
SFAS No. 52 APPLICATIONS IN INFLATIONARY AND NON-INFLATIONARY ENVIRONMENTS

Ahmad Hosseini
Sonoma State University
Rohnert Park, California

Alan Reinstein
Wayne State University
Detroit, Michigan

Introduction

Overseas operations provide an increasing share of sales and profits for many American corporations. In its 1989 annual report, 3M reported that 45 percent of its sales were to foreign customers. Coca Cola reported that 80 percent of its total operating income in 1990 attributable to the soft drink business was generated outside the United States. Many multinational companies (MNCs) now strive for 50 percent foreign and 50 percent domestic sales. Companies such as Dow Chemical generate more than half of their profits from foreign sales, even though domestic sales exceed 50 percent of their total sales.

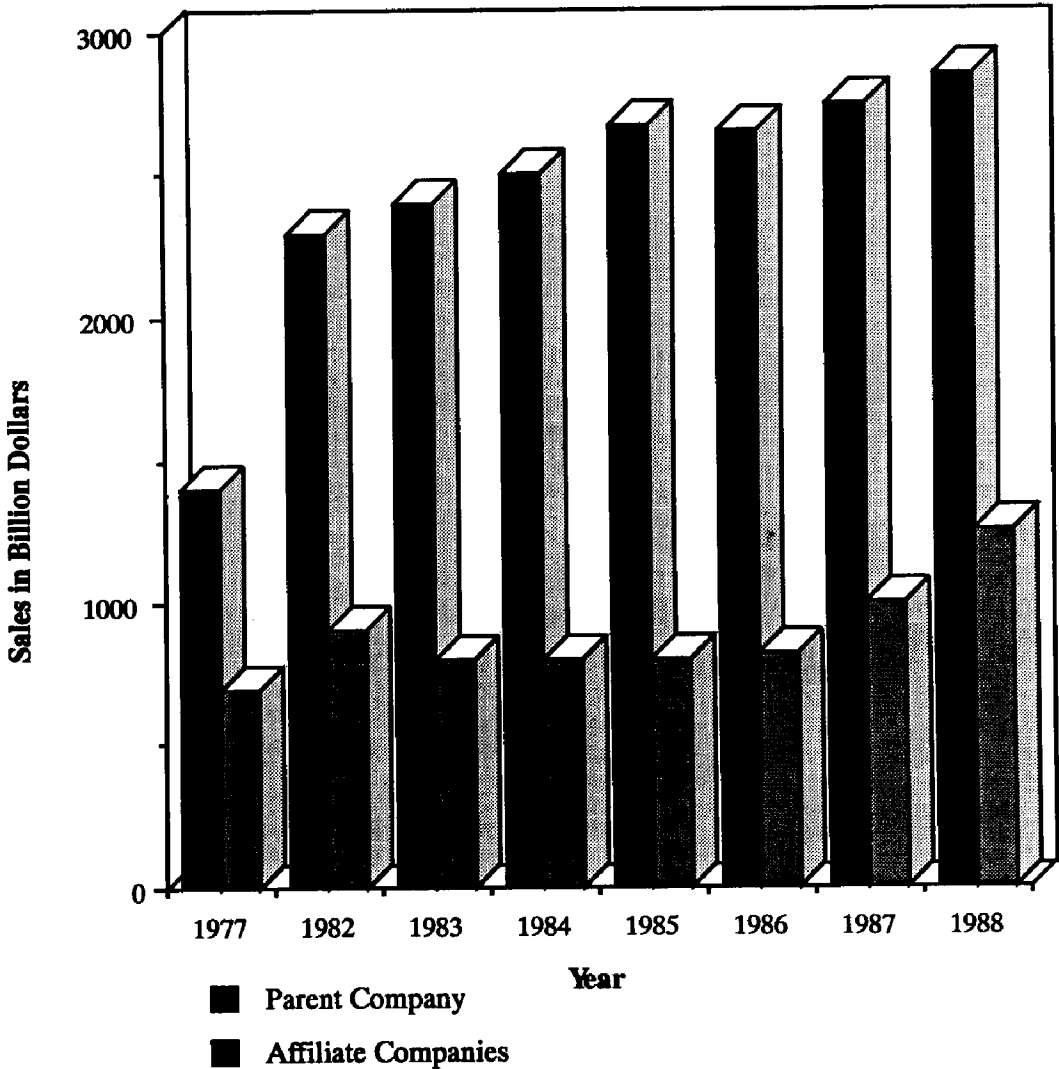
MNC operations have been steadily growing. Exhibit I shows the trend in growth of sales by MNCs from 1977 to 1988 [24]. In 1988, sales of MNCs and their foreign affiliates grew by 7.5 and 13.5 percent, respectively. Out of global sales of \$4.022 trillion by MNCs, \$1.194 trillion was reported by the foreign affiliates of the MNCs.

Determining the best method of reporting transactions denominated in foreign currencies in financial statements continues to be a complex and important issue. Misstating reported foreign operations can impair the ability of MNCs to raise capital at home and abroad. Several studies have examined the implications of the current U.S. standard (e.g., [2], [14], [16]). Other studies have offered a decision-making framework for managing foreign currency transactions (e.g., [3], [8], [17], [19]).

Since 1982, SFAS No. 52 has governed accounting for the foreign operations of U.S. based MNCs. Douppnik and Evans [5], surveying financial executives to determine how MNC subsidiaries have applied the provisions of SFAS No. 52 in selecting their functional currency, showed that when the decision is complicated, management will be biased towards choosing the local currency as the functional currency. However, they failed to examine several significant factors affecting how MNCs select functional currencies. Moreover, no published study has yet investigated the variety of related hedging techniques available under SFAS No. 52.

After outlining briefly the history of U.S. currency translation and related hedging standards, this study examines how U.S. MNCs with foreign operations apply key provisions of SFAS No. 52, such as selecting their functional currencies, in both inflationary and non-inflationary environments. Then, based upon a study sent to 400

**Exhibit 1: Multinational Companies (MNCs)
Trend of Sales by MNCs from 1977-1988**



randomly selected financial executives of 1,000 of the largest MNCs, conclusions are drawn on how these companies select their functional currencies and perform various hedging techniques both in inflationary and non-inflationary environments.

History of Foreign Currency Translation

Chapter 12 of Accounting Research Bulletin No. 43 [9] required current items to be translated at their current exchange rate and non-current items at their historical exchange rate. This process, known as the current/non-current method, was open to manipulation because it ignored the underlying attributes of the account to be trans-

lated. For example, foreign long-term debt obligations were reported at historical exchange rates regardless of fluctuations in exchange rates.

APB Opinion No. 6 [10] allowed MNCs to use a monetary/non-monetary method to report the results of foreign operations. Monetary items such as accounts receivable were to be translated at their current exchange rate, non-monetary items at their historical exchange rate. However, this method ignored changes in the replacement values of non-monetary items (such as fixed assets or inventory), even when their underlying values declined dramatically.

ARB No. 43 was succeeded by SFAS No. 1 [11] which allowed MNCs to use either the monetary/non-monetary or the current/non-current method, providing certain disclosures were made. However, as the foreign operations of U.S. MNCs burgeoned, a new standard was introduced.

In 1975, the Financial Accounting Standards Board (FASB) issued its Statement No. 8 [12], which utilized the temporal translation method (described below). Statement No. 8 produced distortions in the reports because it ignored exchange rate fluctuations, creating volatile reported earnings.

In 1981, the FASB issued Statement No. 52 [13], which superseded Statement No. 8. The statement generally dampened the recognition of currency fluctuations and the need for hedging techniques, but broadened available methods of hedging. Statement No. 52, unlike all prior pronouncements relating to foreign currency transactions, also required management, within certain parameters, to select a functional currency to translate corporate international operations.

Translation Processes

The temporal translation method of Statement No. 8 assumed that the overall objective of foreign currency translation was to measure and express corporate assets, liabilities, revenue and expenses of foreign operations in U.S. dollars and required that such transactions be measured and disclosed in accordance with U.S. generally accepted accounting principles (GAAP). The theoretical underpinning of this method, known as the "Measurement Base" principle, is similar to that of the monetary/non-monetary approach of APB No. 6 [10].

All transactions were measured as if they occurred in U.S. dollars, requiring the carrying of all fixed assets and inventory at past prices and historical rates. All gains or losses associated with translating foreign currency into U.S. dollars were reported as a gain or loss on the parent company's income statement. Thus, a company could recognize a loss when a foreign currency weakened relative to the U.S. dollar.

All currency fluctuations were recognized immediately on the income statement. This practice often produced large, unpredictable, and uncontrollable variations in net income. Allenman [1] found that these provisions caused ITT's quarterly net income in 1981 to fluctuate from a drop of 119 percent to an improvement of 109 percent.

The large swings in income resulted in widespread dissatisfaction in the financial community, often requiring expensive and time-consuming hedging techniques to mini-

mize these fluctuations. A 1978 survey of 117 executives experienced with SFAS No. 8 found 60 who strongly wished to repeal it and 24 who wanted to modify it substantially [25].

SFAS No. 52

Statement No. 52 shifted from a temporal method to a "functional currency" perspective of recognizing foreign transactions and operating results in the currency used to generate and expend cash. Financial statements now provide information compatible with foreign currency rate changes, while still reflecting world-wide economic results consistent with GAAP.

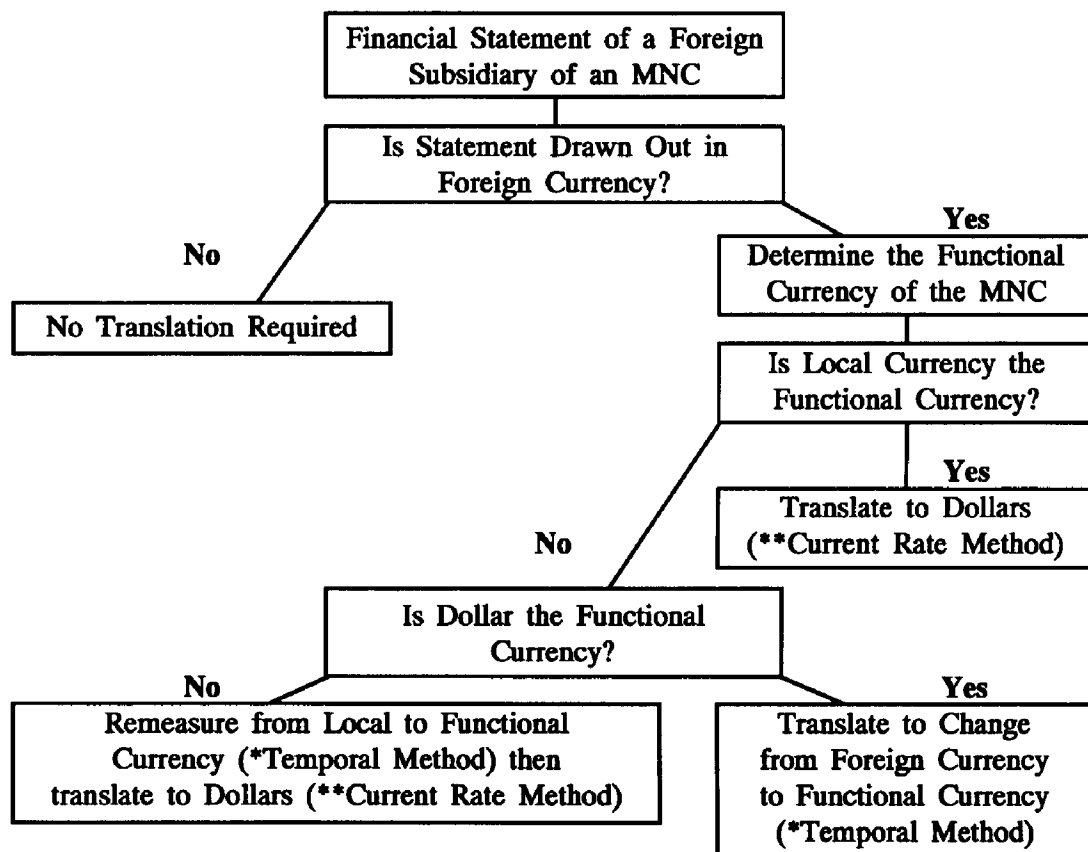
The translation process begins with choosing the functional currency and restating the financial statements of the foreign subsidiary in accordance with GAAP. At this stage, if the entity's functional currency is its local reporting currency, the entity's translated financial statement is consolidated or accounted for under the equity method of accounting. If the entity's records are not maintained in the functional currency, the entity's records are restated in terms of its functional currency using the temporal method of translation. That is, the currency denomination of the related accounts is restated—but not their actual valuation. Specifically, cash is measured as the amount owned at the balance sheet date; receivables and payables at amounts expected to be received or paid in the future; and all other assets and liabilities at the value that occurred after these items were acquired or incurred.

The entity's remeasured financial statements are first translated into the reporting currency using the current rate method. The translated financial statements are then consolidated or accounted for under the equity method. Exhibit II charts the translation procedure under SFAS No. 52. The flowchart assists in determining the translation procedure to be adopted once the functional currency has been determined.

First, the currency in which the financial statement is maintained is determined. If the currency is U.S. dollars, then no translation is required. If currency is foreign, the functional currency determines which of the following translation procedures need to be adopted.

- 1) *Translation when local currency is the functional currency.* Translation is carried out by the current rate method.
- 2) *Translation when local currency is not the functional currency.*
 - a) *U.S. Dollar is the functional currency.* Financial statements are translated to dollars using the temporal method originally advocated by SFAS No. 8.
 - b) *Foreign currency is the functional currency.* When a foreign entity's records are not maintained in its functional currency, remeasurement of the statement into the functional currency is required. Next, as in step 1 above, the statement is translated using the current rate method.

Exhibit 2: Chart of Translation Procedures for Financial Statements of Foreign Subsidiaries



Translation Rules-FASB 52

Account Type	*Temporal Method	**Current Rate Method
Monetary Asset/Liabilities	Current Rate	Current Rate
Non-Monetary Assets/Liabs	Historical Rate	Current Rate
Shareholders Equity	Historical Rate	Historical Rate
Revenues	Average Rate of Period	Average Rate for Period
Expenses: Monetary	Average Rate of Period	Average Rate for Period
Expenses: Non-Monetary	Historical Rate	Average Rate for Period

Functional currency designations of a company’s foreign operations are a key feature of SFAS No. 52 for two reasons. The functional currency determines: (1) the method used to translate foreign operations into U.S. dollars and (2) the extent to which changes in exchange rates affect consolidated operating results.

Subsidiaries should report translation gains or losses on the income statement when selecting the U.S. dollar as functional currency and “suspend” them on the balance sheet when using a local functional currency. Each foreign entity’s financial statements should be recorded in that entity’s functional currency and then adjusted, if necessary, to conform with U.S. GAAP. The entity’s financial statement must then be translated into the parent company’s reporting currency (usually the U.S. dollar). Thus, each foreign subsidiary must identify its functional currency and generally it is the currency in which the entity operates and generates cash flows. If the entity operates in only one country, the functional currency is obvious. But if it operates in two or more countries, the determination of the functional currency may be difficult.

The pronouncement describes three situations where the choice of the functional currency is easily determined. First, if a foreign subsidiary is a self-contained entity, with its operations integrated within a country, the functional currency should be that country’s currency. Second, if a foreign subsidiary is little more than a sales branch of the U.S. parent corporation, then the functional currency should be the U.S. dollar. According to the pronouncement, if the subsidiary is domiciled in a country having a highly inflationary economy (defined as having more than 100 percent cumulative inflation in three years or less, e.g., in the mid-1980s, Brazil, Argentina or Mexico), then the U.S. dollar must serve as the functional currency.

However, the Statement anticipated that the choice of the functional currency could be difficult because a foreign subsidiary’s characteristics may not be delineated clearly, requiring considerable management judgment in selecting the appropriate functional currency. The FASB asked management to consider all relevant economic facts and circumstances in making this selection, including:

1. Primary sources of the entity’s cash flow (e.g., inparent’s or subsidiary’s currency).
2. Sales price sensitivity to short-term fluctuations in exchange rates (e.g., influenced by local operating factors or by exchange rate changes or other international factors).
3. Nature of the sales market for the entity’s products (e.g., for subsidiary’s or parent’s market).
4. Sources of expenses (e.g., goods acquired locally or from parent).
5. Primary source of financing for the foreign operation (e.g., acquired locally or from parent; denominated in local or parent’s currency).
6. The volume of intercompany transactions and arrangements (e.g., minor or major volume of transactions between parent and subsidiary).

Hedges and Other Means of Minimizing the Impact of Exchange Gains and Losses

As MNCs agree to exchange, at future specified dates, currencies of different countries, exposed asset and liability positions may arise. To minimize any adverse impact of currency fluctuations on these positions, MNCs often agree to exchange currencies at predetermined rates on specific future dates. MNCs generally use these forward exchange contracts to hedge their investments or commitments. If the MNC uses the U.S. dollar as functional currency, exchange rates gains and losses generally accrue only from foreign-denominated transactions or balances, such as Italian lira receivables included in French franc financial statements and the translation of monetary accounts such as cash, receivables, payables and debt. However, exchange gains and losses resulting from U.S. dollar-denominated transactions included in foreign financial statements are exactly offset by the translation process and, therefore, do not affect income. To minimize the impact of these exchange gains and losses, a forward exchange contract could be used to sell Italian liras at a future date, thereby creating a Swiss franc liability to offset exactly the foreign receivable in the French financial statements. In addition, if a wholly owned French company holds net monetary assets of, say, 100,000 francs, a corporation might choose to liquidate franc assets or purchase franc liabilities of 100,000 francs.

When the local currency is the functional currency, foreign denominated transactions including U.S. dollar trade accounts contained in overseas financial statements will produce exchange gains and losses in income. These foreign denominated transactions, particularly U.S. dollar accounts, are most likely to occur on intercompany activity between a multinational corporation's affiliated companies. To minimize this exchange impact, forward exchange contracts typically are purchased to permit the company to buy foreign currency forward at a fixed rate.

The provisions of SFAS No. 52 permit any foreign currency transaction, including those denominated in currencies moving in tandem, to hedge a commitment, whereas SFAS No. 8 only permitted forward exchange contracts denominated in the same currency.

Statement of Research Propositions

The research questions in this study were motivated primarily by prior findings on how MNCs' subsidiaries applied the provisions of SFAS No. 52 in selecting their functional currency. The following are the research hypothesis:

- H₁: MNCs select their functional currencies using similar bases in inflationary environments and similar basis in non-inflationary environments.**

- H₂: MNCs selecting functional currencies weight indicators used in the selection similarly in countries with similar economic conditions (i.e., inflationary/non-inflationary environments).**

H₃: Provisions of SFAS No. 52 have significantly altered the use of forward exchange contracts, by broadening the spectrum of allowable hedging techniques.

Sample Selection and Survey Instrument

A questionnaire was developed based upon Statement No. 52 to examine how financial executives of MNCs select functional currencies and hedging techniques. The survey instrument was modified through in-depth interviews with five corporate treasurers, comptrollers and others responsible for making these functional currency selections, one banker and six academicians.

Revised questionnaires were sent to 400 randomly selected financial executives of the 1,000 largest U.S. MNCs as determined by Fortune magazine and cross-listed with Dun and Bradstreet's Principal International Business, The World Marketing Directory. Follow-up questionnaires were sent out 30 days after the first mailing. A total of 109 valid responses were received, a 27 percent response rate.

The responses were tested for a non-response bias by Oppenheim's (1968) early-late hypothesis. The results indicate no significant ($p < 0.05$) differences between early and late respondents, thereby minimizing the probability that the results contain non-response bias.

Results

The respondents were first asked to identify the functional currency selected for their foreign operation in six non-inflationary countries—Britain, Canada, France, Germany, Japan and Switzerland, and three inflationary countries—Brazil, Mexico and Argentina. The results are presented in Table I.

Table I: Identification of Functional Currency for Different Countries In Two Different Environments

<u>Functional Currency</u>	<u>Non-Inflationary Environment</u>	<u>Inflationary Environment</u>
	Percent	Percent
Local Currency	82	14
U.S. Dollar	14	83
Both U.S. Dollar & Local Currency	4	3
TOTAL	100%	100%

We first hypothesized that the sampled companies used similar bases to elect their functional currencies in the six non-inflationary and three inflationary economies. A

chi-square test was performed at the .05 level of significance, with the critical chi-square value of 21.026 (df = 12; seven countries and three responses) and a computed chi-square value of 14.3615. Since the null hypothesis could not be rejected, the evidence indicates that the sampled companies selected their functional currencies similarly.

Eighty-two percent of the respondents identified the local currency as their functional currency in non-inflationary environments, with only 14 percent using the U.S. dollar. On the other hand, 83 percent of the respondents use U.S. dollars as their functional currency in the inflationary countries. Fourteen percent of the respondents in inflationary countries used the local currency as their functional currency, a direct violation of the provisions of SFAS No. 52. These respondents either failed to comprehend the provisions of the standard or—more probably—applied the incorrect provision to a minor subsidiary, where the differences between the two methods were immaterial.

A possible explanation for management's choice in a non-inflationary environment between (1) reporting effects of foreign currency translations gains or losses on the income statement (required when the U.S. dollar is the functional currency) or (2) suspending them on the balance sheet (required when the local currency is the functional currency) is that financial executives generally favor using local currencies to reflect underlying changes in the local environment regardless of the provisions of SFAS No. 52. The difficulty in delineating a foreign subsidiary's characteristics is that the criteria of selecting a functional currency, as outlined in SFAS No. 52, require a great deal of "management judgment." The patterns followed avoided the volatile effects of translation gains/losses in the determination of net income.

Selecting a Functional Currency

Each sampled company responded to the importance of the six indicators used in determining their functional currency on a four point scale, from "very unimportant" to "very important". Table II reports the results of these ratings.

Hypothesis H₁ states that the sampled companies placed similar importance on the indicators used to select the functional currencies in countries with similar economic characteristics (i.e., inflation rates). Again, the critical chi-square values exceed the computed chi-square values, indicating no significant differences in the importance of functional currency indicators in countries with similar inflation levels.

Since the null hypothesis could not be rejected (p. <0.05), the results in Table II present only the ratings of the indicators used to select the functional currencies categorized by inflation level (as opposed to rankings for each country).

Table II: Degree of Importance of Six Indicators In Selecting The Functional Currency in Two Different Environments

<u>Economic Indicators</u>	<u>Non-Inflationary Environment</u>	<u>Inflationary Environment</u>
	<u>Summary Score*</u>	<u>Summary Score*</u>
Cash Flow:	1.03	1.34
Sales Market:	.77	.57
Sales Price Indicators:	.62	.96
Expense:	.62	-.28
Financing:	.18	-.67
Intercompany Transactions:	-.17	-.40

*Summary score equals the sum of multiplying all very important responses by 2, important responses by 1, unimportant by -1 and very unimportant by -2 and then dividing these results by the number of total responses received.

While the absolute scores for the economic indicators in the two environments varied, the rankings and rank orders of the indicators between the two environments varied only slightly. The results suggest that MNCs use similar indicators for selecting functional currencies in inflationary and non-inflationary environments.

The ratings for non-inflationary environments indicate that cash flow, followed by the sales market and sales price indicator are considered to be the most important factors in selecting functional currencies. The ratings for inflationary environments also indicate that cash flow is the most important economic indicator. A subsidiary's cash flow directly impacts the parent's cash flow and is generally available for remittance through intercompany account settlement.

The sales price indicator was rated as the second most important factor in an inflationary environment, because the sales price is responsive to changes in exchange rates. Although not receiving a high rating, sales markets were easily the third most important factor. The positive summary scores for these three indicators under both environments indicates that MNCs placed most importance on these factors.

For both inflationary and non-inflationary environments, the other three variables—expenses, financing and intercompany transactions—received either very low positive or negative summary scores, indicating that MNCs viewed them as unimportant factors. Thus, MNCs generally favor the first three indicators for selecting their functional currencies.

Hedging Techniques Under SFAS No. 52

Before SFAS No. 52, MNCs hedged their earnings records with forward exchange contracts (i.e., agreements to exchange currencies at a predetermined rate at a prede-

terminated future date). Research by Evans, Folks and Jillings [6] and Shank, Dillard and Murdock [20] suggests that firms entered into hedges because the provisions of Statement No. 8 created large "unpredictable movements" in their reported earnings.

Houston and Mueller [15], studying the impact of SFAS No. 52 on the foreign currency hedging activities, found that the Standard reduced, but did not cease, translation exposure hedging activities. Our study further analyzes the impact of SFAS No. 52 on hedging activities by identifying its effect on the popularity of the 12 major hedging techniques.

Statement No. 8 required MNCs to meet rigorous conditions before employing a forward exchange contract. The contract terms of an identifiable foreign currency commitment had to coincide with the initial commitment date and extend at least to the payment date of the anticipated transaction. The contract also had to be denominated in the same currency as the commitment and be firm and uncancellable. If the contract were to hedge an exposed net asset or liability position, the discount or premium would be amortized on a straight line basis over the life of the contract, and the gain or loss on the balance sheet date would be included in the determination of net income.

The provisions of SFAS No. 52 altered significantly the use of forward exchange contracts by broadening the spectrum of allowable hedging techniques. For example, under Statement No. 8, inventories and capital assets did not produce exchange gains and losses, because they were translated at historical exchange rates. But under Statement No. 52, U.S. dollar-reported equity in foreign financial statements can decrease significantly when exchange rates fall. Thus, the nature of the forward exchange contract dictates the accounting treatment—by distinguishing among contracts (1) intended to hedge a foreign currency exposed net asset or net liability position, (2) intended to hedge a foreign currency commitment on an after tax basis, and (3) entered into solely for speculative purposes. In addition, the designation of a hedge is required for the first time under SFAS No. 52, and transactions other than forward exchange contracts may now be accounted for as hedges if they are designated as such.

SFAS No. 52 has revised the accounting treatment of translation gains or losses (for subsidiaries using the local currency as functional currency). Gains or losses are now accumulated with other foreign currency translation adjustments in a separate portion of stockholder's equity until a complete liquidation occurs or until a permanent impairment of the net investment occurs, requiring the removal of the gain or loss from the equity section of the balance sheet and including it in the determination of net income.

Thus, the issuance of SFAS No. 52 influenced management's use of forward exchange contracts as hedging techniques. The popularity of the 12 hedging techniques suggested in SFAS No. 52 as applied by MNCs in inflationary and non-inflationary environments was analyzed, and 12 hedging techniques were identified both from a review of the literature and discussions with six financial executives involved in international operations. The respondents were asked to indicate the degree of usefulness of each hedging technique in the two different economic environments on a three-point

scale (i.e., 1 = very useful; 2 = useful; and 3 = not very useful). The results of the rating are presented in Table III.

The forward exchange contract generated the highest summary score, 2.46, in non-inflationary environments. Accelerating or delaying the settlement of inter-subsiary account payables (2.37) and accelerating or delaying the settlement of inter-subsiary account receivable (2.35 and 2.36) received high summary scores.

Companies operating in inflationary environments ranked three hedging techniques as most useful: tightening credit to reduce local receivables and develop disposable cash (2.37), using forward exchange contracts (2.37) and accelerating/delaying the collection of inter-subsiary accounts receivable (2.36).

Other highly rated useful hedging techniques include increasing sales prices (2.20), increasing/decreasing local currency borrowing levels (2.18) and delaying the payments of account payable and surrender discount if necessary (in soft currency). Advancing accounts payable payments and taking purchase discounts (in hard currency) (2.33) also are considered useful tactical hedging tools.

Some "not very useful" responses included using back-to-back loans (summary score of 1.76), options (1.7), delaying collections of receivables denominated in hard currency and accelerating those denominated in soft currency (1.75), currency swaps (1.60) and increasing sales prices (1.75). Thus, MNCs generally favor older, more established hedging techniques over newer, more sophisticated ones.

As stated earlier, Statement No. 8 required MNCs to include translation gains or losses as a component of income, which often necessitated required using hedging techniques to reduce the variability of income. Many commentators expected that those selecting the local currency as a functional currency under SFAS No. 52 would be less concerned about differences among hedging techniques because (1) translation gains and losses would be deferred to minimize net income fluctuations, (2) real hedging costs would become so important that firms would tend to look for less costly hedging methods, and (3) management is expected to pay more attention to economic reality since the burden of the accounting exposure has become less imminent.

Houston and Mueller [15] found that SFAS No. 52 discouraged MNCs from using hedging techniques for minimizing translation exposure. Incorporating their findings with the results of this research generates a ranking of the financial executives' preferences of 12 available hedging techniques. These results should be of particular interest to financial executives who select effective functional currencies for their firms' foreign operations or for other financial managers.

TABLE III: Comparison of the Degree of Usefulness of the Twelve Hedging Techniques for Inflationary and Non-Inflationary Environment

<u>Hedging Techniques</u>	<u>Non-Inflationary Environment Summary Scores*</u>	<u>Inflationary Environment Summary Scores</u>
1 - Forward Exchange Contract	2.46	2.37
2 - Increase/Decrease Borrowing Levels in Local Currency	2.30	2.18
3 - Accelerate/Delay the Settlement of Inter-subsidary Account Payable	2.37	1.92
4 - Accelerated/Delay the Collection of Inter-subsidary Account Receivable	2.35	2.36
5 - Accelerate/Decelerate Subsidiary Dividend Payment or Royalties	2.26	1.89
6 - Tighten Credit so as to Reduce Local Receivables and Develop Disposable Cash	1.90	2.37
7 - Delay the Payments of Accounts Payable, Advance Payable Payments	2.00	2.32
8 - Increasing Sales Price	1.75	2.20
9 - Delay Collection of Accounts Receivable in Hard Currency/ Accelerate Collection in Soft Currency	1.75	2.20
10 - Back-to-Back Loans	1.72	1.76
11 - Currency Swaps	1.60	1.86
12 - Option	1.63	2.21

*Summary score equals the sum of all "not very useful" responses by 1, "useful" responses by 2 and "very useful" responses by 3 and dividing the results by the number of total responses.

Summary

In non-inflationary environments, cash flow, sales market, sales price indicator and expenses are the most important factors in selecting functional currencies; in inflationary environments, cash flow is the most important economic indicator. In non-inflationary environments, the most useful hedging techniques are the forward exchange contract, and accelerating or delaying the settlement of inter-subsidary account receivable. In inflationary environments, the three most useful hedging techniques are tightening credit to reduce local receivables and develop disposable cash, using forward exchange contracts, and accelerating or delaying the collection of inter-subsidary accounts receivable. These findings should be of use to accounting standard setters and to decision makers who select functional currencies and hedging techniques for MNCs.

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