Multinational Operations

Functional Currency FC: Where company generates and expenses cash or where the currency used in primary economic environment.

Local Currency LC: In which currency country of operations exists.

Presentation / Reporting Currency PC: In the currency, where parent company prepares Financial Statements**.**

There are two methods to re measure or translate financial statements from subsidiary to parent company.

Remeasurement (Temporal method) involves converting local currency into functional currency where Presentation and Functional currency are same.

Translation (All Current method) involves converting functional currency into reporting currency where functional and local currencies are same.

If subsidiary is in hyperinflationary environment then temporal method is used under US GAAP. Under IFRS subsidiary statements are restated for inflation and translated using all current method.

Current Rate method:

1. Convert net income at average rate.
   (All income statement is converted @ average rate)
2. Convert net assets (assets-liabilities) at current rate, except common stock at historical date, and dividend at actual date currency.
3. Report cumulative gains / losses in equity section.

Temporal method:

1. Convert monetary assets and liabilities at current rate.
2. Convert Non-monetary assets like fixed assets, deferred revenue, intangibles at historical rate. (Exception: Non-monetary assets at Fair value measured at current rate.)
3. Dividends, common stock measured at historical/ actual date like current method.
4. Calculate Equity.

5. Convert income statement sales, other expenses at average rate.
6. Non-monetary expenses like COGS, depreciation, amortization at historical rate.
7. Now calculate Cumulative transaction adjustment (CTA) in income statement.
8. Retain earnings (begin) + NI –Dividends + CTA = RE Ending.

In **Current rate method**, net assets of subsidiary are exposed to foreign currency fluctuations, since balance sheet is translated at current rates.

In **Temporal method** assets are historical cost and currency changes do not impact them. All monetary assets are converted at current rate; therefore net monetary assets are exposed to currency fluctuations. Since CTA reported on income statement (Clean surplus method), net income is volatile.

Ratios:

Under current rate method, pure ratios do not change after conversion.
Current ratio, quick ratio, debt to capital is balance sheet pure ratios; net profit, gross margins, operating margin, interest coverage are from income statement.

Mixed ratios are asset turn over, ROA, ROE, inventory turn over, AR turn over vary for both current and temporal methods. Import point to realize is how numerator and denominators are converted either by current rate / average rate or historical rates. Second point to keep in mind is direction of foreign currency value.

Hyperinflation: According to FASB, hyperinflationary environment is where cumulative inflation exceeds 100 percent over three years. That is annual inflation rate of 26 percent per year.