
KEY PROBLEMS IN ACCOUNTING FOR FOREIGN CURRENCY TRANSACTIONS

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Abstract: The main problems in accounting for foreign currency transactions arise from the continuous dynamics of exchange rates and the resulting foreign exchange differences. Changes in exchange rates have a huge impact on the financial results of the entity carrying out such transactions, on its financial position, on the magnitude of a number of important indicators of financial and accounting analysis, including profitability, liquidity and solvency. All this necessitates the application of appropriate accounting approaches to reflect effects of changes in exchange rates through transactions in foreign currencies so as to present in a true and fair manner the operations of the entity in its financial statements and to provide relevant, reliable and comparable accounting information to their users, enabling the latter to make soundly based economic decisions.

The key accounting problems in reflecting foreign currency transactions are: 1) what exchange rates are to be applied upon initial recognition of these transactions; 2) how to recognize and reflect the on currently the exchange differences arising out of the dynamics of exchange rates in the implementation of the transactions; 3) how to present in the financial statements of an entity the effects of changes in exchange rates related to transactions in foreign currency. Different alternatives for solving these problems in theoretical and applied aspects are possible. Studies of accounting theory and practice in this strand on a global scale have shown significant differences in accounting approaches, rules and procedures in different countries. This gives grounds to consider problems related to reflecting the effects of changes in exchange rates and their presentation in the financial statements as some of the most problematic and difficult accounting areas with different views on possible approaches. An important step towards the search for the most appropriate solutions that will find wide application globally are the growing in recent years convergence processes in the field of accounting and the trend towards establishing a single set of high quality globally accepted accounting standards. One of the concrete results of the efforts of the international community in this direction was the revision of International Accounting Standard (IAS) 21 The Effects of Changes in Foreign Exchange Rates in 2003. The requirements for reflecting foreign currency transactions set forth in this standard correspond to the approach applied according to Generally Accepted Accounting Principles (United States) in reporting these transactions, known as "the two-transaction method". From the position of this approach, the initial recognition of the transaction and the subsequent settlement of payments on it by transmitting cash amounts are treated as two separate transactions. It requires as a basic rule, exchange differences in the valuation of cash, receivables and payables in foreign currencies to be recognized and to reflect the financial results of the current period in which they arise as a result of the change in exchange rates.

The accounting information on foreign currency transactions carried out by the entities in contemporary conditions is a key prerequisite both for their efficient management and for fulfilling the requirements as regards fair presentation of the financial position and results of operations in the financial statements.

Keywords: accounting, foreign currency transactions, information.

1. INTRODUCTION

The main issues in the financial reporting of foreign currency transactions arise from the continuous dynamics of exchange rates and the resulting foreign exchange differences. Changes in exchange rates have a huge impact on the financial results of the entities carrying out such transactions, on their financial position, on the magnitude of a number of important indicators of financial and accounting analysis, including profitability, liquidity and solvency. All this necessitates the application of appropriate approaches to reflect the accounting effects of changes in exchange rates through transactions in foreign currencies so as to present in a true and fair manner the operations of the entities in their financial statements and to provide relevant, reliable and comparable accounting information to their users, enabling the latter to make soundly based economic decisions.

2. KEY ACCOUNTING PROBLEMS RELATED TO REFLECTING FOREIGN CURRENCY TRANSACTIONS IN CONTEMPORARY CONDITIONS AND POSSIBLE APPROACHES TO THEIR RESOLVING

The key accounting problems in reflecting foreign currency transactions in contemporary conditions are:

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- what exchange rates are to be applied upon initial recognition of these transactions;
 - how to recognize and reflect the on currently the exchange differences arising out of the dynamics of exchange rates in the implementation of the transactions;
 - how to present in the financial statements of an entity the effects of changes in exchange rates related to transactions in foreign currency.

Different alternatives for solving these problems in theoretical and practical aspects are possible. Studies of accounting theory and practice in this strand on a global scale have shown significant differences in accounting approaches, rules and procedures in different countries. This gives grounds to consider problems related to reflecting the effects of changes in exchange rates and their presentation in the financial statements as some of the most problematic and difficult accounting areas with different views on possible approaches. An important step towards the search for the most appropriate solutions that will find wide application globally are the growing in recent years convergence processes in the field of accounting and the trend towards establishing a single set of high quality globally accepted accounting standards. One of the concrete results of the efforts of the international community in this direction was the revision of International Accounting Standard (IAS) 21 The Effects of Changes in Foreign Exchange Rates in 2003 as part of a project to improve International accounting standards undertaken by the International Accounting Standards Board in the light of queries and criticisms raised in relation to the standards by securities regulators, professional accountants and other interested parties. These amendments to standard whose implementation started on January 1, 2005, as the changes introduced therein over the years reflected the convergence processes and the aspiration towards an increasingly greater convergence in the terminological and conceptual relationship between accounting systems based on the International Financial Reporting Standards and the Generally Accepted Accounting Principles (United States).

The enterprises which carry out foreign currency transactions and implement as a formal accounting basis for preparation and presentation of financial statements the International Financial Reporting Standards are required, in reporting such transactions, to comply with the requirements of IAS 21 The Effects of Changes in Foreign Exchange Rates. In considering the problems regarding the creation of accounting information on transactions in foreign currency a key term is "functional currency" and the related approaches governed by IAS 21 The Effects of Changes in Foreign Exchange Rates. The functional currency is the currency of the primary economic environment in which an entity operates. This is the environment in which it primarily generates and expends cash. Foreign currency is a currency other than the functional currency of the entity. The standard requires each individual entity regardless of whether it is an enterprise with foreign operations - such as a parent or a foreign operation - such as a subsidiary, to determine its functional currency and measure its results and financial position in that currency. Functional currency of the enterprise reflects the underlying transactions, events and conditions of significance for it.

The determination of functional currency should be based on the following main factors:

- the currency that mainly influences the sales prices of goods and services (this is often the currency in which the prices of goods and services of the enterprise are determined and paid);
- the currency of the country whose competitive impact and regulations mainly determine the sales prices of goods and services;
- the currency that mainly influences labour costs, material and other costs of providing goods or services (usually the currency in which such costs are determined and paid).

As additional supporting evidence to identify the functional currency the following factors may also be used:

- the currency in which funds from financing activities are generated (i.e., issuing debt and equity instruments);
- the currency in which receipts from operating activities are usually retained.

Once defined, functional currency should not be changed unless in case of change of the primary economic environment in which the entity operates, i.e., in the event of change of the underlying transactions, events and conditions, relevant to it.

On initial recognition, foreign currency transactions must be recorded in the functional currency as to the foreign currency amount there should be applied spot rate between the functional and the foreign currency as at the transaction date. In view of facilitating accounting reflection in practical terms, it is permissible to use the average rate close to that on the transaction date, but only provided that no significant currency fluctuations (e.g., weekly or monthly average rates can be used, as per which the foreign currency transactions that have occurred during the specific week or month may be recorded).

Foreign currency transactions include every transaction that is denominated or requires settlement in a foreign currency. Such transactions arise when an enterprise:

- buys or sells goods or services whose price is denominated in foreign currency;
- borrows or lends funds when the amounts payable or receivable are denominated in foreign currencies; or
- otherwise acquires or disposes of assets, incurs or settles liabilities denominated in foreign currencies.

The requirements for reflecting foreign currency transactions set forth in IAS 21 The Effects of Changes in Foreign Exchange Rates correspond to the approach applied according to Generally Accepted Accounting Principles (United States) in reporting these transactions, known as "the two-transaction method"⁹⁴. From the position of this approach, the initial recognition of the transaction and the subsequent settlement of payments on it by transmitting cash amounts are treated as two separate transactions. It requires as a basic rule, exchange differences in the valuation of cash, receivables and payables in foreign currencies to be recognized and to reflect the financial results of the current period in which they arise as a result of the change in exchange rates.

In applying the "two-transaction method" three important points can be distinguished in relation to the use of exchange rates in the implementation of transactions in foreign currency:

- as at the date of the foreign currency transaction;
- as at the date of the financial statements;
- as at the date of settlement of the transaction in foreign currency.

As a result of the fact that there is a difference between the transaction date and the date of settling the payments thereon, account relationships emerge - receivables and payables in foreign currencies. When they arise, these receivables and payables are reported in accounting terms by using the spot rate between the functional and the foreign currency as at the date of initial recognition of the transaction. The accounting reflection of receivables and payables in foreign currencies in this manner is performed in compliance with the principle of accrual, according to which results from transactions and other events are charged at the time of the event, and not upon the receipt and payment of cash amounts, as they are included in the financial statements for the period to which they relate. By current accrual accounting provides information not only about past transactions involving payment or receipt of cash, but also about receivables and liabilities of the entity associated with future movement of the cash. Financial statements prepared on the basis of accruals provide important and useful information that their users could use in making economic decisions.

According to IAS 21 The Effects of Changes in Foreign Exchange Rates as at the date of the financial statements, receivables and payables in foreign currencies, in their capacity as currency monetary items should be translated at the closing rate, i.e., at the exchange spot rate at the reporting date. As monetary items are treated cash and all other assets and liabilities to be received or paid in fixed or determinable cash amounts. Exchange rate differences arising from the translation of monetary items at the closing rate as at the date of each drawing up of the financial statements, are recognized to the period in which they arise. The main sign for determining a monetary item is the right to receive or the obligation to deliver accurate or determinable number of currency units while the main sign of non-monetary item is the absence of such right. Non-monetary items in foreign currency that are measured based on historical cost as at the date of the financial statements reflect the exchange rate as at the date of the transaction that resulted in their recognition, and those that are measured at fair value are reported at exchange rate at the date when fair value was determined.

At the date of settlement of the transaction in foreign currency paid or received cash is measured at the current spot rate between the functional and the foreign currency on that date. Thus determined, the amount of cash paid to settle an account payable in foreign currency is compared with its value in functional currency, calculated at the exchange rate at the date of the foreign currency transaction (its date of arising) or if it is revaluated - the date of the last revaluation (i.e., at the closing rate at the date of the last financial statement). Upon receipt of cash under receivable in currency it is necessary to compare the amount with the value of the receivable in the functional currency formed as per the exchange rate at the date of the transaction, as a result of which same has arisen, or at the last revaluation date, if it is revaluated. The emerging differences resulting from the comparison between the values expressed in functional currency at the date of settlement of payments for transactions in foreign currency should be recognized in profit or loss in the period in which they arise.

⁹⁴ Choi, F., Meek, G., International Accounting, Seventh International Edition, Pearson Education Limited, 2014, p.179

When a foreign currency transaction is settled within the same reporting period in which it has arisen, all exchange rate difference is recognized and reported in that period. If however, the transaction is settled in a subsequent accounting period, the exchange rate difference that is reported in each period until the date of settlement is determined by the change in exchange rates during that period.

The above requirements concerning the measurement of monetary items in foreign currency, including of receivables and payables and the recognition of the related exchange rate differences are highly significant for entities carrying out transactions in foreign currency since they affect the formation of their financial result for the reporting period.

In global accounting theory and practice there are two basic approaches to reflect gains and losses from exchange rate differences on revaluation of foreign currency receivables and payables – "deferral approach" and "accrual approach".⁹⁵ According to the first approach, gains and losses from exchange rate differences resulting from the subsequent measurement of foreign currency receivables and liabilities are not recognized in the financial result for the current period. These foreign exchange gains and losses that have not yet been realized in cash (unrealized) are deferred until actual payment or receipt of cash. After payment or receipt of cash, the realized foreign exchange gains and losses are included in the financial result for the period. The "deferral approach" to accounting for gains and losses from exchange rate differences related to revaluation of foreign currency receivables and payables is not acceptable under either International Financial Reporting Standards or Generally Accepted Accounting Principles (United States).

According to the second approach, gains and losses from exchange rate differences upon revaluation of receivables and payables denominated in foreign currency should be reflected in the financial result for the current period in which exchange rates have changed. As a result of its implementation, the effect of the change in exchange rates, which will affect cash flows is reflected at the time of occurrence of the event causing such effect. The second approach complies with the accounting principle of current accrual. Both IAS 21 The Effects of Changes in Foreign Exchange Rates and Generally Accepted Accounting Principles (United States) require entities to use the "accrual approach" to account for foreign exchange gains and losses on revaluation of foreign currency receivables and payables. Under this approach the entities report these unrealized foreign exchange gains and losses in net income in the period in which the exchange rate changes. When applying the "accrual approach", the change in the exchange rate from the date of initial recognition of the foreign currency transaction to the date of the financial statements would result in a foreign exchange gain or loss to be reported in net income in that period. The change in the exchange rate from the date of the financial statements to the date of settlement of the transaction payments in foreign currency would result in a subsequent foreign exchange gain or loss that would be reported in the subsequent accounting period.

In compliance with the requirements of IAS 21 The Effects of Changes in Foreign Exchange Rates as a whole, exchange rate differences arising upon settlement of monetary items or upon translating monetary items of an entity as per rates other than those which have been reported on initial recognition during the period or in previous financial statements, they are recognized to the profit or loss for the period in which they have arisen. This is based on the view that such exchange rate differences have a direct effect on cash flows - upon settlement of the transaction payments or will affect its cash flow in the near future - upon reflecting the exchange rate differences from revaluation of monetary items in foreign currency as per the closing rate at the date of the financial statements.

An exception to this general approach as regards the recognition of exchange rate differences from foreign currency transactions is the requirement that exchange differences relating to monetary items, which in its essence is part of a net investment in a foreign operation, to be deferred and recorded as a separate component of equity in the consolidated financial statements of the reporting entity. The recognition of such exchange rate differences to the profit or loss for the period is completed upon disposal of the net investment, i.e., during the same period during which a gain or loss is recognized upon disposal of the investment. It is considered that the settlement of such monetary items is neither planned nor likely to occur in the foreseeable future, the related exchange differences do not affect cash flows and therefore they should be presented in the consolidated financial statements as a separate component in equity. Such exchange differences shall be recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the investment.

⁹⁵ Doupnik, T., Perera, H., International Accounting, Fourth International Edition, McGraw-Hill Education, 2015, p.347

3. CONCLUSION

All the foregoing provides grounds to conclude that the problems related to accounting for foreign currency transactions and to presentation of the effects of changes in exchange rates in the financial statements are particularly important and topical for the entities that operate internationally and transact in foreign currencies as a result of their export and import activities. The accounting information on transactions in foreign currencies carried out by the entities in contemporary conditions of continuously increasing globalization is a key prerequisite both for their efficient management and for fulfilling the requirements as regards fair presentation of the financial position and results of operations in the financial statements and for enabling the adoption of soundly based economic decisions by users of the information contained therein.

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- [3] International Accounting Standard (IAS) 21 The Effects of Changes in Foreign Exchange Rates