

Foreign exchange differences: Accounting practice vs accounting principles

1 Introduction

There is little doubt that the professional accountant in South Africa had not, until recently, adequately addressed the reporting problems arising in an enterprise which trades with foreign countries or is involved in foreign operations. Fluctuations in foreign exchange rates and the resultant impact on financial reporting is by no means a modern phenomenon. The South African accountant had, in the past, been able to rationalise his apathy by sheltering under the umbrella of lack of materiality. However, the significant decline in the value of the SA rand against the US dollar in the past 18 months has had such a critical impact on the results of many South African enterprises, that the accountant has been goaded into exercising his intellect over the conflict between the rigid application of accounting principles and the development of acceptable (or possibly, expedient) accounting practices.

An accounting principle evolves from a conceptual framework which dictates the basis for achieving the objectives of financial reporting. The primary objective of financial reporting is that the reported information must be useful.⁽¹⁾ Since the report is addressed to a variety of users, the reporter must be conscious of their information needs and endeavour to satisfy those needs within the constraints and parameters of the financial statements.

Information contained in the financial statements must necessarily reflect the economic consequences of transactions carried out by the enterprise in the environment in which it operates. Because of the growth in international trade and the development of multi-national organisations, an enterprise may be exposed to the vagaries of changes in the economic environment of countries situated well beyond the borders of its own habitat. This exposure is generally evidenced in the impact of the movements of exchange rates on the transactions carried out in foreign currencies by the enterprise.

This paper is confined to the financial reporting consequences of exchange rate fluctuations on uncovered long-term borrowings.

2 Financial reporting developments

Prior to the late 1960s various accounting practices had evolved for the translation of foreign currency transactions and the recognition of exchange differences. In 1975, the Financial Accounting Standards Board (FASB) in the United States issued FAS 8⁽²⁾ which finally codified the now recognised and still acceptable two-transaction method of translating foreign currency transactions. The requirement that exchange differences should be recognised in income in the accounting period in which they arose was not unanimously accepted and met with a measure of resistance. However, the argument of fluctuating exchange rates leading to distortions of income was countered by the reasoning that "determination not to avoid exchange exposure should be accounted for by recognising the gain or loss that results from that decision".⁽³⁾ The argument that management's evaluation of the cost of borrowing recognises both interest differentials between countries and rate changes and that the effect of these rate changes should therefore be deferred and amortised over the life of the loan, was also rejected.⁽⁴⁾

The FASB subsequently reviewed the existing standard and in 1981 after close consultation with the Accounting Standards Committee (ASC) in the United Kingdom FAS 52⁽⁵⁾ was issued. The standard was designed to "provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows".⁽⁶⁾ This is compatible with the achievement of the objective of reporting useful information – information about the cash flows of an enterprise.⁽⁷⁾ Thus, the recognition in income of exchange differences on monetary items in the period in which the exchange rate changes, as required in FAS 8, was corroborated. The argument for deferral of an exchange difference where the rate change is likely to reverse, was dismissed on the grounds that future exchange rates cannot be reliably predicted and deferral may result in recognition of exchange differences unrelated to the rate changes of the period.⁽⁸⁾ The argument that exchange differences should be deferred and amortised so as to result in the charging of an effective interest rate was unacceptable on the basis that this effective rate cannot be determined until the monetary item is finally settled.⁽⁹⁾

Simultaneous to the issue of FAS 52, the ASC issued an exposure draft and in 1983 a statement⁽¹⁰⁾, which was in agreement with FAS 52 in all material respects. However, SSAP 20 recognised that there may be exceptional circumstances in which the recognition of an exchange gain on a long-term monetary item should be restricted.⁽¹¹⁾

Following closely on the heels of the US and UK statements was IAS 21.⁽¹²⁾

It is the philosophy of the FASB to issue standards for the reporting of financial information based purely on accounting principles. The ASC similarly follows this practice. However, the International Accounting Standards Committee (IASC), which represents countries from a variety of cultures is necessarily more pragmatic in its approach. The Accounting Practices Board (APB) in South Africa issues statements of generally accepted accounting practice.

3 Reporting developments in South Africa

The Accounting Practices Committee (APC) of the Institute of Chartered Accountants in South Africa issued ED 39⁽¹³⁾ in 1983. ED 39 was, in general, based on the requirements of the international standard. International standards are invariably broadly based and may allow options which are not necessarily appropriate in the economic environment of a particular country. The reaction to ED 39⁽¹⁴⁾ was that:

- it did not give sufficient specific guidance;
- the options available for the recognition of exchange differences arising on foreign currency transactions would obviate uniformity in accounting disclosure.

The review of ED 39 was so extensive that the new draft was further exposed for comment. The revised draft was issued as ED 47.⁽¹⁵⁾ Possibly the most provocative change in ED 47 dealt with the treatment of exchange differences arising on uncovered foreign currency transactions.

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4 Uncovered foreign currency transactions

Whereas ED 39 had allowed the option of either amortising the exchange difference arising on unsettled long-term monetary items over the period of the related monetary item, or taking the difference to income in the year in which the rate change arose, ED 47 required that:

"exchange differences... arising on settlement of monetary items, or on reporting an entity's unsettled monetary items which are denominated in a foreign currency at rates different from those at which they were previously recorded, should be recognised in income for the period".⁽¹⁶⁾

This requirement, coming at a time when the rand was weakening dramatically against a strong US dollar, would subject enterprises in South Africa which had not hedged their exposure on their foreign currency obligations, to the reporting of sometimes massive exchange losses in their current income statement – see Section 9. The withdrawal of the option of "to amortise or recognise" brought ED 47 into line with the requirements of FAS 52 and SSAP 20. The draft was, nevertheless, greeted with some degree of apprehension and resistance.

Any debate on the issue of the recognition of exchange differences must focus on the appropriate application of accounting principles, may include an evaluation of accounting practices currently in vogue, but must exclude expediency in reporting. Proponents of deferral and amortisation argued sufficiently convincingly to ensure that the option of amortisation or recognition offered in ED 39, and withdrawn in ED 47, was reinstated in AC 112⁽¹⁷⁾ issued in 1985.

This paper tests the arguments submitted in support of amortisation of exchange differences arising on long-term monetary items, against the conceptual framework from which accounting principles are developed to achieve the objectives of financial reporting.

5 Objectives of financial reporting

The objective of financial reporting is to communicate to the users of the information relevant and appropriate economic measurements of and information about the resources and performance of the reporting enterprise. Financial statements should reflect the economic realities of the enterprise at the reporting date.

The Corporate Report, the discussion paper of the Institute of Chartered Accountants in England and Wales, has listed seven characteristics which should be exhibited by a set of financial statements. The financial statements should be:

- relevant;
- understandable;
- reliable;
- complete;
- objective;
- timely;
- comparable.⁽¹⁸⁾

It is in the context of this framework that the accountancy practice documented by AC 112 should be considered and tested.

The FASB has defined liabilities:

"Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events".⁽¹⁹⁾

The estimation of values is a fact of corporate reporting and the best estimate of the probable future sacrifice of economic benefit should be made at the balance sheet date for all liabilities, including liabilities denominated in foreign currencies. Foreign exchange markets are

inherently uncertain and the closest approximation in rand of a foreign liability at the year end must necessarily be one which is based on the exchange rate ruling at the year end.⁽²⁰⁾ Adjustments to the originally recorded rand value of the liability should be taken to income as would be the case in the adjustment of any other liability or provision. The seven precepts of corporate reporting enumerated above demand this.

The recognition in income of the exchange differences reflects the impact on income of the effects of future cash flows timeously measured, using the most relevant information available. This recognition, when tested against each of the seven precepts of corporate reporting enumerated above, is found to provide information which meets the objectives of financial reporting.

However, the dramatic, and to some, the disastrous decline in the value of the rand has inhibited somewhat, the routine application of this fundamental truth. The reflection of foreign liabilities in rands based on the year-end rate in the present economic environment results in most cases in material losses arising out of the adjustment. The charging to income of these losses is obviously anathema to management, who having been buffeted by the economic recession, balk at the idea of the reduction in earnings per share when the cause is an exogenous one to the enterprise which they manage. It is argued that exchange differences are part of the comprehensive borrowing of the enterprise and should thus be included in income on a systematic basis over the period of the "borrowing". This justification for deferral and amortisation has now been enshrined in AC 112.⁽²¹⁾

6 Translation gains and losses – basis of recognition

Financial statements should embody the economic realities of the enterprise to which they relate. The fundamental economic reality of the business cycle of an enterprise is found in cash flows; and the best measure of the performance of an entity is to consider the quantum of the net cash flows over the life of the enterprise. However, to all intents and purposes enterprises have an infinite life and this has resulted in the necessity of periodic reporting. Periodic reporting, in breaking into an enterprise's natural business cycle, causes distortion as the cash flows in one period may impact another. The concept of accrual accounting was established to mitigate these distortions. The FASB defines accrual accounting:

"Accrual accounting attempts to record the financial effects on an enterprise of transactions *and other events and circumstances* that have cash consequences for the enterprise in the periods in which those transactions, events and circumstances occur rather than only in the period in which the cash is received or paid by the enterprise..."⁽²²⁾ (Our emphasis.)

It is, thus, appropriate for accounting practice to reflect the cash impact of events and transactions in the period to which those events and transactions relate.

AC 112 states that one of the objectives of foreign currency translations is to provide information which is compatible with the economic effects of the changes in exchange rates on the enterprise's cash flows.⁽²³⁾ Translation using year-end rates provides the best estimate of the future cash flows of the enterprise in relation to its foreign currency liabilities and, thus, the reporting of the gains/losses in income accords with the accrual concept. Further, as a change in the exchange rate is an economic event affecting the enterprise it should be recorded in the period in which it occurs. FAS 52 states:

"... Past rate changes are historical facts, and the board believes that users of financial statements are best

served by the accounting for rate changes that affect the functional cash flows of a foreign entity as those rate changes occur".⁽²⁴⁾

AC 112 also distinguishes between short-term and long-term monetary items: the deferral of exchange differences is only permitted with long-term monetary items.⁽²⁵⁾ There is no conceptual basis for this and such a requirement obviously places an undue emphasis on balance sheet classifications and the settlement date rather than the economic effects of movements in exchange rates.

If the exchange differences were deferred and amortised the effects of the movements in exchange rates may be allocated to periods not related in any way to the economic events giving rise to that movement; the accrual concept would, thus, be violated.

The accounting treatment suggested by the authors (ie, the reflection of translation gains and losses in income) satisfies not only the accrual concept but also the standards by which financial reporting should be measured. Whereas the deferral and amortisation of translation gains/losses would cause financial statements to be:

- irrelevant: the economic effects of the event would be reported in periods unrelated to their occurrence;
- incomprehensible: the financial statements would contain unwarranted complexities;
- unreliable: the information would be neither objectively determined nor would it be verifiable.

There would also be a lack of objectivity and comparability.

7 The arguments for deferral and amortisation

It would be churlish of the authors not to consider the specific arguments raised by the commentators to ED 39 and ED 47 who supported the option of deferral and amortisation. This section considers these arguments as well as their flaws. Five central arguments for deferral and amortisation were raised:

- The need for flexibility to be maintained in the accounting practice as the foreign exchange markets in South Africa are in an embryonic stage.
- Exchange rates fluctuate sharply and to insist on a translation at the balance sheet date and to take the resulting gain/loss to income is to place undue emphasis on that date.
- Deferral and amortisation results in a better matching of the costs associated with the foreign "borrowing" with the period to which the "borrowing" relates.
- Translation gains/losses are built into the overall costs of the foreign borrowing. The translation difference in any one year should, therefore, be spread over the period of the "borrowing".
- Exchange differences on unsettled long-term monetary items are unrealised and should not be included in current income.

These arguments taken individually and collectively appear to provide a reasonable prima facie conceptual basis for the deferral and amortisation of translation difference and, therefore, are worthy of some detailed examination.

(i) The need for flexibility

There is a school of thought that maintains that accounting practice should be as flexible as possible to cope with the differing economic environments and events which impact different enterprises. However, this leads to a certain amount of incomparability in financial reporting as well as a loss of objectivity and relevance. The practice of

providing alternative accounting treatments in South Africa has led to some criticism of both the APC and the APB. The recent articles in the financial press have maligned the accounting profession by accusing it of pandering to the whims of management rather than to the needs of shareholders and other users of financial statements.⁽²⁶⁾ These unfortunate accusations can only be rebutted if we narrow the accounting treatments available for similar economic events because in that way the ammunition of the detractors will be removed and the accusations of expediency will fall away.

Nevertheless, the conceptual argument against the type of flexibility as proposed by AC 112 is flawed in the sense that it proposes the choice of two economic truths for one economic transaction or event. Clearly, this would be against generally accepted accounting principles. Notwithstanding the fact that the concept of generally accepted accounting practice is enshrined in the Company's Act, this practice should not subvert accounting principle.

(ii) Sharply fluctuating exchange rates - undue emphasis on balance sheet date

The proponents of this argument stress that exchange rates fluctuate considerably over time and that the translation at a specific date ignores this reality. Hence, if a translation takes place after the rate has sharply declined the enterprise is unduly burdened with the loss that results; a loss which could reverse shortly after the year end.

The authors contend, however, that the emphasis on the balance sheet date is, in fact, correct because it complies with one of the fundamental rules of financial reporting. That is, financial statements should reflect the financial position at a certain specific date and the results for the period ending on that date. The rules of financial reporting cannot be changed for one specific balance sheet caption. The estimation process relates to all assets and liabilities in the balance sheet. The advent of a turbulent economic period cannot justify the emergence of expedient accounting practices.

(iii) Deferral and amortisation - better matching

The arguments for this approach cite the fact that the costs of the borrowing should be matched over the period of the borrowing and that management takes a long-term view of foreign exchange rates and, therefore, the deferral of exchange losses arising out of periodic translations is appropriate.

The matching concept per AC 101⁽²⁷⁾ matches revenues with costs and not assets/liabilities with costs. Neither does the matching concept propagate the smoothing of income but rather the matching of a cost to the period in which the income associated with the occurrence of that cost is recorded.

It is noted that the proponents of deferral and amortisation do not attempt to consider the quantum of income generated by the application of the resources gained from the foreign borrowings and smooth this income over the period of the borrowing. It is a fact of economic life that the resources used in any one period may yield a different income in relation to other periods. The revenue is not spread, and, therefore, the cost associated with the financing of the resources required to generate this revenue should not be spread. It is, thus, a misapplication of the matching concept to spread the cost of the loan over the period of the loan.

If businessmen take a long-term view on exchange rates in determining the cost of borrowing, that in

itself is not an argument for deferring exchange differences. Any uncovered foreign currency transaction is exposed to some element of risk because of fluctuations in exchange rates. If an enterprise chooses not to hedge this risk it enters the business of currency speculation and it must faithfully report the consequences of doing so. In reporting the economic effects of uncovered transactions carried out by an enterprise, the economic reality of the fluctuations in the exchange rate must be recognised by reflecting the impact of these fluctuations in income for the period in which the fluctuations arise. Everingham and Hopkins suggest that "the movement in exchange rates reflects the economic substance of what has occurred".⁽²⁸⁾ Although the exchange fluctuations may reverse before the settlement of the monetary item, the economic reality of one period should not be ignored in anticipation of changed economic circumstances in future periods.

It is our contention that management may at times take a long-term view of the exchange rates but that it is on a purely speculative basis. If their decisions are wrong and differences arise, these should be written off both from a matching point of view and the prudence concept which does not allow the prediction of future profits to offset present losses. If, however, management concedes that the differences will not be reversed then, not only does the accrual concept demand that they be charged to income, the prudence concept demands it also.

Can exchange rate movements in the future be predicted with any degree of certainty? If not, how can the deferral of any exchange difference be justified on the grounds of anticipated reversals in the future? Surely such a deferral would be a failure to report in income, current economic reality on the grounds of unsupportable hopes for the future?

(iv) Translation gains/losses – interest costs

Proponents of deferral and amortisation argue that there is a relationship between the differential interest rates and exchange exposure, the cost of borrowing includes both the interest cost and the economic consequence of the exchange exposure, and that according to the matching concept, the exchange differences should therefore be spread over the life of the monetary item. However, factors other than the differential interest rates affect exchange rates, and it would, therefore, seem inappropriate to consider the total exchange difference as an anticipated or budgeted cost of borrowing. No rational procedure can be prescribed to accrue the total cost at an average effective rate because until the liability is settled that average rate cannot be objectively determined. The spreading of exchange differences would, therefore, seem to be a mere smoothing of income under the guise of compliance with the matching concept. The consequence of deferral and amortisation is the changing of the pattern of gain/loss recognition in income. This does not necessarily eliminate the volatility that advocates of this approach seek to eliminate.

It would be irrational for management to predict a borrowing cost related to fluctuations in the rand exchange rate without taking steps to insure against it. The insurance of forward cover is available to most enterprises and the cost of such insurance is a cost necessary to give greater certainty to rand denominated cash flows. Indeed, not to take cover when cover is available at reasonable cost could be seen to be indulging in currency speculation. In either case, ie, whether cover is taken out or not, the

loss of rand revenue relating to the transactions, whether because of direct cost or exchange rate change, would have to be recorded in the year in which the loss is incurred. The exchange difference should not be part of the borrowing cost because its variability inhibits the comparability of borrowing alternatives.

(v) Exchange differences on unsettled long-term monetary items are unrealised

Another argument in favour of deferral is that exchange differences arising on unsettled long-term monetary items are unrealised and as such should not be included in current income. The principle of realisation does not require that the transaction must have already resulted in cash but merely that the resultant cash flow can be determined with reasonable certainty. SSAP 20 accepts that the year-end rate is sufficient approximation for the determination of the future cash flows of the long-term monetary item.

A corollary to this is that losses should be recognised while gains are deferred. The concept of prudence dictates the recognition of losses but does not allow similar recognition of gains until "the ultimate cash realisation of which can be assessed with reasonable certainty".⁽²⁸⁾

Because the same objective is used, there is no less certainty in determining the ultimate cash realisation of gains than there is in the determination of losses. Why then should they be treated differently?

8 An analysis of attitudes in South Africa

The Institute of Chartered Accountants in South Africa invites comments on exposure drafts published by the APC. In general, comment is received from audit firms, academics and large business enterprises which are concerned about financial reporting.

Comments received on ED 39 and ED 47 from three selected categories of commentators were analysed. The categories were:

- (i) audit firms;
- (ii) academics;
- (iii) large business enterprises.

ED 39 issued in 1983 permitted the option of either amortising the exchange differences arising on unsettled long-term monetary items over the period of the related monetary item, or taking the difference to income in the year in which the rate change arose.

Comments on ED 39	Agreed with option	Disagreed with option	No comments received
Audit firms*	3	3	1
Academics	–	1	1
Large business enterprises	–	–	–

The following points should be noted:

Audit firms

- 1 In respect of the audit firms that agreed with this option, one firm gave no reason, a second firm also gave no reason and in addition stated that deferral should not be allowed if it was likely that recurring losses would arise, and a third firm merely stated that such differences should normally be taken to the income statement, but that they did not disagree with the deferral option.
- 2 On the other hand, the three firms that disagreed

with the option gave sound reasons which included those stated in SSAP 20, namely:

- (a) The year-end translation provides the best estimate of future cash flows.
- (b) Reporting differences in the income statement accords with the accrual concept.
- (c) Translation is an objective measure.
- (d) Taking the difference to income accords with the prudence concept.

*The auditing firms which submitted comment on ED 39 were: Arthur Young; Deloitte, Haskins and Sells; Fisher Hoffman Stride; Kessel Feinstein; Peat Marwick Mitchell; Pim Goldby; Price Waterhouse.

Academics

The reason given by the academics for the recognition of differences immediately was the prudence concept, and the university which offered no comment, did state that discussion of reasons for alternatives should be provided so that viewpoints exposed by the APC could be considered in the correct context.

Large business enterprises

No comment was received from large business enterprises. This is not surprising, because of the option contained in the exposure draft.

ED 47 issued in 1984 required that exchange differences should be recognised in income for the period.

Comments on ED 47	Agreed with recognition	Disagreed with recognition	No consensus reached	No comments
Audit firms†	6	4	1	1
Academics	3	—	—	—
Large business enterprises‡	2	5	—	1

Further information:

Audit firms

- 1 Major reasons given for agreement with recognition in income included:
 - (a) Financial statements should reflect economic realities of that year and effects of a business decision.
 - (b) Asset with no intrinsic value would be created if deferral were to be permitted.
 - (c) Lack of comparability would result were optional treatments to be allowed.
 - (d) Best estimate of the liability is required at a point in time.
 - (e) Most pragmatic route leading to consistency within an accounting framework.
 - (f) Prudence.
- 2 Reasons advanced for disagreement with recognition in income were:
 - (a) Deferral is in accordance with the matching concept.
 - (b) Sharply fluctuating exchange rates exist, and too much emphasis is placed on rate ruling at a particular day of the year.
 - (c) Translation gains/losses are built into the overall costs of the foreign borrowing.
 - (d) Not generally accepted accounting practice in South Africa.
 - (e) Not economically realistic.
 - (f) Distorts income from year to year.
- 3 It is interesting to note that a firm which had previously agreed with the deferral option in ED 39,

now agreed with the policy stated in ED 47, ie, to recognise gains/losses in income immediately.

An auditing firm which had not commented on ED 39, submitted comment on ED 47 disagreeing with the proposed treatment in the exposure draft, this policy coinciding with the accounting policies adopted by the companies with material exchange losses, audited by this firm.

Different partners in one auditing firm submitted three different comments, one being in agreement, another in disagreement, and the third adopting a non-committal view because consensus could not be reached.

†The auditing firms which submitted comment on ED 47 were Aiken and Carter; Arthur Andersen; Arthur Young; Coopers and Lybrand; Deloitte, Haskins and Sells; Ernst and Whinney; Fisher Hoffman Stride; Peat Marwick Mitchell; Price Waterhouse; Spencer Steward. Comments from three partners in one firm are included in the analysis above.

Academics

- 1 Major discussion revolved around the distinction between short and long-term borrowings. The conclusions reached were as follows:
 - (a) Short-term: If these borrowings are not covered forward, this is in effect speculating and the results of speculations should be reflected in the income statement.
 - (b) Long-term: The problem is much more complex, but in considering the definitions of liabilities and expenses and losses contained in SFAC 3, an increase in the estimate of the eventual repayment of these borrowings should be regarded as a loss and, therefore, included in the income statement.
- 2 Other comments advanced were:
 - (a) Deferral and amortisation has no theoretical justification.
 - (b) The interest charge cannot be adjusted since this is against the historical cost concept.
 - (c) Prudence overrides the matching concept.

Large business enterprises

Major reasons advanced for the deferral of exchange differences arising on long-term monetary items have been highlighted in a previous section of this article – see section 7.

‡The comments on ED 47 received from large business enterprises include the following companies:

Afrox; Anglo Alpha; Chemical Services Limited; Defy Group; Gencor; Liberty Life Group; Premier Group; South African Breweries.

General

It should be pointed out that there were quite a number of respondents who, although in agreement with the proposed treatment in ED 47, expressed concern about unrealised gains being recognised in income and, therefore, being available for distribution.

Aggregation of comments on ED 39 and ED 47

Preferences	Auditors	Academics	Businesses
Recognise or defer	4	—	5
Recognise only	5	4	2
Both of above	1	—	—
No consensus reached	1	—	—
No comment	1	1	1

The lack of consensus among auditors is further highlighted by an analysis of the treatment of exchange losses incurred by large business enterprises which have obviously disagreed with the treatment proposed in ED 47.

9 Analysis of treatment of exchange differences

Name of company	Foreign exchange loss for 1984 year end (millions)	Net income (loss) before taxation (millions)	Accounting policy adopted
Tedalex	108,6	(63,8)	Exchange differences included in income for the period or transferred to non-distributable reserves where appropriate.
Sentrachem	57,1	22,0	Profits and losses arising from currency fluctuations are recognised in the income statement with the following exceptions: <ul style="list-style-type: none"> – unrealised profits are deferred and credited to a provision for currency fluctuations; – profits and losses relating to foreign loans raised to finance capital projects are capitalised if incurred prior to commencement of production; – if the rand is not expected to continue depreciating, unrealised losses on foreign loans are deferred and written off to the income statement over the period of the loans.
Gencor	46,5	412,3	Differences on long-term monetary items, after adjustments for notional interest savings compared to equivalent South African interest rates, are deferred for amortisation over the remaining long-term tenure of the items, calculated from the commencement of the current accounting period.
Anglo Vaal	33,5	179,4	Unrealised surpluses arising on translation are credited direct to non-distributable reserves. Unrealised losses are charged against such surpluses, and where they exceed the amount in the reserves the balance is written off in the income statement.
Toyota	32,8	47,1	Exchange gains and losses are dealt with in the income statement.
Barlow Rand	27,1	796,8	Profits and losses are included in operating profit, except for unrealised profits on conversion of non-current assets and liabilities which are deferred until realised.
AECI	24,0	157,0	Differences arising from exchange rate fluctuations are taken to income when they occur. Unrealised differences relating to long-term borrowings are charged, net of taxation, against non-distributable reserve and taken to income over the remaining period of the loans.
C G Smith	20,7	365,4	Profits and losses on translation are accounted for in the income statement in the year in which they arise.
Rex Trueform	16,7	4,0	In order to minimise the risk inherent in foreign transactions management effects, when it deems appropriate, forward cover in respect of certain exports and imports in foreign currencies. Exchange differences arising on the extension of forward exchange contracts not yet utilised at the financial year end have been carried forward to be set off against specific future transactions covered forward.
Kanhym	14,7	(41,1)	From 1 January 1984 all exchange differences on current liabilities are accounted for in the income statement. Exchange differences on long-term loans are accounted for over the remaining period of the loans. Until 31 December 1983 all exchange losses were accounted for immediately in the income statement.
Premier	13,0	124,0	Where medium and long-term borrowings are not covered by forward contracts, any differences arising from exchange rate fluctuations are taken to income over the remaining period of the loans. Gains, losses and forward cover costs are deemed to be an integral part of the cost of borrowing and accordingly are dealt with in the income statement as interest paid.

- 1 The foreign exchange losses are taken from figures quoted in Finance Section of the Sunday Star (dated 10 March 1985).
- 2 The accounting policies are extracted from 1984 annual financial statements of abovementioned companies.
- 3 One audit firm performs the audits of six of the above 10 listed companies (either on their own, or as joint auditors). There are six different accounting policies adopted amongst these six companies, yet all audit reports are unqualified.
- 4 An audit firm which disagreed with the proposed treatment in ED 47 (ie, recognition in income immediately) has signed an unqualified audit report for a company which has adopted the policy recommended in ED 47. Other companies audited by this firm adopt a policy of deferral and these reports are also unqualified.

10 Conclusion

There is little uniformity or consensus in the reporting of exchange differences among the enterprises surveyed. This may be a consequence of the codification of generally accepted accounting practices as contrasted with accounting principles. The arguments for deferral are neither persuasive nor do they have conceptual merit. If management seek offshore loans without taking out protection against the devaluation of a currency or if they find that they cannot take out such protection they have per force entered into a secondary business – currency speculation. The consequences and rewards of such risky ventures should be properly reflected and not hidden behind a mass of meaningless accounting manipulation and disclosure.

References

- 1 Statement of Financial Accounting Concepts No 1: Objectives of Financial Reporting, issued by the FASB, 1978, paragraph 32.
- 2 Statement of Financial Accounting Standards No 8: Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements, issued by the FASB, 1975.
- 3 Ibid paragraph 115.
- 4 Ibid paragraph 182.
- 5 Statement of Financial Accounting Standards No 52: Foreign Currency Translation, issued by the FASB, 1981.
- 6 Ibid paragraph 4.
- 7 Op cit SFAC No 1 – paragraph 37.
- 8 Op cit FAS No 52 – paragraph 125.
- 9 Op cit FAS No 52 – paragraph 128.
- 10 Statement of Standard Accounting Practice No 20: Foreign Currency Translation, issued by the Accounting Standards Committee of the Institute of Chartered Accountants in England and Wales, 1983.
- 11 Ibid paragraph 50.
- 12 International Accounting Standard No 21: Accounting for the Effects of Changes in Foreign Exchange Rates issued by the International Accounting Standards Board, 1983.
- 13 Exposure draft No 39: Accounting for the Effects of Changes in Foreign Exchange Rates issued by the SA Institute of Chartered Accountants, 1983.
- 14 Comment papers on ED 39 submitted to the Accounting Practices Committee of the SA Institute of Chartered Accountants.
- 15 Exposure draft No 47: Accounting for the Effects of Changes in Foreign Exchange Rates issued by the SA Institute of Chartered Accountants, 1984.
- 16 Ibid paragraph 48.
- 17 AC 112: Accounting for the Effects of Changes in Foreign Exchange Rates issued by the SA Institute of Chartered Accountants, 1985.
- 18 The Corporate Report: A discussion paper published for comment by the Accounting Standards Steering Committee of the Institute of Chartered Accountants in England and Wales 1975, paragraph 3.3.
- 19 Statement of Financial Accounting Concepts No 3: Elements of Financial Statements of Business Enterprises issued by the FASB 1980, paragraph 28.
- 20 Op cit SSAP 20 – paragraph 9.
- 21 Op cit AC 112 – paragraph 31.
- 22 Op cit SFAC No 1 – paragraph 44.
- 23 Op cit AC 112 – paragraph 03.
- 24 Op cit FAS 52 – paragraph 125.
- 25 Op cit AC 112 – paragraph 66.
- 26 Financial Mail 12 April 1985, page 12. "Stop all this footsy-footsy".
- 27 AC 101 Disclosure of Accounting Policies issued by the Institute of Chartered Accountants in South Africa, 1974, paragraph 05.
- 28 Seminar on Financial Reporting – Current Problems presented by B H Hopkins and G K Everingham, page 8.