Chapter 11
Translation of Foreign Financial Statements
Part 2: The Application

Advanced Accounting
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Student Learning Outcomes

- Part 1
  - Defined functional currency and identified factors suggesting functional currency
  - Explained the objectives of the translation process
- 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

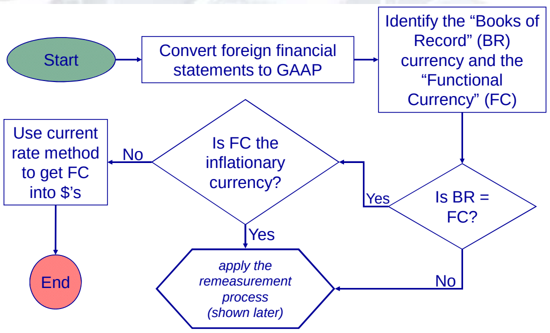
Basic Translation Process: Functional Currency To Reporting Currency

- Foreign financial statements should be restated into US GAAP before translation begins
- If functional currency is foreign entity's local currency use current rate method to translate
  - Also called functional or translation method
- If functional currency is not foreign entity's local currency use historical rate method to translate
  - Also called temporal or remeasurement method

Translation Process Applied

- The basic translation process is applied to foreign subsidiary's trial balance before it is included in consolidated/combined financial statements.

The Translation Process



Current Rate/Functional Method

Account	Translated at
Assets and Liabilities	Current exchange rate at date of translation
Revenues and Expenses	Current exchange rates that existed at time revenues and expenses were recognized. Practical: weighted average
Equity accounts (excluding RE)	Historical exchange rate at date of investment in subsidiary
Retained Earnings	On date of investment in subsidiary: historical rate Income additions: translated per revenue and expense above, i.e., weighted average Dividends: historical rate at date of declaration
Translation adjustment recorded as a component of	Other Comprehensive Income

Translation Adjustment

- Results from the process of translating foreign financial statements from their functional currency into the domestic entity's reporting currency
- Since various rates are used, equality of accounting equation is lost
- Translation adjustment is necessary to balance foreign entity's trial balance
- Adjustment is NOT included in net income
- Adjustment is shown as a separate component of other comprehensive income (OCI)

For Example

- Sori Corporation, a foreign corporation, began operations on January 1, 20X0. On January 1, 20X1, when net assets totaled 100,000 FC, 90% of Sori stock was acquired by Pome Corporation, a US Corporation. Sori's functional currency is the foreign currency and it maintains its records in the functional currency.
- Sales are billed in foreign currency. The level of sales and purchases was constant over the year.

12/31/X1 Trial Balance

Account	Balance in Functional Currency DR	CR
Assets	200,000 FC	
Liabilities		61,000 FC
Common Stock		80,000 FC
Retained Earnings, 1/1/X1		20,000 FC
Revenue		282,000 FC
Expense	243,000 FC	
Total	443,000 FC	443,000 FC

January 1, 20X0	1 FC = $0.98
January 1, 20X1	1 FC = $1.00
December 31, 20X1	1 FC = $1.05
20X1 Average	1 FC = $1.03

Trial Balance Translation

Account	Balance in Functional Currency DR	Balance in Functional Currency CR	Ex Rate	Balance in Dollars DR	Balance in Dollars CR
Assets	200,000 FC		1.05	$210,000	
Liabilities		61,000 FC	1.05		$64,050
Common Stock		80,000 FC	1.00		80,000
Retained Earnings, 1/1/X1		20,000 FC			20,000
Revenue		282,000 FC	1.03		290,460
Expense	243,000 FC		1.03	250,290	
Total	443,000 FC	443,000 FC		$460,290	$454,510

Notice that DR and CR are not equal.
To balance, a credit of 5,780 is needed.

Trial Balance Translation

Account	Balance in Functional Currency DR	Balance in Functional Currency CR	Ex Rate	Balance in Dollars DR	Balance in Dollars CR
Assets	200,000 FC		1.05	$210,000	
Liabilities		61,000 FC	1.05		$64,050
Common Stock		80,000 FC	1.00		80,000
Retained Earnings, 1/1/X1		20,000 FC			20,000
Revenue		282,000 FC	1.03		290,460
Expense	243,000 FC		1.03	250,290	
Total	443,000 FC	443,000 FC		$460,290	$454,510
Translation Adjustment					5,780
Total				$460,290	$460,290

Net Income = 282,000 FC – 243,000 FC = 39,000 FC

Direct Calculation of the Current-Period Translation Adjustment

- Net assets at the beginning of the period multiplied by the change in exchange rates during the period
- Change in net assets (excluding capital transactions) multiplied by the difference between the current rate and the average rate used to translate income
- Change in net assets due to capital transactions (including investments by the domestic investor) multiplied by the difference between the current rate and the rate at the time of the capital transaction

Direct Calculation of the Current-Period Translation Adjustment

- Net assets at the beginning of the period multiplied by the change in exchange rates during the period — 0x(1.05-1.00) = $0
- Change in net assets (excluding capital transactions) multiplied by the difference between the current rate and the average rate used to translate income — 39,000x(1.05-1.03) =$780
- Change in net assets due to capital transactions (including investments by the domestic investor) multiplied by the difference between the current rate and the rate at the time of the capital transaction — 100,000x(1.05-1.00)=$5,000

Trans. Adjustment=$5,780

Subsequent Recognition Of Translation Adjustment

- Translation adjustments may affect income when there is a partial or complete sale or complete or substantially complete liquidation of the investment in the foreign entity
- In this case, some or all of the translation adjustment would be included in the gain/loss on disposition of the investment

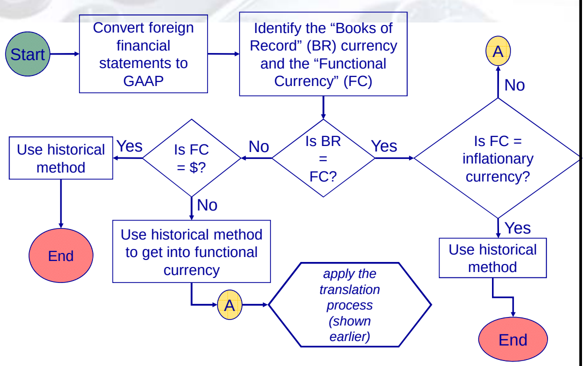
Remeasured Financial Statements

- Remeasurement process intended to produce financial statements that are the same as if the foreign entity's transactions had been originally recorded in the functional currency
- Remeasurement is based on the historical or temporal method
- Historical exchange rates between the functional currency and foreign currency are used to remeasure certain accounts
- Adjustment from remeasurement process is remeasurement gain/loss, included in net income

Remeasurement Is Necessary When

- The foreign entity's financial statements are prepared in a currency that is not the functional currency. The functional currency may be:
  - Another foreign currency
  - The US$
- The foreign entity's financial statements must be remeasured into the functional currency before they are translated into parent's domestic currency

The Remeasurement Process



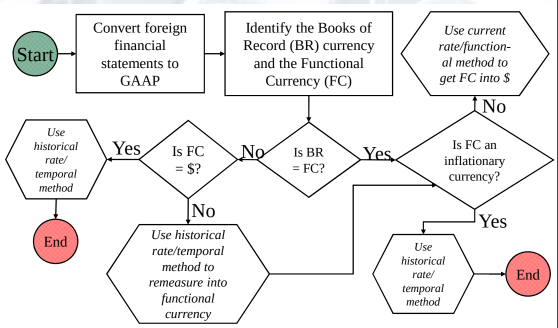
Remeasurement of Financial Statement Accounts

Account	Translated at
Assets and Liabilities	
Monetary items and all liabilities	Current exchange rate at date of translation
All other assets	Historical exchange rate at date of acquisition
Revenues and Expenses, other than amortization of historical amounts	Current exchange rates that existed at time rev/exp were recognized. Practical: weighted average
Amortization of historical amounts	Historical exchange rates
Equity accounts (excluding RE)	Historical exchange rate at date of investment in subsidiary
Retained Earnings	On date of investment in subsidiary: historical Income additions: translated per rev/exp above Dividends: historical rate at date of declaration
Remeasurement gain or loss	Component of Net Income

Historical Rate / Temporal Method

- *Remeasure* into functional currency before *translating* into parent's domestic currency
- The remeasurement process is intended to produce financial statements that are the same as if the entity's transactions had been originally recorded in the functional currency
- The resulting **remeasurement gain or loss** is included as a component of net income.

The Remeasurement Process



Historical Rate/Temporal Method

Account	**Remeasure Using…**
Assets and Liabilities:	
Monetary assets and liabilities measured at current values	Current exchange rate
Non-monetary items are not measured at current values	Historical exchange rate
Revenues and Expenses:	
Representing amortization of historical amounts	Historical exchange rate
Other income and expense items	Weighted average exchange rate for the period
Equity accounts (excluding RE)	Historical exchange rates
Retained Earnings	Beginning remeasured balance plus (minus) remeasured net income (loss) less dividends remeasured at historical rates
Remeasurement gain or loss	Component of current period net income

Historical Rate / Temporal Method (continued)

Monetary items: Rights to receive or pay an amount of money which is:

- Fixed in amount, or
- Determinable without reference to future prices of specific goods/services; i.e., its value does not change according to changes in price levels

Highly Inflationary Economies

- If foreign entity's financial statements are expressed in functional currency
  - Statements translated directly into parent's reporting currency
- This procedure not followed if foreign country has highly inflationary economy
  - Cumulative inflation rate of 100% or more over 3 years
  - Unstable measure of value likely to produce misleading results
- Domestic currency serves as foreign entity's functional currency
  - Results in remeasurement of statements into $
  - No further translation necessary
  - Remeasurement gain/loss included in current period net income

Concluding Comments: Functional Currency is Local Currency

- Use current rate/functional method
- Assets and liabilities: Use current rate
- Equity, excluding R/E: Use historical rates
- Retained earnings: Beginning translated balance ± translated net income/loss – dividends (translated at historical rates)
- Revenue and expense: Use weighted-average exchange rate
- Cumulative translation adjustment: Plug or computed, OCI

Computed Translation Adjustment

- Net assets at the beginning of the period multiplied by the change in exchange rates during the period
- Change in net assets (excluding capital transactions) multiplied by the difference between the current rate and the average rate used to translate income
- Change in net assets due to capital transactions (including investments by the domestic investor) multiplied by the difference between the current rate and the rate at the time of the capital transaction

Concluding Comments: Functional Currency is Not Local Currency

- Use historical rate/temporal method
- Monetary assets and liabilities: Use current rate
- Non-monetary assets: Use historical rates
- Equity, excluding R/E: Use historical rates
- Retained earnings: Beginning translated balance ± translated net income/loss – dividends (translated at historical rates)
- Revenues & Expense:
  - Amortization of Historical Amounts: Use historical rates
  - All Other Revenues & Expenses: Use weighted average rate
- Remeasurement Gain/Loss: Plug, Net Income

The Next Step

- Translation Rules
- Exercises 11-1, 11-2
- Supplementary Problems