THE EFFECT OF TRANSLATION ON MULTINATIONAL CORPORA TIONS’ INTERNAL PERFORMANCE EVALUATION

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Abstract. This study investigated the effect that FASB No. 8 has had on the internal performance evaluation practices of 70 U.S.-based MNCs. Questionnaire data were gathered and analyzed while additional information was obtained through personal interviews. The results indicated that FASB No. 8 caused changes in corporate managerial reporting policies. Thirty-one participants (44.2 percent) changed to the temporal method of translating financial information for internal reporting purposes. Twenty-seven (38.8 percent) began using an income figure that had been adjusted for translation gains and losses to evaluate foreign subsidiary managers. Forty-six (65.7 percent) stated that financial statements presented in local currency provide better information than U.S. dollar statements for the internal evaluation of foreign operations. The author argues that MNCs need performance evaluation systems that are developed independently of FASB external reporting standards and that advocate a local perspective relative to foreign operating environments.

INTRODUCTION

Statement of Financial Accounting Standards No. 8, “Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements,”1 required the use of the temporal, or monetary/nonmonetary,2 approach to translation for external financial reporting. Any corporation that employed a different method of translation for external reporting prior to the issuance of FASB No. 8 was required to change to the temporal method; however, no change was required relative to internal reporting. FASB No. 8 also required that foreign exchange gains and losses be recognized immediately in net income during the period of exchange rate change, and the Statement forbade the use of foreign exchange reserves to avoid reporting exchange gains and losses in earnings. The 1975 edition of Accounting Trends and Techniques3 showed that for 1974 the current/noncurrent method of translation was employed by 50.9 percent of the corporations surveyed. Only 13.1 percent of the corporations used the monetary/nonmonetary approach. Of the 600 corporations surveyed, 393 reported that they did not disclose the foreign exchange gain or loss resulting from translation. These statistics indicated that, at the time FASB No. 8 was issued, the majority of corporations were going to have to make changes in their external financial reporting policies. What was not obvious was the effect FASB No. 8 would have on internal reporting practices of multinational corporations—that is, on the translation method used for reporting internal information and on internal performance evaluations of foreign subsidiaries and managers.

In December 1981, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 52, “Foreign Currency Translation,” which replaces the controversial FASB No. 8. For external reporting, FASB No. 52 advocates use of the functional currency translation approach which includes: a. Identifying the functional currency of the entity’s economic environment. Normally that is the currency of the environment in which an entity primarily gener-

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ates and expends cash; b. measuring all elements of the financial statements in the functional currency; c. using the current exchange rate to translate from the functional currency to the reporting currency, if they are different.\textsuperscript{4} In addition, Statement No. 52 calls for disclosing and accumulating adjustments in a separate component of consolidated equity. Translation adjustments are an inherent result of the translation process and are segregated in stockholders' equity, rather than recognized in net income, as was called for by FASB No. 8. Transaction gains and losses are to be included in determining net income for the period in which the exchange rates change. These gains and losses result when the exchange rate changes and an entity is involved in transactions denominated in currencies other than the functional currency.\textsuperscript{5}

Given that a corporation followed the reporting requirements of FASB No. 8, and that the local currency was identified as the functional currency, the entity will now have to change from using the temporal approach to using the current rate approach for translating externally reported information. Again, what is not known is the effect FASB No. 52 will have on internal reporting practices of multinational corporations.

This paper presents the results of a study of the effect FASB No. 8 had on the internal performance evaluation practices of multinational corporations (MNCs). The paper documents the translation methods used prior to the issuance of FASB No. 8 and those used subsequently by International Division Executives (IDEs) for internal and external reporting. The treatment of foreign exchange gains and losses relative to internal performance evaluation is disclosed. The paper includes explanations offered by the IDEs about how and why translation affects the internal evaluation of foreign subsidiaries and their managers. Recommendations for performance evaluation strategies are developed by integrating the results of the data analysis with a review of the current literature, including FASB No. 52.

The sample population for this study includes U.S.-based industrial corporations of various sizes, for which size is defined as dollars of foreign sales.\textsuperscript{6} A total of 293 companies was selected by cross-referencing Dun and Bradstreet's Million Dollar Directory 1977 and The Directory of American Firms Operating in Foreign Countries [1975].\textsuperscript{7} Each corporation was identified as U.S.-based and operating at least one manufacturing subsidiary abroad. Whereas the selection process did not produce a random sample of MNCs, no generalizations of results are made. A questionnaire was mailed to the senior International Division Executive (IDE) of each of the 293 selected corporations; 71.7 percent replied, and 70 (38.5 percent of eligible corporations) usable questionnaires were received. Of the remaining 112 eligible corporations, 31 declined to participate either because company policy did not allow participation or because the requested information was too confidential (Table 1).

Participants were asked to answer questions pertaining to translation and internal performance evaluation. The IDEs were asked whether U.S. dollar or local currency financial statements provide better information for the internal performance evaluation of foreign subsidiaries and managers. If a corporation's performance evaluation measures are applied after translating the foreign subsidiary's financial statements to U.S. dollars, then translation certainly becomes a variable that needs to be further investigated. The questionnaire was designed to provide information as to which translation methods were used before and after the issuance of FASB No. 8. This information was needed to determine the effect FASB No. 8 has had on translation techniques applied to information that is used