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CHAPTER THREE

Literature Review

1. INTRODUCTION:

The foreign exchange rates and its fluctuation is one of the most controversial topics in international accounting field. In 1971, the world had witnessed the official breakdown of fixed international exchange system and floating system had taken its place where the price of any currency - exchange rate is determined by demand and supply in the currency market as any commodity. The floating system leads to fluctuation of the exchange rates, which has become daily a phenomena and economic problem as well. The phenomena of changes in foreign exchange rates are happening and the world is going ahead towards the globalization and internationalization, competitiveness and economic openness. The world today does not witness the increasing rate of international trade and foreign investment, but also it witnesses the strong presence of multinational companies.

Thus, companies shouldn't only understand the effects of changes of foreign exchange on their values and performance but they should manage it properly towards achievement of their goals efficiently and effectively.

The fluctuation of foreign exchange rate had gained due attention and still from the accounting researchers, because the effect of foreign exchange changes is the issue in accounting theory and the problem in accounting practice.

The significance of foreign exchange rates in the accounting agenda is due to different factors such as:

(1) The foreign exchange rate changes create fertile and attractive land for accounting research and studies because the problems of foreign exchange led and lead to continuous debate and opening questions and conceptual conflicts.

"While most technical issues in accounting tend to resolve themselves over time, currency translation has proven to be an exception" (Choi, Mueller, 1984: 108).
Flower (1999:351) states the fact that there are several fundamentally different ways of translation of financial statements which gives rise to fascinating area of empirical and theoretical study.

Gray (1993:11-13) states clearly the factors that rise significance of exchange rate changes in accounting field:

1. Shifting from Fixed exchange rate into Floating exchange system since 1970s.
2. Increasing trend of international trade.
5. Diversity of accounting practices regarding accounting and disclosure of the effects of changes in exchange rates.

Jeff Pearcy (1984) believes that the adoption of consolidated financial statements was a crucial step in history of accounting for foreign currency because the growing importance of multinational business has led to a demand for more information to be published about them and has also its effect. Management has needed worldwide information on a comparable basis so that they could display results, which were not distorted by currency fluctuation (Pearcy, 1984, 24).

(2) The changes in foreign exchange don’t only affect accounting measurement and disclosure and quality of financial statement but also affect company cash flow and its performance (Aminhd and Levich, 1994:1-11).

Also the changes in foreign exchange have effects on valuation and on the system of performance evaluation, control, information system and process of decision-making (Morsicato, 1978; Demirag, 1986).

Thus, the foreign exchange has accounting, economic and managerial aspects, which should be considered by accountants when they are going to deal with it.

(3) The foreign exchange itself is dynamic economic variable, which affects and get affected by another economic variables such as inflation and interest rate. The problem of foreign exchange changes makes the company as open system affects and get affected by its environment.
The researcher, after revising the history of Foreign Currency Accounting (FCA) and Literature Review has found that number of accounting studies had to deal with the subject from different aspects, which can be classified as follows:

(1) The Studies Prior (1970s)
(2) The studies related to measurement and disclosure issues of foreign exchange rates change.
(3) The Studies in impact of accounting standards and treatment of foreign exchange on the users of accounting information:
   a. Capital market reactions / stocks prices.
   b. Management action
   c. Attitudes and perceptions of managers, C.A and analysts.
(4) The studies of impact of managerial preference on accounting policy selecting of foreign currency.
(5) The studies of impact of accounting treatment of exchange on reported earnings.
(6) The studies of the relationship between foreign exchange fluctuation and performance valuation and control system of foreign subsidiaries and operations.
(7) The studies of accounting practices of foreign currency.
(8) The studies in the relationship between foreign exchange fluctuation and corporate performance:
   Stock price / Returns and cash flows
   Capital Cost
   Pricing Policies

2. Accounting Researches Prior to the 1970s:
Prior to the 1970s, accounting and disclosure for foreign exchange changes received little systematic study. Still, the first part of this century did treat the subject to a limited extent.

Ashdown (1922) wrote one of the earliest articles in this field. He described the reporting practices of U.S. firms in regard to their foreign business operations, especially the translation of foreign currency.
Lopata (1936) studied 30 companies in U.S. in regard to their accounting practices for foreign currency items during 1935, published a study similar to Ashdown's. Choi (1968) presented the results of his survey, (similar to Lopata's review with the adoption that Choi used a questionnaire and a sample size of 75 companies). Both researchers described the accounting practices as employed by U.S. MNCs. They didn't prescribe what should be but rather focused on how companies actually practiced.

Hepworth (1956) and MCM Method
Whereas Ashdown (1922), Lopata (1936) and Choi (1968) described the current practices, Hepworth prescribed how foreign subsidiary operating results "should be". He concluded that monetary / non-monetary / translation method should be implemented, in US. Whereas the American Institute of Certified Public Accountants (AICPA) recommended the current / non-current translation method.

Hepworth addressed the issue of which translation method to be used to the various types of accounts, but not where to report the translation adjustments.

When Hepworth (1956) suggested the MCM to be used in US, Baxter and Yamey (1951) had suggested the same method to be used in U.K (Jita, 2001).

CONCLUSIONS:

First, that issue of foreign currency transaction was not in the agenda of accounting researchers because it became only as accounting problem after collapse of international exchange system in 1971, whereas the issue of translation of financial statements was related to companies having foreign branch and subsidiary and they should prepare consolidated Financial statements of the multinational companies that existed since 19th century.

Second, the researcher has selected the 1970s as crucial date because the subject of the present thesis - Foreign Exchange related to the conditions of International Exchange System which shifted officially in "1971" from Fixed System to Floating System of foreign currency.

Third, there were number of studies done in 19th century which are considered as pioneering efforts e.g. Plumb (1891) and L.R. Dicksee (1904). Pumb (1891) provided the
earliest discussion of foreign currency corporate accounting. He described the accounting practices by U.K. accounts regarding foreign branches accounts translation. He concluded that the current rate method used by British Accountant.

Dicksee (1904) developed that sketch into a comprehensive accounting solution to the problems of accounting for foreign operations.

Pumb and Dicksa outlined their views regarding problems of foreign currency as under:
1- Problem of foreign currency translation is re-measurement problem not presentation problem.
2- They adopted parent company approach, which considers the foreign operations are extension to parent company operations.
3- They adopted multi-rates method to translation of foreign branches accounts which was called floating / non-floating method. This method actually is a historical background of contemporary translation methods developed by accounting profession as current non-current, monetary non-monetary and temporal methods (Kazumoto, 1998:100-111).

3. THE STUDIES OF MEASUREMENT AND DISCLOSURE ISSUES OF FOREIGN CURRENCY:

The theory of exchange rate determination has a large impact on the choice of translation method for accounting purposes. Since translation of foreign entity financial statements provides information, the best exchange rate is that rate which most clearly conveys the economic impact of events and status of the entity.

Lorenser (1972) and the temporal method

The American initiative was due to the existence of different methods of translation of financial statements, which produce such fundamentally different valuations of overseas assets and losses or gains on translation, presents a disturbing state of affairs. (Flower, 1999:360).

The American Institute of Certified Public Accountants set about resolving the problem of translation in a systematic way. First it commissioned a member of its research staff,
Leonard Lorensen to undertake a through accounting research study (ARS 12) in 1972 "It is probably no exaggeration to describe the report as one of the best pieces of academic research applied to a major practical problem in accounting, certainly it is one of the most influential," (Flower, 1999). Lorensen (1972) recommended Temporal Method to be used for translating financial statement. This method under historical cost accounting will produce the same result if monetary / non-monetary method (Choi and Mueller, 1984: 130).

The financial Accounting standard Board (SASB) accepted the recommendations of the Lorensen study with few restrictions. In October 1975 it issued statement of financial accounting standards No. 8 which made the application of the temporal method obligatory (Flower, 1999: 362).

Aliber and Stickney (1975) argued that the current non-current method and the monetary non-monetary method, commonly used prior to the issuance of ASB No.8. They concluded that the implicit assumptions of these methods are both logically inconsistent and empirically unjustifiable. Aliber and Stickney suggested that translation methods should be based on the firm's planning horizon, as opposed to the more traditional accounting classification schemes of assets and liabilities. Therefore, the choice of exchange rate would be situational, depending not only on management's intentions of how long the firm intends to hold the assets or have the liability but also on the location of the foreign entity.

Glover (1975) surveyed the disclosure practices of 45 American MNCs, he discovered that: few disclosed the existence of exchange restrictions of any kind, almost all disclosed the general rates used and most companies used a modified monetary/ non-monetary translation method, with inventory and prepaid expenses translated at the current rate. He recommended: using the current exchange rate for all assets and liabilities; disclosure of exchange restrictions; disclosure of geographical distributions of foreign assets, liabilities and earnings, but not giving special accounting treatment to gains and losses resulting from exchange rate movements and ordinary foreign operations. SAS 8, issued in 1975, did not reflect Gover's recommendations. But SFAS 52, issued in 1981, incorporated the current rate translation method, recommended not only by Glover but also by many others.

Patz (1977)
There is a school of thought that rejects the use of exchange rates; instead it proposed the application of purchasing power parity index (PPPI), which is defined as:

\[ \text{PPPI} = \frac{\text{The purchasing power of the domestic currency}}{\text{The purchasing power of the foreign currency}} \]

Patz advocated this approach. He argued that the purpose of translated statements is to express the economic power and results of the operations of the foreign firm, viewed as a viable concern expected to continue to operate for the foreseeable future in its present setting in terms of that setting. The objective of the firm is the maximization of command over goods and services locally, not maximization of command over domestic currency.

Tatz stated the difference between PPP and traditional methods of translation that the PPP approach based on two views: First that the translation is not measurement process but is a mathematical operations and translation does not create new relationships it contends with existing ones, measurement, on the other hand creates new relationships, it is more than simply a mathematical operation. It is a creator, not a converter of information. Translation, in contrast, is a mathematical operation only and so is neutral with respect to information.

Second, traditional translation theory involves a concept of the firm as an extension of the parent, a source of dollar, cash flows but PPP theory involves a concept of firm as a viable, separate going concern (Patz, 1977: 18).

The application of PPP in translation remains a completely theoretical issue. They are not permitted by any accounting standards (Flower, 1999: 387).

Earl and Paxson (1978)

As exchange rates fluctuate, foreign currency receivable and payables become problematic and not only are doubtful exchange gains and losses introduced in the financial accounts but management accounts can become disturbed, consequently harming management decision and control (Earl and Paxson, 1978:92).

They recommended that the value accounting to be use in accounting for foreign currency transaction.

They argued that the value accounting for currency transactions involve incorporating both the exchange rate and the value of money into the accounting system.
The accounting employs forward rates for translating foreign currency transaction, according to them; this leads to improve management decision and control. Forward rates also provide a fair inter company transfer price which aids performance evaluation.

**Beaver and Wolfson (1982)** assumed that purchasing power parity and interest rate parity and the international Fisher effect, all held in a complete and perfect market setting. They concluded that except in the case of certainty, current cost translated at current rates is the only combination that exhibits both desired properties. Historical cost translated at historical rates exhibits only symmetry, while historical cost translated at current rates exhibits neither. They believed its crucial to economic interpretability is the inclusion of translation gains (Losses) in income.


The best translation measure depends on its ability to predict current value income using simulated financial data for the three industries with various proportions of inventory and fixed assets to total assets in six countries, Rupp concluded that neither the temporal translation method nor the current rate method provides a better accounting signal, which corroborates the conclusion of Beaver and Wolfson (1982). He stated that the "better" treatment of translation gains and losses depends on whether the dollar is depreciating or appreciating in value vis-à-vis foreign currencies. This last conclusion is in stark contrast to Beaver and Wolfson's conclusion that economic interpretability is not achieved unless translation gains and losses are included income.

**Troberg (1982)** evaluated SFAs No.8 (the temporal method) and SFAS No. 52 (the modified temporal and current rate methods) on two criteria: (1) how well each translation approach preserved foreign net income information and (2) how well each method preserved the financial relationships found before translating the statements to the US dollar. Using correlation analysis studying four U.S. multinational companies over the time period of 1976 to 1981, unlike Beaver and Wolfson, he concluded that the current rate method was preferable over the temporal method. His research indicated that the current rate method retained the integrity of the financial relationships, wherever the other foreign
currency translation methods did not. Troberg's sample was very small. Thus, Troberg's study should be viewed as a preliminary investigation.

**Harris (1983)** his views that the purchasing power parity doesn't hold. He concluded that no single relative price ratio (e.g. Purchasing power ratios or Foreign exchange ratios) would provide a translation measure that is consistent and free of measurement error. Thus, Harris concurs with the conclusion of Aliber and Stickney regarding the viability of extant translation methods and provides evidence on translation in the absence of perfect and complete markets. In addition, his test results led him to question the benefits of translating foreign financial statements.

**Taussig (1983)** evaluated the strengths and weaknesses of the current rate method of translation versus the temporal method. Using simulation to compare probable results under three different operating environments, he concluded that: the temporal method with inclusion of translation adjustments in the income statements was preferable over the current rate method when the company operates in a highly inflationary environment and that the current rate method with the translation adjustments reported in the balance sheet is preferable in non-inflationary environments. Part of his conclusion was based on the idea that companies in highly inflationary environments tend to repatriate (i.e. send home to the parent company) cash as soon as possible whereas companies in non-highly inflationary economics re-invest earnings. Thus, his research confirmed the idea of the SFAS 52.

**Asechemie (1996)**
The objectives of this study were to know the effects of disclosure of foreign transactions on the evaluation of firm in **Nigeria**. He assumed that statement of foreign transactions has usefulness and influence on external users of accounting information in their decision-making, because that statement provides additional information, which is not available in other statements. The results of his study confirmed the hypothesis that the information of foreign transactions has effect on the evaluation of the firm by users of financial statements.

**Ziebart and Choi (1998)**
This study examined the sign and magnitudes of the reporting errors that result under the best translation approach - current cost translated at the current exchange rate. Accordingly,
a benchmark is established regarding the best "we will be able to accomplish when certain foreign currency market conditions exist." The results demonstrate that a foreign currency translation that is economically interpretable is not easily achieved. To achieve economic interpretability, they suggest that supplemental information regarding current values; the timing of assets acquisitions, historical exchange rates at the time of the acquisitions and the current exchange rates should be provided in financial statements or the accompanying footnotes.

**CONCLUSIONS:**

The translation problem is concerned with transmitting "pure" or undistorted information that allows information recipients to unambiguously infer the economic impact of the state of the world on the firm.

Thus, the translation process should provide useful information, which reflects the expected economic effects of foreign exchange rate changes in cash flow and equity of the company. And the criteria of selecting the best translation method should be based on the objectives of financial statements in providing relevant information about performance results, financial position and expected cash flows of the company to the related parties. The users of financial statements need information to help them to take proper decisions. Thus, the translation method should provide useful information, which required by the all the interested parties to help them to evaluate properly the actual performance of parent companies and its subsidiaries and to evaluate and **predict the future cash flow of this economic entity.**
4. THE STUDIES OF IMPACT OF ACCOUNTING STANDARD OF FOREIGN CURRENCY ON THE USERS OF FINANCIAL STATEMENTS AND CAPITAL MARKET:

Some studies attempted to understand the reactions of investors through studying the capital market and stock prices, some related to studying the impact of accounting standard of foreign currency on management decision making. Also there are studies investigated the analysts reaction towards these accounting regulation issued.

Finally the attitude of executives and C.A. was the objective of number of accounting studies.

Briefly, academic researchers interested in measuring the effects of accounting regulations of foreign currency have utilized two different approaches: Security market's reactions and survey techniques (Wilner, 1982:44).
A. Capital Market Studies:


A number of studies conducted in the early 1970s indicated that the capital markets were very efficient in digesting and interpreting the reported earnings of major US corporations. Each study maintained that a change in accounting method has little or no effect on market value unless there is a change in economic value of the company. Therefore, if an accounting change is not reflective of a tax change that affects cash flow of the company, the market reaction will be very short-term and basically neutral (Stanley, Block, 1979:136). The capital market studies centered on whether accounting regulation and standards of foreign currency affected the price of the stock and thereby the return on investment or profit for stock holders (Gray, 1993: 43).

Dukes (1978) undertook a series of analyses to evaluate the effects of mandatory adoption of SFAS No. 8. He analyzed security returns of 479 multinationals over the time periods in three ways; multinational firms versus a control sample of domestic firms; multinational firms versus the market portfolio and firms using the method prescribed in the new standard prior to January 1975 to those who did not. Upon finding no significant differences between test groups, Dukes concluded that FASB No. 8 appeared to have no significant effects on returns of multinational corporations.

Makin (1978) investigated capital market reactions to the issuance of SFAS No. 8. Using a different approach. He classified companies into three groups based on each company's degree of internationalization. Using weekly returns, he tested the three groups for differences in five intervals over the time period from January 1970 through March 1988. He found no anticipated earnings effects of SFAS No. 8 on prices.

Dukes used multivariate analysis and Makin used a market model to derive the same conclusion.
Jain (1980) re-examined the question whether SFAS No. 8 had a significant effect on security returns. He tested a sample of 281 firms using multivariate cross-sectional comparisons of multinational and domestic firm and time series analysis of residual returns. The multivariate cross-sectional analysis showed no significant differences between multinational and domestic firms. The time series analysis produced conflicting results. Jain also investigated the effects of SFAS No.8 on the four balance sheet accounts and two income statement accounts. Jain found that multinational firms judged to be taking action to neutralize effects of SFAS 8 on earnings had significantly different capital structures than domestic firms. He concluded that SFAS No.8 had an effect on the financial structure of selected companies.

Ndubizu (1985) investigated the effects of SFAS No. 52 on 125 multinational corporations. His research classified the companies based on the date (year) companies selected to adopt SFAS No. 52. He concluded (from tests using the capital assets pricing model and the Arbitrage pricing model) that there was no statistically significant market effect related to the adoption of SFAS No. 52. Based on a questionnaire used in the study, he additionally concluded that information producers had no clear preference for SFAS No. 8 or SFAS No. 52. This final finding is reasonable in the light of the inconsistencies inherent in translation methods.

Kim (1985) tested four event dates surrounding the issuance of SFAS No. 52 for price reaction and trading volume. Results of his study provided conflicting evidence for his sample of 425 multinational corporations. The test results for price reaction were not significant. Similarly, the results of tests relating to the trading volumes were ambiguous. The conflicting results of Kim's study provide an example of the difficulty in selecting events under the "sunshine policy" of the FASB.

Ziebart and Kim (1987) evaluated market reactions associated with SFAS No. 8 and SFAS No. 52. Based on their analysis of security price reactions at ten different events times For 286 multinational firms (74-80). They concluded that contrary to the findings of the earlier studies, there had been a negative market reaction to the issuance of SFAS No. 8. They also found that the market had reacted positively to the issuance of SFAS No. 52.
Finally, they concluded that the translation method used by a firm prior to adoption of SFAS NO. 8 could not be shown to have a consistent effect on security market reactions subsequent to the adoption of SFAS No. 8.

In 1981 the SFAS No. 8 superseded by No. 52 in (U.S.)
According to SFAS No. 52, in order to determine the method of translation to be used, a company had to determine the functional currency of its foreign subsidiary. The choice of functional currency could also affect other decision taken by companies, for example, if the functional currency of a company's foreign subsidiaries is the local foreign currency, the company may choose to discontinue certain hedging activities undertaken while SFAS No. 8 was in effect.

Mo and Lung (2004)
This study aimed to examine the market reactions to the mandatory accounting for foreign currency exchange and compare the different reactions in Taiwan and US. The Taiwan FASC (Financial Accounting Standard Committee) issued statement of financial Accounting Standard No. 14, Accounting for foreign currency exchange, on December 10, 1988, effective on January 1, 1989. This statement required Taiwan listed firm to report significantly different earnings and to use an improved format of disclosure subsequent to the effective date of the statement, since Taiwan has different institutional arrangements of accounting regulation From the US, this study hypothesizes that the empirical results would be different from the ones reported in Ares (1986), Griffin (1983 and Kelley (1985). This study contends that the so-called different institutional arrangements in these two countries include the regulatory body, standard setting procedures, ownership structure of listed firms, governance structure of stock market, usefulness of financial information and economic attributes in relation to foreign currency exchange. This study applies standard market model and event study methodology to investigate the market reactions around the statement date and effective date. In addition, this study further tests the robustness and generalization of empirical findings, including confounding events, tests of market model, correlation of residuals, between events dates and alternative comparative sample sub-groups. The empirical results robustly reveal that significant market reactions can be detected around the announcements date of the statement No. 14.
Management Actions, Analysts and Certified Accountants (CPAs):
The impact of accounting standard of foreign currency on managerial decision-making and the attitudes of managers, analysts and external auditor (CA) were targets of some accounting studies.

B. Management Actions

Evants, Folks and Jilling (1978) one approach used to determine the impact of SFAS No. 8 on firm management decisions was to compare responses before and after SFAS No. 8 were issued.

Evants, Folks and Jilling followed this strategy. Their study based on a direct mail survey of 156 U.S. multinational corporations. They found that SFAS No. 8 did affect firm management policies. They concluded that there is clear evidence that firms whose accounting practices didn't conform closely to SFAS No. 8 when it was issued are pursuing more aggressive foreign exchange risk management strategies after adopting SFAS No. 8. The authors also found that the aspects of foreign exchange risk management had become more sophisticated and that more time and money were spent on such activities than earlier. They conclude (1978: 23-24):

In short, the impact of FASB statement No. 8 on the selection of exchange risk management objectives can be subjected under three main headings. First, it has introduced at some firms a tension between managing accounting exposure and managing economic or cash flow exposure. Second it has concentrated entity entirely the attention of some firms on management of accounting exposure, drawing attention away from operational strategies for exchange risk management. Third, for some firms, exchange risk management has become much more of a short-term function while longer term operational means to objectives may be overlooked.

Cooper, Fraser and Richards (1978) the objective of study was to determine whether because of SFAS 8 Firm had changed any management practice or procedures regarding foreign operations and translation methods or deferral practices. Based on the results of questionnaires, they concluded that management practices did indeed change in response to...
SFAS 8. In their sample of 195 corporations 95% used deferred before SFAS 8 and had to change reporting practice to adhere to SFAS 8, and 35% said they change capital investment decisions due to SFAS 8.

Massar (1978) analyzed a questionnaire to conclude that SFAS 8: distorted real operating results and provided misleading information, which led to uneconomic changes in financing method and resulted in non-productive activities.

Shank, Dillard and Murdock (1979) used a different approach in their study of SFAS No. 8. They gathered responses from firms that were required to make changes in their accounting methods to conform to the new standard. A questionnaire was utilized to guide field interviews conducted with financial and operating managers in 25 major corporations (1979: 1). Similar to Evants, Folks and Jilling, Shank, Dillard and Murdock concluded that SFAS No. 8 significantly increased the amount of management time and attention devoted to foreign currency accounting in a large proportion of their sample. More specifically, they found that SFAS No. 8 had a major impact on firm choice of currency in which debt was denominated the involvement of the sample firms in the forward exchange markets and on the internal reporting and control systems of sample firms.

Bindon (1983) used a survey of multinational corporations to evaluate two questions: (1) whether SFAS No. 8 had an effect on inventory management practices and (2) whether the requirement of SFAS No.8 that inventory at the historical exchange rate had a significant effect on reported earnings. Seventy-eight of the sample of 180 firms responded. Bandon’s results were negative concluding that inventory practices of most firms were not significantly affected by the adoption of SFAS No. 8.

C. Attitudes of Managers, C.A. And Analysts

There were number of accounting studies undertaken to identify and to investigate the reactions and attitudes of financial managers, professional accountants (C.A.) and financial analysts. Thus, those studies combined of preparers and auditors of a financial reporting as
well as some external users of the financial reporting to understand the opinions of that
group regarding accounting treatment of foreign currency changes that will help accounting
standards setters to recommend the comprehensive approach for foreign currency problems
which not only can improve the quality of accounting information system and its credibility
but also can help the management, investors, creditors and others users of financial
reporting to take proper decision to evaluate the actual performance of company and its
ability to generate the futuristic cash flow.

The researcher Cleary states that the management responsibility is to manage the foreign
exchange risk properly to increase the value of company; therefore, the foreign currency
translation should not be taken without consideration the performance evaluation, control
system and usefulness of information in decision-making.

Revzin (1976) drew the following conclusions based on interviewing multinational
corporate managers; managers worry about security analysts' opinions of fluctuating
earnings per share reports, accountants and security analyst, defend SFAS 8, MNCs resist
SFAS 8 and SFAS 8 caused some corporations to restructure their debt abroad.

Choi, Lowe and Worthley (1978) identified the attitudes of financial managers and CPAs
relative to SFAS 8.
They concluded that majority of the CPAs preferred SEAF 8, while the majority of
financial managers rejected SFAS8 especially in three areas:
(1) Treatment of inventory
(2) Treatment of long-term debt
(3) Including foreign exchange difference (Losses) or gain in income statement.

Financial manages according to this survey believed that including foreign exchange
differences gains or losses in current income may lead to:
(1) Introduce greater volatility in reported earnings.
(2) Make shares less attractive and decrease the share prices.
(3) Push corporate management to hedge the accounting exposure on cost of
economic exposure and also the financial managers believed that SFAS 8 might
lead to distorting the allocation of resource in the national economy. The study data were obtained through mailed questionnaires.

Stanley and Block (1978)
Concluded that financial managers dislike FAS 8 because it tends to create volatility and what they regarded as distortions in reported earnings. They found that as a result, financial managers were giving more attention to exposure management, "many going so far as to take action to reduce accounting exposure even at the expense of greater economic exposure."

Rodriguez (1980) interviewed financial officers of 40 multinational firms. Data collected in 1977 related primarily to manager's perceptions of the effects of SFAS 8 on the firm. She found that the primary measure of exposure to exchange risk analyzed by managers in her sample was translation exposure.

One concern that arose relative to firm determination of functional currencies was the subjective nature of the process would firms adequately distinguish between differing economic conditions using the functional currency indicators provided in SFAS 52?
Evans and Doupnik (1986) investigated different aspects of the determination of functional currency. Based on 177 responses they concluded that there are substantive differences between the foreign subsidiaries determined to have local foreign functional currencies and those designated to have the U.S. dollar as their functional currency. Evans and Doupnik also found that the currency indicator do provide adequate discriminatory power between foreign operations that are self-contained and those that are extension of the parent company.

Arnold and Holder (1986) focused on more general issues surrounding SFAs No. 52. They investigated the impact of standard No. 52 on financial reporting of companies as well as perceptions and decision made by managers and analysts. Data was obtained from a personal interview with 29 analysts and executives from 22 companies as well as from review of 1983 the annual reports of over 170 companies. They
concluded that SFAS 52 had allied many of the concerns the companies voiced regarding SFAS No. 8. They also found that companies are hedging transaction and economic exposure more and translation exposure as a result of adoption SFAS No. 52. On a less positive note, they concluded that financial analysts do not have a good understanding of the new disclosures and their implications.

Griffin and Castanias (1987) focused on the impact of SFAS No. 52 on equity security analysts. Their study consists of two parts. Interviews with 49 equity security analysts were undertaken to assess their understanding of SFAS No.52 and their use of the disclosure in forecasting earnings. Second monthly earnings forecast date was analyzed to determine whether analysts forecast accuracy and perceptions of uncertainty were affected by the issuance and adoption SFAS No. 52. Griffin and Castanias concluded that analysts were more uncertain about earnings for 1982 and revised their forecasts more when compared to a control group of companies not affected by SFAS No. 52. They also concluded that, when compared to the control group the accuracy of the analysts forecasts increased after companies adopted SAS No. 52.

Chen, Comiskey and Mulford (1990)

The objective of the study was to investigate the effects of SFAS No. 52 on analyst forecast dispersion. Statement of financial accounting standard (SFAS) No. 52, foreign currency translation (1981), amended the accounting procedures for foreign currency statements by requiring the exclusion from income of most foreign currency translation adjustments. As a result, the earnings of affected multinationals were expected to become less volatile, this expectation is used in the present study to form a hypothesis that the adoption of SFAS No. 52 led to a reduction in the level of disagreement, known as forecast dispersion, among financial analysts in their forecasts of earnings. Forecast dispersion is considered to be a relevant measure of firm risk and has also been linked to stock trading volume. In detecting a reduction in dispersion associated with the adoption of SFAS No. 52, the present study indicates that an economic consequence was associated with the adoption of the accounting standard. The results and implications should be of particular interest to accounting policy makers as an insight into the effects of SFAS No. 52 an affected firm is provided. Financial analysts and market participants should also found the study to be of interest because it
provides better understanding as to why earnings forecasts may differ, potentially leading to a reduction in those differences and enhanced confidence in earnings forecast data.

CONCLUSIONS:

Success in identifying the economic effects related to accounting standards has varied with few exceptions. Studies have failed to find significant effects; this does not necessarily imply that there are no economic effects relating to accounting standards. But only those tools available are not powerful enough to detect those effects. Other accounting studies have concluded that certain facets of managerial behavior were affected by SFAS NO 8 then by SFAS NO52. Managers spent more time, effort and resources to respond to SFAS No. 8. But, as Bandon's study indicated, not all of managerial behavior changed, indicating a certain degree of selectivity by managers. Most studies seem to indicate that translation exposure hedging increased as direct results of adopting SFAS No. 8. This is interpreted to be a negative in that removing variability from earnings can result in an increased economic exposure that might adversely affect future cash flows.

Based on the evidence cited, SFAS No. 52 has undone some of the effects of SFAS No. 8. Survey studies indicate that companies now undertake fewer or lower amounts of costly translation exposure hedging and make more decisions based on the economic impact of transactions instead of the resultant income impact. Evans and Doupnik (1986) concluded that companies are even abiding by the spirit of SFAS No. 52 applying appropriate functional currency indicators and the prescribed translation methods.

As a result of the issuance of SFAS No. 52, most manages appear to be more content with the state of the art.
5. THE STUDIES OF IMPACT OF MANAGERIAL PREFERENCES ON ACCOUNTING POLICY SELECTING OF FOREIGN CURRENCY:

The primary behavioral model assumed in these studies is agency theory when faced with a conflict of interest; managers will maximize their own wealth instead of shareholder wealth.

Griffin (1982, 1983) investigated characteristics of companies lobbying on SFAS No. 8 and SFAS No. 52. Griffin (1982) analyzed company characteristics of companies lobbying against SFAS 8 after its issuance. Variables examined included the income statement category of "Foreign exchange gain (loss)"; debt covenants, size, dividend constraints and an individual firm risk factor. He found limited evidence supporting the hypothesis that firm responding to FASB's call for comment experienced greater swings in pretax earnings than other multinational corporations.

He also reported that firm size and leverage were salient explanatory factors. It is not surprising that foreign exchange gain (loss) was not found to be significant. The item "Foreign exchange gain (Loss)" is best described as the net gain (Loss) resulting when all foreign currency gains and losses have been added together. Included in this item are the net transactions gain (loss) for the period and the net translation gain or loss measured after the effects of hedging. As a result, this variable may be too aggregated to be easily interpreted. Unfortunately, it is usually the only information disclosed regarding the magnitude of Foreign Currency gains and losses each year.

Using the model developed in his 1982 study, Griffin then attempted to predict lobbying behavior of firms on the successor of SFAS No. 8, SFAS no.52. He concluded (1983: 130) that "the models adequately described management's behavior, but their predictive ability is only a modest improvement over naive perdition rules" His conclusions regarding the firm characteristics of leverage and foreign gains (Losses) were contrary to those in his 1982 study.
Kelly undertook two studies relating to firm lobbying behavior and SFAS No. 8. *Kelly, in (1982)* investigated the relationship between lobbying activities and changes in financing or operating activities subsequent to adoption of SFAS No. 8. Kelly found no relationship between corporate lobbying activities against SFAS No. 8 and changes in financing or operating activities subsequent to its adoption. She concluded that the companies that lobbied against SFAS No. 8 were characterized by greater leverage, larger assets size and a lower percentage of manager stock ownership and that a large proportion of manager remuneration in such companies was made up of incentive compensation. Only company's size was related to company's decision to alter financing or operating activities.

*Kelly, in (1985)* examined the relationship between debt contracts and degree of firm ownership by management and the decision by firms to lobby SFAS No. 8. She classified lobbying firms into two groups based on lobbying against the proposed standard due to implementation issues or to expected income effects. Kelly concluded that the firms that lobbied against SFAS No. 8 due to implementation issues were characterized by large assets size and a large percentage of foreign sales than non-lobbyers, but not significantly so. Contrary to her expectation, she also found that management ownership proportion was lower in the firm that lobbied against SFAS No. 8 due to expected income effects.

*Salatka (1984)* posited that political costs and the existence of costly contracting in companies would lead to a negative market reaction to SFAS No. 8. Comparing daily abnormal return of a sample of multinational companies with a control sample of domestic companies, he tested the securities market reaction to the accounting policy decision process surrounding the issuance of SFAS No. 8. Salatka found a negative capital market impact for companies affected by the standard i.e. the multinational companies, on the day prior to the release of the exposure draft of SFAS No. 8. Seventeen other events relating to the issuance of SFAS No. 8 were tested and found to be not significant. His study provided mixed results. Size was consistently significant and Leverage was significant but had the opposite of predicted sign.

*Brown (1985)* evaluated the effect of SFAS No. 52 at adoption date on earnings and security prices. She investigated cumulative average returns of late and early adopters and found a significant difference. Brown concluded that there had been a strong market
reaction to a firm's decision to adopt the new standard in 1981. Based on univariate analysis of seven firms' attributes, she found that firms choosing to adopt SFAS No. 52 in 1981 were different from adopter, in either 1982 or 1983. Also, the late adopters—firms that continued to apply SFAS No. 8 during the transitional years did not experience greater volatility in earnings than firms that adopted SFAS No. 52 in 1981. Her last conclusion contradicts allegations that SFAS No. 8 led to large fluctuations in income.

Ayres (1986) examined the relationship between the year firms adopted SFAS No. 52 and characteristics of firms suggested by positive theory as size, Financial leverage, risk dividend constraints, management compensation (Watts and Zimmerman, 1978: 53). She hypothesized that there would be an association between firm choices to adopt SFAS No. 52 early i.e. in 1981 and the percentage change in reported earnings, size, the percentage of stock owned by directors and officers, debt/equity ration and dividend constraints. She concluded that smaller firms adopted SFAS No. 52 during 1981. These firms also reported a decrease in earnings in the adoption year and had lower director and officer stock ownership and more binding constraints on dividend payouts than later adopters. Her conclusion that firm choosing to adopt SFAS No. 52 early has different characteristics than late adopters corroborates Brown's conclusion.

Cray (1993)
There are three theories: income maximization theory, income smoothing theory and income minimization theory.
According to logic of income minimization theory, the management of large companies prefers accounting policy that will reduce the reported earnings to avoid any political costs. Watts and Zimmerman (1978) provided evidence to support the income minimization theory in selecting accounting policy. Gray (1993) in his dissertation aimed to test the validity of theories of selecting accounting standards mentioned above. He answered the question of why some US multinational corporations (MNCS) decided to implement SFAS No. 52 in 1981 (two years before it was mandatory), while other US MNCS those to continue to apply SFAS No. 8. In the process of answering this question, Gray examined the largest fifty U.S. Industrial Corporations and the largest fifty U.S. Commercial Banking corporations relative to their preference for SFAS 52 or SFAS 8 as
disclosed in their 1981 annual reports. He concluded that the majority of MNCS (irrespective of corporate size) chose the accounting standard that resulted in higher reported earnings. All of MNCS that implemented SFAS 52 reported not translation losses. By implementation SFAS 52, they excluded that loss from the income statement and thereby increased reported earnings. This research result supported the income maximization theory of accounting standard selection (Gray (1993: 70) Finally Gray recommended that on the variables to be used to predict accounting choice of Foreign currency translation, these variables not only related to characteristics of company like financial leverage and changes in management but also related to its degree of internationalization such as foreign assets, sales.

Pacecca (2004)
The study examined the ability of positive theory - economic consequences theory - to explain the managerial preferences of accounting choice with reference to accounting treatment of foreign currency transactions in Australian companies. There are two accounting treatment for unrealized exchange differences of foreign currency monetary items arising from exchange rate changes subsequent to the data of the transaction:.

(1). The immediate recognition method of accounting for foreign currency transactions requires unrealized exchange difference arising from foreign currency transactions to be recognized immediately in the period they occur.

This means that when the exchange rate varies, causing the value of the monetary items, which is denominated in the foreign currency to change, the gain or loss arising from this change in value is to be recognized in the income statement in the period in which it arises.

This method is consistent with the view that the current exchange rate provides a more accurate reflection of the value of the monetary assets or liabilities, Pacecca (2004: 3).

(2). Defer and amortize method. The exchange gains or loss of closing balances of foreign currency items are not taken to the income statement in the period in which they arise, but are capitalized as a liability or assets and written off over the life of the monetary item.
This study used independent variables that are recommended by positive theory to explain managerial preference of accounting choice such as size, risk, leverage and interest coverage.

This study assumed that immediate recognition method of unrealized exchange difference produce volatility in reported earnings, but the deferring and amortizing method leads to stabilize the reported method. Pacecca concluded that the results of the study provide some support for the positive theory.

He clarified that there was association between leverage and interest coverage and accounting choice while there was no association between the size, risk and accounting choice. Pacecca recommended implementing this analysis of accounting choice in another accounting area.

Aiken and D. Ardern (2004)
Despite successive professional pronouncements providing managers with scope to choose between two translation methods, because Australian Accounting Standards setter has adopted the Situational Approach that recommended current method to be used in case of independent foreign operations and temporary method to be used in case of dependent foreign operations. The proportion of firms in Australia using the current method as compared to the temporal method has remained relatively constant over time.

Here, use is made of environmental contingency variables to evaluate and explain the consistency of management's adoption of translation methods for foreign financial statements. Tests of the affects of significant operating environmental conditions as on-going constraints on management's decisions and actions do not support hypotheses that choice is usually opportunistic, conservative, deceptive or unnecessarily short-run, given management's risk planning process as whole. One the basis of the statistical evidence presented, the adoption of particular translation methods can apparently reflect a parent company's broad on-going investment and operating strategies for the organization as a whole.

These views agreed with approach that believes accounting policies are part of management policy and strategy to achieve the goal of the organization efficiently. Thus, accounting policy of foreign currency translation can not be isolated from its organizational content and its economic environment.
CONCLUSIONS:
From studies above, it appears that positive theory does provide some insight into association between company characteristics and management decision. However, as Griffin and Kelly show the relationships between the variables and firms are complex and not yet well understood. Interaction between variables can lead to results that may not be valid or which do not provide adequate insight to allow predictive models to be developed.

6. THE STUDIES OF IMPACT OF ACCOUNTING TREATMENT OF EXCHANGE RATE CHANGES ON REPORTED EARNINGS:
Several accounting studies explored whether foreign currency translation methods affect reported earnings. Nance (1981) examined five methods of translation to check the results of translation on reported earnings and earnings variability. He hypothesized that results are independent of currency and industry group. Using data from financial reports of 160 U.S. MNCs from 12-year reporting period. He developed a mathematical model to identify and to classify different translation effects on earnings. Based on his analysis, he concluded that none of the five methods of translation were entirely satisfactory the monetary/non-monetary method with inventory translated at the current rate was the most satisfactory method for translating conventional historical cost based financial statements, earnings per share different with the translation method used and earnings per share variability was independent of currency and industry group.

Hassini (1981) also investigated the effects of different translation methods on reported earnings, especially the impact on reported return on investment (ROI). Hassini concluded that many factors affect (ROI) not just the translation method used. He indicated a preference for the current rate translation method as it produced results most comparable with internal rate of return.

Thus, the accounting profession continues to disagree on the best translation method to use.
7. PERFORMANCE EVALUATION AND ACCOUNTING FOR FOREIGN CURRENCY:

"Management goal is usually accepted to be the maximization of the economic value of the firms" (Rodriguez, 1979: 50). Managers believed financial statements users evaluate them in relation to how well they achieve the profit maximization goal. Managers also believe that "accounting imagery frequently dominates economic realism" (Kemp, 1982: 169).

Lessard and Lorange (1977) questioned the benefits using the same set of exchange rates in both setting budgets and tracking performance relative to budgets. They believed that the treatment of exchange risk was a source of conflict and distortion in decentralized MNCs. They concluded the operating control of individual foreign subsidiaries should be decentralized and financial controls should be centralized. The position of translation adjustments in the financial statements is not always clear. Is translation adjustments part of operations or financing?

Lessard and Lorange (1977: 628) suggested using of internal forward rates (IPRs) to resolved the centralization / decentralization dilemma, as well as to improve the decision making and management central system, because using internal forward rate (IPRs) according to them, satisfying two major criteria for good management control system i.e., goal congruence and fairness.

Morsicato (1978) studied the interaction of financial statement translation of foreign operations and performance evaluation system. Based on 113 questionnaires and 33 interviews, she concluded that SFAS 8 affected the internal performance evaluation policies of MNCs. Budgeting is an issue integral to internal performance evaluation policy.

Wilner (1982) examined the interaction of accounting reporting variables and organizational reward via a behavioral experiment where in managers from 16 MNCs participated. He examined the information inductance hypothesis. Inductance hypothesis is
based on the idea of inducement, wherein requests for information are thought to induce certain behaviors.

His results suggested that "managers" might sacrifice cash flows to the firm in making decision if the bottom line effects are disadvantageous to their own position. While this study did not utilize the agency theory framework, it presented an example of a situation commonly addressed in agency theory i.e., whether a manager will choose to maximize his/her own wealth at a cost of the owners when faced with a conflict of interest (Watts and Zimmerman, 1978).

Demirag (1986) examined the type of exchange rate used in foreign subsidiary budgets and responsibilities allocated for translation and transaction gains and losses in performance evaluation. The study was limited to U.K.-based MNCs. The empirical data was collected during 1982 by questionnaires and interviews.

Concluded that a majority (52%) of companies in the UK survey employed forecast rates in determine budgets overall, UK MNCs do not appear to be sufficiently concentrating with identifying and measuring the operating effects of real exchange rate changes in performance evaluation of foreign subsidiary managers. This is according to him because MNCs in the UK do not clearly distinguish managers' performance from subsidiaries operating performance.

He also found the UK MNCs tend to allocate responsibility for exchange gains or losses to where there is authority. Translation gains and losses are generally ignored in performance evaluation of foreign subsidiary managers. However, a significant minority (48.6%) of UK MNCs appears to hold their foreign subsidiary managers responsible for transactions gains and losses. The authority granted to foreign subsidiary managers to reduce the impact of exchange rate movement by hedging in financial markets appears to be very limited and in many cases is restricted by very rigid corporate guidelines (Demirag, 1986: 163).

Troberg (2005) suggested using Global Currency Unit (GCU) as a balanced approach to performance evaluation in multinational enterprises (ME).

The use of the parent's currency in the evaluation process may overemphasize the importance of the parent currency, thus affecting the way the operations of the ME are conducted. A possible consequence is that the overall financial results are not optimized on
global basis. One can argue that there is a lack of global perspective. Likewise, using the subsidiary's currency means similar shortcomings to using the parent's currency that is attaching too much importance to the subsidiary's currency and consequently, lack of global perspective. He believed if an enterprise wants to be considered truly multinational, it must have global perspective and hence adopt a global strategy. A global strategy according to him means a plan whereby an enterprise states its major business decisions, by taking into account global opportunities, global alternatives and future global consequences. Furthermore, the aim of a global strategy is to maximize results on a multinational basis rather than to treat international activities as a portfolio of diverse and separate country companies. Developing a global strategy depends upon the way executives think about doing business around the world.

The design and implementation of a global strategy requires that managers in both headquarters and subsidiaries follow a worldwide approach, which considers subsidiaries as neither satellites nor independent city-states but as parts of a whole. Each part of the system makes its unique contribution with its unique competence. This approach named geocentrism by Perlmutter (1989).

Troberg (2005) in his study mentioned numbers of advantages of using (GCU) such as:
(1) Pushing management in ME to adopt global think
(2) Neutrality
(3) Stability in value, thus reducing effects of foreign exchange rates changes.
(4) For facilitating the planning and performance evaluation process within the ME and assure a global orientation. Troberg (2005: 30).

8. THE STUDIES OF ACCOUNTING PRACTICES OF FOREIGN CURRENCY:

Numbers of accounting researches studied the accounting practices and policies adopted actually in the area of foreign currency transaction and translation, Parkinson (1972). He supported issuing an accounting standard to mandate that similar circumstances should be accounted for in a similar manner. He examined whether MNCs accounted for foreign currency translation in a similar manner in 1981 annual reports. Indeed, dissimilar manner
accounting for similar events occurred in 1981 just as Parkinson suspected might happen when managers can choose among methods.

Parkinson felt that dissimilar accounting for similar events provided a lower quantity of information for decision-making. He finally concluded that the **current rate method of translation** was superior to the current / non-current and the monetary / non-monetary methods.

**Pakkala (1975)** reviewed annual reports of 50 US MNCs to identify accounting practices regarding foreign subsidiaries. Contrary to Hepworth's (1956) prescription rejecting the current / non-current translation method, Pakkala concluded that fully one-half of MNCs used the current / non-current method. Pakkala also noted that there was no uniformity in accounting treatment of exchange differences and the application of different translation methods led to different results. (Pakkala, 1975: 36).

**In Britain, it is clear that the closing rate method has established itself** as virtually the universal method. A survey of the 1990 accounts of 300 large and medium-sized British companies showed that of the companies with evidence of foreign operations, all used the closing rate method for translating balance sheet items, except for these companies that did not disclosed the method (ICAEW, 1992). In France a survey of 100 large groups showed that 95 percent used the closing rate method in 1993 (Nobes, 1999: 372). In the Netherlands, a survey of 120 companies in 1989 reported that 77 percent used the closing rate method (Flower, 1999: 372).

**Sijini (1999)**
The objective of his research is to study and evaluate accounting for foreign currency transactions and translation of financial statements. Also this research aimed to survey the actual accounting practices and accounting policies adopted on the effects of changes in foreign exchange rates by selected industrial companies **in Saudi compared to International Accounting Standard No. 21**.

Sijini paid attention to the significant relationship between inflation and foreign exchange that should be considered in selecting method of translation rate changes. He believed that
inflation and changes in foreign exchange rates have impact on the quality of information of financial statement of foreign subsidiaries and that leads to distortion of operating results and financial position of these companies. These financial changes in inflation and foreign exchange rates does not help in making proper decisions regarding transfer prices, capital investment and evaluation performance (Sijini, 1999: 75).

He supported to re-state the financial statement of foreign subsidiary, which is located in hyper inflationary economy and then to translate by the current rate. He argued that the approach would provide useful information for parent company investors to help them in forecasting expected cash flows (Sijini, 1999).

The empirical data of this study was collected by a survey of annual reports of an industrial Saudi companies listed in the Saudi stock exchange market for (1989-1993).

He concluded that actual accounting practices in some Saudi companies confirm mostly with the recommendations of international accounting standard (IAS) No. 21 issued in 1983 and that accounting practices regarding foreign currency translation in a study sample did not take into consideration the effects of foreign and domestic inflation when translating foreign subsidiary financial statements.

Radford (2005)

The purpose of this study was to analyze the implementation of the accounting standard AASB 1012 issued in November 2000 replaced AAS 20. AASB 1012 foreign currency translation by companies listed on the Australian stock exchange in relation to accounting for their subsidiaries. AASB 1012 establishes a number of definitions and guidelines to assist companies in determining which methods of translation should be used in particular circumstances. However, not only are these guidelines confuse confusing but they differing from those specified in the related accounting standards in the United Kingdom (UK) and the United States of America (US).

Radford (2005: 1) concern is how Australian companies interpret AASB 1012, and whether they would classify foreign operations differently from their counter parts in the UK or US.
The purpose of this research is to gather information about the utilization in the classification process of the factors provided in AASB. Additionally, the study attempts to determine of AASB 1012 is being applied in a manner similar to the functional currency approach used in other countries.

The results indicated that the dominant factor for classification of foreign operations is the financial independence of those operations from the parent entity. This directly contradicts the emphasis in AASB 1012 on the criterion exposure to exchange gains and losses a key to classification. Results also indicated that functional currency approach is not being adopted in Austria. He recommended the AASB 1012 should be amended to clarify the classification process.

The empirical data of the study was collected by a questionnaire survey of Australian listed companies with overseas operations. It is adapted from one used by Evans and Doupnik (1986) to evaluate functional currency decisions required under FAS 52.

His study indicated that there are two approaches in classification of foreign operations as independent or as integrated they are simply taking different paths to arrive the same answer, direct approach which adopted by IAS 21 and AASB 1012 and indirect approach which adopted by FAS 52 (US) and (UK) SSAP 20. Under indirect approach first we should determine the functional currency and then determine the nature of foreign operations whether they are independent or not.

**CONCLUSIONS:**

The Situational Approach of selecting translation method of financial statement became international choice adopted by IAS 21, FAS 52, SSAP 20 and AAS 20. This approach is flexible and according to the nature of economic relations between the parent and its subsidiaries (situation) the translation method to be selected.

India also adopted the situational approach in the last revising of AS 11 in 2003 in conformity with international harmonization of accounting practices.
9. FOREIGN EXCHANGE FLUCTUATION AND CORPORATE PERFORMANCE:

The foreign exchange rates changes does not only affect accounting information system and management control and performance evaluation systems but also affect performance of company and its ability to generate cash flows, because the economic effects of changes in foreign exchange rate affect the costs and revenues and prices which affect the profitability and market value of the company. Thus, even, a domestic company with no foreign inputs, and no foreign currency assets or liabilities it cannot immune to the risk of foreign exchange volatility if company's competitive position is affected (Amihud and Levich, 1994: 3-11).

Actually the fluctuation of foreign exchange rates has impact on financial position and expected cash flows as well as on the operating performance of the company. Thus, the changes in foreign exchange became accounting and economic problems as well as a challenge before the management of company to face and manage it efficiently.

In 1971 the fixed exchange rate system officially collapsed and the validity of the Bretton Woods system was over when the floating rate system took its place (Gray, 1993). Under the floating system, the foreign currency became as any commodity its price determined by market forces. This leads to changes in exchange rates which are not hourly but which are often by minutes and became daily phenomena.

In the 1980s the phenomena of fluctuation of foreign exchange rates increased along with the Vulnerability of all companies to international competition. These factors suggest that the potential importance of exchange rates on the performance of the companies may be growing. Thus, the accounting for decision making and information system can not stay in isolation from these events, therefore accounting researchers and accounting practices as well attempted and still attempt to find "economic-manage-accounting" approach for exchange rate changes problem and its impact on company's performance and its accounting and management system.

There are number of accounting studies which investigated the relationship between exchange rates and corporate performance and these studies dealt with different subjects such as:
1- Impact of exchange rate changes on firm valuation.
2- Impact of exchange rate changes on stock prices - Returns.
3- Impact of exchange rate changes on the capital cost and pricing policies.

Adler and Dumas (1984) stated that exchange rate movements might affect even firms, which operate in domestic markets (see, Yucel, 2004:3).

Demely and Sheshy (1990) found that the exchange rate change affected market values of large exporters in their study. (See, Yucel, 2004:4).

Bilson (1994) investigated the impact of foreign exchange rate changes on the revenue of the companies, case study of American airlines.

Foreign exchange exposure is of increasing importance in the airline industry as the large carriers expand into foreign markets. Net foreign currency cash flows at American airlines have grown from $119 million in 1986 to $393 million in 1990. International revenue has grown from 19.3 percent of the total system in 1986 to an estimated 26.7 percent in 1990 [Bilson (1994, P 222)].

It is consequently important to know how the profitability of the airline will be influenced by the fluctuation of exchange rates.

He concluded that the effect of exchange rate on the profitability of an airline is considerably more complex than its effect on cash flows. Also he indicated that the company's value is affected by exchange rate changes because part of its revenues is in foreign currency (See, Amihud and Levich, 1994).

Levi (1994) investigates the relationships between exchange rates changes and valuation of firm.

According to macro-economic analysis if the exchange rate - external value of the currency decrease, this leads to increase the exports and to decrease the imports because the cost of exports and imports affected by changes in exchange rate in different directions.

In micro-economic analysis, the changes in foreign rates has effects on revenues and cost and profitability and value of the company as well as the excepted cash flows and
performance of this company, these effects known as the economic effects or economic risk of exchange rates changes on the company value.

Levi analyzed the micro-economic effects of exchange rates changes and in particular, their impact on the valuation of firms with foreign sales. The effect of exchange rate changes on value includes two components: (1) the revenue and (2) quantity sold. He concluded there are no significant statistical relations between value of foreign sales and exchange rate changes (See, Amihud and Levich, 1994).

The researcher believes that results due to that the exchange rate affects and gets affected by another economic variables such as inflation and interest rate and aggregate demand and supply. Also exports affected not only by exchange rate but also by other factors such as structure of foreign market, Govt. intervention and elasticity of demand and supply.

Cumby (1994) offered some explanations for the weak relationship between exchange rate changes and the stock prices of companies. Cumby argued that the relationship between company's equity values and exchange rates varies over time or hedging in the financial markets. Taken together, the evidence suggests that firms are successful in eliminating their foreign exchange risk, which arises the question of why they make such a choice (See, Amihud and Levich, 1994).

Brown and Otsuk (1994) investigated the effects of exchange rate changes on asset return. Brown presented a comprehensive multi-country and multi-period Arbitrage pricing theory model to examine whether exchange rate changes are priced. They concluded that the exchange rate changes are priced in most of the 21 countries, but in the United States its effect is marginal. The implication is that in general, exchange rate volatility does affect the equity cost of capital in most countries, but in the United States this effect is mute(See, Amihud and Levich, 1994).

Jorion (1994) investigated effect of exchange rate changes on the cost of debt Jorion measured the cost of debt in the United States, Germany and Japan in the same currency: the U.S. dollar. The relevant cost of borrowing depends both on the nominal rate of interest
in any currency and on the rate of change of the exchange rate of that currency with respect to the U.S. dollar.

The results showed that the cost of borrowing in foreign currencies was often higher than the dollar nominal cost of borrowing, and that over the long run there was little difference between them. Also, the real cost of debt in three countries were, on average, the same over the long term.

These results are consistent with the fact that Purchasing Power Parity (PPP) holds over long-term. Both the rest of debt and the cost of equity determine the cost of capital. In general, differences in the real cost of capital among countries may induce changes in the exchange rate. This should be taken into account when investors in one country are using another country's domestic cost of capital to evaluate cash flows in that country (See, Amihud and Levich, 1994).

Knetter (1994) studied the impact of exchange rate changes on pricing policies with reference to exporting companies in U.S. and Germany.

Exporting companies can respond to changes exchange rate by application of proper pricing policies in the markets.

Knetter presented theory and evidence on the policy of "Pricing to market" (PTM) by which firms change the price in response to exchange rate changes. This policy determines the pass through of changes in exchange rates from exporters to importers.

The extent of the pass through depends on the market structure, the market power of the exporting company, and the strategy of competitors. Knetter examined the nature of PTM by exporters in two countries: Germany and the United States.

He concluded that for the United States, the dollar price of export product is unaffected by exchange rate changes in destination countries. This means adaptation of one price policy across countries by US exporting companies.

In Germany there is greater evidence of PTM, implying a greater ability of German exporters to discriminate between markets (See, Amihud and Levich, 1994).
Bartove and Bodnar (1995) found that the companies which adopted temporal method of translation of financial statement because the U.S. dollar is the functional currency, these companies affected significantly by exchange rate changes, compared to those companies which are foreign currency as functional currency.

Other number studies did find the significant relationship between the fluctuation of exchange rates and firms’ stock returns such as (Solano, 1998:3):

2) Loudon (1993) and Khoo (1994) on Australia market.
3) Amihud (1994) US

Choi and Prasad (1995) developed a model and examined the exchange rate sensitivity of 404 US multinational firms. Their findings indicated that change in exchange rate affected firm’s value. They found that 60 percentages of firms had significant exchange rate exposure (see, Yucel, 2004: 3).

Solano (1998) investigated the impact of exchange rate changes on stock returns of a sample of 67 non-financial companies quoted in the Spanish Stock Exchange market between January 1992 and December 1997, therefore time series regression of stock returns and movement in exchange rate are carried out. Next, across sectional analysis is executed.

He found that the firm stock returns affected by fluctuation in foreign exchange. Solano indicated that the real effects of the exchange rates are seemed in the long-term, rather than on the short-term. The results showed that:

1) The exporter companies affected positively with decrease of Spanish currency while importer and domestic companies affected negatively.
2) The exchange rate risk is related to the degree of foreign involvement.

European Study (2003) investigated the impact of fluctuation of exchange rate on the European firms’ stock returns. It found that the more than 65% of sample affected significantly by changes of exchange rate in the long term.

This study indicated that the extent of exchange rate risk affected by factors such as:

1) Time horizons
2) Liquidity positions
(3) Size of firm
(4) Debt ratio

Wenlin (2004) investigated impact of foreign exchange rates changes on exports of companies. This study employed the pooled time series. The results showed that the depreciation rate of the new Taiwan Dollar has a positive effect on the change of export volume.

Yucel (2004) investigated the impact of exchange rate changes on stock returns of Turkish companies.
This study applied the coefficient of the regression of stock returns on exchange rate. He found that 11.8% of sample forms a positive and significant economic exposure for the examined period. The proportion and mean exposure coefficient are high for exporter companies compare to non-exporter. This last result is in agreement with the results of other studies that the exporter company's stock value is more sensitive to change in foreign exchange rates Mao and Kao (1990) Bartove and Bodnar (1995). Also Demely and Sheehy (1990) arrived at the same result.

YingTu (2005) analyzed the impact of changes in foreign exchange rate on the companies. This study used regression models to examine factors, which may influence exchange rate exposure. The results of his study are as follows:
1. Some evidence shows the effect of exchange rate changes in operating revenue for some firms.
2. Taiwan electronic corporations with bigger size may have lower exchange rate exposure.
3. Firms with higher exporting ratio and foreign investment ratio tend to have higher exposure to exchange rate risk.

Asian Study (2005) analyzed the effects of fluctuation of foreign exchange rates on Asian firms' stock returns. This study results were in argument with European Study's results (2003).
Impact of exchange rates fluctuations on the corporate cost of capital and the pricing strategies adopted.

In addition to their effects on corporate cash flows, exchange rates affect the corporate cost of capital and the corporate pricing strategies. Exchanges rates changes constitute one of the macro-economic factors which investors’ price in the market that are, there may be a risk premium to compensate the holders of shares whose value is affected by exchange rate changes. For the risk associated with this factor. Consequently, the exchange rate changes affects the firm's cost of capital. These effects may differ across countries and thus may result in differences in the cost of capital between countries.

Exporting companies can respond to exchange rate fluctuation by implementing proper pricing strategies in the markets with imperfect competition, in addition to adjusting the quantities they sell. The extent of the pricing policies depends on the market structure, the market power of the company, nature of products etc.

CONCLUSIONS:
After the survey and presentation of accounting studies regarding the relationship between the foreign exchange rate changes and corporate performance, the researcher can state clearly, that the exchange rate movement can affect the value of companies, as it directly affects their cash flows and indirectly affects their cost of capital. This is what is known as foreign exchange economic exposure and results from changes of the home currency value of the firms to unexpected changes in exchange rates.

The extent of this risk depends not only on the amount of international transaction the companies analyzed excited, but also on the extent to which the economies in which they carry out their transactions are exposed to foreign influences. The exposure to risk in turn, has two different facts as Shapiro (1983) point out: the transaction exposure, which is the possibility of incurring exchange gains or losses upon, settlement at future date, on transactions already entered into and denominated in a foreign currency, the effects of which normally are in the short term, and operating exposure, which results from the fluctuation in currency values, which, together with price adjustment, can affect the
forecasted amount of the company operational cash flow, thereby giving rise to long-term effects.

Considering the increasing globalization and interdependency of national economies that is taking place, it is logical to assume that there could be a link between the fluctuations of exchange rates and corporate performance, even in the case of companies that are geared exclusively to their domestic markets (Alder and Dumas, 1984) because the future cash flows of the company will change with exchange rate fluctuations. In other words, exchange rate changes have important implication for financial decision-making and for firm profitability (Yucel, 2004, 2).

The fluctuation of exchange rate and its impact on performance and future cash flows and financial position of company infract the companies to take proper actions and strategy not to reduce the risk of that fluctuation but also manage it economically and efficiently. Thus, the management of foreign exchange risk became unavoidable and essential for all companies especially in the era of economic openness and globalization. The corporate management is a responsible not only to manage the economic and capital resources and to improve the business reports system but also to protect the real value of those resources.

The exchange rate risk management is considered as a part of strategy not only in the national level but also in the corporate level.

In the exchange rate risk management, the financial studies usually discuss subjects such as:

(1) The types of exchange risk- accounting risk, transaction risk and economic risk.
(2) The measurement of foreign exchange risk
(3) The techniques for risk management
(4) Internal and external hedging

Besides the corporate management may take crucial decision to adjust with, risk of permanent exchange rate changes such as:

- Production, market location decision
- Mix marking, Finance, capital structure and capital budget.
- Changes in economic entity and extension, hence those decisions are strategic in nature which should be taken in the top level of the management.

The accounting treatment of financial instruments and hedging included in the International Accounting Standards separately in IAS No. 32, 39 which is out the scope of this Thesis.
THE GENERAL OBSERVATIONS ON THE ACCOUNTING STUDIES THAT HAVE BEEN PRESENTED:

1. The exchange rate changes affect different aspects of corporate units. Hence it has accounting, managerial and economic dimensions:
   a. **Accounting dimension** that states the effects of rate changes on the quality of accounting information for decision making and the measurement and discourse issues.
   b. **Managerial dimension.** That states the effects of rate changes on performance evaluation and the management decision.
   c. **Economic dimension** that states the effects of exchange rate on the performance of the corporate and its cash flows.

2. The problem of changes in exchange rate is a multi-dimensions problem which cannot be tackled by only a pure accounting approach but there is a need to adopt an "integrated approach" that will consider the importance of credibility and usefulness of business reporting and management philosophy, strategy and the effects of the changes in exchange rates on accounting information systems and management functions and on the corporate performance. Thus the accounting and reporting for foreign currency fluctuation is much interesting topic for empirical studies because the scope of the studies related to dynamic factor that stays strongly on the ground of the reality and requires comprehensive understanding.

3. The approach suggested should consider the economic relationship between exchange rate and other economic factors such as: foreign inflation, domestic inflation and interest rate to help the users of financial statements to take proper decisions and evaluate the financial and managerial ability of the firm and to understand its environment where it operates in based on relevant information provided.

4. That all of these studies (except 4) studies – done in the developed countries in the researcher’s opinion it is due to that:
   a. The developed countries had adopted the floating exchange rate before the developing countries as example; the floating exchange was adopted India in 1990 and Yemen in 1996.
b. The developed countries have a lion's share in the international trade as well as in multinational companies, and the problem of foreign exchange accounting is much related to international business.

5. Also, there are no empirical studies done in India and Yemen regarding accounting and reporting for the effects of changes in foreign exchange rates compared with IAS NO21. Thus, the present dissertation will have significant importance in the accounting research field.

6. The previous studies used the questionnaire or annual report survey but the present study has employed:

A. The Questionnaire

B. The Annual Report Survey

C. The Interviews conducted to get full understanding of the foreign currency accounting and other issues related.

D. The present thesis has dealt with foreign currency fluctuation as accounting measurement problem associated with inflation problem. Thus, the interpretation based on this view; In addition to that, the foreign currency is discussed as disclosure problem based on the extensions approach in accounting disclosure suggested by Bedford, 1973).

E. The present study is not only confined to study foreign exchange fluctuation in financial accounting but management accounting involved and issues related to the foreign exchange discussed such as:

Performance evaluation and capital budgeting.

F. In addition to the critical analytical approach, the researcher has tried to adopt traditional and contemporary approaches (i.e., pragmatic Approach & Positive Theory) to understand the accounting phenomena. (See, Porwal, 2001:27-40; Balkaoui, 2000: 60-80).