Chapter 11
Translation of Foreign Financial Statements
Part 1: The Theory

Advanced Accounting
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Student Learning Outcomes

- Define functional currency and identify factors suggesting functional currency
- Explain the objectives of the translation process
- Part 2:
  - Apply functional currency translation process to a trial balance and calculate the translation adjustment
  - Explain how the translation adjustment is accounted for
  - Apply the remeasurement process to a trial balance and explain how to account for the remeasurement gain or loss
  - Differentiate between the two methods for converting functional currency to the parent/investor's currency and explain the circumstances under which each method should be employed

Foreign Currency Translation

- The process of expressing amounts denominated or measured in foreign currencies into amounts measured in the reporting currency of the domestic entity
- Adjustment to US GAAP
- Relationships suggesting the need for translation
  - Home office/branch
  - Parent/subsidiary
  - Investor/investee

FASB's Statement No. 52

- Adopted a functional currency approach
- Focuses on whether domestic entity cash flows will be directly or indirectly affected by changes in the exchange rates of foreign currencies

Functional Currency

- ASC §830
- The currency of the primary economic environment in which the entity generates and expends cash
- Local currency: Translation required
- US dollar: Remeasurement required
- Foreign currency: Remeasurement followed by translation required

Objectives of the Translation Process

- Provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity
- Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. GAAP

Functional Currency Is Not the Foreign Currency

- Foreign entity is a conduit for the U.S. parent's operations
- The foreign subsidiary's translated financial statements are identical to those statements that would have resulted had the transactions been originally recorded in the dollar functional currency
- The financial statement relationships for the translated financial statements are identical to those that would have resulted had the transactions been originally recorded in the dollar functional currency
- The transactions of the foreign entity had an immediate or potentially immediate impact on the dollar cash flows and equity; therefore, the impact was included in net income

Functional Currency Is the Foreign Currency

- Rate changes are not expected to have an immediate impact on the parent's cash flows
- The foreign subsidiary operates independently of the US parent, not as a conduit

Functional Currency Is the Foreign Currency

- No translation gains/losses should be included in current net income
- Translation adjustments should be classified as a separate component of other comprehensive income
- Translation adjustment is a plug

Expected Economic Effects of a Rate Change

- Exchange rates may or may not affect cash flows of related company
- Foreign entity conducts business in its own currency
  - Exchange rate changes relative to parent do not affect foreign entity's cash flow
  - Translation should not affect net income
- The foreign entity conducts business in a foreign currency
  - Cash inflows/outflows are affected
  - Translation gains/losses should be included in net income

Identification of Functional Currency

	When the Functional Currency	
	Is Not the Foreign Currency	Is the Foreign Currency
Nature of the subsidiary entity	Operates as a conduit in which transactions occur in the parent's functional currency.	Operates as an independent entity through which transactions occur in the subsidiary's functional currency.
Exchange rate changes	Affect the economic well-being of the parent.	Do not affect the economic well-being of the parent.
Effect of exchange rate changes on net income	The effect is a gain or loss which is recognized as a component of net income.	The effect is not currently recognized as a component of net income but rather as a component of other comprehensive income.
Effect of exchange rate changes on the parent's cash flow	Changes have an immediate or potentially immediate impact on cash flows.	Changes do not have immediate or potentially immediate impact on cash flows. Impact is unclear.
Financial relationships between accounts	Relationships after translation are different than prior to, therefore reflecting the economic effect of exchange rate changes.	Relationships after translation are same as prior to. exchange rate changes have no economic effect on parent.

Concluding Comments

- Defined functional currency and identified factors suggesting functional currency
- Explained the objectives of the translation process
- Part 2:
  - Apply functional currency translation process to a trial balance and calculate the translation adjustment
  - Explain how the translation adjustment is accounted for.
  - Apply the remeasurement process to a trial balance and explain how to account for the remeasurement gain or loss
  - Differentiate between the two methods for converting functional currency to the parent/investor's currency and explain the circumstances under which each method should be employed