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 (for example, U.S. dollar). 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. These items are ***not*** exposed to translation adjustment. Exposure to translation adjustment is referred to as Statement of Financial Position, translation, or accounting exposure. ***Statement of Financial Position exposure*** can be contrasted with the ***transaction exposure*** discussed earlier that arises when a company has foreign currency receivables and payables in the following way:

> ***Transaction exposure gives rise to foreign exchange gains and losses that are ultimately realized in cash; translation adjustments that arise from Statement of Financial Position exposure do not directly result in cash inflows or outflows.***

Each item translated at the current exchange rate is exposed to translation adjustment. In effect, a separate translation adjustment exists for each of these exposed items. However, positive translation adjustments on assets when the foreign currency appreciates are offset by negative translation adjustments on liabilities. If total exposed assets are equal to total exposed liabilities throughout the year, the translation adjustments (although perhaps significant on an individual basis) net to a zero balance. The ***net*** translation adjustment needed to keep the consolidated Statement of Financial Position in balance is based solely on the net asset or net liability exposure.

A foreign operation will have a ***net asset Statement of Financial Position exposure*** when assets translated at the current exchange rate are greater in amount than liabilities translated at the current exchange rate. 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. The relationship between exchange rate fluctuations, Statement of Financial Position exposure, and translation adjustments can be summarized as follows:

Statement of Financial Position Exposure	**Foreign Currency**	
	Appreciates	**Depreciates**
Net Asset	Positive Translation adjustment	Negative Translation adjustment
Net Liability	Negative Translation adjustment	Positive Translation adjustment

TRANSLATION METHODS

Four major methods of translating foreign currency financial statements have been used worldwide:

i. Current/noncurrent method,
ii. Monetary/nonmonetary method,
iii. Temporal method, and
iv. Current rate (or closing rate) method.

Current/Noncurrent Method

The rules for the current/noncurrent method are as follows: 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. Although once the predominant method, the current/noncurrent method has been unacceptable in the United States since 1975, has never been allowed under International Financial Reporting Standards, and is seldom used in other countries.

Monetary/Nonmonetary Method

To remedy the lack of theoretical justification for the current/noncurrent method, Hepworth developed the monetary/nonmonetary method of translation in 1956. 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—primarily cash and receivables. Nonmonetary assets are assets whose monetary value can fluctuate. They consist of marketable securities, inventory, prepaid expenses, investments, non-current assets, and intangible assets; that is, all assets other than cash and receivables. Monetary liabilities are those liabilities whose monetary value cannot fluctuate over time, which is true for most payables.

Under the monetary/nonmonetary method, cash, receivables, and payables carried on the foreign operation's Statement of Financial Position are exposed to foreign exchange risk. There is a net asset exposure when cash plus receivables exceed payables, and a net liability exposure when payables exceed cash plus receivables.

Cash + Receivables > Payables → Net asset exposure

Cash + Receivables < Payables → Net liability exposure

One way to understand the concept of exposure underlying the ***monetary/nonmonetary*** method is to assume that the foreign operation's cash, receivables, and payables are actually foreign currency assets and liabilities of the parent company. For example, consider the Japanese subsidiary of a New Zealand parent company. The Japanese subsidiary's yen receivables that result from sales in Japan may be thought of as Japanese yen receivables of the New Zealand parent resulting from export sales to Japan. If the New Zealand parent had yen receivables on its Statement of Financial Position, an increase in the value of the yen would result in a foreign exchange gain. There also would be a foreign exchange gain on the Japanese yen held in cash by the parent. These foreign exchange gains would be offset by a foreign exchange loss on the parent's Japanese yen payables resulting from foreign purchases. Whether a net gain or a net loss exists depends on the relative size of yen cash and receivables versus yen payables. Under the monetary/nonmonetary method, the translation adjustment measures the net foreign exchange gain or loss on the foreign operation's cash, receivables, and payables as if those items were actually carried on the books of the parent.

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. For example, land carried on the books of a foreign subsidiary should be translated such that it is reported on the consolidated Statement of Financial Position at the amount of parent currency that would have been spent if the parent had sent parent currency to the subsidiary to purchase the land.

Consistent with the temporal method's underlying objective, assets and liabilities reported on the foreign operation's Statement of Financial Position at historical cost are translated at historical exchange rates to yield an equivalent historical cost in parent currency terms. Conversely, assets and liabilities reported on the foreign operation's Statement of Financial Position at a current (or future) value are translated at the current exchange rate to yield an equivalent current value in parent currency terms. (As is true under any translation method, equity accounts are translated at historical exchange rates.) Application of these rules maintains the underlying valuation method (historical cost or current value) used by the foreign subsidiary in accounting for its assets and liabilities.

Current Rate Method

The fourth major method used in translating foreign currency financial statements is the current rate method. The fundamental concept underlying the current rate method is that 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 to foreign exchange risk:

i. All assets and liabilities of the foreign operation are translated using the ***current exchange*** rate.
ii. Equity accounts are translated at ***historical exchange*** rates.

The Statement of Financial Position exposure measured by the current rate method is equal to the foreign operation's net asset position (total assets minus total liabilities).

Total assets > Total liabilities → Net asset exposure

A positive translation adjustment results when the foreign currency appreciates, and a negative translation adjustment results when the foreign currency depreciates (assuming that assets exceed liabilities). The translation adjustment arising when the current rate method is used also is unrealized. It can become a realized gain or loss if the foreign operation is sold (for its book value) and the foreign currency proceeds from the sale are converted into parent currency.

Under the current rate method, revenues and expenses are translated using the exchange rate in effect at the date of accounting recognition. In most cases an assumption can be made that the revenue or expense is incurred evenly throughout the year and an average-for-the-period exchange rate is used. However, when an income item, such as a gain or loss on the sale of an asset, occurs at a specific point in time, the exchange rate at that date should be used for translation. Alternatively, all income statement items may be translated at the current exchange rate.

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***.