from the belief that the foreign statements represent the most meaningful presentation of a foreign operation and that translation should preserve the relationships in those statements. That view also supports retaining the foreign accounting principles (paragraphs 80-82) and is related to the view that the historical cost of a foreign asset can be measured only in foreign currency (paragraphs 133-138).

85. The unit-of-measure issue focuses principally on the assets and liabilities of foreign operations that are measured at past prices in foreign currency. There is general agreement that cash, receivables, and payables measured or denominated in foreign currency, and assets and liabilities measured at current or future prices in foreign currency are translated at the current rate regardless of which currency is considered the unit of measure.²⁹

86. An important conceptual distinction between the two opposing views involves the way in which the effect of the translation process is recognized. If the dollar is the unit of measure, a change in the dollar carrying amounts of assets and liabilities resulting from a rate change affects net income. If, however, the foreign currency is the unit of measure in dollar statements of foreign operations, prior dollar translated statements need to be restated to current equivalent dollars to make them comparable with current translated statements. Restatement does not change the prior periods' statements in any way except to update the amounts to current

equivalent dollars and, therefore, does not result in an exchange gain or loss.

87. The Board considered the purpose of consolidated financial statements under present generally accepted accounting principles in assessing whether the dollar or the foreign currency should be the appropriate unit of measure for foreign statements included in an enterprise's financial statements. *ARB No. 51, "Consolidated Financial Statements,"* paragraph 1, states:

The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.

88. The Board believes that to be consistent with that purpose the translation process should reflect the transactions of the entire group, including foreign operations, as though the transactions were of a single enterprise. For example, when an enterprise purchases an entity, the cost of the investment to the enterprise establishes the cost for the assets acquired for consolidated financial statements regardless of the carrying amounts recorded by the acquired entity. Therefore, even though the acquired entity may have its own recorded cost for an asset, the acquiring enterprise's cost governs in the consolidation process (paragraph 41).

89. The dollar is usually the unit of measure for financial statements of a U.S. enterprise, and there is no controversy regarding the cost of an asset acquired by a U.S. company in a foreign currency transaction that is settled at the rate in effect at the transaction date. Cost is measured in dollars at the transaction date, and that cost does not subsequently change as a result of rate changes. Although advocates of a one-transaction perspective (paragraph 113) have a different view of what constitutes cost if settlement is at a rate different from the one in effect at the transaction date, they nevertheless recognize the dollar as the unit of measure.

90. Since translated cost in dollars may be affected by the foreign currency chosen, attempting to use a particular foreign currency as the unit of measure for foreign statements included in dollar financial statements creates a practical problem—that of selecting the particular currency to measure the cost of an asset. For example, if an oil tanker is acquired at a price negotiated in Japanese yen and its cost is recorded in financial statements that use the U.S. dollar as the unit of measure, the dollar cost of that asset remains constant regardless of rate changes (paragraph 89). If, however, the cost is measured and recorded in the financial statements of a foreign operation and translation retains the foreign currency as the unit of measure, the cost of the tanker reported in the dollar statements changes with changes in the dollar rate for that foreign currency. That is true regardless of the currency used to acquire the asset or the currency in which revenue from use of the asset will be generated. The tanker could be used to transport oil from the Middle East to France (and other European countries) and the revenue generated thereby might be stated in French francs (or other European currencies). But the historical cost of the asset in the translated dollar financial statements would fluctuate with changes in the dollar rate for, say, the pound sterling if that were the local currency in which the cost of the tanker was originally measured and recorded.

91. Another example that also illustrates the potential consequences of selecting the local currency of a

foreign operation as the unit of measure involves goodwill. If a U.S. enterprise acquires for cash a foreign operation located in Germany at a price in excess of the fair value of the net assets acquired, the difference is recognized as goodwill. If the enterprise acquires the interest directly, the goodwill is measured in dollars and it does not change solely because of a rate change. If, however, the enterprise's Swiss subsidiary acquires the interest with the proceeds of a Eurodollar borrowing or financing from the enterprise and records the investment in the Swiss accounts, the basis for the same goodwill reported in the dollar statements will change with changes in the dollar rate for the Swiss franc even though it does not change in the Swiss accounts. Moreover, the dollar basis of the goodwill will begin a new pattern of changes based on the relation of the new currency to the dollar if the enterprise's investment in the foreign operation in Germany is shifted from the Swiss subsidiary to, say, a subsidiary in the United Kingdom, even if the shift is for good business or tax reasons. In other words, adopting a foreign currency rather than the dollar as the unit of measure allows the translated dollar cost of an asset to be affected by discretionary selection of the accounting records in which the asset is recorded.

92. To use more than one unit of measure in a single set of financial statements raises questions about describing the results. If various foreign currencies are used as the units of measure in translated financial statements of foreign operations of an enterprise, aggregating the resulting dollar amounts with each other and with the dollar amounts from domestic operations would produce totals that are neither dollar measures nor measures in any other currency. In the Board's judgment, the notion of a single enterprise that underlies consolidated financial statements requires a single unit of measure.

93. Since attempting to use a foreign currency as the unit of measure both produces results not in conformity with generally accepted accounting principles and creates conceptual and practical problems, the Board concluded that the dollar, not the local currency of the foreign operation, should be the unit of measure. Thus, the Board rejected Objective D and adopted Objective C.

94. Objectives A and C, adopted by the Board, are combined in paragraph 6 of this Statement as a single objective of translation. Some respondents to the Exposure Draft criticized that objective as an attempt to account for local and foreign currency transactions of foreign operations as if they were dollar transactions or, to a few respondents, as if they were dollar transactions in the United States. In the Board's judgment, those criticisms are not valid. Neither the objective nor the procedures to accomplish it change the denomination of a transaction or the environment in which it occurs. The procedures adopted by the Board are consistent with the purpose of consolidated financial statements. The foreign currency transactions of an enterprise and the local and foreign currency transactions of its foreign operations are translated and accounted for as transactions of a single enterprise. The denomination of transactions and the location of assets are not changed; however, the separate corporate identities within the consolidated group are ignored. Translation procedures are merely a means of remeasuring in dollars amounts that are denominated or originally measured in foreign currency. That is, the procedures do not attempt to simulate what the cost of a foreign plant would have been had it been located in the United States; instead, they recognize the factors that determined the plant's cost in the foreign location and express that cost in dollars.

95. If translation procedures were capable of changing the denomination of an asset or liability from foreign currency to dollars, no exchange risk would be present. Translation procedures obviously cannot accomplish

that, and the procedures adopted in this Statement affirm the existence of an exchange risk in foreign currency transactions and foreign operations and specify accounting for the resulting exchange gains or losses.³⁰

Compatibility with Expected Economic Effects of Rate Change (Objective E)

96. In its deliberations on each of several translation methods, the Board considered the views of respondents to the Discussion Memorandum and Exposure Draft and others who suggested, directly or indirectly, that the translation method should produce an exchange gain or loss that is compatible with the expected economic effects of a rate change. That is, the translation method should produce an exchange gain (or at least avoid producing an exchange loss) if the economic effect of a rate change appears to be beneficial and an exchange loss (or at least not an exchange gain) if the economic effect appears to be detrimental.

97. In the Board's opinion, that objective cannot be fulfilled without major changes in the present accounting model. The economic compatibility issue is usually raised in the context of a foreign operation with significant assets carried at cost in the foreign statements and significant long-term debt denominated in foreign currency. Methods used or proposed to achieve the compatibility objective fall into one or a combination of three categories: (a) exchange gains and losses are recognized by translating both assets carried at cost and long-term liabilities at the current rate, (b) no exchange gains or losses are recognized when exchange rates change on either assets or liabilities by translating both at historical rates,³¹ and (c) no exchange gain or loss is recognized on assets translated at historical rates, and the gain or loss computed on the liabilities translated at the current rate is deferred and recognized over later periods by accounting for it (i) as an adjustment of the translated cost of the assets, (ii) as an adjustment of the effective rate of interest on the liability (that is, as a premium or discount), or (iii) as a deferred credit or deferred charge.³²

98. All of the proposed methods meet the compatibility objective in the sense that they at least avoid producing an exchange loss if a rate change is one that the proponents deem beneficial and avoid producing an exchange gain if a rate change is one that the proponents deem detrimental. In addition, if assets exceed liabilities, methods that translate both assets and liabilities at the current rate (paragraph 97(a)) produce a gain or loss that is in the right direction according to the proponents of the proposed objective. In the Board's view, however, the result cannot be described as an accurate measure of the beneficial or detrimental effect of a rate change because its computation involves multiplying the unamortized historical cost of assets in foreign currency by the current rate (paragraphs 106, 107, and 147-149). Further, in the Board's judgment, the proposed methods either conflict with present generally accepted accounting principles or are unacceptable for other reasons. The Board's views that are summarized in this and the preceding paragraph are expanded and illustrated in the following paragraphs.

99. Under present generally accepted accounting principles, the time for recognizing gains or losses on assets and liabilities depends on their carrying bases. Thus, recognition of gains and losses on assets accounted for at cost is usually deferred until the assets are sold or their costs are otherwise deducted from operating revenue. The translation method adopted by the Board retains that timing for recognition of gains and losses and by so doing amplifies or highlights one effect of carrying assets at cost. A simple example illustrates the type of translated result that proponents of the compatibility objective describe as not compatible with the expected economic effect of a rate change.

100. The balance sheet of a hypothetical foreign operation consists of FC125 in cash, FC100 owed to a local bank, and FC25 of stockholders' equity. The exchange rate is $FC1 = \$1$. Under the translation procedures adopted by the Board, the asset and liability are translated into \$125 and \$100, respectively. If the rate changes to $FC.50 = \$1$, translation at the new rate gives \$250 for the asset and \$200 for the liability. The net exchange gain of \$25 (\$125 gain on the asset less \$100 loss on the liability) is almost universally accepted as the result of a valid translation procedure and few, if any, question whether it is a reasonable representation of the economic effect of the rate change.

101. However, a different pattern of gains and losses results and a difference of opinion arises if, instead of cash or a receivable, the asset held when the rate changes is one that is normally accounted for at its costs or amortized cost. If the foreign operation in the foregoing example spends its cash balance before the rate changes to buy an asset such as inventory, land, or equipment, the cost of the asset acquired is $FC125 = \$125$. Under the procedures adopted by the Board, the translated dollar cost remains at \$125 after the rate change. The liability is translated at \$200, however, resulting in an exchange loss of \$100 for the period of the rate change. Proponents of the compatibility objective hold that it is erroneous to report the \$100 exchange loss on the liability when the rate changes because the expected economic effect of the rate change is beneficial by reason of an equal or greater expected eventual gain on the asset.

102. The eventual gain or loss on the asset is usually recognized when the asset is sold or its translated cost is otherwise deducted from operating revenue (translated at the new rate). Assuming the rate remains stable and the revenue in foreign currency equals cost in foreign currency, the reported gain on the sale is \$125 (sales price $FC125 \times 1/.50 = \$250$ less cost \$125 = \$125 gain), the same as the exchange gain in paragraph 100.

103. Two criticisms of the translation procedures adopted by the Board may confuse discussions of the economic compatibility issue. The first is that the Board's procedures result in recognizing only the loss on the liability, thereby ignoring the gain on the asset and misstating the profitability of a net foreign investment. However, the example shows that the gain on the asset is often recognized in a later period than the loss on the liability and is often included in gain or loss on sale of the asset (as in the example), reflected in operating income as the difference between operating revenue translated at the new rate and depreciation or amortization translated at the old rate, or otherwise included in income as other than exchange gain or loss.

104. The second criticism is that the exchange loss on the liability, which is recognized by the Board's procedures, is not really a loss in dollars because the whole series of transactions from borrowing to repayment is in the same foreign currency. However, the difference between the original borrowing (initially translated as \$100) and its repayment (equivalent to \$200) must be accounted for. To satisfy the debt requires the equivalent of \$200 whether dollars or foreign currency are paid. No question arises if a U.S. parent transfers \$200 to settle the debt. The substance is the same if the debt is paid with foreign currency received from operations in the foreign country. The cash (FC100) used to pay the debt is translated as \$200 at all times between the rate change or the receipt of the cash and immediately before its use to pay the debt. Repayment of the debt requires cash with an equivalent dollar value of \$200, and the loss of \$100 is undeniable because cash held or received after the rate change cannot reasonably be translated at other than the new rate ($FC.50 = \$1$). The only way to

avoid recognizing a loss of \$100 is to translate the original borrowing as \$200 by restating the earlier financial statements as if the rate had always been $FC.50 = \$1$. However, that is appropriate only if the foreign currency is the unit of measure in the translated statements (paragraphs 83-86), not if the dollar is the unit of measure.

105. Since the *incompatible* loss result described in paragraph 101 can be avoided only by anticipating the gain on the asset or by deferring recognition of the loss on the liability, the proposed objective directly conflicts with present generally accepted accounting principles. Under present generally accepted accounting principles, recognition of gains on assets carried at cost must normally await sale (or depreciation or amortization), and those gains may not be anticipated indirectly by deferring otherwise recognizable losses. In contrast, under present principles, identified losses should be recognized when they occur and should not be deferred as assets or deferred charges, offset against gains on unsold assets, or treated as valuation accounts to unsold assets.³³

106. A major obstacle to implementing the compatibility objective is that to determine whether a translation method produces a compatible exchange gain or loss, one must first be able to ascertain the expected future economic effects of a rate change. The proposal seems to rest significantly on a general assumption that a local currency's strengthening is beneficial and its weakening is detrimental. That assumption rests on a further assumption that the relation between rate changes and economic effects is reasonably straightforward—that only the rate changes, while other variables—such as output, sales volume, production costs, and sales prices—remain essentially unaffected. However, determining the expected economic effect of a rate change is more complex than that.

107. For example, to assess the expected economic effect of a rate change on a foreign operation's investment in plant and equipment, and possibly other long-lived assets, requires a long-term economic forecast in which many interrelated and interacting forces involved in a rate change should be considered. The Board believes it may be difficult or impossible under most circumstances to predict with reasonable certainty the general effects over an extended future period of a rate change. A foreign operation in a country that experiences a major rate change may be affected both directly and indirectly by the adaptations and shifts that occur in that country's economy as a result of the currency adjustment. The nature and effect of those adaptations and modifications depend on a complex relation among factors, such as the relative degree to which general demand for imports and exports responds to changes in the foreign exchange price, the level of income and employment, the rate of economic expansion, monetary and fiscal policies instituted by the country whose currency has either weakened or strengthened, and conditions and forces existing in countries that are major trading partners. Accordingly, a foreign operation may experience complex changes in the local market demand and market price for its goods, changes in its local cost of goods and services procured, and in the local availability and cost of financing. Moreover, not all operations in the same environment will be affected in the same way because of differences in activities and realignments of price and cost structures within the local economy. In addition, a foreign operation's exposure to the effect of a rate change may go beyond its recorded assets and liabilities. A foreign operation's unrecorded exposure to rate changes might include, for example, sales and purchase backlog commitments at fixed foreign currency prices or fixed foreign currency streams of revenue or expense, such as rent payments. The proposed objective could be impractical in many circumstances because of the foresight required to identify the future economic effects of a rate change at the time it occurs.

108. Finally, the proposed compatibility objective seems to be based on an assumption that it is needed only in translating foreign statements that are to be incorporated in the financial statements of a U.S. enterprise. However, it appears to be a response to the fact that U.S. generally accepted accounting principles require certain assets to be accounted for at cost. The argument for economic compatibility of reported results with expected effects of rate changes could be directed with equal force to reporting foreign currency transactions of a U.S. enterprise or, with minor modification, even to reporting its domestic operations.

109. For example, a U.S. enterprise serves the needs of important foreign customers by selling them the entire output of a plant located in the United States. The enterprise also owes long-term debt denominated in the foreign currency, and as a result of the dollar's weakening against the foreign currency it incurs an exchange loss. However, the rate change appears to be beneficial to the enterprise because, other things remaining constant, the dollar value of its foreign revenue (and therefore also its dollar net income) should increase. To report a result compatible with that assessment requires recognition of a gain from an upward adjustment of the related plant assets. Further, a rate change involving a weakening dollar has the same effects on expected dollar revenue and expected dollar gross profit as an increased selling price in a U.S. market. Consistent with the compatibility objective, therefore, an increase in the selling price of the output of a U.S. plant that produces for the U.S. market should, other things being equal, result in a reported gain from revaluation of the plant compatible with the expectation of its improved future revenue and profits. That those kinds of gains are not now recognized reflects a characteristic of present generally accepted accounting principles, not a defect in the Board's translation procedures.

110. Present financial accounting and reporting reflects primarily the effects of past transactions and existing conditions, not future transactions or conditions. Accordingly, assets are generally carried at cost, and related gains are recognized only when assets are sold or the cost is otherwise deducted from revenue. Many have commented on the strengths and weaknesses of the present accounting model, and some have proposed major changes in it. This Statement pertains to translation of foreign currency transactions and foreign currency financial statements, and the Board believes that consideration of fundamental changes in generally accepted accounting principles relating to measurement bases of assets and liabilities is beyond this Statement's scope. The Board does not intend to use translation procedures to effect major changes in the accounting model presently in use.

111. Since, for the reasons given, the Board chose an objective of translation and a translation procedure that preserve the present accounting model, it rejected proposed Objective E. The Board rejected the view that the objective of compatibility can be implemented by changing translation procedures without considering the implications for underlying concepts and measurements.

FOREIGN CURRENCY TRANSACTIONS

Import or Export of Goods or Services

112. The Board's conclusions on accounting for foreign currency transactions reflect the view that collection of a receivable or payment of a liability is a transaction separate from the sale or purchase from which the

receivable or liability arose. Thus, if an enterprise has foreign currency exchange exposure (*exchange exposure*) on a receivable from a sale or a liability from a purchase requiring settlement in foreign currency, the results, if any, of that exchange exposure should be accounted for separately from sales, cost of sales, or inventory. A rate change does not affect previously recorded revenue from exports or the cost of imported goods or services.

113. An alternate view, sometimes referred to as a one-transaction perspective, is that a transaction involving purchase or sale of goods or services with the price stated in foreign currency is incomplete until the amount in dollars necessary to liquidate the related payable or receivable is determined. The initial amount recorded in dollars as cost or revenue is considered to be an estimate until final settlement. According to that view, an exchange gain or loss related to the transaction should be treated as an adjustment of the cost of imports or revenue from exports.

114. The Board considered and rejected the one-transaction view. Specifically, the Board rejected the idea that the cost of an imported asset or the reported revenue from an export sale is affected by later changes in the related liability or receivable. The exchange exposure in a purchase or sale transaction whose price is denominated in foreign currency stems not from the purchase or sale itself but from a delay in payment or receipt of the equivalent dollars. No exchange gain or loss can occur if, as soon as the price is fixed in foreign currency, the U.S. purchaser immediately buys foreign currency with dollars and pays the foreign seller, or the U.S. seller receives foreign currency from the foreign buyer and immediately converts it into dollars. In other words, exchange gains and losses on import or export transactions result from a combination of a rate change and one of the following: the U.S. buyer owes an amount denominated in foreign currency, or the U.S. seller holds a receivable denominated in foreign currency or holds foreign currency received from a foreign buyer.

115. The exchange gain or loss that may result from an exchange exposure is the result of an event (a rate change) that is separate from the original purchase or sale transaction. Since an exchange exposure can usually be eliminated, a determination not to avoid exchange exposure should be accounted for by recognizing the gain or loss that results from that decision.

116. Paragraph 7(a) specifies that the purchase or sale price in foreign currency be translated into dollars at the rate in effect at the transaction date. Since transactions are often preceded by commitments, and exchange exposure may be viewed as beginning at the commitment date if the price is fixed in foreign currency at that time, the dollar basis of the transaction might be established at the commitment date rather than the transaction date. However, a major obstacle to choosing the commitment date is the fact that, although certain commitments are often disclosed, rarely are commitments recorded under present generally accepted accounting principles. Losses on *firm* commitments are recorded ³⁴ but not the commitments themselves. The Board believes that recognizing exchange gains and losses on a commitment date basis would be both impracticable and inconsistent with the timing of recognizing the underlying transaction in the financial statements.

117. A commitment date basis could present implementation problems because various degrees of commitment are possible before consummation of a business transaction. For example, a noncancelable sales contract negotiated in a foreign currency might be considered by some as a reasonable basis on which to recognize an exchange gain or loss. However, a firm commitment to provide goods or services might require a

commitment by the seller to purchase goods or services in foreign currency to fulfill his obligation. Both commitments would need to be considered to reflect exchange gains and losses properly on a commitment date basis, but the purchase obligations might not necessarily be in the form of fixed contractual commitments. Moreover, since commitments are not now recorded, measuring exchange gains and losses from a commitment date would require ascertaining the commitment date on each individual transaction. An importer or exporter with relatively few individual transactions might manage that, but it would be burdensome, if not impossible, for one with numerous foreign currency transactions or for a foreign operation to separate transactions with commitments from those without commitments and maintain a record of commitment dates, prices, and applicable exchange rates.

118. The problem of inconsistency in using the commitment date under present generally accepted accounting principles is illustrated by a long-term supply contract for raw materials under which both the purchaser and the seller now recognize cost and revenue, respectively, in their financial statements on a performance basis. Since that kind of agreement might be considered a commitment, an enterprise that is party to a five-year supply contract requiring payments in a foreign currency may conceivably have a significant exchange gain or loss if the total future payments are considered on a commitment basis. Since the supplier recognizes revenue and operating profit over the life of the contract, for him to recognize as current gain or loss the expected effect of a rate change on future income would be inconsistent with the timing of recognition of the operating income from the contract. Likewise, an enterprise that must pay foreign currency for its raw materials could also have a significant exchange gain or loss, but its immediate recognition (except to the extent of "accrued net losses on firm purchase commitments"³⁵) would be inappropriate for similar reasons.

Foreign Borrowing or Lending

119. The Board's conclusions on accounting for foreign currency transactions involving the borrowing or lending of foreign currency reflect the view that the effect of a rate change on the repayment or collection of a loan should be accounted for separately from the original borrowing or lending transaction. An alternate treatment considered by the Board is based on a one-transaction perspective similar to that described in paragraph 113: that an exchange gain or loss related to a loan payable denominated in foreign currency is an adjustment of the cost of assets purchased with the borrowed funds. The Board's reasoning in rejecting a one-transaction perspective for borrowing foreign currency is similar to that stated in paragraphs 114 and 115.

120. Another possibility in accounting for borrowing or lending of foreign currency is to treat a related exchange gain or loss as an adjustment of the cost of borrowing or the return from lending. Following that concept, an enterprise ideally would adjust the cost or return from funds borrowed or loaned by using the interest method to amortize expected exchange gains or losses on principal and interest over the life of the debt or receivable. Since at the date of lending or borrowing it is impossible to predict the rates that will prevail during the life of the loan, prospective (and partially retroactive) methods have been suggested to amortize the exchange gain or loss. The Board rejected those methods for the reasons stated in paragraphs 164, 181, and 182.

FOREIGN STATEMENTS

121. Paragraphs 123-139 compare four normative methods for translating assets and liabilities measured in foreign currency against the objective of translation adopted by the Board (a situational approach to the application of those methods is discussed in paragraphs 140-152). The principal distinction among various normative methods of translation is the requirement to translate particular classifications of assets and liabilities at either the current or historical rate.

- a. The temporal method translates cash, receivables and payables, and assets and liabilities carried at present or future prices at the current rate and assets and liabilities carried at past prices at applicable historical rates.
- b. The monetary-nonmonetary method generally translates monetary assets and liabilities at the current rate and nonmonetary assets and liabilities at applicable historical rates. For translation purposes, assets and liabilities are monetary if they are expressed in terms of a fixed number of foreign currency units. All other balance sheet items are classified as nonmonetary.
- c. The current-noncurrent method generally translates current assets and liabilities at the current rate and noncurrent assets and liabilities at applicable historical rates.
- d. The current rate method translates all assets and liabilities at the current rate.

122. The objective of translation requires that the assets, liabilities, revenue, and expenses in foreign statements be translated and accounted for in the same manner as assets, liabilities, revenue, and expenses that result from foreign currency transactions of the enterprise (paragraph 9). Since foreign statements are prepared in conformity with U.S. generally accepted accounting principles before translation, the objective is generally achieved by (a) translating cash, receivables, and payables at the current rate and (b) translating other assets and liabilities in a way that retains the accounting principles used to measure them in the foreign statements. The Board adopted intact none of the four normative methods considered but found the temporal method, proposed by *ARS No. 12* (see footnote 20), the most useful in meeting the objective.

Temporal Method

123. The temporal method generally translates assets and liabilities carried at past, current, or future prices expressed in foreign currency in a manner that retains the accounting principles used to measure them in the foreign statements. That is, the measurement bases of the assets and liabilities measured are the same after translation as before. Thus, the temporal method changes a measurement in foreign currency into a measurement in dollars without changing the basis of the measurement and thereby achieves one of the objectives of translation, which is to retain the measurement bases of foreign statement items (paragraph 82). The temporal method can also accommodate any basis of measurement—for example, historical cost, current replacement price, or current selling price—that is based on exchange prices.

124. The translation procedures to apply the temporal method are generally the same as those now used by many U.S. enterprises under the monetary-nonmonetary method. The results of the temporal method and the monetary-nonmonetary method now coincide because under present generally accepted accounting principles monetary assets and liabilities are usually measured at amounts that pertain to the balance sheet date and nonmonetary assets and liabilities are usually measured at prices in effect when the assets or liabilities were acquired or incurred. The monetary-nonmonetary classification itself contains nothing to preserve the

measurement bases and timing of revenue and expenses recognition that are in the foreign statements (paragraphs 126 and 127). Rather, the coincidence of results between the monetary-nonmonetary method and the temporal method is due solely to the nature of present generally accepted accounting principles—assets and liabilities are measured on bases that happen to coincide with their classifications as monetary and nonmonetary. The results of the temporal method and the monetary-nonmonetary method would differ significantly under other accounting principles that, for example, required nonmonetary assets and liabilities to be measured at prices in effect at dates other than those at which they were acquired or incurred. Since the temporal method retains the measurement bases of the foreign statements equally as well under all accounting methods based on exchange prices as it does under historical cost accounting, the Board believes that it is the more generally valid method for achieving the objective of translation. It provides a conceptual basis for the procedures that are now used to apply the monetary-nonmonetary method.

125. The same point as in the preceding paragraph also applies to the current-noncurrent method. Some of the translation procedures under that method are the same as under the temporal method, but the major exceptions include translation of current assets carried at cost (inventory and prepaid expenses) and noncurrent liabilities and receivables. The current-noncurrent classification itself contains nothing to preserve accounting principles after translation (paragraph 129), but under present generally accepted accounting principles the measurement bases of many assets and liabilities happen to coincide with their classification as current or noncurrent. The major exceptions—inventory and long-term debt—show the deficiencies of the method when the measurement bases and the classifications do not coincide. As long as most foreign currencies weakened against the dollar, as they usually did from the time of the original writing of Chapter 12 of *ARB No. 43* until about 1969, translating inventory at the current rate and long-term debt at historical rates under the current-noncurrent method probably produced conservative results. Inventory was stated lower in dollars than if translated at historical rates (though not necessarily at the lower of cost or market as described in paragraphs 46-49), and exchange gains (not losses) on long-term debt were deferred until the time of settlement or classification as a current liability. Once the dollar began to weaken against foreign currencies, however, that translation method lost its conservative appeal because it produced the opposite results.

Monetary-Nonmonetary Method

126. The monetary-nonmonetary method produces acceptable results under present generally accepted accounting principles (paragraph 124), but no comprehensive principle of translation can be derived solely from the monetary-nonmonetary distinction. Nonmonetary assets and liabilities are measured on different bases (for example, past prices or current prices) under different circumstances, and translation at a past rate does not always fit. Translating nonmonetary items at a past rate produces reasonable results if the items are stated at historical cost but not if they are stated at current market price in foreign currency.

127. For example, if a foreign operation purchases as an investment 100 shares of another company's common stock (a nonmonetary item) for FC1,000 when the rate is FC1 = \$1, the cost of that investment is equivalent to \$1,000. If the investment is carried at cost by the foreign operation, treating the investment as a nonmonetary item and translating it at the historical rate is appropriate. However, if the investment is carried at market price, translating that basis by the historical rate usually produces questionable results. For example, if the current market value of the investment is FC1,500 and the current rate is FC1 = \$1.25, translating FC1,500

into \$1,500 using the historical rate does not result in the current market value measured in dollars ($FC1,500 \times 1.25 = \$1,875$) or the historical cost in dollars. The monetary-nonmonetary method can produce the \$1,875 current market value only if it is recognized that, under the method, the current rate is the applicable historical rate for nonmonetary assets carried at current prices. The point has been confusing enough to cause some proponents of the monetary-nonmonetary method to argue that nonmonetary assets, such as investments and inventories, become monetary assets if they are carried at market price.

128. Although the deficiencies of the monetary-nonmonetary method have been recognized and dealt with in practice, the Board found the monetary-nonmonetary method concept inadequate as a comprehensive method of translation.

Current-Noncurrent Method

129. Existing definitions of current and noncurrent assets and liabilities contain nothing to explain why that classification scheme should determine the rate used to translate. The attributes of assets and liabilities that are measured in financial statements differ from their characteristics that determine their classification as current or noncurrent. Consequently, different kinds of assets or liabilities may be measured the same way but classified differently or classified the same way but measured differently. For example, under present generally accepted accounting principles both inventory and plant and equipment are measured at historical cost, but inventory is classified as a current asset and plant and equipment as noncurrent assets. Since translation is concerned with measurement and not with classification, the characteristics of assets and liabilities that determine their classification for purposes of disclosure are not relevant for selecting the rate for translation. The weaknesses of the method are most pronounced in translating inventory and long-term debt.

130. Under the current-noncurrent method, inventory carried at historical cost in foreign statements is generally translated at the current rate. As indicated in paragraph 134, that translation results in a measure in dollars that departs from historical-cost-based accounting. Later changes in market prices or rates cannot change the historical cost of an asset already owned. Once recorded, the historical cost of an asset can be amortized or otherwise included in expense in accounting records but cannot be changed because of varying prices without changing the basis of accounting from historical cost to something else. (Paragraphs 153-158 give additional reasons for the Board's rejection of the current rate to translate inventory carried at cost.)

131. Measured in local currency, long-term debt denominated in local currency and a related unamortized discount or premium (determined by the interest method) together represent the present value of future interest and principal payments based on the effective rate of interest at the date the debt was incurred. Translating long-term debt and a related discount or premium at the historical rate after a rate change, as required by the current-noncurrent method, does not retain that measurement basis. Translation at the historical rate produces a result that is unrelated to the current dollar equivalent of the present value of the remaining interest and principal payments based on the effective rate of interest at the date the debt was incurred. Furthermore, unless the rate change reverses before the debt is settled, translation at the historical rate merely delays recognition of the exchange gain or loss—it does not avoid the gain or loss. (Paragraph 164 gives additional reasons for translating long-term debt at the current rate.)

132. For the reasons set forth in paragraphs 129-131, the Board rejected the current-noncurrent method.

Current Rate Method

133. The current rate method is, of the four normative methods discussed, the most significant departure from present practice. The arguments for the current rate method discussed in this section are related to those for using the foreign currency as the unit of measure (paragraphs 83-93). The current rate is used under the situational approach, discussed in the next section, but the underlying concept there is different.

134. The Board believes that a foreign operation's assets and liabilities should be measured in the foreign statements in conformity with U.S. generally accepted accounting principles applicable to the reporting enterprise and that those principles should be retained in the translation process (paragraphs 82 and 122). If assets and liabilities that are measured at past prices in foreign statements are translated at the current rate and included in dollar financial statements, the dollar financial statements depart from historical-cost-based accounting because inventory, property, plant, equipment, and other assets normally carried at cost are reflected at varying dollar amounts resulting from changes in rates. The dollar amounts do not, except by coincidence, represent reasonable measure of replacement cost or selling price and would be unacceptable under present U.S. generally accepted accounting principles even if they did.

135. A contrary view expressed is that the historical cost of an asset acquired by a foreign operation can be measured only in the foreign currency and that the asset has no historical cost in dollars. According to that view, translating the foreign currency historical cost of an asset into a fewer or greater number of dollars following a rate change is simply the result of an *absolute, mathematical revision in the rate* and thus does not represent a departure from the historical-cost principle of accounting; the foreign currency cost is the only historical cost, and that cost has not changed.

136. Some advocates of the view described in paragraph 135 believe that the results of the *absolute, mathematical revision* is an exchange gain or loss and others do not. Those who support the foreign currency as the unit of measure would restate prior financial statements because of the rate change and, therefore, would report no exchange gain or loss. Those who support the dollar as the unit of measure would report an exchange gain or loss as a result of a rate change. The Board believes that latter approach is inconsistent with the view that there can be no dollar measure of the historical cost.

137. The Board believes that although an asset's acquisition price may have been stated in a particular currency, its equivalent cost in another currency can be approximated by multiplying the stated currency price by the rate in effect at the date of acquisition. Just as the length of an object can be measured in inches and then remeasured in centimeters by applying the appropriate conversion rate, the cost of an asset can likewise be measured in various units of measure (different currencies) by applying the appropriate translation rates.

138. Assets in foreign countries can be purchased indirectly for dollars by acquiring the necessary foreign currency in a foreign exchange market. The situation is not fundamentally different if the foreign currency is acquired before the purchase; the dollar cost of the purchase is known through the measurement conversion process (paragraph 137). Or, viewed another way, spending foreign currency to buy an asset means that the

currency cannot be converted into dollars for remission to a U.S. parent. The dollars not received in conversion because the foreign currency was used to buy an asset—the dollars foregone—are the cost of the asset acquired in the most literal sense of the word cost.

139. Accordingly, the Board rejected the view that historical cost can be measured only in the foreign currency. It also rejected use of the current rate method based on that premise for the reason stated in paragraph 134 as well.

A Situational Approach to Translation

140. Paragraphs 123-139 compared the four basic normative methods for translating balance sheet accounts against the objectives of translation adopted by the Board. Another, somewhat different, approach to translation has also been suggested, which is not a normative method but looks instead at the nature of each foreign operation. It distinguishes between foreign operations that are extensions of affiliated domestic operations (*dependent* operations ³⁶) and those whose operations are essentially self-contained and, therefore, not dependent on affiliated domestic operations (*independent* operations ³⁶). The situational argument is that since many factors influence the creation of a foreign operation, translation must look further than the location of a business operation; it should also look at its nature.

141. According to that view, if a foreign operation depends on domestic operations, the foreign operation should be accounted for as an extension of those domestic operations (that is, as part of a single domestic operation) and its foreign statements should be translated by one of the normative methods other than the current rate method. If a foreign operation is independent, its foreign statements should be translated by the current rate method.

142. A principal reason given to support using the current rate method to translate independent foreign operations is that the assets and liabilities of those operations are not individually at risk to rate changes; rather, the entire business is at risk. Since the foreign activities are conducted entirely in a foreign environment and future cash flows will be in a foreign currency, future operating results can be expressed in a meaningful way in dollars only if all revenue and costs (including those carried forward from a period before the rate change) are translated at the current rate. From the enterprise's viewpoint, its net investment in the foreign operation represents its total exposure to a rate change. Only by translating the net assets of the foreign operation at the current rate can the effect of rate changes be properly measured.

143. The situational approach involves both practical and conceptual problems, including the difficulty of finding or developing criteria or conditions to distinguish *independent* and *dependent* foreign operations. Proponents of the situational approach have explained the distinctions only broadly and have not given specific criteria. A few circumstances have been suggested or implied as indicating independence, such as regulation of the foreign operation by local authorities or a minimum of intercompany sale and borrowing transactions between the foreign operation and its parent or other domestic affiliates.

144. The Board considered criteria for independence of foreign operations but was unable to develop criteria that it believed to be satisfactory to identify an independent foreign operation. At least part of the difficulty lies

in the inherently contradictory concept of an independent subsidiary, which seems to deny the single enterprise concept that underlies consolidated financial statements (*ARB No. 51*, paragraph 1). If foreign operations are as independent of their U.S. parent companies as some proponents of the situational approach seem to argue, the validity of consolidating them is questionable. Further, since many domestic subsidiaries may also have the characteristics of independent operations, however *independence* is defined, the distinction has implications that reach beyond the translation of foreign statements.

145. Certain respondents to the Discussion Memorandum and Exposure Draft, recognizing the purpose of consolidated financial statements as set forth in paragraph 87, recommended that if the current rate method were deemed appropriate for certain foreign operations for the reasons set forth in paragraph 142, those operations should be accounted for under the equity method rather than line-by-line consolidation. The Board believes that the situational approach raises broad questions about concepts of consolidation and the equity method applicable to domestic as well as foreign operations that are beyond the scope of this Statement.

146. Even if criteria could be developed, there are apt to be problems in applying any set of criteria to determine independence, including whether foreign operations should be viewed on the basis of country-by-country, foreign-operation-by-foreign-operation, or segment-by-segment of each foreign operation. In addition, changes in classification (from dependent to independent or vice versa) between reporting periods, presumably necessitating the use of different translation methods for each period, could produce results that would not be comparable with those of prior periods. It is also unclear how to translate the financial statements of a foreign operation that is independent of its parent but dependent on another foreign economy (for example, a foreign operation that manufactures its product in various European countries and sells its product to an unaffiliated or affiliated South American operation).

147. The situational approach is a way of looking at the exchange exposure of foreign operations that are considered independent, and the effect of a rate change on the net investment is a gain or loss to be included in income of some accounting period. Proponents of the approach believe that the results are erroneous if exchange gains and losses on liabilities are recognized earlier than exchange gains and losses on assets, especially since the latter are not identified in operating results as exchange gains and losses (paragraphs 100-102 contain an example). They argue that a foreign operation involves risk of rate changes in addition to the other risks involved in every business operation, and translation procedures should measure the effects of exchange risk. They argue further that since gains and losses can only be measured through valuations, translation must involve valuation at the current exchange rate—the effect of exchange risk is measured by valuing *all* assets and liabilities before and after movements in the rate. Or stated in another way, a net investment is an integrated whole on which the effect of a rate change can best be determined by multiplying the investment by the change in rate. According to that view, all independent foreign operations in a country whose currency weakens should be worth less (the net investment multiplied by the decline in rate gives an exchange loss) and, conversely, independent foreign operations in a country whose currency strengthens should be worth more.

148. However, translation is a poor valuation process for assets carried in financial statements at cost because it relies on prices in a single market. It reflects only the exchange price between dollars and a single foreign

currency and does not adequately reflect prices in other markets in which a foreign operation could buy or sell those assets. Thus, multiplying the historical foreign currency cost of an asset by the current rate cannot, except by coincidence, measure the value of the asset. For example, an enterprise in England acquired land in 1964 at a cost of 1,000,000 pounds sterling when the rate was $\text{£}1 = \$2.80$; the dollar equivalent historical cost was, therefore, \$2,800,000. If the land being carried at cost in the foreign statements at December 31, 1974 is multiplied by the current rate $\text{£}1 = \$2.35$, the product will be \$2,350,000. However, the current dollar equivalent of the value of that land may be more or less than \$2,350,000 and depends on prices not included in either historical-cost-based financial statements or exchange rates. In other words, translation procedures cannot measure the dollar value of a foreign investment that is subject to exchange risk unless the current value of the investment is included in the foreign statements.

149. Some respondents to the Exposure Draft interpreted the Board's emphasis on a translation method that preserves the measurement bases of assets and liabilities in foreign statements as a denial that translation at the current rate involves valuation. On the contrary, the Board recognizes that accounting for certain assets and liabilities (for example, inventory or investments carried at market price, obligations for pensions and warranties) involves estimates and valuation in the foreign statements and that translating those items at the current rate after a rate change introduces an additional value change in dollars. Foreign currency and receivables and payables denominated in foreign currency are stated in a fixed number of foreign currency units regardless of rate changes, and their foreign currency measures do not change when the rate changes. However, their dollar measurements change solely as a result of a rate change; that value change, which does not exist in the foreign statements, is the exchange gain or loss. The Board believes that all of the value changes in dollars described in this paragraph are the valid result of remeasuring foreign statements in dollars. What the Board did reject, for reasons given in the preceding paragraph, was translation at the current rate of items carried at cost in the foreign statements. In the Board's view, that procedure is not a valid valuation process and, further, it is unacceptable under the historical-cost-basis of accounting required by current generally accepted accounting principles.

150. The key distinction in the situational approach to translation is between independent and dependent foreign operations, and the difference can result in significantly different accounting. Thus, if the purchase of land in the example in paragraph 148 was financed by locally incurred long-term debt due on December 31, 1974, the \$2,350,000 equivalent of the payment to liquidate the debt is \$450,000 less than the \$2,800,000 equivalent proceeds of borrowing. If the foreign operation is considered to be independent by the advocates of the situational approach, both the land and the debt are translated at the current rate, and no exchange gain or loss is recognized when the rate changes because the amount of the debt equals the carrying basis (cost) of the asset, leaving no net investment subject to exchange risk. If, however, the foreign operation is assumed to be dependent on its parent, advocates of the situational approach agree that the \$450,000 should be recognized as gain on the debt in determining net income over the 10-year period (although they may disagree on the timing of recognition) and that no exchange loss because of the weakening of the pound sterling should be recognized on the land, which is translated at the historical rate.

151. The Board can see no reason to base the calculation and recognition of exchange gains and losses solely on the dependence or independence of foreign operations. If the argument is sound that the net investment,

rather than individual assets and liabilities, is subject to exchange exposure, it is as sound for dependent as for independent foreign operations. To hold that an independent foreign operation is fundamentally different from a dependent operation raises questions about the propriety of consolidation for independent operations that, as already noted, are beyond the scope of this Statement (paragraph 144). In summary, the Board recognized that foreign operations may be structured differently but could find no persuasive reasons to translate their financial statements differently for purposes of consolidation or combination with financial statements of a U.S. reporting enterprise.

152. A modification of the situational approach to translation is the suggestion that to apply the current rate method to foreign operations located in highly inflationary economies (for example, some South American countries), the foreign statements first should be restated in terms of units of the general purchasing power of the local currency and then translated at the current rate because to do otherwise could produce unreasonable results in dollars. The Board believes that, even without the problem of identifying *highly inflationary* economies, restating part but not all of an enterprise's financial statements in units of general purchasing power mixes the units of measure used in the financial statements and results in an aggregation of numbers that cannot be meaningfully described except in terms of the procedures followed to obtain them. That is, adding units of general purchasing power (the unit of measure used in the restated foreign statements) translated at the current rate and units of money (the unit of measure used in conventional statements) produces a total that represents neither aggregate units of money nor aggregate units of general purchasing power. Moreover, to restate in units of general purchasing power only foreign statements in currencies that weaken against the dollar is to introduce a bias into the translated statements. According to its advocates, translation under the situational approach of all assets and liabilities at the current rate results in exchange losses on investments in countries with weakening currencies and exchange gains on investments in countries with strengthening currencies (paragraph 147). The proposed linking of translation at current rate and restatement in units of general purchasing power of foreign statements has the effect of reducing the exchange losses that normally result from translating net investments in countries with weakening currencies at the current rate while at the same time leaving undiminished the exchange gains that normally result from translating net investments in countries with strengthening currencies at the current rate.

Translation of Inventory

153. Numerous respondents to the Discussion Memorandum and Exposure Draft recommended that inventory carried at cost be translated at the current rate. Many of those recommendations were from supporters of the current rate or current-noncurrent methods. The Board rejected those methods for reasons given in paragraphs 129-139. Others argued or implied that inventory should be considered a monetary asset because it is but one step removed from accounts receivable and will soon bring cash into the enterprise. That view is rejected not only because inventory is a nonmonetary asset (paragraph 127) but also because the monetary-nonmonetary distinction is not an appropriate criterion in this Statement for choosing the applicable rate.

154. Several respondents who generally supported the monetary-nonmonetary or temporal methods recommended that inventory carried at cost—other than on a last in, first out (LIFO) basis—should be translated at the current rate. (Some respondents would apply the current rate to LIFO inventory.) The reasons they gave for that major exception to methods they otherwise supported was the need to reflect economic reality or the

impracticality of applying historical rates to inventories.

155. Certain advocates of the exception described in the preceding paragraph argued that translating inventory at historical rates distorts the dollar gross profit during an inventory turnover period after a rate change. Related arguments given for reflecting economic reality by using the current rate were that inventory is exposed to exchange risk the same as a receivable and that deducting cost of goods sold translated at historical rates from operating revenue translated at the current rate produces *inventory profits or paper profits* if the foreign currency strengthens.

156. Translating inventory carried at cost at the current rate departs from historical-cost-based accounting (paragraph 134). A desire to approximate replacement cost of inventory may underlie some arguments for using the current rate, which are similar to those used to support replacement cost methods. However, even if the use of replacement cost were presently acceptable in principle, translating inventory cost in foreign currency at the current rate does not, except by coincidence, give a reasonable approximation of replacement cost for reasons given in paragraph 148. Nor does that translation method measure the exposure of inventory to rate changes because the basis of the exposure risk is unrecorded. The exchange exposure of inventory depends on its future selling price, not on its cost.

157. Applying historical rates to inventory may result in a dollar gross profit on sales immediately after a rate change that differs from the dollar gross profit both on sales before the rate change and on sales after the inventory turnover period following the rate change. The Board believes that is the expected result of using the dollar as the unit of measure in concert with generally accepted accounting principles. That is, when selling prices change, matching historical costs of inventory with sales affects gross profit both in dollar statements of the parent company and in translated statements of foreign operations. For example, gross profit increases in the parent's statements if cost of inventory is deducted from sales after a selling price increase, resulting in so-called *inventory profits* from inflation. In other words, the phenomenon criticized is a feature of historical cost accounting; translation of inventory at historical rates does not introduce that feature.

158. The Board rejected in principle the proposal to translate inventory at the current rate for the reasons given in the preceding paragraphs. However, the Board recognized the practical aspects of applying historical rates to detailed inventory records and provided for the use of averages and other reasonable approximations as long as the result is not materially different from the result of following the standards of this Statement (paragraph 29). Translating all or part of an inventory at the current rate may under certain circumstances give a reasonable approximation of translation at historical rates.

Translation of Revenue and Expense Accounts

159. The Board believes that the transaction method, rather than the closing rate method, should be used to translate revenue and expense accounts because it satisfies an objective of translation adopted by the Board, namely, to measure all transactions in a single unit of measure (dollars).

160. The closing rate method, in contrast, is linked to the view that the foreign currency should be retained as the unit of measure, requiring at least two units of measure in an enterprise's financial statements. Translating

revenue and expenses at the closing rate retains the foreign currency as the unit of measure for transactions occurring during the year (including those previously reported for interim periods). If the rate changes, dollar translations of prior local currency transactions during the current year are restated (updated) to reflect the new dollar equivalents of the transactions, and no exchange gain or loss on the current year's transactions is separately recognized. Since the Board believes that the dollar, rather than the foreign currency, should be the unit of measure in translated statements, it rejected the closing rate method.

EXCHANGE GAINS AND LOSSES

Foreign Currency Transactions

161. The Board concluded that an exchange gain or loss shall be recorded when a rate change occurs because (a) when the rate changes, certain assets and liabilities should be adjusted to reflect the new rate (paragraph 7(b)), (b) the resulting gain or loss is not an adjustment of the cost of an asset acquired in a foreign purchase or of the revenue recorded in a foreign sale (that is, the Board rejected the so-called one-transaction view), and (c) other methods of deferring recognition of the gain or loss are also unacceptable (paragraphs 163-166).

162. The Board also concluded that the accounting treatment specified in paragraph 17 offers more practical implementation than does a one-transaction view. Current recognition of an exchange gain or loss does not require, as does the one-transaction view, the tracing of exchange gains or losses on foreign currency payables or receivables to related assets, revenue, or expenses. Another implementation problem under the one-transaction view is that a purchase or sale of goods or services may take place in one accounting period and an exchange gain or loss on the related payable or receivable may occur in a subsequent period.

163. Other alternative answers considered and rejected were (1) to record an exchange gain or loss when payables or receivables are settled, (2) to record an exchange gain or loss when the rate changes more than a specified percentage from the rate previously used, and (3) to record no gain or loss if the rate change is likely to reverse.

164The Board views an enterprise that holds foreign currency or has a receivable or a payable denominated in foreign currency as being in a special situation, namely, the enterprise is subject to a gain or loss solely as a result of a rate change. Accordingly, when the rate changes, an exchange gain or loss resulting from the adjustment of accounts denominated in foreign currency should be immediately included in the determination of net income to report properly the results of that situation at the time it occurs. Financial statement users are thus informed of the results of a rate change in the period of change rather than at conversion or settlement in a later period, which may be several years after the rate change for certain receivables and payables. Methods that involve amortizing exchange gains or losses also fail to recognize the effect of a rate change in the period of occurrence and are, therefore, also rejected (paragraphs 173-182).

165. The Board considered and rejected the possibility of recording exchange gains and losses only if the rate changes more than a specified percentage. The allowable percentage range chosen, within which rates might fluctuate without affecting the financial statements, would of necessity be arbitrary. A more serious weakness

in the proposal is that, since even a relatively minor change in rate can sometimes have a material impact on the financial statements, depending on the size of an enterprise's exposed position in the foreign currency, the method may ignore material effects of rate changes. Therefore, the Board concluded that the rate at the balance sheet date should be used.

166. The Board also considered and rejected the view that an exchange gain or loss should be deferred if the rate change that caused it is likely to reverse. The argument is that to recognize gains and losses from all rate changes in determining net income creates needless fluctuations in reported income by reporting exchange gains and losses that are cancelled by reversals of rate changes. The Board rejected the underlying argument and its implication for accounting (paragraphs 196-199). The proposal is also incapable of practical application. First, it requires distinguishing rate changes that will reverse from those that will not. Second, it requires predicting the changes in an enterprise's exposure to rate changes between the time of a rate change and the time of its reversal. And third, it requires an arbitrary time limit to prevent rate changes from being ignored indefinitely. The proposal contains no objective basis for accounting measurement.

Foreign Statements

167. In concept, exchange gains or losses from translating foreign statements are the direct effects, measured in dollars on existing assets and liabilities at the dates rates change, that are attributable solely to rate changes between the foreign currency and the dollar.

168. In practice, however, the exchange gain or loss is usually determined at the close of a period by translating both the ending balance sheet and income statement accounts at the rates required by the translation method (that is, current or historical rates for assets and liabilities and weighted average rate for most revenue and expenses). When the translation is completed and the net income less dividends in dollars is added to the beginning dollar balance of retained earnings, the sum of those amounts will usually not equal the ending dollar retained earnings shown in the translated balance sheet. The difference is the exchange gain or loss from translating foreign statements.

169. Applying the translation procedures for foreign statements (paragraphs 11-14) results in an appropriate measure in dollars of the net income of a foreign operation consistent with the objective of translation. However, the method in practice of calculating the exchange gain or loss from translating foreign statements, as described in paragraph 168, may sometimes include in exchange gains or losses other gains or losses from market price changes. For example, an enterprise that uses the dollar as its unit of measure acquires securities that it accounts for at current market price, and those securities' prices are stated in foreign currency. Since the cost of the securities acquired and subsequent changes in market price are recorded in dollars (not in foreign currency), following the procedures required by paragraphs 7(a) and 7(c), the accounting does not produce *exchange gains and losses* as described in paragraph 16. In the Board's view, it is unnecessary in measuring and recording transactions and events in dollars to distinguish between the effect of changes in the foreign market price of a security and changes in the market price of the foreign currency itself, even if that distinction can be made. To meet the objective of translation (paragraph 9), the same result should be obtained in translating similar securities presented in foreign statements. However, the averaging and approximations permitted by this Statement can result in exchange gains and losses that include gains and losses properly attributable to other

revenue and expense accounts. The procedures that would be required to segregate those *other* gains and losses from exchange gains and losses for purposes of this Statement's disclosure requirements (paragraph 32) may not be practical. The Board accepted as reasonable the results determined by applying the requirements of paragraphs 11-14 by the procedures described in paragraph 168.

170. Some respondents to the Exposure Draft suggested that certain enterprises that carry investments in securities at current market price but do not include unrealized gains or losses on those investments *in the determination of net income* should be exempt from the requirement of paragraph 17 to include in the determination of net income *exchange* gains and losses relating to those investments.

171. The Board concluded that if unrealized appreciation or depreciation on investments is measured in dollars, the translation procedures required by this Statement do not produce exchange gains or losses that pertain thereto. Accordingly, the Board concluded the *exemption* for those enterprises was not necessary.

172. The Board considered the following possible methods to account for exchange gains or losses in arriving at its conclusion stated in paragraph 17:

- a. Adjust cost of, or amortize over life of, assets carried at cost in dollars (assets translated at historical rates);
- b. Amortize over remaining term of long-term liabilities;
- c. Adjust stockholders' equity;
- d. Defer based on certain criteria;
- e. Include immediately in the determination of net income.

Adjustment Related to Assets Carried at Cost

173. One view to support accounting for exchange gains and losses as adjustments of the cost basis of assets is that the cost of an asset equals the total sacrifice required to discharge all related liabilities. Accordingly, if a foreign operation has an exposed net liability position at the time of a rate change, the exchange gain or loss is an element of the cost of the related assets. That view is similar to a one-transaction perspective and is rejected for reasons similar to those in paragraphs 114 and 115.

174. Another view is that an exchange loss that results from the combination of the strengthening of a foreign currency and an exposed net liability position is considered *covered*, in whole or in part, by assets carried at cost in foreign currency. *Cover* is the amount by which the foreign currency cost of those assets translated at the current rate exceeds their cost translated at historical rates (their cost in dollars). According to the argument, the *covered* loss should be deferred rather than included in determining net income when the rate changes. The reduction in income over the lives of the assets from amortizing the deferred loss on the net exposed liability position is considered to be at least offset by the effect of depreciation based on lower historical translation rates (*lighter costs*) that will be deducted over the assets' lives from revenue (received in cash or receivables from sales) translated at the higher current rate.

175. Likewise, an exchange gain that results from the combination of the weakening of a foreign currency and an exposed net liability position should be deferred under the *cover* approach to the extent required to offset the

unrecognized potential loss on the assets translated at the historical rate. The potential loss represents the difference between translating the foreign currency costs of the assets at the higher historical rates and translating them at the lower current rate. The cover approach views translating the assets at historical rates as speculation about the assets' ability to produce a product that will sell for an increased foreign currency selling price which, when translated at the lower current rate, will sufficiently cover the historical dollar cost of the assets. Amortization of the deferred gain over the life of the assets is, therefore, considered appropriate to offset the effect of depreciation based on higher historical rates (*heavier cost*) to be included in determining net income of later periods.

176. The Board rejected the cover approach because it is essentially a procedure whereby a change that has occurred in the dollar measure of liabilities is deferred to be offset against a *potential* change in the future dollar value of assets carried at cost. That potential dollar value of the assets depends on foreign currency proceeds from sale or other disposition of the assets. Since changes in the values of assets carried at cost (for example, property, plant, and equipment) are not normally recognized under generally accepted accounting principles until the assets are sold, offsetting is accomplished under the cover approach by *not* including immediately in the determination of net income gains or losses on changes in the dollar measure of liabilities denominated in foreign currency. The argument for deferral is in effect that changes in the dollar measure of one item should not be recognized because changes in the dollar value of another item are not recognized. However, the Board believes that offsetting of that type is not proper under present generally accepted accounting principles that recognize certain gains and losses only at time of sale or other disposition. If offsetting is desirable at all, it should be accomplished by changing generally accepted accounting principles to recognize changes in the dollar value of items now carried at cost. However, to do so would require reconsideration of historical cost as a fundamental concept of accounting—a process that is beyond the scope of this Statement.

177. The questionable result of offsetting recognizable gains and losses from changes in the dollar measurements of liabilities denominated in foreign currency against unrecognizable increases in the values of assets carried at cost in foreign currency is highlighted if the liability is paid but the asset remains unsold. For example, a rate change from $FC1 = \$1$ to $FC.80 = \$1$ occurs while a foreign operation has an exposed net liability position of FC80 and a depreciable asset with an undepreciated cost of FC100 and a remaining life of five years. The \$20 loss on the exposed net liability position ($FC80 * .80 = \$100$; $\$100 - \$80 = \$20$) is *covered* because the foreign currency cost of the asset translated at the current rate (\$125) exceeds the cost translated at the historical rate (\$100) by \$25, which is \$5 more than the loss on the liabilities. Thus, under the *cover* approach, the full \$20 loss can be deferred and amortized over the remaining five-year life of the asset. Using straight-line depreciation and amortization, the expense for each of the succeeding five years is \$24 (\$20 depreciation based on cost translated at the historical rate plus \$4 amortization of the deferred loss). The added expense (\$4 amortization of the deferred loss) is said to be necessary to offset the effect of matching *light* depreciation expense translated at historical rates against foreign currency revenue translated at the higher rate after the rate change.

178. If, however, all liabilities outstanding at the time of the rate change are settled by the end of the second year, the loss has occurred, even to the satisfaction of those who believe that exchange gains and losses are *unrealized* until payment of liabilities and collection of receivables (paragraph 188). However, the result that is

said to justify the *cover* approach—matching of the increased expense from adding the annual amortization of the deferred loss against the increased revenue from translating current sales at the new higher rate—cannot be achieved unless the loss is deferred and amortized after it has been *realized*.

179. The *cover* approach appears to be based on the presumption that a rate change may be expected to affect future earnings in a way that offsets an exchange gain or loss related to an exposed net liability position. The Board believes that future impacts of rate changes should be reflected in the future and not anticipated by deferring an exchange gain or loss.

180. Another apparent assumption of the *cover* approach is that future revenue generated by the assets carried at cost will be in the same currency as the exposed net liability position. That may not be valid for many foreign operations.

Adjustment Related to Life of Long-Term Liabilities

181. Another method that has been suggested would limit deferral of exchange gains or losses from an exposed net liability position to amounts associated with long-term liabilities denominated in foreign currency. The amount deferred would be amortized over the remaining term of the long-term liabilities, in effect accounting for the deferred exchange gain or loss as an adjustment of financing costs (interest expense). The Board rejected the method because of the Board's basic view (stated in paragraph 164) that the gain or loss results solely from the rate change and to recognize it in other periods obscures what has occurred. Furthermore, the method masks the economic difference in the source (denomination) of financing. That is, foreign currency denominated debt has an exchange exposure that dollar denominated debt or equity financing does not. Spreading the result of the exposure over the future rather than recognizing it in full when a rate changes fails to contrast an economic difference between financing denominated in foreign currency and dollar borrowings or equity financing.

182. The Board considered the argument that management assesses the likelihood of rate changes and differences in interest rates between countries in deciding to borrow foreign currency rather than dollars or one foreign currency rather than another and that all or part of the effect on long-term debt of a rate change is, therefore, an added or reduced cost of borrowing a particular foreign currency. The Board does not deny that management may assess borrowing alternatives in that manner. To be consistent with that view, though, would require interest accruals over the life of the borrowing at the anticipated effective interest rate. However, the Board concluded that it is inappropriate to attempt to account currently for the expected effect of future rate changes on interest and principal payments. The Board also concluded that adjusting translated long-term debt by the amount of the related exchange gain or loss at the time of a rate change and spreading that gain or loss as an adjustment of interest expense subsequent to the rate change does not produce a result consistent with the expected effective interest rate at the date of the borrowing even if the expectations about rate changes at the time of borrowing are realized. Therefore, the Board rejected the proposal.

Adjustment to Stockholders' Equity

183. Certain respondents to the Discussion Memorandum and Exposure Draft suggested that exchange gains

or losses be accounted for as adjustments of stockholders' equity. The Board rejected that method because it believes that a gain or loss resulting from an exposure to rate changes should be included in the determination of net income in accordance with the all-inclusive income statement presently required of most enterprises by generally accepted accounting principles. A foreign investment exposes a U.S. company to the effects of rate changes which can be economically beneficial or detrimental. The Board believes that those benefits or detriments should be reflected in the determination of net income at a time and in a manner that is consistent with generally accepted accounting principles.

Deferral Based on Certain Criteria

184. The following criteria were suggested for deferring exchange gains or losses:

- a. Realization;
- b. Conservatism;
- c. Likelihood of reversal of rate change;
- d. The effect on future income of rate change.

185. It was suggested that exchange gains or losses be deferred based on the criterion of realization. Realized gains and losses should be recognized immediately while unrealized gains and (possibly) losses should be deferred until realized. Chapter 12 of *ARB No. 43* permitted different accounting treatment for *realized* and *unrealized* exchange gains and losses but gave no guidance on how to distinguish them. In the Board's view, the distinction between *realized* and *unrealized* exchange gains and losses is a questionable concept for the purpose of translation as well as a difficult concept to implement.

186. The concept of realization usually applied in accounting pertains to conversions of other assets into cash or receivables. It usually applies to conversion of inventory but is also applied to assets such as marketable securities, property, plant, equipment, and certain intangible assets. A sale of an asset is the most common basis of realization in accounting.

187. That meaning of realization is preserved if transmission of funds (for example, dividends) from a foreign operation to a domestic operation is the event that determines *realization* of exchange gains and losses from translating foreign statements, but that narrow view of realization is not particularly useful. First, it is questionable how transmission of funds causes an exchange gain or loss to be realized. For example, an exchange gain that results from translating a foreign operation's exposed net liability position cannot be reasonably associated with a dividend remittance. Likewise, an exchange gain that results from translating a foreign operation's exposed net asset position that primarily reflects accounts receivable cannot be reasonably associated with a dividend remittance if the foreign currency collected on settlement of the receivables is used to purchase other assets. Second, if remittance of dividends is the criterion for realization in translation of foreign statements, all of a foreign operation's unremitted earnings must be considered *unrealized*. That interpretation requires investments in foreign operations to be carried at cost and largely invalidates consolidation of foreign operations. It therefore is rejected.

188. The suggestion by some respondents to the Discussion Memorandum and Exposure Draft that realization

of exchange gains and losses should be based on spending cash, collecting receivables, and paying liabilities is the opposite of the usual concept of realization, namely, converting assets into cash or receivables. Converting cash into other assets is usually called a *purchase* and does not constitute realization in any accepted sense of the word. Moreover, it is generally impracticable to determine whether or not a given transaction converts a previously unrealized gain or loss into a realized gain or loss. Under the proposed realization test, not all collections of receivables or payments of liabilities are bases of realization but only collections or payments of receivables and payables that were in existence at the date of a rate change. Similarly, not all cash spent realizes previously unrealized exchange gains or losses but only the spending of cash held at the time of a rate change. The problem was complicated when rate changes were official devaluations or revaluations. Floating rates increase the complexity. The Board believes that attempting to base realization of exchange gains and losses on cash disbursements and collections and settlements of receivables and payables would involve unreasonable effort to make a distinction between realized and unrealized gains or losses for which the Board sees no theoretical justification.

189. Another suggestion is that unrealized exchange gains should be deferred based on the criterion of conservatism. The Board believes that although the concept of conservatism may be appropriate in other areas of accounting, its application to exchange gains and losses is inappropriate.

190. Conservatism is a way of dealing with uncertainty and is intended to avoid recognizing income on the basis of inadequate evidence that a gain has occurred. The Board believes that a rate change in a foreign exchange market provides sufficient objective evidence of the occurrence of a gain or loss to warrant changes in the dollar carrying amounts of cash, receivables, payables, and other assets and liabilities measured in foreign currency at current or future prices. To defer an exchange gain *solely because it is a gain* in effect denies that a rate change has occurred. Thus, the Board believes that even if it were feasible to identify unrealized gains, to defer recognition of unrealized exchange gains while recognizing unrealized exchange losses is an unwarranted inconsistency in translation.

191. The inconsistency of deferring an exchange gain while recognizing an exchange loss is further illustrated by translation of two accounts receivable from the same customer, one from a sale just before a rate change and the other from a sale just afterwards. Both receivables are translated at the new rate after the rate change and are, therefore, treated as comparable. If the foreign currency weakens against the dollar, the *unrealized* exchange loss on the earlier receivable is recognized to be conservative. Otherwise, the deferral of the loss would have the effect of increasing the dollar measure of the receivable to the same amount as before the rate change. If, however, the foreign currency strengthens against the dollar, the *unrealized* exchange gain on the same receivable is deferred, again to be conservative. But the effect of deferring the gain is to reduce the dollar measure of the receivable to the same amount as before the rate change. Therefore, the earlier receivable is no longer treated as comparable to the later one. Moreover, the inconsistency is unwarranted because the dollar measure of the earlier receivable is as objectively determinable as that of the later receivable.

192. The Board rejected the recommendation that exchange gains or losses be deferred if rates are likely to reverse. That proposal is often a part of both the realization and conservatism proposals because those proposals are often based on arguments that gains should not be recognized because the related rate change

might reverse *before the gain is realized*. But the proposal to defer if rates are likely to reverse raises separate issues because it depends on predicting rate changes in the future (paragraph 166). Given the high degree of unpredictability of exchange rates, the proposed method creates a situation in which operating results are misstated simply through errors in forecasting. A procedure of that type invariably causes divergent decisions about the movements of rates. In addition, to determine how much of an exchange gain or loss will be reversed when the rate change reverses necessitates a forecast of the financial position at the time of the later rate change, which may be another extremely uncertain variable. In the Board's judgment, the proposal is not practical.

193. Another recommendation proposed is that accounting for exchange gains or losses vary depending on the likely effect of rate changes on future income. As pointed out in paragraph 107, the future effects of rate changes may vary widely, and the effects are uncertain. The Board believes it inappropriate to inject forecasting of future effects into the accounting for exchange gains or losses.

Additional Factors Considered

194. An additional factor in the Board's decision to include exchange gains or losses in the determination of net income at the time of a rate change is that deferral approaches generally raise significant questions of implementation. For example, should amounts deferred be determined on a global basis, currency-by-currency, country-by-country, foreign-operation-by-foreign operation, or some other basis? If exchange gains or losses are aggregated on a global basis, most suggested amortization approaches become exceedingly complex, if not impractical, for a company with numerous foreign operations to apply. Not aggregating on a global basis can result in exchange gains being included in the determination of net income at the time of a rate change and exchange losses being deferred, or vice versa, depending on the deferral method employed.

195. Another factor that supports including exchange gains or losses in the determination of net income at the time of a rate change is that after a rate change operating revenue (other than amortization of deferred income) as well as other cash receipts and disbursements are translated at the current rate. To recognize the effect of a rate change on current transactions (by reporting in the translated statements an increased or decreased dollar equivalent for the transactions) when they occur and yet defer the effect of a rate change on past unsettled transactions (for example, receivables from previously reported sales) places the enterprise in the anomalous position of having recognized the entire effect of the rate change on a recent transaction while holding in suspense its effect on a previous transaction.

Rate Changes and Earnings Fluctuations

196. Many respondents to the Discussion Memorandum and Exposure Draft commented that to include exchange gains and losses in determining net income when rates change would distort reported net income or otherwise confuse readers of the financial statements. Some of those arguments were based on the assumption that rate changes would reverse. Some respondents to the Exposure Draft presented examples showing how application of the proposed standard would have caused reported income to fluctuate in recent years. Since many of the rate changes did reverse, those comments, based on hindsight, argued that the proposed standard would have caused unnecessary fluctuations in their reported net income.

197. The Board's view has previously been indicated regarding the assumption that rate changes will reverse

(paragraphs 166 and 192).

198. In addition, the Board rejected the implication that a function of accounting is to minimize the reporting of fluctuations. Past rate changes are historical facts, and the Board believes that users of financial statements are best served by accounting for the changes as they occur. It is the deferring or spreading of those effects, not their recognition and disclosure, that is the artificial process (see *FASB Statement No. 2*, "Accounting for Research and Development Costs," paragraph 54, and *FASB Statement No. 5*, "Accounting for Contingencies," paragraphs 64 and 65).

199. In the Board's opinion, readers of financial statements will not be confused by fluctuations in reported earnings caused by rate changes. That view was supported by comments of financial analysts who said they preferred to have exchange gains and losses accounted for when rates change. Exchange rates fluctuate; accounting should not give the impression that rates are stable.

INCOME TAX CONSEQUENCES OF RATE CHANGES

200. The Board concluded that if an exchange gain or loss related to a foreign currency transaction of a foreign operation is taxable in the foreign country, the related tax effect shall be included in the translated income statement when the rate change occurs. Inclusion is appropriate regardless of the fact that the foreign operation's exchange gain or loss may be partially or completely (for a dollar denominated asset or liability) eliminated upon translation, because the rate change is the event that causes the tax effect in the foreign operation's financial statements. The fact that the exchange gain or loss does not exist (or exists only partially) in dollars should in no way affect the accounting for the tax effect, which does exist in dollars.

201. A method has been proposed for measuring exchange gains or losses resulting from translating foreign statements that in effect would correct what some might consider an erroneous relationship of translated tax expense to translated pretax income. Following the proposal, the exchange gain or loss would include the future tax effect in the translated financial statements of using the historical rate for translating inventory, plant, and equipment. The resulting deferred tax accounts would be amortized as an adjustment of tax expense as inventory and fixed assets are charged against operations.

202. In the Board's opinion, the use of historical rates to translate certain income or expense items (for example, cost of goods sold and depreciation) does not require interperiod tax allocation. Timing differences, defined as "differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income" (paragraph 13(e) of *APB Opinion No. 11*), do not arise from translating assets or liabilities at historical rates. Accordingly, the effective tax rate in the translated dollar statements may differ from the effective tax rate in the foreign statements. Applying historical rates may also change various other relationships in the translated dollar statements from those in the foreign statements (for example, gross profit percentages). However, the Board believes that is the expected result of using the dollar as the unit of measure in concert with generally accepted accounting principles.

203. The Board concluded that the existing authoritative literature (*APB Opinions No. 11, 23, and 24*)

provides sufficient guidance about whether deferred taxes should be recognized for exchange gains or losses that result from applying the requirements of this Statement. *APB Opinions No. 23 and 24* apply because exchange gains and losses from translation of foreign statements are an integral, *Par.* of measuring in dollars the undistributed earnings of foreign subsidiaries and investees.

FORWARD EXCHANGE CONTRACTS

204. A forward contract is an agreement to exchange at a specified future date currencies of different countries at a specified rate (the *forward rate*). The purpose of a forward contract may be to hedge either a foreign currency commitment or a foreign currency exposed net asset or net liability position or to speculate in anticipation of a gain.

Hedge of Foreign Currency Exposed Net Asset or Net Liability Position

205. The Board concluded that if a forward contract is intended to hedge an exposed foreign currency position, the gain or loss on the forward contract (determined by the method specified in paragraph 25) shall be included in determining net income currently. To recognize the gain or loss only at maturity of the contract could result in benefiting (penalizing) one period's income by recognizing an exchange gain (loss) resulting from the translation process currently to the detriment (benefit) of a later period's income when a loss (gain) on the forward contract is recorded.

Speculative Contract

206. An enterprise that uses a forward contract to speculate exposes itself to risks from movements in forward rates. Therefore, for reasons similar to those expressed in paragraphs 164-166, the Board concluded that the gain or loss on the forward contract (determined by the method stated in paragraph 26) shall be included in determining net income currently as the value of the contract changes.

Hedge of Identifiable Foreign Currency Commitment

207. Although the Board rejected the one-transaction approach as a general basis for translation of foreign currency transactions (paragraphs 114 and 115), it decided (for the reasons given in paragraphs 116-118) that the dollar basis of a foreign currency transaction shall be established at the transaction date. By rejecting the commitment date as the date for making that determination, the Board implicitly accepted a one-transaction view for an unrecorded future foreign currency transaction (that is, a commitment in foreign currency) for the period from the commitment date to the transaction date. In other words, the effects of rate changes between commitment date and transaction date are not separately identified and accounted for as exchange gains or losses; rather, they are included in the dollar basis of the transaction.

208. A number of respondents to the Exposure Draft opposed current recognition in income of the gain or loss on a forward contract intended to hedge a future foreign currency transaction. In their view, the exposure to rate changes during the commitment period could (or should) be hedged by a forward contract, even though the accounting does not separately recognize the exposure on the commitment. They believe that to include a gain or loss on a forward contract that hedges a commitment in determining net income when rates change rather

than to include the gain or loss in the dollar basis of the related transaction could benefit (penalize) one period's income to the detriment (benefit) of a later period's income. For example, a U.S. enterprise contracts with a U.S. customer to sell for \$1,000,000 certain equipment to be delivered in 18 months. At the same time the enterprise enters into a firm, uncancelable commitment with a foreign company to manufacture the specified equipment for FC900,000 (equal to \$900,000 at the existing current rate). Simultaneously, the enterprise enters into a forward contract to receive FC900,000 in 18 months. By so doing, the enterprise is viewed as having fixed its gross profit on the transaction at \$100,000 (ignoring premium or discount on the forward contract). If at a balance sheet date between the commitment date and the anticipated transaction date for receipt of the equipment, the spot rate has changed from $FC1 = \$1$ to $FC1 = \$1.07$, a gain of \$63,000 exists on the forward contract. However, the dollar price of the equipment has also increased \$63,000. If the gain on the forward contract is not deferred, the gross profit of the sale when recorded will be \$37,000 rather than \$100,000. Since the enterprise's intent on entering into the forward contract was not to speculate in the forward market but to fix the equipment's dollar cost at \$900,000 and thus fix the gross profit at \$100,000, those respondents argued that the gain on the contract should be deferred until the transaction date. On further consideration, the Board concluded that gains or losses on forward contracts that meet the conditions stated in paragraph 27 shall be deferred until the date the commitment is recorded (that is, the transaction date). The deferred gain or loss shall then be included in the dollar basis of the transaction.

209. The requirements in this Statement for measuring gains or losses on forward contracts represent a modification of the requirements proposed in the Exposure Draft. That draft proposed accrual of the difference between the original market value of an unperformed forward contract (zero) and its current market value. Stated another way, the difference between the contracted forward rate (or the forward rate last used to measure a gain or loss on the contract) and the forward rate available for the remaining maturity of that forward contract multiplied by the amount of the forward contract is a gain or loss to be included in determining net income.

210. Certain respondents to the Exposure Draft questioned valuing a forward contract at current market value if the intent is to hold the contract to maturity to hedge a foreign currency receivable or payable. In their view, it is inconsistent to value, for example, a two-year contract at a forward rate because it is a forward contract and translate at the current rate the two-year foreign currency payable that is hedged.

211. The Board concluded that a gain or loss on a forward contract shall be determined on a basis consistent with management's intent for entering into the contract. That is, the results of a speculative forward contract should be determined by changes in its market value; the results of a forward contract intended to hedge an identifiable foreign currency commitment or exposed net asset or net liability position should be accounted for in a manner consistent with the accounting for the related exposure. Therefore, the Board specified the procedures in paragraphs 23-26.

212. An alternative approach for a forward contract intended to hedge a specific foreign currency transaction for the period between transaction date and settlement date is to use the rate in the forward contract rather than the spot rate at the transaction date to establish the related amounts payable or receivable. Although a forward contract may limit or eliminate exposure on a payable or receivable denominated in foreign currency, the Board views such a forward contract as an independent transaction that should be accounted for separately. It also

believes that the original discount or premium on a forward contract normally reflects an interest rate differential between two countries which should be recognized over the life of the contract if the contract hedges a foreign currency exposed net asset or net liability position. Further, since specific identification of individual forward contracts with related unsettled foreign currency transactions may not be readily ascertainable, the procedures specified by paragraph 23 are a more practical approach.

DISCLOSURE

213. In reaching its conclusion regarding disclosures, the Board considered disclosures required by *FASB Statement No. 1* as well as additional possible disclosures presented in the Discussion Memorandum.

214. Since this Statement specifies a single accounting method for foreign currency translation, the Board concluded that the disclosure requirements as stated in *FASB Statement No. 1* are no longer appropriate.

215. Paragraph 32 herein requires disclosure of the aggregate exchange gain or loss included in the determination of net income for the period. An exchange gain or loss does not measure, nor is it necessarily an indicator of, the full economic effect of a rate change on an enterprise. The disclosure required by paragraph 32 provides information to users of financial statements about the effects of rate changes on certain assets and liabilities which may be useful in evaluating and comparing reported result of operations.

216. A few respondents to the Exposure Draft suggested that some components of the aggregate exchange gain or loss (for example, gains and losses on unperformed forward exchange contracts) be separately disclosed. The Board concluded that since enterprises often manage and hedge their exchange exposure on an overall basis, separate disclosure of any of the components, particularly gains or losses on forward exchange contracts, should not be required.

217. Disclosure of gains or losses on forward exchange contracts that are deferred in accordance with paragraph 27 is not required by paragraph 32. The Board reasoned that those gains or losses are, in effect, offset by unrecorded exchange losses or gains on the related foreign currency commitments; therefore, separate disclosure would be inappropriate.

218. The Exposure Draft (paragraph 20) contained a proposed requirement that the aggregate amount of tax effects related to exchange gains or losses be disclosed. Some respondents to the Exposure Draft explained certain difficulties in determining the tax effects and pointed out that disclosure of tax effects might imply that the gain or loss was *extraordinary*—an implication contrary to the requirement of paragraph 23 of *APB Opinion No. 30* that exchange gains or losses not be reported as extraordinary items. Other respondents suggested that other accounting pronouncements already required explanations of unusual tax effects (for example, *APB Opinion No. 11*, paragraph 63). The Board concluded that those comments had merit, and, therefore, this Statement does not require disclosure of the tax effects of exchange gains or losses.

219. Certain respondents to the Exposure Draft proposed an exemption from the disclosure requirements of paragraph 32 for certain enterprises whose principal business purpose is investing in foreign securities and that

present those investments at current market price (determined by applying the current rate to the market price of securities traded and quoted in foreign currency). They argued that it is impracticable and of questionable usefulness for those enterprises to attempt to isolate the portion of the change in market price measured in dollars that arises from rate changes from the portion that arises from changes in foreign currency market prices.

220. The Board concluded that *exemption* for those enterprises was not appropriate because the segregation described in paragraph 219 is not intended by paragraph 32 of this Statement (and was not intended in paragraph 20 of the Exposure Draft). Exchange gains and losses as described in paragraph 16 do not include the effects of rate changes on assets (other than those denominated in foreign currency) carried at current prices measured in dollars. However, those effects should be considered, if practicable, in providing the disclosures required by paragraph 33 (see paragraph 223).

221. Some respondents to the Exposure Draft stated that disclosing the exchange gain or loss from an exposed net liability position when the foreign currency strengthens would give the wrong signal (a loss) because the rate change is expected to have future beneficial effects. In the Board's opinion, an exchange gain or loss neither is nor should be a signal of the direction of future operating results. An exchange gain or loss merely reflects the effect of a rate change on a given financial position at a specific time. Other respondents indicated that other effects of rate changes on reported results of operations should be disclosed in addition to the disclosure of exchange gains or losses.

222. The Board acknowledges that more information than disclosure of exchange gains or losses is needed for an understanding of the effects of rate changes on the operating results of an enterprise. Therefore, it modified paragraph 21 of the Exposure Draft in paragraph 33 of this Statement.

223. Paragraph 33 of this Statement requires that, if practicable, the effects of rate changes on reported revenue and earnings be described and quantified. The Board concluded that a practicability qualification was necessary. As indicated in paragraph 107, it may be difficult or impossible to quantify the economic effects of rate changes (for example, on selling prices, sales volume, and cost structures). In the Board's opinion, disclosing only the mathematical effects of translating revenue and expenses at rates different from those used in a preceding period could be misinterpreted if other significant direct and indirect economic effects of rate changes on operations are not considered and disclosed. Thus, the Board concluded that since the effect of rate changes on revenue and earnings cannot always be measured with sufficient precision, it could not require disclosures of that type in all financial statements. The Board noted, however, that some companies have disclosed certain information (not necessarily in financial statements) that might be interpreted as showing the effect of rate changes on revenue and earnings. The Board's intention is to encourage disclosures of that kind if, in the opinion of management, they provide useful information. The Board believes that if that information is disclosed in financial statements, a clear explanation of the methods and underlying assumptions used to determine the amounts is also essential, as required by paragraph 33 of this Statement.

224. The Board believes that management can best decide how information about the effects of rate changes on revenue and earnings should be described or quantified. The nature and extent of foreign currency transactions or foreign operations of enterprises vary, and that which is possible or appropriate for one enterprise

may not be possible or appropriate for others. The purpose of disclosure of the effect of rate changes in addition to exchange gains and losses is to assist financial statement users in understanding the financial effects of rate changes on the reported results of operations. Disclosing only exchange gains and losses if rate changes significantly affect reported revenue and earnings in a way or to an extent that can be determined would not, in the view of the Board, comply with the intent of paragraph 33 of this Statement. The disclosures urged by that paragraph are not forecasts, but rather descriptions and estimates of the effect on reported results of operations of rate changes that the Board believes will assist users in comparing recent results with those of prior periods.

225. Some respondents requested clarification of the circumstances requiring an enterprise's financial statements to be *adjusted* for a change in rate subsequent to the date of the financial statements. The Board concluded that financial statements should not be adjusted for rate changes after their date; however, disclosure may be necessary (paragraph 34). If the estimated effect of a rate change is disclosed, the disclosure should include consideration of changes in financial position from the date of the financial statements to the date the rate changed. The Board recognizes that in some cases it may not be practicable to determine the changes in financial position; if so, that fact should be stated.

226. The disclosure of geographical, or otherwise segmented, information on foreign operations is being considered in the FASB project, "Financial Reporting for Segments of a Business Enterprise.

EXCHANGE RATES

Multiple Rates

227. The Board concluded that if multiple rates exist, the rate to be used to translate foreign statements should, in the absence of unusual circumstances, be the rate applicable to dividend remittances. Use of that rate expresses results of operations in dollars in a more meaningful way than any other rate because the earnings can be converted into dollars only at that rate. Further, in translating an asset carried at a current price, the dividend rate measures the dollar amount that might be realized from sale of the asset and remittance of the proceeds and thereby establishes the asset's value in dollars. In translating an asset carried at cost, the dividend rate at the time the asset was acquired measures the sacrifice made by the parent in foregoing a remission of the local-currency cost of the asset and thus establishes the asset's dollar cost.

228. The dividend rate measures the dollar sacrifice in all situations, including those involving multiple rates in which the foreign operation purchased an imported asset at a preferential or penalty rate. Before being used to pay for the imported asset, the local currency cash with which payment is made is translated at the dividend rate. That rate thus measures the translated cost of the asset. If the preferential or penalty rate, whichever applies, were used to translate the local currency cost of the asset, its translated cost would not represent the dollar sacrifice made.

Differing Balance Sheet Dates

229. If foreign statements of an operation are as of a date different from that of the enterprise and are combined or consolidated with or accounted for by the equity method in the financial statements of the

enterprise, the Board concluded that for purposes of applying the requirements of this Statement, the current rate is the rate in effect at the foreign operation's balance sheet date. The use of that rate is necessary to present dollar measurements as of that date.

230. Some respondents to the Exposure Draft questioned that conclusion. In their view, use of a foreign operation's financial statements as of a date that differs from that of the enterprise's financial statements is justified only on the basis that those financial statements approximate financial statements as of the enterprise's year-end. Accordingly, they argue, the current rate should be the rate in effect at the date of the enterprise's financial statements, not the rate at the date of the foreign operation's financial statements.

231. Paragraph 4 of *ARB No. 51, "Consolidated Financial Statements,"* states:

A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation. It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, statements for a period which corresponds with or closely approaches the fiscal period of the parent. However, where the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary's statements for its fiscal period; when this is done, recognition should be given by disclosure or otherwise to the effect of intervening events which materially affect the financial position or results of operations.

Similarly, paragraph 19(g) of *APB Opinion No. 18* states:

If financial statements of an investee are not sufficiently timely for an investor to apply the equity method currently, the investor ordinarily should record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting should be consistent from period to period.

232. Reconsideration of *ARB No. 51* and *APB Opinion No. 18* was not within the scope of the project that led to the issuance of this Statement. Accordingly, the Board neither accepted nor rejected the view expressed in paragraph 230. However, the Board believes that if that view is appropriate, the determination that the operation's financial statements at other than the enterprise's year-end are reasonable approximations of its financial statements as of the enterprise's year-end should be based on dollar measurements (translated statements) and not local currency measurements (foreign statements). Using as the current rate a rate at a date other than the foreign operation's balance sheet date could produce translated financial statements that are not in accordance with the requirements of this Statement. For example, if between the date of the foreign operation's financial statements and the date of the enterprise's financial statements there have been changes in the foreign currency measure of the foreign operation's financial position (that is, total assets and total liabilities) or the components thereof (for example, cash and inventory), including changes that may have occurred in anticipation of a significant rate change, using the rate as of the enterprise's financial statements will not result in financial statements for the foreign operation that reflect dollar measures of financial position and results of operations as of either date.

233. Certain respondents to the Exposure Draft expressed another view opposing the Board's conclusion. In their view, using as the current rate a rate at other than the enterprise's balance sheet date raises implemental issues in eliminating intercompany transactions if the rate has changed during the intervening period. The Board believes that those implemental problems are similar to other implemental problems caused by intercompany transactions within the intervening period and, therefore, apparently can be accommodated in the consolidation, combination, or equity accounting process.

234. Another opposing view expressed in response to the Exposure Draft was that using as the current rate the rate in effect at the foreign operation's balance sheet date rather than the rate in effect on the date of the enterprise's balance sheet would be contrary to the principle underlying *FASB Statement No. 5*, "Accounting for Contingencies," if an intervening rate change resulted in an exchange loss. According to that view, the rate change causes an asset to be impaired or liability incurred, and the amount of the loss is known as of the date of the enterprise's balance sheet. The Board believes that if foreign statements are as of a date other than the balance sheet date of the enterprise, the terminology "date of the financial statement" as used in paragraph 8(a) of *FASB Statement No. 5* refers to the end of the most recent accounting period for which foreign statements are being combined, consolidated, or accounted for by the equity method.

235. The Board believes that rate changes subsequent to the date of a foreign operation's balance sheet are similar to those subsequent to the date of an enterprise's balance sheet. Disclosure may be necessary, but the financial statements should be adjusted (paragraph 34).

DEFERRED INCOME TAXES

236. The procedures set forth in this Statement (paragraph 50) for determining the amount of deferred taxes in a translated balance sheet represent a modification of the procedures proposed in the Exposure Draft. That draft proposed that all deferred tax charges or credits be translated at historical rates.

237. Certain respondents to the Exposure Draft questioned translation at historical rates if the *net change* method of deferred tax allocation is followed. In their view, use of historical rates requires that originating and reversing timing difference be distinguished for translation purposes—a requirement that is inconsistent with the *net change* method. Under the *net change* method, a single computation is made at the *current* tax rate for the net effect of both originating and reversing differences occurring during a period relating to a particular group of similar timing differences. The method results in a balance of deferred taxes that is a residual, that is, the difference between the deferred taxes originally recorded and subsequent reduction of deferred taxes at different tax rates as timing differences reverse.

238. Other respondents to the Exposure Draft questioned translation at historical rates of deferred income tax charges or credits applicable to timing difference on items translated at the current rate. In their view, that approach does not result in proper dollar measures of deferred tax charges and credits relating to timing differences.

239. The Board considered those views and the objective of translation (paragraph 6) and concluded that the procedures set forth in paragraph 50 should be followed. The Board believes that those procedures result in deferred tax charges and credits in a translated balance sheet that are consistent with the requirements of *APB Opinion No. 11* and the objective of translation.

EFFECTIVE DATE AND TRANSITION

240. The Board concluded that because of the various methods of translation or of recognition of exchange gains and losses now followed in practice and because of the complex nature of the translation process, a prospective method of transition is not feasible. The Board considered whether the transition should be by prior period restatement or by cumulative effect adjustment (the method specified in the Exposure Draft). The Board concluded that prior period restatement is the preferable method to provide useful information about foreign currency transactions and foreign operations for purposes of comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.

241. The Board recognizes, however, that the procedures called for by this Statement may sometimes differ significantly from procedures followed in previous periods. In addition, restatement requires the availability of records or information that an enterprise may no longer have or that its past procedures did not require. Therefore, if the effect of the restatement on all individual periods presented cannot be computed or reasonably estimated, the cumulative effect adjustment method shall be used in accordance with paragraph 36.

242. On considering all circumstances, the Board judged the effective date specified in paragraph 35 to be advisable.

Appendix E: GLOSSARY

243. This Appendix defines certain terms used and not defined elsewhere in this Statement.

Attribute: The quantifiable characteristic of an item that is measured for accounting purposes. For example, historical cost and replacement cost are attributes of an asset.

Conversion: The exchange of one currency for another.

Enterprise: See Reporting Enterprise.

Exposed Net Asset Position: The excess of assets that are measured or denominated in foreign currency and translated at the current rate over liabilities that are measured or denominated in foreign currency and translated at the current rate.

Exposed Net Liability Position: The excess of liabilities that are measured or denominated in foreign currency and translated at the current rate over assets that are measured or denominated in foreign currency and translated

at the current rate.

Foreign Currency: A currency other than the currency of the country being referred to; a currency other than the reporting currency of the enterprise being referred to; composites of currencies, such as the Special Drawing Rights on the International Monetary Fund (SDRs), used to set prices or denominate amounts of loans, etc., have the characteristics of foreign currency for purposes of applying this Statement.

Foreign Currency Financial Statements: Financial statements of a foreign operation that employ as the unit of measure a currency other than the reporting currency of the enterprise being referred to.

Foreign Currency Transactions: Transactions (for example, sales or purchases of goods or services or loans payable or receivable) whose terms are stated in a currency other than the local currency.

Foreign Currency Translation: The process of expressing amounts denominated or measured in one currency in terms of another currency by use of the exchange rate between the two currencies.

Foreign Operation: An operation whose financial statements are (a) combined or consolidated with or accounted for on an equity basis in the financial statements of the reporting enterprise and (b) prepared in a currency other than the reporting currency of the reporting enterprise.

Foreign Statements: See Foreign Currency Financial Statements.

Local Currency: Currency of a particular country being referred to; the reporting currency of a domestic or foreign operation being referred to.

Reporting Currency: The currency in which an enterprise prepares its financial statements.

Reporting Enterprise: An entity whose financial statements are being referred to; in this Statement, those financial statements reflect (a) the financial statements of one or more foreign operations by combination, consolidation, or equity accounting and/or (b) foreign currency transactions.

Settlement Date: The date at which a receivable is collected or a payable is paid.

Spot Rate: The exchange rate for immediate delivery of currencies exchanged.

Transaction Date: The date at which a transaction (for example, a sale or purchase of merchandise or services) is recorded in accounting records in conformity with generally accepted accounting principles.

Translation: See Foreign Currency Translation.

Unit of Measure: The currency in which assets, liabilities, revenue, and expenses are measured.

Footnotes

FAS8, Footnote 1--For convenience, this Statement assumes that the enterprise uses the U.S. dollar (dollar) as its reporting currency and unit of measure. A currency other than the dollar may be the reporting currency in financial statements that are prepared in conformity with U.S. generally accepted accounting principles. For example, a foreign enterprise may report in its local currency in conformity with U.S. generally accepted accounting principles. If so, the requirements of this Statement apply.

FAS8, Footnote 2--To *measure in foreign currency* is to quantify an attribute of an item in a unit of currency other than the reporting currency. Assets and liabilities are *denominated in foreign currency* if their amounts are fixed in terms of a foreign currency regardless of exchange rate changes. An asset or liability may be both measured and denominated in one currency, or it may be measured in one currency and denominated in another. To illustrate: two foreign branches of a U.S. company, one Swiss and one German, purchase on credit identical assets from a Swiss vendor at identical prices stated in Swiss francs. The German branch measures the cost (an attribute) of that asset in German marks. Although the corresponding liability is also *measured* in marks, it remains *denominated* in Swiss francs since the liability must be settled in a specified number of Swiss francs. The Swiss branch measures the asset and liability in Swiss francs. Its liability is both measured and denominated in Swiss francs. Assets and liabilities can be measured in various currencies. However, currency and rights to receive or obligations to pay fixed amounts of a currency are denominated only in that currency.

FAS8, Footnote 3--Debt securities held that are essentially equivalent to notes receivable shall be adjusted to reflect the current rate (paragraph 39).

FAS8, Footnote 4--In multilevel consolidation, foreign statements may be translated into another foreign currency and consolidated with other foreign statements before being consolidated with the enterprise's financial statements. Translation at each step of a multilevel consolidation shall be in conformity with the standards in this Statement.

FAS8, Footnote 5--Since foreign statements are expressed in local currency, the term *foreign currency* in this context includes the dollar.

FAS8, Footnote 6--Various measurement bases are described in paragraphs 70 and 179 of *APB Statement No. 4*, "Basic Concepts of Accounting Principles Underlying Financial Statements of Business Enterprises."

FAS8, Footnote 7--For example, a loss on a forward contract shall not be deferred if future revenue from sale or other disposition of an asset is estimated to be less than the sum of (a) the asset's dollar cost including the deferred loss on the related forward contract and (b) reasonably predictable costs of sale or disposal.

FAS8, Footnote 8--If the transaction date for a commitment that is hedged by a forward contract (paragraph 24) occurs during the period before the balance sheet date, the spot rate at the transaction date shall be used instead of the spot rate at the subsequent balance sheet date.

FAS8, Footnote 9--A long-term commitment may have more than one transaction date. For example, the due date of each progress payment under a construction contract is an anticipated transaction date. For purposes of this Statement, each future progress payment due is a commitment, and the period between the commitment date for the entire contract and the due date of each progress payment is the minimum life for a forward contract that hedges that payment.

FAS8, Footnote 10--The intended use of successive forward contracts satisfies the condition in paragraph 27(a) if the nature of the forward exchange market precludes a single forward contract's covering the entire period, provided the first contract commences at the commitment date.

FAS8, Footnote 11--If exchangeability between the dollar and the foreign currency is temporarily lacking at the transaction date or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Statement. If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the enterprise shall be carefully considered (*ARB No. 43*, Chapter 12, paragraph 8).

FAS8, Footnote 12--If unsettled intercompany transactions are subject to preference or penalty rates, translation at the rate applicable to dividend remittances may cause a difference between intercompany receivables and payables measured in dollars. Until that difference is eliminated by settlement of the intercompany transaction, it shall be treated as a receivable or payable in the enterprise's financial statements.

FAS8, Footnote 13--Certain enterprises, primarily banks, are dealers in foreign exchange. Although certain gains or losses from dealer transactions may fit the definition of exchange gains or losses in this Statement, they need not be included in the aggregate exchange gain or loss required to be disclosed if dealer gains or losses are disclosed.

FAS8, Footnote 14--For enterprises having fiscal years of 52 or 53 weeks instead of the calendar year, this Statement shall be effective for fiscal years beginning in late December 1975.

FAS8, Footnote 15--Pro forma disclosures required by paragraphs 19(d) and 21 of *APB Opinion No. 20* are not applicable.

FAS8, Appendix A, Footnote 16--*APB Opinion No. 16*, "Business Combinations," prescribes

generally accepted accounting principles for business combinations. Paragraphs 87-92 are particularly pertinent.

FAS8, Appendix A, Footnote 17--*APB Opinion No. 18*, "The Equity Method of Accounting for Investments in Common Stock," prescribes generally accepted accounting principles for the equity method.

FAS8, Appendix A, Footnote 18--An asset other than inventory may sometimes be written down from historical cost. Although that write-down is not under the rule of cost of market, whichever is lower, the standards prescribed in this paragraph shall be applied. That is, a write-down may be required in the translated statements even though not required in the foreign statements, and a write-down in the foreign statements may need to be reversed before translation to prevent the translated amount from exceeding translated historical cost.

FAS8, Appendix A, Footnote 19--This paragraph is not intended to preclude recognition of gains in a later interim period to the extent of inventory losses recognized from market declines in earlier interim periods if losses on the same inventory are recovered in the same year, as provided by paragraph 14(c) of *APB Opinion No. 28*, "Interim Financial Reporting."

Footnote 20--Leonard Lorensen, *Accounting Research Study No. 12*, "Reporting Foreign Operations of U.S. Companies in U.S. Dollars" (New York: AICPA, 1972); R. MacDonald Parkinson, *Translation of Foreign Currencies* (Toronto: Canadian Institute of Chartered Accountants, 1972).

FAS8, Appendix B, Footnote 21--Financial Executives Institute, *Survey of U.S. Company Foreign Translation Practices*, 31 July 1973.

FAS8, Appendix B, Footnote 22--Financial Accounting Standards Board, *Financial Statement Model on Accounting for Foreign Currency Translation* (Stamford, Connecticut: FASB, March 1974).

FAS8, Appendix B, Footnote 23--National Association of Accountants, *Research Report No. 36*, "Management Accounting Problems in Foreign Operations" (New York: NAA, 1960), p. 17.

FAS8, Appendix B, Footnote 24--Samuel R. Hepworth, *Reporting Foreign Operations* (Ann Arbor, Michigan: University of Michigan, 1956).

FAS8, Appendix B, Footnote 25--Proposed APB Opinion, "Translating Foreign Operations," Exposure Draft, 20 December 1971.

FAS8, Appendix B, Footnote 26--Accounting Research Association Newsletter, 20 January 1972, p. 1.

FAS8, Appendix C, Footnote 27--Although conversion may be at a rate other than the one at which cash, a receivable, or a payable is recorded, *translation* is not involved. However, an exchange gain or loss results from conversion at a different rate.

FAS8, Appendix C, Footnote 28--*APB Statement No. 4* (paragraph 165) states the following regarding the unit of measure:

"In the United States, the U.S. dollar fulfills the functions of medium of exchange, unit of account, and store of value. It provides the unit of measure for financial accounting. Stating assets and liabilities and changes in them in terms of a common financial denominator is prerequisite to performing the operations--for example, addition and subtraction--necessary to measure financial position and periodic net income."

FAS8, Appendix D, Footnote 29--Proposals to defer recognition of exchange gains and losses on long-term receivables and payables--either by deferring exchange gains and losses resulting from translating the assets and liabilities at the current rate or by translating the items at historical rates until collection or settlement (as, for example, by the current-noncurrent method)--raise issues separate from the unit-of-measure issue and are discussed in paragraphs 172-194 and 129-132.

FAS8, Appendix D, Footnote 30--Some arguments supporting translation of all accounts at the current rate raise questions about whether translation can or should result in exchange gains and losses (paragraphs 80-82, 84-86, and 133-138).

FAS8, Appendix D, Footnote 31--The argument that a rate change can be ignored because it will probably reverse before a debt is paid or a receivable is collected is a different issue which is considered in paragraphs 166 and 192.

FAS8, Appendix D, Footnote 32--The three categories are discussed individually in paragraphs 140-152, 129-132, and 172-194.

FAS8, Appendix D, Footnote 33--Matters relating to recognizing gains on assets carried at cost or deferring losses on liabilities are discussed further in paragraphs 147-149 and 172-194.

FAS8, Appendix D, Footnote 34--*ARB No. 43*, Chapter 4, Statement 10 reads: "Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts."

FAS8, Appendix D, Footnote 35--*ARB No. 43*, Chapter 4, Statement 10.

FAS8, Appendix D, Footnote 36--The terms *dependent* and *independent* were used by Parkinson (see footnote 20) and are used in the same context here.

FAS8, Appendix D, Footnote 36--The terms *dependent* and *independent* were used by Parkinson (see footnote 20) and are used in the same context here.