

Translation and Consolidation of the Financial Statements of Foreign Operations

Presented by:

Endra M. Sagoro

Economic Faculty

Yogyakarta State University

Translation of Financial Statements

- Translation is *the conversion of a set of financial statements, originally prepared in one currency, to another currency* (often so that a subsidiary may be consolidated with the parent)
- Although the current Handbook pronouncement is well established in Canada, many methods have preceded this approach and a brief review is useful

Translation of Financial Statements

- In a world of fixed exchange rates, it would perhaps be possible to translate financial statements in a meaningful manner using historical rates
 - However, exchange rates are not fixed, and the logical starting point may be to translate every asset and liability in a set of statements at the current rate of exchange
 - This would give rise to a gain or loss on translation, and, when this approach was first introduced, strenuous objections were raised as there was a violation of the historical cost principle

Translation Methods

- The objection to violation of historical costs was most serious for non current assets and liabilities, so a new method was derived:
- The *current/noncurrent method*
 - Used in U.S. and Canada from the early 1930s until the late 1970s
 - Accounts in the financial statements were grouped according to “maturity” and translated at current or historical rates accordingly
 - This approach was superseded because of logical flaws, most notably that non-current liabilities were being translated at historical rates of exchange

Translation Methods

- Although the current non-current method was supplemented by an APB Opinion which permitted the translation of long-term debt at the current rate, it was superceded by the *monetary/nonmonetary method* which provided that monetary accounts be translated at the current rate and non-monetary accounts be translated at historical rates
 - *This approach is significantly more logical, as the choice of rate is based on an underlying conceptual difference in the nature of the item, rather than its term to maturity*

Translation Methods

- *Monetary items represent money and claims to money the value of which, in terms of the monetary unit, whether foreign or domestic, is fixed by contract or otherwise*
 - Payables and receivables and all other fixed claims to money are monetary items
 - Future income tax liabilities and assets are classified as monetary items
 - Estimated liabilities (such as provisions for warranties) are not considered monetary items

Translation Methods

- As financial reporting practices have evolved over the years, the use of market valuation in financial statements has become increasingly common
- This caused the monetary/nonmonetary approach to become outmoded, to be replaced by a method which recognized this development in accounting practice
- This approach is referred to as *the temporal method*

Translation Methods

- The temporal method
 - *Distinguishes between items on the basis of the “time” the value was determined* (temporal = time)
- Under this method, all *monetary items* (value is determined at the balance sheet date) are translated at the *current rate* of exchange
- Items carried at *market value* (value determined currently also) are translated at the *current rate*
- *Nonmonetary items* are translated at the applicable *historical rates* (*generally, the rate on the date of acquisition of the item*)

Translation Methodologies

- The current rate method remains part of practice
 - All assets and liabilities are translated at current rate
 - Only “net assets” (SE) translated at the historical rate
 - The translated statements retain the same ratios and relationships that exist in local currency originals, so these financial statements are said to provide a more effective tool for the evaluation of management
- *Canadian standards provide for a choice to be made between the temporal and current rate method, on the basis of the relationship between the parent and subsidiary companies*

The concept of exposure

- The choice under Canadian standards is related to the concept of exposure
- *Exposure is the risk of gain or loss arising from unanticipated changes in exchange rates*

The concept of exposure

- The choice under Canadian standards is related to the concept of exposure
- *Exposure is the risk of gain or loss arising from unanticipated changes in exchange rates*
- Three types of exposure are relevant
 - Transaction exposure
 - Translation exposure
 - Economic exposure

The concept of exposure

- **Transaction exposure:**
 - *Risk of actual cash gain or loss associated with settlement of foreign currency denominated items*

The concept of exposure

- **Transaction exposure:**
 - *Risk of actual cash gain or loss associated with settlement of foreign currency denominated items*
 - This arises when exchange rates change, affecting the value of a transaction in progress
 - As discussed in Chapter 12, immediate recognition of gains or losses is the normal treatment

The concept of exposure

- **Translation exposure:**
 - *Risk of an apparent gain or loss associated with translation of various financial statement items at different rates*

The concept of exposure

- **Translation exposure:**
 - *Risk of an apparent gain or loss associated with translation of various financial statement items at different rates*
 - This is referred to as an “apparent” gain or loss, as there are not necessarily direct cash flow implications
 - The current rate method tends to have an exposed asset position; the temporal method tends to have an exposed liability position

The concept of exposure

- **Economic exposure:**
 - *The risk of an effect on long-run earnings ability arising from a change in exchange rates*

The concept of exposure

- **Economic exposure:**
 - *The risk of an effect on long-run earnings ability arising from a change in exchange rates*
 - Effect is not always readily apparent
 - Translated financial statements should in some manner capture the potential effects on earnings ability arising from changes in exchange rates
 - The Canadian standards attempt to differentiate among firms on the basis of the associated economic exposure, and choose the translation method accordingly

Canadian Translation Practices

- *The core issue in the choice of translation method is the economic exposure of the parent arising from the activities of the subsidiary and the parent subsidiary relationship*
 - *When the operations of the subsidiary are integrated with those of the parent, there are generally many product, revenue, and cash flows between the two companies*

Canadian Translation Practices

- *The core issue in the choice of translation method is the economic exposure of the parent arising from the activities of the subsidiary and the parent subsidiary relationship*
 - *When the operations of the subsidiary are integrated with those of the parent, there are generally many product, revenue, and cash flows between the two companies*
 - ***As a result, there are significant risks of gains or losses associated with the flows, and these current gains or losses should be identified, measured, and reported as part of income***

Canadian Translation Practices

- Translation exposure may be quantified
 - *The exposure is a function of the net balance translated at the current rate, as opposed to the historical rate*
 - Under the *temporal method*, the exposure is therefore a function of the net balance of monetary assets (monetary assets less monetary liabilities)
 - This is effectively the same as transaction exposure
 - *Under the temporal method, gains or losses arising from the translation of financial statements should be taken into income as the risk of gain or loss is effectively currently realizable*

Canadian Translation Practices

- *Core issue: economic exposure*
 - *When the operations of the subsidiary are not integrated with those of the parent (when the **subsidiary is self sustaining**), there are generally few product, revenue, or cash flows between the two companies*
 - ***As a result, the risk of gains or losses associated with flows is somewhat limited***
 - *There is risk, however, but this is associated with the long run earnings ability of the subsidiary, and the eventual proceeds of disposition when the subsidiary is sold*
 - ***There is no need to recognize an income effect***

Canadian Translation Practices

- Translation exposure may be quantified
 - The exposure is a function of the net balance translated at the current rate
 - Under the *current rate method*, the exposure is a *function of the net asset balance* (total assets less total liabilities)
 - *This is, effectively, the same as the balance of shareholders' equity, which can only be realized if the investment is sold*
 - Accordingly, *under the current rate method, gains or losses arising from the translation of financial statements are reported as a separate component of shareholders' equity, not realized in income*

Canadian Practice



Annual Report 2001

Earnings of self-sustaining foreign operations are translated to Canadian dollars at average rates of exchange during the year. Assets and liabilities are translated at year-end rates. The differences between translating assets and liabilities at year-end rates, and the exchange rates on the date of acquisition of those assets and liabilities, have been included in shareholders' equity as unrealized translation adjustments.

- *Self sustaining foreign operations are translated using the current rate method*
- *Exchange differences are separately disclosed as part of shareholders' equity*

Canadian Practice

ANNUAL REPORT 2000

GEORGE WESTON LIMITED.

Foreign monetary balances of Loblaw and integrated foreign operations are translated at the exchange rates in effect at each year end date and foreign non-monetary balances are translated at their historical exchange rates. Exchange gains or losses arising from the translation of these foreign monetary balances are reflected in the current year's net earnings.

Revenues and expenses denominated in foreign currencies are translated at the average exchange rates for the year.

- *Foreign revenues and expenses of the parent and other domestic operations, as well as integrated foreign operations, are translated using the temporal method*
- *Exchange differences are recognized as gains or losses, components of current income*

International View

- How do practices in Canada relate to practices elsewhere?
 - Concepts underlying the choice of methods in US standards are similar; the choice is based on the functional currency of the subsidiary
 - If the functional currency is the same as the parent, the temporal method is used as the implication is that the risks associated with changing exchange rates are similar
 - If the functional currency differs, then the current rate method is used, as the exposure is limited to the net investment

Canadian rules: International View



For years after December 31, 1998, the assets and liabilities of the Company's operations having a functional currency other than the U.S. dollar are translated into U.S. dollars using the exchange rate in effect at the year end and revenues and expenses are translated at the average rate during the year. Exchange gains or losses on translation of the Company's net equity investment in these operations are deferred as a separate component of shareholders' equity.

The appropriate amounts of exchange gains or losses accumulated in the separate component of shareholders' equity are reflected in income when there is a reduction in the Company's net investment in the operations that gave rise to such exchange gains and losses.

- *Magna, reporting under Canadian GAAP, has reported using the language of the American functional currency rules, which in actual practice yield similar results to the Canadian GAAP “integration” rule*

Canadian rules: International View



Foreign exchange gains and losses on transactions occurring in a currency other than an operation's functional currency are reflected in income except for gains and losses on foreign exchange contracts used to hedge specific future commitments in foreign currencies. Gains and losses on these contracts are accounted for as a component of the related hedged transaction. Gains and losses on translation of foreign currency long-term monetary liabilities are deferred and amortized over the period to maturity.

- *Magna here uses the language of the American functional currency rules, yet follows a uniquely Canadian approach, the deferral and amortization of gains and losses on translation of long term items*
- *This rule has **now been changed** to immediate recognition in the income statement for the year*

International View

- Under International Accounting Standards, the methods of foreign currency translation and the recognition of foreign currency gains and losses are broadly similar to those provided for under Canadian rules
 - An integrated foreign operation is referred to as integral and is translated using the temporal method
 - A self sustaining foreign operation is referred to as a foreign entity and is translated at the closing rate

International View

- The systematic choice of method in Canadian practice based on the parent subsidiary relationship is a strong feature of the Canadian rules, and many countries do not have a rigorous framework to guide the choice
- In annual reports of international companies, we see a variety of translation practices, including methods which (to a Canadian) would be considered to be outmoded

International View

a) In general, the financial statements of foreign subsidiaries having a financial and economical autonomy are translated as follows:

- Balance sheet items other than shareholders' equity are translated at the year-end rate of exchange.
 - Income statement items are translated at the average exchange rate for the year.
 - The translation adjustment is included in consolidated shareholders' equity and has no impact on net income.
- *This is an application of the current rate method*

2000 Annual report

Renault

c) For foreign companies whose activities are an extension of the parent company's business, the historical-rate method is applied for non-monetary balance sheet items and the translation adjustment is included in net income.

- *This is an application of the temporal method, despite the difference in terminology*

Reference

Secord, Peter. 2003. *Modern Advanced Accounting*.
Canada: McGraw-Hill.