NAME: JOAN PATRICK ESSIET

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TRANSLATION OF FOREIGN CURRENCY FINANCIAL STATEMENTS

Statement of Financial Position Exposure

As exchange rates change, assets and liabilities translated at the current exchange rate change in value from Statement of Financial Position to Statement of Financial Position in terms of the parent company’s reporting currency and these items are exposed to translation adjustment. Statement of Financial Position items translated at historical exchange rates do not change in parent currency value from one Statement of Financial Position to the next and these items are not exposed to translation adjustment.

Exposure to translation adjustment is referred to as Statement of Financial Position, translation, or accounting exposure. Transaction exposure gives rise to foreign exchange gains and losses that are ultimately realized in cash while translation adjustments that arise from Statement of Financial Position exposure that don’t directly result in cash inflows or outflows.

Each item translated at the current exchange rate is exposed to translation adjustment which implies a separate translation adjustment exists for each of these exposed items. If total exposed assets are equal to total exposed liabilities throughout the year, the translation adjustments net to a zero balance.

A net liability Statement of Financial Position exposure exists when liabilities translated at the current exchange rate are greater than assets translated at the current exchange rate.

There are four major methods of translating foreign currency used worldwide. Namely; Current/Noncurrent, Monetary/nonmonetary, Temporal and Current rate or closing rate method

CURRENT/ NON CURRENT METHOD:

Under this method, current assets and current liabilities are translated at the current exchange rate; noncurrent assets, noncurrent liabilities, and stockholders’ equity accounts are translated at historical exchange rates. There is no theoretical basis underlying this method.

MONETARY/NONMONETARY METHOD

This method was developed by Hepworth in 1956, to remedy the lack of theoretical justification for the current/noncurrent method. Under this method, monetary assets and liabilities are translated at the current exchange rates; nonmonetary assets, nonmonetary liabilities, and stockholders’ equity accounts are translated at historical exchange rates.

Monetary assets are those assets whose value does not fluctuate over time e.g cash and receiveables while Nonmonetary assets are assets whose monetary value can fluctuate. They consist of marketable securities, inventory, etc.

TEMPORAL METHOD

The basic objective underlying the temporal method of translation is to produce a set of parent currency translated financial statements as if the foreign subsidiary had actually used the parent currency in conducting its operations.

CURRENT RATE METHOD

Here, a parent’s entire investment in a foreign operation is exposed to foreign exchange risk and translation of the foreign operation’s financial statements should reflect this risk. To measure the net investment’s exposure, all assets and liabilities of the foreign operation are translated using the current exchange rate and equity accounts are translated at historical exchange rates

The current rate method and the temporal method are the two methods required to be used under IAS 21, The Effects of Changes in Foreign Exchange Rates.