Managing Foreign Operations and Currency Translation

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When a multinational corporation based in the United States owns over 50 percent of a foreign entity, the American parent company is typically required to provide consolidated financial statements. In such cases, the financial accounts of the foreign subsidiary must first be translated from the foreign currency into US dollars. This can be a complex process, and there are several factors that must be considered when managing the translation of foreign finances.

Determine the Functional Currency

First and foremost, it is vital to determine and document the functional currency used by the foreign subsidiary. It is perhaps the most important step in the process of foreign currency translation. In fact, the mode of translation, as well as any translation adjustments, is dependent almost entirely on the functional currency employed by the foreign entity. Functional currency will also determine how the conversions themselves ought to be calculated.

"Functional currency" is a term applied specifically to the currency in which the subsidiary holding generally conducts the bulk of its day-to-day operations. The functional currency could be the entity's local currency, US dollars, or even the currency of another country entirely.

The first step in translation is always to ensure that the foreign entity's accounts are converted to US GAAP. This is so that all foreign reporting is in line with US GAAP, before any further conversion takes place. At this point, it becomes important to "remeasure" the entity's accounts in its functional currency.

When remeasuring foreign accounts, it is important to choose the appropriate conversion rate. It is quite common for many multinational businesses to convert a foreign entity's balance sheet at the incorrect rates. Certain items, mostly nonmonetary goods, ought to be converted at historic rates. This includes patents, inventories carried at cost, and any depreciation of property, plants, or equipment. On the other hand, items such as deferred income taxes and unamortized policy acquisition costs should be translated at the current exchange rate.

If the foreign subsidiary uses US dollars for their daily transactions, then the process of translation is complete after remeasurement. However, for those that use their local currency, the current rate method is required. With this method, companies need to translate their cost of sales and depreciation rates at the weighted average exchange rate for the time period in question.

Volatile Inflation Rates

Once the functional currency has been concluded and documented, it becomes necessary to investigate the currency's stability. Specifically, it should be determined if the inflation rate has become volatile.

In such cases translation using a standard current exchange rate could actually produce highly inaccurate, unrealistic results. This is because when the foreign economy is highly inflationary, its relative rates of

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inflation can have a profound affect on currency exchange rate changes. In fact, in most cases, the local currency of a highly inflationary economy will have weakened considerably against the US dollar.

The situation in Argentina is an excellent example of this phenomenon. Argentina's average consumer price index increased 1,342 percent over three years between 1978 and 1980. At the same time, the US dollar increased in strength 398 percent against the Argentinean peso.

In such a volatile, inflationary circumstance, the application of the current rate method would be entirely unreliable. It could be expected that such action would result in a significant downward revaluation of balance sheet amounts. Long-lived assets such as property holdings and equipment would be particularly affected. Conversely, operating income values would be improved due to the much lower depreciation charge.

It is therefore of the utmost importance that inflation rates be assessed prior to the application of any translation methodology. A "highly inflationary" economy is typically defined as one having a cumulative inflation rate of 100 percent or more over a three year period. In the case of such volatile inflation rates, the standard methods of translation are generally unsuitable.

Keep Aware of Special Circumstances

In some circumstances, an account may not be possible to convert using standard methods. Retained earnings accounts, for example, require adjustment prior to translation. In such cases, they must first be adjusted by adding income to retained earnings reported at the beginning of the career, then subtracting any translated dividends. This kind of adjustment is absolutely necessary in order to obtain an accurate translation of these accounts. It is therefore highly important that accounts be reviewed and checked for anomalous behavior prior to attempting any kind of monetary conversion.

Conclusion

The functional currency utilized by the foreign subsidiary is an instrumental factor in the determination of appropriate methods of currency translation. In order to obtain a precise, reliable translation of foreign subsidiary account holdings, it is crucial that a thorough understanding of the functional currency first be obtained. Checking for anomalous circumstances, such as volatile inflation rates or special accounts, is the only way to ensure an accurate result.

When companies are faced with pressing requirements related to foreign operations and currency translation accounting, consideration should be given to contracting with an outsourced financial services provider with expertise in these areas.

References and Further Reading

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