On revising FASB 8—use a Band-Aid or major surgery?

The Financial Accounting Standards Board let loose a whirlwind when it issued Statement 8, the pronouncement on foreign exchange translation, in January 1976. As a result of the barrage of criticism, the FASB is on the verge of revising its most controversial standard.

But there is little agreement on the form of change. The statement seems to distort reality for some companies; the possible alternatives distort reality for others.

The practices dictated by FASB 8, however, are totally consistent with basic economic reality. In addition, while proposed alternative rules have the advantage of reducing the variability of earnings, they do so only at the expense of relevance.

Despite the near-unanimous criticism of FASB 8, it should be retained as the foundation of any new accounting presentation. At the same time the FASB should consider the real issue—how best to describe the more specific aspects of an international company's financial situation.

Statement 8 was designed to solve a long-standing problem. Investors found it next to impossible to compare the performance of multinational companies as long as U.S. corporate managers were allowed a choice of foreign exchange translation methods. FASB 8 struck a blow for standardization.

But why did the rule makers settle on the temporal definition of account translation? Is there any logic behind the translation of accounts receivable at current exchange rates and plant and equipment at historical exchange rates? Why translate long-term debt at what may be a short-term exchange rate?

Economically sensible, but . . .

In many ways, FASB 8 comes closest among the alternatives to an economist's dream. As I shall demonstrate, its temporal definition captures the single most fundamental characteristic of the international financial environment—the relationship between exchange rates and inflation. And initially it seemed the FASB 8 rules would capture this relationship at little cost.

One thing we can say about foreign exchange rates is that they tend to offset differences in domestic inflation rates. That is, the currencies of countries experiencing relatively rapid inflation usually devalue, and currencies with less rapid inflation usually revalue. When prices and exchange rates predictably move this way, the problem of foreign exchange exposure vanishes.

For example, if inflation always increases the value of a foreign plant's output enough to offset devaluation of the foreign currency, the dollar value of the plant stays the same.

FASB 8 exploits this economic behavior by translating such foreign currency accounts at a constant exchange rate. It defines as unexposed those assets and liabilities most likely to be economically unexposed.

Of course, the generalization in this definition will be truer for some companies and currencies than for others. But if one has to choose a single rule to apply to all companies and currencies, Statement 8 seems a logical choice.

On the other hand, the foreign currency values of some assets and liabilities, such as accounts receivable, are fixed. Since their values cannot change to offset exchange rate fluctuations, they are truly exposed and are translated at current exchange rates.

Thus FASB 8 leans heavily on the dichotomy between monetary accounts, which are fixed in foreign currency terms, and nonmonetary accounts, which are not.

If FASB 8 seems to make economic sense, why do corporate managers complain that it distorts the value of their operations and leaves investors with the mistaken notion of highly risky ventures? Did the FASB choose the wrong set of rules? Or could some simple amendments satisfy everyone?

Some think the obvious candidate for change is the treatment of inventory. In a period of general inflation, most foreign inventories are unexposed under FASB 8. Historical cost at historical exchange rates is usually lower than market or current cost at current exchange rates.

As a result, the average foreign subsidiary translates as a net liability because unexposed inventories are often financed by exposed local currency liabilities. In an age of dollar devaluation, no wonder most treasurers of multinational companies are unhappy with the rules!

The corporate claim is that because many inventories are exposed, they should be translated at current exchange rates. For example, fast turnover in a revaluing currency can mean real economic gains that should be used to offset the losses incurred with strong-currency debt. On the other
hand, in the same environment more stagnant inventories may be economically unexposed. The relationship between inventories and exchange rates depends on a complex combination of factors. Because exposure is a function of the nature of the product, industry organization, management response, and foreign government behavior, the inventories of different MNCs are exposed in varying degrees.

Furthermore, within each multinational the values of individual products in diverse markets or countries may also change differently in reaction to fluctuating exchange rates.

The suggestion that we patch up FASB 8 by translating inventories at current rates is clearly appropriate for some inventories while entirely inappropriate for others. Such an amendment would have the desired effect of shifting most foreign subsidiaries into net foreign currency asset positions. But the amendment would bring little cheer to many treasurers if it took effect just as the dollar entered a long phase of strength. The FASB would continue to hear complaints of unrealistic reported losses.

Obviously we cannot revise our rules with each change in the dollar’s prospects. But can we simply allow each corporation to choose the method most appropriate to its situation? Or, in the search for fairness, can we tolerate the choice of a different method for each product line or country?

With each step we may find ourselves moving closer to economic relevance but further from the standardized treatment demanded by investors.

The real villain

Close analysis reveals the culprit to be historical cost accounting, not FASB 8. When current costs migrate from footnotes to the main statements, the problem disappears. Current costs are situational because they capture, among other things, the complex of factors that determine each inventory’s relationship to exchange rates. The product of current costs and current exchange rates is certainly a much better measure of real dollar value than any of the alternatives.

The treatment of long-term debt is another bone of contention. As a monetary liability, long-term foreign currency debt is translated at current exchange rates. This translation recognizes true economic gains and losses only if future debt service is made at the current exchange rate.

In this age of extremely volatile rates, such a presumption is very unlikely. As a result, the dramatic swings in the translated equivalents of foreign currency debt are unrealistic.

The problem is further complicated when, as recent evidence suggests, a highly volatile spot exchange rate actually masks a much more stable long-term exchange rate. Conceivably, spot exchange rates and the fundamental exchange rate could move in opposite directions.

Under FASB 8, an MNC could inform investors that the value of its liabilities had increased when, in a real sense, it had fallen.

In such an environment, how should we translate long-term debt? Should we translate it at some fundamental exchange rate? On what basis would such a rate be determined?

Gains and losses on long-term debt should certainly reflect long-term reality. Again, however, the problem lies not with FASB 8 but with the treatment of claims on future cash.

One sensible approach is to allow and amortize reserve accounts for these items. Amortization schedules could reflect the specific maturities. Linking of the amortization amount to the time left until the due date brings the accounting value of the outstanding liability in line with the economic value.

The point is, inflation and economic volatility reveal serious shortcomings in the underlying accounting system. Foreign currency translations highlight these deficiencies by relegating them to a single category on the earnings statement.

If we should attack historical cost accounting, not FASB 8, what do we do until such major surgery is possible?

The use of reserve accounts would improve the blatantly misleading treatment of foreign currency debt.

IBM’s case

...IBM reported its exchange gains and losses in accordance with Statement 8 of the Financial Accounting Standards Board, the accounting profession’s rule-making body. In reporting only what the standard seems to require, IBM followed the same practice as most other multinational companies.

IBM reported currency gains and losses on certain balance-sheet items such as cash and accounts receivable. The analysts note, however, that IBM didn’t disclose “the effects of foreign-currency fluctuations on inventory costs, other income-statement expense items and sales.”

If IBM had done so, the analysts speculate, the results may have shown that foreign-currency fluctuations enhanced 1979 net rather than reduced it. They note that Black & Decker Manufacturing Co., in its fiscal 1979 annual report, said foreign-currency adjustments under the accounting standard had reduced its net 10 cents a share. But Black & Decker, volunteering additional information, said net had been enhanced 29 cents a share by other effects of foreign currency; on balance, Black & Decker gained 19 cents a share rather than lost 10 cents...

An IBM spokesman issued the following statement: “We report all that the law requires, and we don’t believe there are any more meaningful figures.”
Let the market work

By far the most efficient mechanism for valuing companies is the market. And if improved valuations are the goal, make available the stuff of which they are made—information!

The financial statements of international companies could provide two important kinds of information that they now lack:

☐ A crucial element of asset values is currency denomination, yet investors cannot determine the currency mix of an MNC's assets. A detailed breakdown of assets would burden them (and the companies) with mammoth, expensive annual reports.

On the other hand, companies could easily and cheaply produce ratios indicating average relationships. For example, the investor who knows the average share of an MNC's receivables denominated in yen enjoys a real advantage in understanding the effect on that company of a yen revaluation.

☐ Investors are adept at calculating the value of long-term financial instruments when they have the details of the maturity schedule. Given the terms of both private and public long-term debt, together with the currency designations of that debt, investors can quickly evaluate how corporate capitalization and gains and losses from financing in foreign currencies.

While the efficiency of this determination is arguable, it would be closer to the truth than the calculations under any standardized accounting system.

With the emphasis on improving investor evaluation, we can dramatically shift the focus of our discussion. Instead of continuing the never-ending search for more realistic accounting, we should focus on a level of disclosure that balances corporate and investor interests.

There is, of course, a trade-off between the costs of very detailed disclosure and the improvement in the market's valuation of each MNC's prospects. Better disclosure could only improve the allocative efficiency of the capital markets—with obvious benefits for all.

Bertrand Horwitz and Richard Kolodny

Has the FASB hurt small high-technology companies?

Controversy has surrounded Statement 8 of the Financial Accounting Standards Board, which deals with value fluctuations of foreign currency held by companies. Part of the controversy has centered on whether FASB 8 actually has done harm.

There's another FASB rule that may well have harmed the companies affected, yet less has been heard about it and little research done on it. It is Statement 2. Now more than five years

old, this statement requires all companies (including private ones certified by public accountants) to report their research and development outlays as expenses. FASB 2 bans capitalization or deferral of such costs.

Since almost all large corporations had been expensing R&D outlays before Statement 2 became operative (January 1, 1975), most of the affected companies were small high-technology concerns. At a time when leaders of industry and government are decrying the decline of entrepreneurial innovation and development in the United States, an accounting rule that hinders such innovation should be viewed with grave concern.

But little concern evidently has been expressed—certainly nothing approaching the uproar occasioned by the experience of multinational companies with FASB 8. Because the small high-R&D companies affected by FASB 2 are dispersed over many industries and are not organized for group action, accounting rule makers have not felt much pressure.

According to a report in Barron's (November 18, 1974) just before FASB 2 took effect, "The FASB acknowledges it had a relatively easy time with its decision, since fewer than 20% of the publicly owned corporations defer R&D, and most are small, with little clout."

The economic consequences of FASB 2 have also received little attention. Recently, however, we did some research and came up with disturbing findings.

Study results

That FASB 2 has adversely affected companies deferring R&D expenditures before 1975 is indicated by the returns from a questionnaire we sent out. We contacted the chief financial officers of 380 research-intensive companies whose common shares are traded over the counter and whose pre-1975 ratios of R&D outlays to income before these outlays averaged at least 5%.

The sample, distributed over 19 two-digit industries, consisted of 168 companies that had deferred such ex-