FA Module 18: Foreign currency transactions (overview)

(The attached PDF file has better formatting.)

(Readings from the third 3rd edition of the Robinson text.)

Reading: chapter 16 §2 Foreign currency transactions, *excluding* subsections 2.2 and 2.3

Insurance (and especially reinsurance) is a global industry. Many countries regulate insurers and some require them to be domiciled in the country. Insurer groups may have a parent domiciled in one country and subsidiaries in other countries. Premiums and claims in one currency are translated into the currency of the parent.

Some reinsurers sell insurance contracts globally. Incurred claims are entered into the financial statements at the accident date in the presentation currency but may be paid years later, with different foreign currency exchange rates.

This module deals with foreign currency *transactions*: a firm in one country sells goods or services in another country or imports goods from another country, with the countries using different currencies (the reinsurance example above). Foreign currency translations are more complex: a firm in one country owns a subsidiary in another country. Foreign currency translations are *not* tested on the final exam.

Economists seek to understand the influences on exchange rates movements (purchasing power parity; interest rate parity). This course explains how exchange rate movements affect financial statements.

Know the differences among the presentation currency, local currency, and functional currency. Final exam problems may give import purchases, export sales, balance sheet dates, and foreign currency exchange rates, to determine the effect of foreign currency transactions on operating income.

Example 1 Accounting for Foreign Currency Transactions with Settlement before the Balance Sheet Date is straight-forward. Real life is more subtle, since one must consider the inflation rates in each country, the interest rates in each country, and changes in the exchange rate. This financial accounting course considers just the exchange rates; the macroeconomics on-line course considers inflation rates and interest rates.

Example 2 Accounting for Foreign Currency Transaction with Intervening Balance Sheet Date adds another year and a reversal in the exchange rate movement. It is easy to confuse transaction gains and losses. The textbook has a 2 × 2 matrix showing asset vs liability on the vertical axis and foreign currency strengthens vs weakens on the horizontal axis. The cells show whether the firm has a foreign currency transaction gain or loss. For insurers, an asset would be premiums due and a liability would be benefits payable.