FA Module 19: Foreign currency translation (overview)

(The attached PDF file has better formatting.)

Reading: chapter 16 §3 translation of foreign currency financial statements, *excluding*

- sub-section 3.6 (companies use both translation methods at the same time)
- sub-section 3.7 (disclosure related to translation methods)

[Sections 4 and 5 are not on the syllabus for this course.]

This module explains foreign currency translation adjustments and remeasurement gains/losses. The method depends on whether the functional currency is the local (foreign) currency or the presentation currency.

- If the foreign currency is the functional currency, use the current rate method:
  - Assets and liabilities are translated at the balance sheet exchange rate
  - Revenue and expenses are translated at the transaction date exchange rate
  - Equity is translated at the historical rate
  - The foreign currency translation adjustment appears on the balance sheet
  - The change in the foreign currency translation adjustment is in other comprehensive income
- If the parent's presentation currency is the functional currency, use the temporal method:
  - Monetary assets and liabilities are translated at the current rate
  - Non-monetary assets, liabilities, and equity are translated at the historical rate
  - Retained earnings are translated separately for each piece in each year
  - The remeasurement gain or loss appears on the income statement (part of net income)

Know how the current rate method and the temporal method affects financial ratios.

- The current rate method and the temporal method affect different financial statements.
  - Only the temporal method affects net income.
- The effects on the balance sheet depend on exchange rate movements from inception to the current date for non-monetary assets and liabilities.

A final exam problem may give data to determine the functional currency, which affects the foreign currency translation method. Know whether the current rate method or the temporal method is used in each scenario. Final exam problems may

- say whether the functional currency is the local currency or the presentation currency or
- give the business conditions that determine the functional currency.

The exam problem will give the

- foreign currency exchange rates at specific dates or a formula for exchange rates by month or quarter
- balance sheet and income statement accounts for the subsidiary.

From these data, you derive the translation adjustment, the remeasurement gain or loss, and financial ratios.

Read carefully subsection 3.1 (translation conceptual issues). Translating accounts at different exchange rates causes the financial statements to be out of balance. The translation adjustment and the remeasurement gain or loss bring the financial statements into balance, but they do so by different methods.

Know the IFRS vs GAAP methods for foreign subsidiaries operating in hyper-inflationary economies. GAAP uses the temporal method; IFRS adjusts the subsidiary's accounts for inflation.