

## **PARTICULARITIES REGARDING THE REFLECTION OF FOREIGN CURRENCY TRANSACTIONS IN FINANCIAL STATEMENTS**

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### **Abstract**

*The structure and the constituent parts of financial statements are regulated at a national level, mainly by Accounting regulations compliant with European Directives – O.M.P.F. no. 3055/2009, but also by Accounting regulations compliant with International Financial Reporting Standards applied by the trading companies whose securities are rated on a regulated capital market – O.M.P.F. no. 1286/2012. From this latter point of view, an important role is played by IAS 1 “Presentation of Financial Statements”, respectively IAS 21 “The Effects of Changes in Foreign Exchange Rates”. Therefore, this study aims to describe a series of theoretical and practical aspects regarding the particularities of presenting elements generated by foreign currency transactions in financial statements, which are prepared in compliance with the Romanian accounting regulations – balance sheet, profit and loss account, cash flow statement, statement of changes in equity, explanatory notes. The paper also approaches the effect of changes in foreign exchange rates, respectively the accounting recognition of exchange differences, which are specific to different foreign currency operations, according to national regulations (and implicitly, to European Directives), but also according to international regulations (IFRS).*

### **Keywords**

foreign currency transactions; financial statements; exchange rate; exchange rate differences; European Directives; IFRS

### **JEL Classification**

M41

### **General aspects regarding the presentation of foreign currency operations in financial statements**

The purpose of financial statements, including those prepared and published by entities which deploy economic operations of foreign trade, consists of the following considerations regarding the synthetic documents:

- it represents the main informing element for the current and potential investors, for the intern and international business partners, who are directly interested in the entity’s activity, in its financial balance, as well as in its recorded results;
- the presented information is fundamental for taking decisions and performing analyses by the entity’s management;
- it represents the basis for calculating microeconomic, macroeconomic and sectorial economic indicators, which are the basis for future statistical data and prognoses.

In order to finish the activity of preparing and publishing financial statements, the entity that performs economic operations of export trade must also undergo a series of stages, such as: collecting data from supporting documents, recording the economic

operations in accounting records, tracking the operations by drawing up specific account books (day book, General Ledger, inventory book), carrying out the closing worksheet accounting and, finally, preparing the financial statements.

The ground rule states that, in Romania, accounting is to be kept only in Romanian and in the national currency and the accounting recognition of the foreign currency operations is kept both in the national and the foreign currency.

In this context, the main particularity which characterises the entities that perform international economic transactions consists in recording in accountancy the expressed operations, quantified in another type of currency from the national one (into foreign currency), a particularity which presents a series of difficulties which may consist in: determining the exchange rate used in the conversion/translation of foreign currency into the national one, the manner of recording in accountancy and of presenting the effects of changes in the foreign exchange rate in financial statements, changes which arise in different stages of the accounting cycle etc.

In the lines that follow, we will take into consideration only four of the five components of the financial statements, since we consider that there is a more visible and accentuated incidence of particularity in case of transactions in foreign currency, respectively concerning the preparation and presentation of operations of foreign trade.

**The balance sheet** reflects the financial position of the entity on the basis of its assets (economic resources controlled by companies), of equities and debts (funding sources), as well as on the basis of assets and debts resulted from foreign currency transactions.

**Profit and loss account** reflects the company's performance, by means of cost structures/charges, revenues, respectively of results, including those associated with foreign trade operations which fit into the category of foreign currency transactions.

**The cash flow statement** illustrates the changes of the financial position, by means of cash flows, respectively of profits and payments associated with activities of exploiting, investing and funding.

**The explanatory notes** must contain information regarding the methods of evaluation applied to different elements of annual financial statements and also methods used in calculating value adjustments.

According to national accounting regulations compliant to European directives, a **foreign currency transaction** is a transaction which is expressed or needs settlement into another currency that is not the national one (*lei*) including transactions resulted when an entity:

- buys or sells goods or services whose price is expressed in foreign currency;
- borrows or loans funds, and the sums that are to be paid or cashed are expressed in foreign currency; or
- purchases or hands over assets in another manner, contracts or pays off debts expressed in foreign currency.

In order to ensure the implementation of rules regarding the accounting of foreign currency transactions, they have to be accounted at the foreign exchange rate, issued by the National Bank of Romania, at the current date of the operation, and the claims and debts expressed in *lei* (*RON*), whose settlement is done according to the exchange rate of a foreign currency, are assimilated into the elements expressed in foreign currency.

### **Presentation of the elements generated by foreign currency transactions in the balance sheet and in the profit and loss account**

In a balance sheet, the evaluation of claims and debts both expressed in foreign currency and with settlement in *lei*, according to the exchange rate, is done at the foreign currency exchange rate issued by the National Bank of Romania, valid at end

of the fiscal year. In order to be presented in the balance sheet, the value of the claims, evaluated as such, is diminished by the adjustments for the loss of value. Cash and other similar values are evaluated in the balance sheet at the current exchange rate issued by the National Bank of Romania valid at the date of the fiscal year end.

Consequently, the Romanian accounting regulations compliant with European directives establishes the following rules of presenting the monetary and non-monetary items, expressed in foreign currency for each date the balance sheet:

- monetary items that are expressed in foreign currency (liquid assets and other assimilated items, such as credentials and bank deposits, claims and debts in foreign currency) must be evaluated and presented in the annual financial statements using the foreign exchange rate issued by the National Bank of Romania, valid at the end of the fiscal year; favourable or unfavourable exchange rate differences between the exchange rate of the foreign currency market, issued by the National Bank of Romania on the registration date of claims or debts in foreign currency, or at the exchange rate that they are registered in accountancy, and the exchange rate valid on the date of the fiscal year end are to be registered as revenues or expenses of exchange rate differences, as appropriate; for the claims and debts expressed in *lei*, whose settlement is done accordingly to the exchange rate of a given foreign currency, the possible favourable or unfavourable differences which arise from their evaluation are registered as revenues or other financial expenses, as appropriate;
- non-monetary items purchased with foreign currency and registered as historical cost (immobilizations, stocks) must be presented in the financial statements using the foreign exchange rate valid on the date that the transaction is performed;
- non-monetary items purchased with foreign currency and registered as fair value (for example, revaluated tangible assets) must be presented in the annual financial statements at the given value.

According to O.M.P.F. no. 3055/2009 with subsequent amendments, the term **monetary items** refer to the liquidities and assets/ debts to be received/ paid in fixed or measurable sums. A monetary item's main feature is the right to receive or the obligation to pay a fixed or definable number of monetary units.

Romanian accounting regulations compliant to European directives have also imposed a series of presentation rules for the monetary and non-monetary items expressed in foreign currency at the end of each month, as it follows:

- at the end of each month, liquid assets and other treasury stock, such as government bonds in foreign currency, credentials and deposits in foreign currency are evaluated at the exchange rate of the foreign currency market, issued by the National Bank of Romania, beginning with the last banking day of the month in question; the registered rate differences are recognised in accountancy as revenues or expenses of the exchange rate, as appropriate;
- the exchange rate differences that arise from reimbursing claims and debts in foreign currency that are rated differently as compared to the exchange rates in which they were initially registered, in the course of a month or to those that are currently registered in accountancy, must be acknowledged in the current month, as revenues or expenses from exchange rate differences (case a): if the claim or debt in foreign currency is settled in the course of the same month in which it appeared, the entire exchange rate difference is acknowledged in that month; case b): if the claim or debt in foreign currency is settled during a following month, the exchange rate difference acknowledged each month, up until the month of settlement, is determined taking into consideration the exchange rate modification in the course of each month);

- the value differences that appear along with the settlement of claims and debts expressed in *lei*, according to a exchange rate different from the one at which they were initially registered, in the course of a month or to those that are currently registered in accountancy, must be acknowledged in the current month, as revenues or expenses from exchange rate differences (case a): if the claim or debt in foreign currency is settled in the course of the same month in which it appeared, the entire exchange rate difference is acknowledged in that month; case b): if the claim or debt in foreign currency is settled during a following month, the exchange rate difference acknowledged each month, up until the month of settlement, is determined taking into consideration the exchange rate modification in the course of each month;

Therefore, relating to the reflection of exterior trade transactions in the balance sheet, respectively in the profit and loss account, from what is mentioned above, it results that:

- in the balance sheet, the monetary items have to be presented at the exchange rate of the fiscal year end;
- in the balance sheet, the non-monetary items have to be presented at the exchange rate of the date of the last accounting recognition;
- in the profit and loss account are presented the differences resulted from updating the monetary items or from settling claims and debts in foreign currency, or whose reimbursing is done according to a given exchange rate, differences that are registered in accountancy as revenues or expenses from exchange rate differences, respectively as revenues or financial expenses; and *the profit and loss account is connected with the equity modifications statement, through the information regarding the reported result and the result of the financial year*, according to Filip & Muțiu (2007).
- in the case of interim financial situations, as well as those elaborated in the course of a fiscal year, for diverse purposes, one must consider the exchange rate of the last day of the month for the monetary items expressed in foreign currency, respectively for claims and debts in foreign currency or whose settlement is done according to an exchange rate.

### **Presentation of the elements generated by foreign currency transactions in cash flows statement and notes**

In what the cash flows statement is concerned, there is the problem of whether to acknowledge, or not, the exchange rate differences as cash inflows or cash outflows. In this respect, due to the fact that cash flows do not include movements between the elements that constitute liquid assets or liquid assets equivalents, but they include inflows and outflows of funds, the exchange rate differences which appear in different situations are considered to be unrealised in regard to the criteria that form the basis of the cash flows statement. Furthermore, if we take into consideration their connection with the generated transactions, there can be identified two categories: **realised exchange rate differences**, which correspond to the settlement of transaction, respectively encashment or payment and **unrealised exchange rate differences**, which correspond to a failure of settlement up until the date of drawing up the cash flows statement, as stated by Filip & Muțiu (2007).

Nevertheless, it is considered that the only category of exchange rate differences that can affect the cash flows statement is the one resulted from the updating of cash and cash equivalents expressed in foreign currency, at the fiscal year end, and at exchange rate of that particular date.

With regard to the explanatory notes, it should be mentioned that for the elements included in the annual financial statements that are or have been initially expressed in

foreign currency, there must be presented the conversion basis used to express the national currency. Thus, Note no.10 "Further information" shall mention these conversion bases used for expressing assets, liabilities, incomes and charges in the national currency, and which were initially expressed in a foreign currency.

### **Recognition of exchange rate differences in terms of Romanian accounting regulations compliant with European directives**

As stated above, according to accounting regulations compliant with European directives approved through O.M.P.F. no. 3055/2009, a **foreign currency transaction** is a transaction which is expressed in or is in need of settlement in another currency, that is not the national one, including transactions resulted when an entity buys or sells goods or services whose price is expressed in foreign currency or purchases or hands over assets in a different manner, contracts or acquires debts expressed in foreign currency. Thus, in an attempt to synthesize, in accountancy, we initially proceed as follows:

- generally, a foreign currency transaction should be registered in accountancy at the exchange rate issued at the current date, by the National Bank of Romania;
- financial leasing debts expressed in foreign currency, as well as financial leasing debts expressed in *lei*, but with settlement in accordance with the exchange rate of a foreign currency, is registered at the exchange rate of the foreign currency market issued by the National Bank of Romania, at the date when the funding was approved.

Later on, as already mentioned, according to Romanian accounting regulations, exchange rate differences may appear in the following situations:

- a. At the end of each month, when according to O.M.P.F. no. 3055/ the measurement of claims and debts in foreign currency is done, at the exchange rate issued by the N.B.R./ National Bank of Romania, in the last banking day of that particular month, with the presentation of the exchange rate differences in corresponding income or expenditure accounts. Thus, the exchange rate differences which may appear when settling claims and debts in foreign currency and claims and debts in *lei*, but whose settlement is done by relating to a foreign currency, shall be highlighted in the current month in which they appear. The present provision is of use both in terms of reflecting the economic reality in the quarterly calculation of the income tax, but most of all in the case of trading companies which choose, for different reasons, a different type of fiscal year from the calendar year, to ensure the comparability between data and information comprised in the financial statements, as Julian (2010) states.
- b. At the end of the fiscal year, when the existing claims and debts are converted at the exchange rate of December 31<sup>st</sup>, the exchange rate difference is represented by the difference between the historical rate and the rate from December 31<sup>st</sup> in the current fiscal year. This is also treated as financial income or financial expense, as it was made obvious in the previous example.
- c. At the end of the fiscal year an obligatory updating of the liquid assets in foreign currency takes place, at the exchange rate valid for December 31<sup>st</sup>, the exchange rate difference resulting from the difference between the rate at the date when the foreign currency was recorded by the entity and the rate from December 31<sup>st</sup>. This type of difference also generates the recording of a financial income or expense in the company's accounting books.

- d. A more special case which cannot be associated to any of the above, but which deserves to be mentioned is the one regarding the modification of the exchange rate between the date of cashing an advance and the date of delivering goods or offering services. For example, in the case of cashing some advance before the delivering of goods or offering of services, the exchange rate used to calculate the tax base for VAT, at the date of cashing the advance, will also remain unchanged at the date of closing the operation.
- Example:** A trading company possesses in its bank account, at the end of the fiscal year N+1, €1.500 resulting from the settlement, respectively the cashing of a claim on the date of 19.11. N+1, at an exchange rate of 4,5 RON/euro. On 31.12.N the exchange rate is of 4,4 RON/euro. The recognition of the value of the exchange rate difference of 150 RON is necessary, by debiting the 665 account “Expenses regarding exchange rate differences”.

### **Recognition of exchange rate differences in terms of accounting regulations compliant with the IFRS. The application of the IAS 21 “The Effects of Changes in Foreign Exchange Rates”**

The main objective of IAS 21 “The Effects of Changes in Foreign Exchange Rates” is to prescribe the manner in which foreign currency transactions and foreign operations are included in financial statements, as well as the manner in which the financial statements are converted in a presentation currency, and the main problems would be:

- what exchange rate (rates) should be used and
- the manner in which the reporting of the effects of changes in foreign exchange rates in financial statements should be done.

IAS 21 “The Effects of Changes in Foreign Exchange Rates” can be applied:

- for the recognition of transactions and balances in foreign currency, except transactions with foreign currency financial instruments;
- when converting the financial results and positions related to foreign operations, that are included in the entity’s financial situations through different consolidation methods (global integration, proportional integration or the equity method);
- when converting the results and financial position of an entity into a presentation currency.

According to IAS 21, a **foreign currency transaction** is a transaction that is expressed or is in need of settlement in foreign currency, including the resulted transactions, when an entity:

- buys or sells goods or services whose price is expressed in foreign currency;
- borrows or loans funds, and the sums that are to be paid or cashed are expressed in foreign currency; or
- purchases or hands over assets in another manner, contracts or acquits debts expressed in foreign currency, through other methods than the above mentioned.

According to IAS 21 “The Effects of Changes in Foreign Exchange Rates”, a foreign currency transaction is registered at the moment of initial recognition in the functional currency, using the exchange rate between the functional currency and the foreign one, valid on the date of performing the transaction.

The functional currency is considered to be, according to IAS 21 “The Effects of Changes in Foreign Exchange Rates”, the currency of the main economic environment in which the entity operates. In other cases, the used exchange rate is a medium one, calculated for a specific reference period, this being applied to all foreign currency transactions, performed in that period of time.

IAS 21 “The Effects of Changes in Foreign Exchange Rates” states that at the end of each reporting period:

- foreign currency monetary amounts shall be converted/translated using the closing rate;
- non-monetary items expressed in foreign currency and evaluated on the basis of historical cost shall be converted/translated using the exchange rate at the date of the transaction;
- non-monetary items expressed in foreign currency and evaluated on the basis of fair value shall be converted/translated at the exchange rate that existed when the fair values were measured.

**Example** of initial recognition: At the date of 10.04.N, a trading company exports merchandise/goods which are worth €40.000. The exchange rate varied in the course of April, registering the following values: 4,3 RON/euro, at the date of 01.04.N; 4,4 RON/euro, on 10.04.N; 4,55 RON/euro, at the date of 15.04.N and 4,55 RON/euro, at the date of 30.04.N. The sale shall be recognised using the exchange rate at the date of the transaction, meaning at the exchange rate of 4,4 RON/euro:

<i>Clients</i>	=	<i>Merchandise sale revenue</i>	176.000 RON
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If, from practical reasons, the company decides to use for all the transactions carried out in April a medium rate calculated for this month, then the sale shall be recognised at a medium exchange rate = 4,45 RON (per euro).

<i>Clients</i>	=	<i>Merchandise sale revenue</i>	178.000 RON
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### Subsequent accounting treatments regarding the exchange rate differences

Exchange differences that may arise at the moment of settlement of monetary items or of reporting a company’s monetary items at different exchange rates than the ones at which they were initially recorded, or than the ones at which they reported in the previous financial statements, shall be recognised in profit or loss (as revenue or expenses) in the period in which they arise.

The 2011 version of IAS 21 “The Effects of Changes in Foreign Exchange Rates” eliminates the limited option of the previous version, according to which there was the possibility of capitalizing exchange rate differences resulted from a depreciation or an amortization of currency, against which there was no possibility of hedging. These differences being now also recognised in profit or loss, the capitalization of exchange rate differences is not allowed in any other circumstances.

**Example:** If we take into consideration the information from the first part of the previous example, two situations may arise:

**Case A:** When the performance and settlement of a transaction take place in the same fiscal year, the cashing of a €40.000 claim takes place, at the date of 03.10.N, at an exchange rate of 4,5 RON/euro.

Therefore, knowing that the sale was invoiced at an exchange rate of 4,4 RON/euro, we will record the settlement of the claim and the recognition of difference at a favourable rate of:

<i>Foreign currency bank accounts</i>	=	%	180.000 RON
		<i>Clients</i>	176.000 RON
		<i>Revenues from currency differences</i>	4.000 RON

**Case B:** When the performance and settlement of a transaction take place in different fiscal years, the exchange difference recognised in each fiscal year that intervenes until the moment of settlement is determined by taking into account the exchange rate changes that arise during each fiscal year.

It is considered that on 31.12.N there was an exchange rate of 4,45 RON/euro, and the claim is due to be cashed on 15.02.N+1, at an exchange rate of 4,55 RON/euro.

Therefore, knowing that the sale was invoiced at an exchange rate of 4,4 RON/euro, we shall initially record the recognition of exchange rate differences at the end of fiscal year N and, subsequently, the settlement of the claim and the recognition of a favourable rate difference:

-recognition of exchange rate differences at the end of fiscal year N:		
<i>Clients</i>	=	<i>Revenues from currency differences</i>   2.000 RON
-settlement of claim and recognition of favourable exchange rate difference:		
<i>Foreign currency bank accounts</i>	=	%   182.000 RON
		<i>Clients</i>   178.000 RON
		<i>Revenues from currency differences</i>   4.000 RON

## Conclusions

As we have seen, the reflection of economic operations conducted in foreign currency (export trade operations, intra-community trade etc.), including the presentation in accountancy of the elements generated by such transactions, is characterised by a series of particular elements which depend on the decision regarding the used exchange rate, or on the manner in which the accounting recognition of the effects of changes in foreign exchange rates, respectively of exchange rate differences, is done.

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