

Foreign Currency Translation under U.S. GAAP-A Simplified Example

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Abstract:

The translation of foreign currency based financial statements is an important issue in today's global business environment. This article will discuss some of the key concepts by the use of a simplified example. The concepts to be discussed include the selection of a functional currency, translation of foreign currency based financial statements under U.S. Generally Accepted Accounting Principles (GAAP) using the current rate method, other comprehensive income and financial statement disclosure. The step by step example should help professionals through the process of foreign currency translation.

Keywords: Foreign Currency Translation, Current Rate Method, Other Comprehensive Income, Statement Disclosure

1. Introduction:

Accounting for currency exchange and currency translation comes about when a company has a branch, joint venture or a subsidiary that prepares its' financial statements in a currency other than the currency of the parent company. For purposes of consolidated financial statements the currency must be restated to the currency used by the parent company in preparing the consolidated financial statements. This paper will discuss the key elements and processes using examples of possible ways that the various elements could be addressed. The key elements and processes include: determination of the functional currency, identification of appropriate exchange rates to be used and where those exchange rates might be found, use of either the current rate or temporal method for calculating currency translation adjustments and finally proper disclosure of the currency adjustment. These items will be discussed through the use of a hypothetical case study.

2. Functional Currency:

The first thing that needs to be determined when acquiring or opening a foreign operation is the functional currency. Under the general guidelines in the Accounting Standards Codification (ASC) Topic 830, Foreign Currency Matters issued by the Financial Accounting Standards Board (FASB), if the operation is basically in control of its' own operations and financing then the currency would be the currency of the country where the operation is located. ASC, Topic 830 also states that this is generally a matter of fact and should be based on the currency where the majority of the cash is received and expended. While this is based on a matter of fact in some cases the facts do not make the decision clear.

As an example we will use the hypothetical case of a branch of a U.S. based company that is in the U.K. The facts are as follows:

Sales

Transacted in U.S. dollars (USD)	\$2,250,000
Transacted in Great British Pounds (GBP)	\$ 975,000 (USD equivalent)
Transacted in Euros	\$1,500,000 (USD equivalent)

Cost of Goods Sold

Transacted in USD	\$1,225,000
Transacted in GBP (USD equivalent)	\$ 625,000
Transacted in Euros (USD equivalent)	\$ 500,000

Other Operating Expenses

Transacted in GBP (USD equivalent)	\$1,875,000
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Based on the total receipts and expenditures of cash there is no clear answer in these facts as the total transaction value for transactions in both USD and GBP is \$3,475,000 while business transacted in Euros accounts for the other \$2,000,000. This analysis leads to the conclusion that either the USD or the GBP could be used as the functional currency. In this case the company chose to use the GBP as the functional currency due to the fact that all tax and financial reporting to the U.K. government was required to be in GBP (Creech, 2014).

3. Income Statement:

Translating financial statements for a foreign entity in preparing for the preparation of consolidated financial statements begins with translating the income statement. ASC Topic 830 requires that all income transactions be translated at the rate that existed at the time the transaction occurred. This is impractical in most cases so ASC Topic 830 allows for the use of an average rate when transactions occur uniformly throughout the year. In our case we will use an average rate based on the average annual rate but businesses that are seasonal or transact business in currencies that fluctuate widely may want to consider translation on average rates based on quarterly or monthly averages. This is generally accomplished by the use of a weighted average rate (Selling & Sorter, 1983). Many business operations conduct transactions in more than one currency. In this case the process requires that the transaction that is in a foreign currency (not the functional currency) first be translated to the functional currency before the income statement in the functional currency can be translated into the parent company's currency for financial reporting. Since foreign currency transactions are recorded at one rate and then later restated for a different rate there can be gains or losses associated with these differences in rates. The gains or losses from foreign currency transactions are included in current income (Veazey & Kim, 1982). To illustrate the process we will use the entity previously used in the discussion of the determination of the functional currency. This business is located in the U.K. and conducts business in Great British Pounds, U.S. Dollars and Euros. The first step in the process will be to convert the foreign currency transactions into the functional currency.

During the year there were sales in USD of \$ 2,250,000 which were translated at a uniform rate of \$ 1.50 per GBP. This gives us sales of 1,500,000 GBP during the year. We then translate the cost of goods sold that were in USD during the year, the \$1,225,000 translates to 816,667 GBP. We now translate the foreign currency transactions conducted in Euros. There were sales of 1,200,000 Euros during the year which yield 960,000 GBP when translated at the recorded rate of 1.25 Euro per GBP. The cost of goods sold translation of 400,000 Euros becomes 320,000 GBP based on the 1.25 rate. In addition the operation had transactions in the functional currency as follows: sales, 500,000; cost of goods sold, 416,667; and operating expenses, 1,250,000 all of which are in GBP. The income statement in Exhibit A has all amounts converted into the functional currency.

At this point the translation to the parent company's reporting currency can take place. In this case the parent company's reporting is the U.S. dollar (USD) which had a weighted average rate of \$ 1.60 per GBP for the year. This rate is used to convert the foreign operation's income statement to the reporting currency. This is shown in Exhibit B. This completes the two step process for the translation of the income statement.

4. Balance Sheet:

The next step is the determination of the translation method to be used for the balance sheet of the foreign operation. ASC Topic 830 primarily allows two translation methods: the current rate method and the temporal method. In determining which method should be used we have to consider whether the foreign operation is in a country that is experiencing hyperinflation defined as a cumulative rate of inflation that is equal to or greater than 100% in 3 years. The foreign operation in this case is in the U.K. and the U.K. has not experienced hyperinflation therefore the current rate method is the appropriate method to use (Makar & Stanko, 1996).

Like the translation of the income statement, balance sheet amounts that are recorded in a foreign (not the functional) currency must be translated into the functional currency first before translation into the reporting currency. This translation is done at the current exchange rate as of the date of the balance sheet (ASC Topic 830). This means that the process will again require two steps. In the case of the U.K branch operation being used as an example there are both account receivable and accounts payable carried in foreign currencies (USD and Euros). Using the current rate of \$ 1.65 USD to 1 GBP the accounts receivable of \$ 165,000 translate to 100,000 GBP. Accounts payable that are carried in USD total \$ 41,250 which translates to 25,000 GBP. In the case of amounts carried in Euros. The accounts receivable balance is 68,750 Euros and the accounts payable balance is 34,375 Euros. The current exchange rate for Euros is 1.375 to 1 GBP so these would translate at 50,000 GBP and 25,000 GBP, respectively. After completing this translation into the functional currency of the branch the balance sheet for the branch is shown in Exhibit C.

Now that we have the balance sheet in the functional currency of the branch operation it can be translated into the reporting currency of the parent company, in this case U.S. dollars. Under ASC Topic 830 the use of the current rate method requires us to restate all assets and liabilities at the current rate while all stockholders' equity accounts are translated at the historical rate (Cantoria, 2011). In this case the current rate is \$ 1.65 per GBP (.6061) and the historical rate is \$ 1.50 per GBP (.6667).

At this point we need to break down the retained earnings as reported above. This schedule is fairly simple since the branch operations do not pay dividends to the parent operation in the U.S. This is shown in Exhibit D.

The next step is the calculation of the cumulative translation adjustment. This calculation is shown in Exhibit E.

Once the cumulative translation adjustment is calculated we can complete the translation of the balance sheet for the U.K. operation. This is shown in Exhibit F.

5. Financial Statement Reporting:

With all translations calculated and the balance sheet now in the reporting currency of the parent company it becomes time to focus on reporting the information in the consolidated financial statements. First the income statements of the parent company and the U.K. branch would be combined and assuming no intercompany transactions would simply be added together to get consolidated totals. The balance sheet items would also be combined to get consolidated totals.

ASC Topic 220-10-45 states the cumulative translation adjustment could be reported either on a separate statement of comprehensive income or on a combined income statement and statement of comprehensive income (Sorensen & Kyle, 2008). Since the illustrative case used here represents a small, privately held business, it would be likely that the company would choose to do a combined statement of income and comprehensive income. This reporting methodology is shown in Exhibit G.

The final part of this process is the reporting of the cumulative currency translation adjustment. This would be combined with any other comprehensive income items and reported in total as a line item under the stockholders' equity section of the balance sheet. If there is more than one component involved in other comprehensive income each component would be shown on the statement of comprehensive income and disclosed in the notes to the financial statements (ASC Topic 220-10-45).

6. Conclusion:

This illustration of the foreign currency translation process, using the current rate method under U.S. GAAP is presented as guidance for the calculations and disclosures required. It provides basic information for students and practitioners.

Exhibit A

U.K. Entity

Income Statement

Year ended December 31, 2012

Sales	
In GBP	500,000
In USD (converted to GBP)	1,500,000
In Euros (converted to GBP)	960,000
Total Sales	2,960,000
Cost of Goods Sold	
In GBP	416,667
In USD (converted to GBP)	816,667
In Euros (converted to GBP)	320,000
Total cost of goods sold	<u>1,553,334</u>
Gross Profit	1,406,666
Operating expenses (all in GBP)	<u>1,250,000</u>
Net Income	<u>156,666</u>

Exhibit B

U.K. Entity

Income Statement

Year ended December 31, 2012

		Average Rate	
Sales			
In GBP	500,000	1.6	800,000
In USD (converted to GBP)	1,500,000	1.6	2,400,000
In Euros (converted to GBP)	960,000	1.6	1,536,000
Total Sales	2,960,000	1.6	4,736,000
Cost of Goods Sold			
In GBP	416,667	1.6	666,667
In USD (converted to GBP)	816,667	1.6	1,306,667
In Euros (converted to GBP)	320,000	1.6	512,000
Total cost of goods sold	<u>1,553,334</u>	1.6	<u>2,485,334</u>
Gross Profit	1,406,666	1.6	2,250,666
Operating expenses (all in GBP)	<u>1,250,000</u>	1.6	2,000,000
Net Income	<u>156,666</u>	1.6	<u>250,666</u>

Exhibit C
U.K Entity
Balance Sheet
31-Dec-12

Cash	148,650
Accounts receivable, net	172,500
Inventories	165,650
Prepaid expenses	<u>8,250</u>
Total current assets	495,050
Property, plant & equipment, net	<u>212,435</u>
Total Assets	<u>707,485</u>
Accounts payable	60,000
Accrued expenses	<u>10,000</u>
Total current liabilities	70,000
Stockholders' equity	
Retained earnings	637,485
Total stockholders' equity	637,485
Total liabilities and stockholders' equity	<u>707,485</u>

Exhibit D
UK Entity
Schedule of Retained Earnings
Year ended December 31, 2012

	GBP		USD
Retained Earnings 1-1-12	480,819	Prior Yr.	710,629
Net Income 2012	<u>156,666</u>	Above	<u>250,666</u>
Retained Earnings 12-31-12	<u>637,485</u>		<u>961,295</u>

Exhibit E
UK Entity
Cumulative Translation Adjustment

	GBP	Rate	USD
Net assets 1-1-11	201,235	1.5168	305,232
Net Income 2011	<u>279,584</u>	1.45	<u>405,397</u>
Net assets 12-31-11	<u>480,819</u>		<u>710,629</u>
Net assets 12-31-11			
at current exchange rate	<u>480,819</u>	1.47795	<u>710,629</u>
Translation adjustment 2011			-1
Net assets 1-1-12	480,819	1.45	710,629
Net Income 2012	<u>156,666</u>	Above	<u>250,666</u>
Net assets 12-31-12	637,485		961,295
Net assets 12-31-12			
at current exchange rate	<u>637,485</u>	1.65	<u>1,051,850</u>
Translation adjustment 2012			90,555
Cumulative translation adjustment			<u>90,555</u>

Exhibit F

U.K Entity
Balance Sheet
31-Dec-12

	GBP	Rate	USD
Cash	148,650	1.65	245,273
Accounts receivable, net	172,500	1.65	284,625
Inventories	165,650	1.65	273,323
Prepaid expenses	<u>8,250</u>	1.65	<u>13,613</u>
Total current assets	<u>495,050</u>		<u>816,833</u>
Property, plant & equipment, net	<u>212,435</u>	1.65	<u>350,518</u>
Total Assets	<u>707,485</u>		<u>1,167,350</u>
Accounts payable	(60,000)	1.65	(99,000)
Accrued expenses	(10,000)	1.65	(16,500)
Retained earnings 12/31/12	<u>(637,485)</u>		<u>(961,295)</u>
Subtotal			(1,076,795)
Cumulative translation adjustment		Above	(90,555)
Total	<u>(707,485)</u>		<u>(1,167,350)</u>

Exhibit G

U.S Company
Consolidated Statement of Income and Comprehensive Income
Year ended December 31, 2012

Net sales	\$15,250,450
Cost of goods sold	<u>6,100,180</u>
Gross profit	9,150,270
Selling, general and administrative expenses	<u>6,045,250</u>
Income from operations	3,105,020
Interest expense	<u>122,545</u>
Income before taxes	2,982,475
Income taxes	<u>1,014,025</u>
Net Income	1,968,450
Other comprehensive income net of tax	
Foreign currency translation adjustment	<u>90,555</u>
Comprehensive Income	<u>\$2,059,005</u>

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