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FOREIGN CURRENCY TRANSLATION

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INTRODUCTION

Some parent businesses have subsidiaries or interests in multiple nations as part of their global operations. It becomes necessary to create financial statements at the end of each fiscal year. Reconciling the parent company's and its subsidiaries' financial records is part of this. Financial transactions must be translated and displayed in a single, common currency inside the financial statements since these businesses frequently operate utilising multiple currencies. Recording transactions using foreign currencies and creating both individual and consolidated financial reports make the significance of foreign currency translation more evident. When parent and subsidiary firms' financial records are maintained in multiple currencies, this is required (Nobles & Parker, 2010).

For instance, a business with headquarters in Nigeria may have a subsidiary in the US. The U.S. subsidiary will keep its accounting records and create yearly financial reports in dollars as it operates in U.S. dollars. To produce a single, consolidated financial statement, the Nigerian parent firm must convert the dollar-based records into Nigerian naira (₦) when combining the subsidiary's financial data into its own (Idekwulin, 2014).

HISTORY OF FOREIGN CURRENCY TRANSLATION

The techniques employed in translation accounting have progressively evolved in response to changes in the global monetary system and the increasing complexity of international corporate operations, claims Doris (1988). Since these experiences mirror more general global patterns, it is helpful to examine the development of financial reporting standards in the United States in order to have a better understanding of the present practices in translation accounting.

Prior to 1965:

U.S. businesses tended to adhere to the current–noncurrent translation method's recommendations in Chapter 12 of Accounting Research Bulletin No. 43. Any gains or losses resulting from the transaction were immediately reported as income under this method. Nonetheless, the profits and losses associated with translation were totalled for the reporting period; net gains were postponed and kept in a suspense account on the balance sheet to compensate for future translation losses, while net losses were recorded in the current income statement.

1965–1975:

ARB No. 43 introduced some freedom at this time. For example, in some situations, previous exchange rates might be used to translate inventories. Similarly, if the currency volatility was considered substantial and long-lasting, long-term debts used to buy fixed assets might be restated at current exchange rates. The cost of the asset included these restatements. Another method for currency translation was made possible by the 1965 publication of Accounting Principles Board Opinion No. 6, which allowed businesses to convert all foreign currency payables and receivables using the prevailing exchange rate.

1975–1981:

The Financial Accounting Standards Board (FASB) released Statement No. 8 in 1975 in an effort to remove the discrepancies brought about by previous translation techniques. This standard forbade the postponement of translation profits and losses and mandated that businesses use the temporal approach of currency translation. All of these gains and losses were required to be recorded as income under FAS No. 8 at the same time period as the exchange rate change. The standard was criticised for skewing financial results even while it was commended for its theoretical validity. Multinational executives were concerned that these

variations would make their companies look riskier than local enterprises, which might affect stock performance. Many said that it caused earnings volatility that didn't represent economic reality.

Since 1981:

When the FASB asked for public input on its first twelve accounting rules in May 1978, the majority of the 200 or so comments addressed FAS No. 8 and called for changes. In order to address these issues, the FASB examined the standard and issued Statement No. 52 in 1981 following two draft proposals and lengthy public discussions. Although the problem of translating foreign currencies in accounting has existed since antiquity, it only became more significant in the United States throughout the 20th century. Interest in this topic has historically increased during periods of economic upheaval, as the aftermath of the Vietnam War and the First and Second World Wars. The approval of FASB Statement No. 52 is the result of years of effort by a number of standard-setting organisations, including the Accounting Principles Board, the Committee on Accounting Procedures from the 1930s, and the current FASB, to provide unified principles.

TERMS USED IN FOREIGN CURRENCY TRANSLATION

1. The practice of re-expressing a foreign entity's financial records or balances into a different currency using appropriate exchange rates is known as translation. The actual exchange of one money for another is not a part of it.
2. Based on the current exchange rate at the time of the transaction, conversion is the actual process of changing one currency into another.
3. The value at which one currency may be swapped for another is known as the exchange rate. It shows how much one country's currency is worth in relation to another.
4. The spot exchange rate, often known as the current market rate, is the rate used for instantaneous currency conversion.
5. Closing Rate: The spot rate that is in effect on the final day of the fiscal year, which is usually the last day of the financial reporting period.
6. A forward rate is an exchange rate that has been fixed for the buying or selling of a currency at a given future date.
7. The official exchange rate, which is used for transactions that satisfy specific requirements, is established by the government or an authorised agency of a nation.
8. The term "exchange difference" refers to the change in value that happens over time when a sum of money is exchanged into another currency using various exchange rates.
9. Cash and sums owed or payable are examples of monetary items, which are assets or obligations that must be paid in a definite or predictable quantity of money.
10. The primary currency of the economic setting in which an organisation typically operates is known as the "functional currency." For instance, the naira (₦) is typically used as the functional currency by businesses in Nigeria.
11. Any currency that is not the reporting organization's functional currency is referred to as foreign currency. Any money other than the naira is regarded as foreign in Nigeria.
12. The currency used by a business to create and display its financial statements is known as the presentation currency.
13. A foreign operation is a part of a business that works in a different nation than the parent or head office, such as a branch, joint venture, subsidiary, or associate.
14. The parent company's whole stake in the net assets of an overseas branch or subsidiary is known as its "net investment in a foreign operation."

MEANING OF FOREIGN CURRENCY TRANSLATIONS

IAS 21's Definition and Approach to Foreign Exchange Transactions Any transaction that is stated in or concluded in a foreign currency is considered a foreign currency translation, according to IAS 21. This comprises, for example:

(a) Purchasing or selling items at a foreign exchange rate.
(a) Taking out a loan or borrowing funds in a foreign currency.

The spot exchange rate in effect on the transaction date must be used to record the transaction in the company's functional currency when it is first recognised. However, if there aren't any notable variations in the exchange rate over that time, it may be convenient to use the average for a week or month. Whether a foreign currency item is monetary or non-monetary, and whether it is recorded at historical cost or fair value, determines the next accounting approach.

Finding the Functional Currency of an Entity

The following elements aid in determining the functional currency of an entity: the currency that has the biggest impact on how much goods and services cost. the nation's currency, where price is influenced by regulatory and competitive factors. The currency that has the biggest impact on labour and material costs.

IAS 21 recommends management to exercise discretion and take into account the following if the functional currency is not immediately apparent:

The currency used by the organisation to raise money through equity or debt.

The currency in which it usually keeps money from its operations.

Elements to Determine a Foreign Subsidiary's Functional Currency

The following factors should be considered when evaluating a foreign operation's functional currency: if the subsidiary functions independently or as an extension of the main business. the percentage of business the subsidiary does with the main company. if the financial flows of the subsidiary are easily transferable and directly affect the cash flows of the parent firm. if the subsidiary can use its own cash flows to pay its debts without depending on the parent company.

IAS 21's limitations

There is frequently insufficient or unclear instruction in the standard.

It mandates that transactions be documented using the currency rate in effect on the transaction date, which may be the order date, invoice date, or receipt date.

IAS 21 does not define the time to be used or whether substantial transactions should alter the average, even though average exchange rates can be employed when rates are steady.

Although it makes a distinction between monetary and non-monetary things, categorisation is made more difficult by the fact that some products—such as debt securities held as investments—display characteristics of both.

RATES USED IN FOREIGN CURRENCY TRANSLATION

Alvan (2014) asserts that the translation of foreign financial statements for inclusion in consolidated domestic financial reports is one of the most complicated and contentious components of international accounting. As mentioned before, combining identical financial data efficiently requires the use of a single currency. Nonetheless, the presence of fluctuating currency rates poses difficulties for translation. Finding the best exchange rate for translation and addressing the ensuing translation discrepancies in the financial records are the two main issues that accountants must address.

Three primary exchange rate possibilities are available to a business during the translation process:

(i) Historical Rate: This is the exchange rate in force on the day the transaction actually took place.

(ii) Closing or Current Rate: The spot exchange rate at the conclusion of the reporting period is referred to here. This would be the rate on December 31 for businesses that use the calendar year. It would be the rate on March 31 for people who have a fiscal year that runs from April 1 to March 31.

(iii) Average Rate: If allowed by local accounting rules, using an average rate for converting revenue and cost items may be more practical. Depending on the circumstances and available data, this rate—which represents the average exchange rate for a certain time period—can be computed as a weighted average or as a basic average.

APPROACHES TO TRANSLATION

There has been no global agreement on a standard method of currency translation despite years of effort by accountants from all around the globe. In response, other nations have implemented their own criteria.

Statement of Financial Position Translation: In real accounting practice, the current exchange rate or the historical rate is used to translate assets and liabilities. The quantity of applied exchange rates allows us to classify existing translation systems. In the first kind, known as the "single-rate method," a single exchange rate (usually the current or closing rate) is used to convert all foreign data into the local currency. varying components are translated at varying speeds using the second type of approaches known as multiple-rate methods.

DIFFERENT TRANSLATION METHODS

A) One-rate Method:

The single-rate strategy, sometimes known as the "current rate" method, entails handling overseas activities or subsidiaries as independent legal entities from the main business. This strategy, which views the overseas subsidiary as an investment, is known as the "net investment" strategy, according to Hendriksen (1985). The net revenue generated by the overseas business is used to calculate the financial return on this investment, which is thought to be advantageous to the parent firm. The foreign subsidiary is treated as independent under this framework, and its assets and liabilities are converted using the exchange rate that was in force on the financial statement date.

When combining the financial accounts, this method maintains the original financial linkages, which is one of its key benefits. The form of the accounts is modified without changing their essential characteristics since all foreign currency amounts are converted using a fixed exchange rate. When the financial statements are based on current values or updated price levels, this method performs admirably.

But there are problems with the approach. Most significantly, it presents the combined data from the viewpoint of each nation's currency rather than from a single, cohesive perspective, which distorts the outcomes. The main goal of consolidating financial statements is to show the parent company's and its subsidiaries' financial performance in one currency for the benefit of the parent company's shareholders. This strategy goes against that purpose. Additionally, translation gains or losses are frequently the result of using the single-rate technique, which presumes that all assets and liabilities are equally affected by changes in exchange rates. Thus, the income statement may provide an inaccurate depiction of the true financial health of the business.

B) The Multiple-rate Method:

When translating financial accounts, the multiple-rate methodology incorporates historical and current exchange rates, as opposed to the single-rate method. This method recognises that various asset and liability classes react differently to fluctuations in exchange rates. The particular translation techniques covered by this strategy include:

The Current/Non-Current Method (CNM) is as follows:
While non-current assets and liabilities are translated using historical exchange rates, based on the rates at the time they were acquired or incurred, current assets and liabilities are translated using the exchange rate as of the financial statement date (the "current rate") under the current/non-current method (CNM). One of the first legally recognised translation techniques in the US was CNM, which has been in use since the 1930s. Since it displays working capital components in their reporting currency counterparts, its main objective is to indicate the liquidity of a foreign entity's financial situation. When the parent business plans to repatriate cash from the overseas subsidiary on a current basis, this strategy might be helpful.

But this strategy has lost some of its relevance in recent years. Repatriation of cash is no longer a primary goal for many subsidiaries, which increasingly function more independently from their parent corporations. Because of this, CNM is seldom suggested as the best translation technique nowadays.

MNM, or the Monetary/Non-Monetary Method:
Professor Samuel Hepworth developed the monetary/non-monetary method (MNM) in 1972 in order to overcome the drawbacks of the current/non-current approach. This approach uses the historical exchange rate to convert non-monetary assets like inventories and fixed assets into their respective currency, while the current exchange rate is used to convert monetary items like cash, accounts receivable, and accounts payable, which reflect fixed quantities in foreign currency. This method is still applicable when a parent business uses a foreign subsidiary to tap into global markets and transfer funds back home using the current exchange rate.

In accordance with SFAS No. 8 (FASB, 1975), the TRM is used to apply different exchange rates to distinct items on the balance sheet. For instance, the current rate is used to convert cash, receivables, inventories, and long-term obligations, whereas historical rates are used to translate fixed assets and inventories recorded at historical cost. To maintain the historical cost principle and guarantee that consolidated financial statements faithfully portray this accounting notion is the principal objective of TRM. Regarding inventory translation in particular, the differences between TRM and the monetary/non-monetary approach (MNM) are often small in reality.
Temporal Method (TM):

The temporal approach attempts to preserve the time-based component of transactions and was created in reaction to the MNM's inadequacies. It was first presented by Lorensen in 1972 and enables a more uniform method of handling things like investments and inventory. This method's major goal is to translate the subsidiary's original financial statements into the parent's reporting currency while preserving the valuation basis of its assets and liabilities. In addition to historical cost accounting, the temporal technique offers guidelines for interpreting financial statements created using different valuation methods. The approach is praised for its adaptability to various accounting traditions, which enables it to give a more realistic depiction of a subsidiary's financial status over time, as noted by John Flower (1991).

The Price Parity Method, or PPM, is:
By concentrating on comparable price levels rather than exchange rates for translation, the Price Parity Method (PPM) adopts a novel strategy. This approach is based on the Purchasing Power Parity (PPP) principle, which holds that comparable price levels across nations drive exchange rates. PPP should be investigated as a substitute for exchange rate-based translation techniques, according to the Committee on International Accounting (1974). Instead of utilising exchange rates, price parity indices, such the Consumer Price Index (CPI) or Wholesale Price Index (WPI), are used to convert foreign accounts into the reporting currency under PPM. A subsidiary's control over products and services inside its local economy is intended to be reflected by this approach.

Developing a cost-based translation approach, using interest rates for translation, or integrating exchange rates with price parity indices are some possible translation techniques that haven't gotten much attention in the literature. Choosing the right pricing index for PPM or picking which interest rates to utilise are only two examples of the difficulties that come with each of these options. In order to prevent translation gains and losses, another alternative, known as the All Current Rate Method (ACRM), suggests translating all accounts, including assets, liabilities, equity, and income statement items, at the current rate.

All financial ratios would be constant both before and after translation if this approach were used.

ACCOUNTING FOR INDIVIDUAL TRANSACTION IN A FOREIGN CURRENCY

When an entity conducts a transaction that is denominated in a currency other than its functional currency, it is essential for that transaction to be converted into the entity's functional currency prior to being recorded in the financial statements.

Transaction Occurrence (i.e., Transaction Date)
When a business entity engages in a transaction where the terms or consideration are expressed in a foreign currency, the amount or value of that foreign currency must be converted into the functional currency of the reporting entity using the exchange rate in effect on the date the transaction took place.

Settlement of Account Balance
If a transaction is settled at a date different from the original transaction date, the amount settled, or the fair value of the consideration settled, must be translated using the exchange rate prevailing at the settlement date, rather than at the original transaction date.

Translation Procedure
The process of translating foreign currency transactions should follow these steps in order:

1. Translate all assets to determine the total value of assets.
2. Translate all liabilities to determine the total value of liabilities.
3. Subtract the total liabilities from the total assets to calculate the shareholders' equity.
4. Translate ordinary shares and share premiums separately to determine the portion of shareholders' equity that is not related to retained earnings.
5. Subtract the value from step 4 from the total equity in step 3 to calculate total retained earnings.
6. Compare the retained earnings in the functional currency (taking into account any dividends paid, if applicable) with the retained earnings derived from step 5.
   - An increase in retained earnings indicates net income for the period, while a decrease represents a net loss.
7. Translate individual revenue and expense accounts to calculate income or loss before any translation gains or losses.
8. The difference between the values in steps 6 and 7 represents the translation gain or loss. This ensures the detailed income statement accounts are reconciled with

the net income or loss resulting from the translation of monetary items like purchases and sales, which should be translated at the average exchange rate for the period.

Disclosure Requirements

Entities must disclose certain information in their statement of accounting policies regarding translations and foreign currency transactions in accordance with SAS No. 7. The following should be disclosed:

- How the company's accounting policy handles the translation and conversion of foreign currency numbers.
- The accounting treatment of profits and losses from foreign currency.
- Gains or losses from changes in currency rates that have been reported in the profit and loss statement, netted off.
- Whenever relevant, any restrictions on the return of investment capital or profits to Nigeria.
- The notes to the financial statements should include any significant changes in exchange rates that have occurred after the date of the statement of financial position and have an impact on profit or loss or items in the balance sheet.
- How much any postponed profits or losses in foreign exchange are worth.

Reporting of Translation Gains or Losses

It is possible for a business to incur translation profits or losses if its assets or liabilities are denominated in a currency other than its own, as stated by David (2003). The company's financial statements should reflect these adjustments. A company's consolidated income statement will reflect any gains or losses experienced by its subsidiaries. Due to the practice of recording non-monetary assets using the historical exchange rate, translation modifications solely impact monetary items. The discrepancy in translation should be included in the profit or loss portion of the income statement or the first section of the comprehensive income statement according to both US GAAP and International Accounting Standards (IAS).

The British accounting standards group backs this approach, saying that profits and losses from currency exchanges should be included in the profit or loss for the period in question for the sake of honest and fair financial reporting. This lines up with the accrual principle of accounting, which states that costs and revenues should be recorded as they come in, rather than when the money is actually received or paid out. Another point of view held by Britons is that the company's true performance would be distorted if gains were deferred and losses were recognised. This is a typical practice among EU member states that adhere to the Anglo-Saxon method of financial reporting, including the United Kingdom, Ireland, the Netherlands, and Scandinavia. Alternatively, nations such as Germany and France often deduct negative translation disparities from their revenue statements. On the other hand, they deal with positive translation discrepancies in different ways. When converting monetary items, Germany frequently sticks with the historical rate even when the closing rate would yield a better outcome.

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