Our Ref: JEE/sra
Your Ref:

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Private & Confidential

Mr Stephen McEwan
Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
LONDON
WC1X 8AL

Dear Sir,

FRED 24, The effects of changes in foreign exchange rates

We have reviewed FRED 24 and are deeply concerned by the effect that its proposals will have on consolidated accounts.

We have particular difficulty with FRED 24 paragraphs 37 and 38 and their effects on the presentation and preparation of a consolidated profit and loss account. We appreciate that paragraph 37 essentially repeats IAS 21 paragraph 30, and that there must be a vast body of practical experience in its application. However, coming "cold" to paragraph 37 it appears to us to be both flawed in its logic (or drafting or both) and impractical.

Not generating new gains or losses

We are very concerned that the primary advantages of the closing rate method (or its simplified cousin) as discussed in the IASB's "basis for conclusion" paragraph A14, have not been given due weight. Consider a foreign operation with a seasonal business and a functional currency which in the course of a year appreciates (or depreciates) against the functional currency of the parent. In this situation it is perfectly possible for the translation method of FRED 24 paragraph 37(b) to "turn" a local currency net profit for the year to a loss, or vice versa.

We cannot see the benefit of a parent company reporting a loss (or profit) from a subsidiary which satisfies SSAP 20's criteria for the use of the closing rate/net investment method when in local currency that subsidiary has in fact made a profit (or loss). This particular example strongly emphasises the benefits of maintaining the original currency ratios.

Translating at transaction date rates

We are also very concerned about the practicality of paragraph 37 (b) as drafted. As written it could be a request for every overseas entity to maintain parallel books and records in the presentation currency of the parent, since this would be the only way to ensure that transactions such as the cost of stock consumption, and depreciation and amortisation, were translated at the required exchange rate.

If that is not the intention, then what is the 'date' of a transaction such as a depreciation charge?

Even if the idea of paragraph 37(b) should survive, the "guidance" given in paragraph 38 is inadequate, and, more to the point, offers no practical methodology to assist in either of the situations of significant fluctuation (assuming this to imply oscillation about a mean) or sustained appreciation (assuming this to be distinguished from "fluctuation") in particular exchange rates.

Specifically, the use of a (single) average rate, as suggested by the first sentence of paragraph 38, is not conceptually in line with paragraph 37(b) unless the exchange rate movements are so "small" as to have an immaterial effect. Separately, and more importantly, to deny the reporting entity any form of averaging when exchange rates fluctuate (or move in one direction) significantly renders the standard unworkable.

As implied by our comments above, we do not support the abandonment of the closing rate/net investment method. However, if it must go, then let there at least be permission for, and perhaps guidance on, a reasonable degree of "within-period-averaging" of the profit and loss account in all circumstances. We also note that the reference to 'an' average rate is unhelpful and that explicit guidance on averaging methods would be extremely valuable.

The purported advantage of the IAS 21 paragraph 30 method

The very simple translation method outlined at A14 has a further advantage which is not mentioned there. (Unless we are mistaken) the simplified closing rate method of paragraph A14 will give the same amounts in the presentation currency regardless of whether the financial statements of a foreign operation are:

(a) first translated into the functional currency of another group entity, or

(b) translated directly into the presentation currency

Summary

To sum up, having regard to consolidated accounts, and paragraphs 37 and 38 in particular, we consider that the proposals in FRED 24 are:

- not justified by the IASB's arguments;
- will lead to the reporting in the income statement of gains or losses that did not occur;
- are not clearly expressed, and
- are impractical.

If the UK is to be forced into recognising translation gains and losses that do not really occur, then we must at least be given clear and effective guidance on how to measure them.

Our preference would for the IASB to accept the closing rate method as set out in SSAP20. We feel that the continuity of brought forward reserves is a better advantage than the simplicity of using the same exchange rate for the comparative and current figures. There too, some greater guidance on the use of average rates, if this was to still be permitted, would not go amiss.

Yours sincerely,

Hacker Young