Chapter 6–Foreign Currency Translation

Introduction and Background

Foreign Exchange Concepts and Definitions

The objective of a currency is to provide a standard of value, a medium of exchange, and a unit of measure. Currencies of different nations perform the first two functions with varying degrees of efficiency but essentially all currencies provide a unit of measure. To measure a transaction in their own currencies, businesses around the globe rely on exchange rates negotiated on a continuous basis in foreign currency markets.

An exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. The exchange rate can be compared directly or indirectly. Assume that \$1.60 can be exchanged for one British pound:

direct quotation (US dollar equivalent):

 $\frac{\$1.60}{1}$ = \$1.60

indirect quotation (foreign currency per U.S. dollar):

 $\frac{1}{\$1.60} = \pounds.625$

The exchange rates that are used in accounting for foreign operations and transactions (other than forward contracts) are spot rates, current exchange rates, historical exchange rates, and average rates. They are defined as follows:

spot rate-the exchange rate for immediate delivery of currencies exchanged current rate-the rate at which one unit of currency can be exchanged for another currency at the balance sheet date or the transaction date

historical rate-the rate in effect at the date a specific transaction or event occurred

average rate-a simple or weighted average of either current or historical exchange rates

Use of historical exchange rates shields financial statements from foreign currency translation gains or losses. The use of current rates causes translation gains or losses.

We need to distinguish between translation gains and losses and transaction gains and losses both of which are considered exchange gains and losses. A realized (or settled) transaction creates a real gain or loss. This is a gain or loss that should be reflected immediately in income. A gain or loss on a settled transaction arises whenever the exchange rate used to book the original transaction differs from the rate used at settlement. If a US parent borrows £1000 when the exchange rate is \$1.50=£1 and then converts the proceeds to dollars, it will receive \$1500 and record a \$1500 liability on the books. If the foreign exchange rate rises to \$2.00=£1 when the loan is repaid, the US company will have to pay out \$2000 to discharge its debt. The company has suffered a \$500 exchange rate loss. This loss is a transaction loss. A translation gain or loss are unrealized or paper gains or losses or gains or losses on unsettled transactions.

Corporate Accounting Concepts and Relationships

The accounting treatment of domestic and foreign entity relationships that involve some degree of control are summarized as follows:

Domestic entity	<u>Foreign e</u>	ntity Accounting treatment
Home office	Branch	Branch accounting
Parent	Subsidiary	Consolidated financial statements
Investor	Investee	Investment in foreign entity at cost or
		equity

The above relationships suggest the need to combine or consolidate the foreign entity's financial statements with those of the domestic entity. The financial statements of a foreign entity typically are measured in the currency of that foreign country. The currency is usually different from the reporting currency of the domestic entity. Hence, a methodology must be developed to express the foreign entity's financial statements in the reporting currency of the domestic entity.

Foreign Currency Translation

Foreign currency translation-the process of expressing amounts denominated or measured in foreign currencies into amounts measured in the reporting currency of the domestic entity

Foreign currency translation is complicated by the reality that the foreign financial statements may have been prepared using accounting principles that are different from those of the domestic reporting entity. Thus, prior to translation, the statements of a

foreign entity must be adjusted to reflect the principles employed by the domestic reporting entity.

Early Methods of Foreign Currency Translation

In 1975, FASB issued SFAS No. 8 on foreign currency translation. In developing this standard, FASB considered a number of different approaches to translating foreign currency financial statments:

1. Current-noncurrent method-translates current accounts at current exchange rates and noncurrent accounts at historical rates;

2. Monetary-nonmonetary method–translates monetary items at current exchange rates and nonmonetary items at historical exchange rates;

3. Temporal method–discussed below

4. Current rate method-translates all assets and liabilities at the current exchange rate.

SFAS No. 8–this standard emphasizes that the translation process should change the unit of measure from foreign currency to dollars without changing accounting principles. The standard evaluated alternative translation methods and recognized the *temporal method* as being the most compatible with its objectives.

Under the temporal method, translation is a function of whether a balance sheet account measures current values or historical costs. Accounts measured by the foreign entity at current values will be translated using the current spot rate at the date of the financial statement.

Balance sheet accounts that are measured by the foreign entity at historical cost are to be translated at the spot rates that existed at the date of the original transaction.

If a foreign entity acquired equipment by paying 100,000 FC on July 1, 200X the equipment would be translated into dollars using the spot rate that existed on July 1, 200X. Equity account balances also represent historical costs and are to be translated at the historical spot rates that existed at the date of the equity transaction.

Income statement accounts that do not represent the amortization of historical costs should be translated at the spot rate that existed at the date of the revenue or expense transaction. The use of such specific spot rates produces a practical dilemma which is resolved through the use of weighted average exchange rates for the period covered by the income statement. Revenues and expenses that result from the amortization of assets or liabilities are translated at the historical spot rates used to translate the underlying historical costs being amortized.

The translation of trial balance accounts at different spot rates results in an inequality which represents the translation exchange gain or loss. Under the temporal method, this gain or loss is included as a component of net income.

We can summarize the use of various spot rates to translate a foreign entity's trial balance as follows:

Trial Balance Account

Assets and liabilities: Measured at current values Measured at historical cost

Equity accounts: Other than retained earnings Retained earnings

Spot Rate Used for Temporal Method

Current rates Historical rates

> Historical rates Translated beginning balance plus translated net income less dividends translated at historical rates

Revenues and expenses:

Representing amortization of historical amounts

Not representing amortization of historical amounts

Historical amounts

Weighted average rates

Translation gain or loss

A balancing amount included as a component of current net income

SFAS No. 52–The US GAAP Standard on Foreign Currency Translation

SFAS No. 8 became the subject of much controversy. It was criticized for its failure to reflect the underlying economic realities of foreign operations and rate changes and for its reporting requirements that resulted in data being volatile due to rate changes rather than operating factors.

In 1981, FASB issued SFAS No. 52 which adopts a functional currency approach which focuses on whether the domestic reporting entity's cash flows will be indirectly or directly affected by changes in the exchange rates of the foreign entity's currency. Assume a foreign entity operates exclusively in its own country using only its currency. It is questionable whether changes in the exchange rate between its currency and that of the parent entity would directly affect the parent's cash flows. After all, how could changes in the rate of exchange between the British pound and the dollar affect you if your transactions were primarily denominated in pounds? However, if a foreign entity operates in a currency other than its own currency, exchange rate changes between these currencies presumably will affect directly cash flows of the parent. In this instance, the resulting effect should be the same as if transactions were denominated in a foreign currency.

Functional Currency Identification

In order to achieve the objectives of the translation process (discussed later), it is critical to identify the foreign entity's functional currency. The functional currency is the currency of the primary economic environment in which the entity generates and expends cash. For example, assume a Japanese company that is a subsidiary of a U.S. company buys labor and materials from Japanese sources and pays for these items with Japanese yen (¥). The finished product of sold to Japanese customers and payment is received in yen. In this situation, changes in the exchange rate between the Japanese yen and U.S. dollar do not generally have an economic impact on the Japanese company or its US parent. Because of this, the Japanese firm's day-to-day operations are not dependent on the economic environment of the US parent's currency. Hence, the Japanese yen would be considered the functional currency of the Japanese firm.

The identification of the functional currency is not always *easily arrived at*. It is important to note that a foreign entity may have a functional currency which is not its domestic currency or that of its parent. The Japanese company could have the Australian dollar as its functional currency, rather than the yen or US dollar, if the Australian dollar is the currency that primarily influences the company's cash flows. This might be the case if the firm's financing, sales, and purchases of goods and services are denominated in Australian dollars. The only exception to this rule is for economies with hyperinflation. If the primary economic environment involves a currency with more than 100 percent cumulative inflation over a three-year period then the dollar is used as the functional currency.

Identification of the functional currency is not subject to definitive criteria. Certain

basic economic factors should be considered in making this identification. Consider:

Indicator	Foreign Subsidiary's Currency As Functional Currency		t's Currency actional Currency	
Cash flows	Cash flows are primarily in the foreign currency. Such flows do not impact the parent's cash flows.		ows directly impact ent's cash flows and dily available to the	
Sales price	Sales prices are influenced by local factors	Sales p	Sales prices are influenced	
Sales market	There is an active and primarily local market.		The sales market is mainly parent's country.	
Expenses	Goods and services are acquired locally and denominated in local currencies.	Goods and ser are acc parent	vices are quired from the 's country.	
Financing	Financing is secured locally and denominated in local currencies. Debt is serviced through local operations.		cing is secured / from the parent or is ninated in the t's currency.	
Intercompany trans.	Intercompany transactions are few. Major interrelationships between foreign and parent operations do not exist.		ompany business is There are major elationships between s. Foreign entity major assets and tions of parent.	

These factors should be considered individually and collectively in order to

identify the functional currency. Remember that the functional currency may be one

other than that of the foreign entity or the parent.

Objectives of the Translation Process

The focus of SFAS No. 52 is critical to achieving the objectives of translation.

The translation process should accomplish the following objectives:

1. Provide information that is generally compatible with the expected economic

effects of a rate change on an enterprise's cash flows and equity

2. Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with US GAAP

The first objective recognizes that exchange rates may or may not have any substantial or direct effect on the cash flows and economic well-being of the constituent entities. The effect of exchange rate changes is dependent on the parent's proper identification of the functional currency. If exchange rate changes are not expected to have an immediate effect on the cash flows, the current period income should not be affected. If exchange rates are expected to immediately affect the parent's cash flows then the effect of such changes should be included in current income.

The expected economic effects of rate changes must be reflected properly in financial statements and may be analyzed as follows:

Expected Economic Effects of Rate Changes When the Functional Currency is Not the Foreign Currency–The first objective of translation seeks to provide accounting information that is consistent with the expected economic effects of rate changes. Consider the following example. Assume that a foreign subsidiary is formed on January 1, 20x4, when the rate of exchange is 1 foreign currency (FC) =\$1.50. At the date of formation, the subsidiary:

1. Received a \$30,000 equity investment in dollars from the parent company's sale of stock

2. Received a \$120,000 loan in dollars from a US bank

Purchased a parcel of land for \$150,000 payable in dollars
At the end of 20X4, when the rate of exchange is 1 FC = \$2.00, the parcel of land is sold for \$200,000.

When evaluating the factors used to identify the functional currency, it would appear that the dollar is the functional currency because: financing is denominated in dollars, acquisitions of goods and services are paid for in dollars, and sales are receivable in dollars. The substance of these transactions suggests that the foreign subsidiary is merely a conduit through which the US parent conducts business and has dollar cash flows. If the translation process is sound, it should provide information that is compatible with the expected economic effects of rate changes. In this fact pattern, the translated dollar amounts for the subsidiary should be identical to the dollar balances that would have resulted had the US parent engaged in these transactions without the foreign subsidiary serving as a conduit.

Expected Economic Effects of Rate Changes When the Functional Currency is

the Foreign Currency–If the FC is the functional currency, rate changes are not expected to have an immediate impact on the parent's cash flows. In response to rate changes, the accounting information should not include any translation adjustment in the determination of current net income. Instead, translation adjustments should be classified as a separate component of owners' equity. Consider:

Assume a foreign subsidiary is formed on January 1, 20X4, when the rate of exchange is 1 FC=\$1.50. At the date of formation the subsidiary:

1. Received 20,000 FC from the US parent

2. Received an 80,000 FC loan from a local bank

3. Purchased a parcel of land from a local party for 100,000 FC At the end of 20X4, when the rate of exchange is 1 FC=\$2.00, the parcel of land is sold to a local party for 100,000 FC.

It would appear that the FC is the functional currency because: financing is denominated in FC, acquisitions of goods and services are paid for in FC, and sales prices are based on local economics and are collected in FC. An analysis of the foreign subsidiary appears as: Notice that the exchange rate change required an adjustment to the loan payable when the dollar was the functional currency but did not require this adjustment when the foreign currency was the functional currency. There is no indication that the exchange rate changes will impact immediately the parent's cash flows. Hence, to include the translation adjustment as a component of income would not be compatible with the economic effects of the rate change.

In reviewing the subsidiary's balance sheet, it becomes apparent that another objective of the translation process has been satisfied. The translation process has produced consolidated financial statements that reflect the financial results of the individual entities as measured in their functional currency. These examples demonstrate the importance of proper identification of the functional currency.

Basic Translation Process: Functional Currency to Reporting Currency

Before beginning the translation process, the financial statements of the foreign entity must be adjusted to conform with GAAP. The next step in the translation process is to identify the functional currency. The discussion below assumes that the foreign entity's currency is the functional currency.

Once a foreign entity's functional currency has been identified, it must be

translated into the domestic entity's reporting currency using an appropriate exchange rate. FASB concluded that the results and relationships presented in functional currency financial statements would be retained if the translation is based exclusively on the current rate of exchange between the functional currency and the reporting currency. The current rate method is governed by the following procedures:

1. All assets and liabilities are translated at the current exchange rate at the date of translation

2. Elements of income are translated at the current exchange rates that existed at the time that the revenues and expense were recognized. Income elements are normally translated at a weighted average exchange rate

3. Equity accounts other than retained earnings are translated at historical exchange rates. If the domestic parent's investment in a foreign company has been acquired as a purchase, the historical rate on the date of acquisition is used to translate accounts

4. Translated retained earnings generally is equal to:

a. The translated retained earnings at the end of the prior period plus

b. The translated income less

c. The value of the dividends translated at the appropriate historical exchange rates at the date of declaration.

If the domestic company has acquired an interest in a foreign company during the current period, the retained earnings balance at the date of acquisition should be translated using the rate at that time. Only after the year of acquisition will retained earnings be translated as the sum of items (a) through (c).

5. Components of the statement of cash flows are translated at the exchange rates in effect at the time of the cash flows. Operations are translated at the rate used for income elements.

Accounting for Translation Adjustments

Translation adjustments result from the process of translating foreign financial statements from their functional currency into the domestic entity's reporting currency. Because various exchange rates are used in the translation process, the basic equality of the balance sheet equation is not preserved. From a mechanical viewpoint, the translation adjustment is an amount necessary to balance a translated entity's trial balance. Translation adjustments do not exist in terms of the functional currency and have no immediate effect on the cash flows of the foreign or domestic entity. At the time of the translation, the effect that exchange rate fluctuations may have on the reporting (parent) entity is uncertain and remote. It would be improper to include the translation adjustment in current reported earnings. The translation should be included as a component of equity.

Although translation adjustments have no immediate effect on reported earnings they may ultimately affect income when there is a partial or complete sale or complete or substantially complete liquidation of the investment in the foreign entity.

Although the translation adjustment is a balancing amount necessary to satisfy the balance sheet equation, the current period's adjustment may be calculated directly as follows:

1. The change in exchange rates during the period multiplied by the amount of net assets (i.e., owners equity) held by the domestic investor at the beginning of the

period plus

2. The difference between the weighted average exchange rate used in translating income elements and the end-of-period exchange rate multiplied by the increase or decrease in net assets for the period, excluding capital transactions, plus (minus)

3. The increase (or decrease) in net assets as a result of capital transactions, including investments by the domestic investor during the period (e.g., stock issuances and retirements and dividends), multiplied by the difference between the end-of-period exchange rate and the exchange rate at the time of the transaction.

After the first year of operation, the annual translation adjustments will be accumulated and presented as a component of equity. Problem 1 is an illustration of this process.

The separate component of equity in which cumulative translation adjustments are reported also should include gains and losses attributable to:

1. Foreign currency transactions that are designated and effective as economic hedges of a net investment in a foreign entity, commencing as of the designation date

2. Intercompany foreign currency transactions that are of a long-term investment nature when the entities to the transaction are consolidated, combined, or accounted for by the equity method

Remeasured Financial Statements

So far we have assumed that the currency of the foreign entity was the functional currency. There are certain instances when the functional currency is not the currency of the foreign entity. In these instances, the financial statements of the foreign entity must be remeasured into the functional currency before the financial statements can be translated. The remeasurement process is intended to produce financial statements that are the same as if the entity's transactions had been originally recorded in the functional currency. Generally, the remeasurement process is based on the same temporal method originally adopted by FASB Statement No. 8. In essence, the historical exchange rates between the functional currency and the foreign currency are used to remeasure certain accounts. The adjustment resulting from the remeasurement process is referred to as a remeasurement gain or loss and is included as a component of net income. The remeasurement process is encountered in two situations. One arises when the entity's financial statements are prepared in a currency that is not the functional currency. Another situation occurs when the foreign entity is in a highly inflationary economy.

Books of Record Not Maintained in Functional Currency–a foreign entity may maintain its records in a currency that is not the functional currency. For example, assume a French subsidiary of an American company buys materials from British vendors with amounts due payable in British pounds. The materials are assembled in France and then returned to the UK for sale. Sales revenues are collected in pounds. The pound would be the functional currency. However, the French company maintains its books in Euros. The financial statements prepared in Euros would have to be remeasured into pounds before they could be translated into dollars.

Assume a French subsidiary of an American firm purchased its materials in the US, payable in dollars and then sold the finished goods in the US, collectible in dollars. The French firm's functional currency would be the dollar although it maintained its books in Euros. The financial statements would have to be remeasured into dollars. However, there is no need for translation.

The remeasurement process requires that both current and historical exchange rates be used. These exchange rates represent the relationship between the books of record currency and the functional currency. Examples of accounts that should be remeasured at historical rates include:

A special remeasurement rule is necessary for inventory (and other assets, such as marketable securities) when the rule of cost or market, whichever is lower, is applied. Before the rule is applied, the inventory cost and market amounts must be expressed in the functional currency. A possible result is for an inventory write-down to occur in the functional currency, even if no write-down is suggested in the books of record currency. It is also possible for a write-down in the books of record currency to be no longer appropriate in the functional currency.

Let us now consider a remeasurement problem involving the Clancy Corporation.

When an entity's financial statements are expressed in the functional currency, the statements are translated directly into the parent's reporting currency. This procedure is not followed for a foreign entity with a functional currency of a nation that has a highly inflationary economy.

FASB decided against adjusting foreign amounts for inflationary effects and instead decided that the domestic currency (dollars) should serve as the foreign entity's functional currency. The foreign entity's statements should be remeasured into the functional currency (US dollars). It is important to note that this will result in the remeasurement of the statements into dollars making any further translation unnecessary and the remeasurement gain or loss should be included in the income for the period.

In those instances where a foreign entity's financial statements are remeasured rather than initially translated, it is important note that: