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Review Paper

THE KEY ISSUES IN THE TRANSLATION OF THE FINANCIAL STATEMENTS OF MULTINATIONAL COMPANIES

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Abstract. *Circumstances, which include international trade intensification, development of various forms of business cooperation outside national borders - co-production, transfer of technology, joint ventures, strategic alliances, direct foreign investments, and dynamic changes in the business environment, require the management of a company to change their focus, from a local to a global approach. Multinational companies are business leaders in a global framework. The aim of this paper is to highlight the key challenges that multinational companies face when translating foreign currency transactions and the financial statements of foreign business operations for the purpose of compiling consolidated financial statements. In addition, the paper examines whether the chosen functional currency and the exchange rate can be viewed as instruments of their financial reporting policy.*

Key words: *consolidated financial statements, IFRS, exchange rate, accounting exposure.*

JEL Classification: M41, F23.

INTRODUCTION

One of the initial activities of companies that opt for the strategy of business globalization is the purchase and sale of goods and services in foreign markets, that is, import and export. The circumstance that a significant portion of business transactions takes place in currencies other than the presentation currency has an important influence on accounting and, therefore, the financial statements of the related enterprise. In order to achieve economic unity as the basic prerequisite for the preparation of consolidated financial statements, and thus accurate presentation of the group's financial position and performance,

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it is necessary to perform the translation (re-calculation) of foreign transactions and present them in the reporting (presentation) currency of the parent. This provides an important precondition for the preparation of annual financial statements of individual companies, and in the case of a group of companies, at the same time a preparatory measure for consolidation is being implemented, as a part of activities of consolidated financial statements` preparation. Currency, by itself, can be equated with other goods, which means it has its own price, while the fact that currency prices fluctuate on a daily basis, so that different exchange rates (daily, average weekly or monthly, that is an exchange rate on the Balance Sheet date - the so-called closing exchange rate) can be used during the translation, leads to the conclusion that the choice of the exchange rate is representative of immediate implementation of an assessment policy - which has reflections on all elements of the annual financial report.

However, even a company that is exclusively focused on the national market and business within the national framework is also exposed to the effects of the foreign exchange currency rates. This means that all companies are exposed to the influence of a foreign exchange rate change. It is particularly important for the company's management to be aware of the above said risk and to take appropriate measures to mitigate and manage that risk.

All the above mentioned confirms that the accounting coverage of changes in the exchange rate is a very challenging area since it has important implications on the content and the value of individual elements of the financial statements, financial position and profitability of a company. In order to understand all the complexities of the stated issues, in this paper we are going to point out at events that initiate the creation of transactions in a foreign currency, the specifics of accounting inclusion and the treatment of exchange rate differences, as well as the possibility to choose the functional currency and exchange rate as an integral part of the financial reporting policy.

1. Foreign Currency Transactions

Foreign currency transaction is a transaction that is disclosed or requires a foreign currency account (calculation), that is, a transaction which can be initiated by the following events (Shahrokh & Saudagaran, 2009):

- Purchase or sale of goods whose prices are denominated in a foreign currency on the basis of which the Statement of financial position contains foreign currency receivables and foreign currency liabilities positions;
- Lending (investing) or borrowing financial assets, thus creating monetary items - receivables and liabilities denominated in a foreign currency;
- Participation in a non-executed contract in a foreign currency, i.e. the contract whose execution has begun, but which on the date of the Statement of financial position is not fully executed, for example, the construction of a property for the needs of an enterprise by a foreign contractor;
- Other events resulting in the acquisition of assets and the settlement of liabilities denominated in a foreign currency.

The accounting coverage of transactions in a foreign currency requires the consideration of the issue of determining or selecting the foreign exchange rate at which transactions expressed in foreign currency will be translated into the reporting (accounting) currency, as well as

defining the manner in which the effects of the change in the foreign exchange rate should be recognized in the financial statements.

The issue of initial recognition of the foreign currency transactions is resolved in accordance with IAS 21 - *The Effects of Changes in Foreign Exchange Rates*, in a way that the translation of income and expenditures items, as well as of the financial position into a reporting exchange rate is performed through the application of the exchange rate valid on the transaction date, that is at the current exchange rate, which has been published by the authorized institution (Central Bank). For practical reasons, the Standard allows the application of a foreign exchange rate that is approximate to the actual exchange rate on the transaction date. Hence, for example, the average weekly or monthly rate is relevant for all the transactions which have occurred during a specific period. However, in conditions of significant exchange rate fluctuations such practice is inappropriate because financial transactions would not be expressed at their fair value.

Different exchange rates can be used for the translation of transactions in foreign currencies - closing exchange rate or exchange rate on the Balance Sheet date, so-called *spot rate* or *spot price* that is an exchange rate on the spot, a future exchange rate, which essentially has the character of a hedging instrument against foreign currency risk, the essence of which is reflected in being based on an exchange contract on a future date. In accordance with IAS 21, monetary items denominated in a foreign currency, such as liabilities to suppliers or receivables denominated in a foreign currency arising from the purchase or sale of goods, liabilities and receivables on advances and loans received or approved in a foreign currency, as well as cash and balance in a bank denominated in the foreign currency, are translated into the reporting currency using the closing exchange rate. Non-monetary items based on a historical basis (purchase price elements, that is cost price) which were paid in a foreign currency during procurement/construction are translated using "the exchange rate on the date of the transaction, whereby no adjustment is made to the amount stated in the financial statements arising from the possible change in the exchange rate in the period from the date of the transaction by the balance sheet date" (Gaffikin et al., 2004).

Expressed through an example, this means that if, during the business year, equipment was purchased from a foreign supplier in the amount of 5000 euro, and at the time of procurement the exchange rate of 1 euro was 120 dinars, followed by the appreciation (strengthening) of the dinar, so that on the Balance Sheet date 1 euro amounted to 118 dinars, no adjustment of the stated amount is made, unless the foreign liability arising from the purchase of equipment has been settled by the Balance Sheet date.

Non-monetary items, which were paid in a foreign currency at the time of acquisition, and were as such recognized at their fair value in the financial reports, are translated into the reporting currency using the exchange rate that was valid at the time when the fair value was determined (Kirk, 2009).

The question of currency selection for measurement of the performance of foreign subsidiaries of the parent entity is closely linked with the previously examined question – the choice of an exchange rate. Hence, there can be a dilemma whether, for example, MNC (multinational company) which was founded in Great Britain should measure the performance of its subsidiaries in the Republic of Serbia in pounds or dinars. Depending on the direction and size of the dinar changes in comparison to the British pound during the reporting period, the results expressed in the two currencies can vary a lot. Thus, for example, it is possible that the business of a subsidiary can be assessed as very profitable

when performance is expressed in dinars, and significantly less profitable when presented in pounds (assuming that the dinar depreciates against the pound).

The two key factors that a company must consider, when choosing the reporting currency, include (Shahrokh & Saudagaran, 2009):

1. The role of the subsidiary in the overall strategy of the group of companies, that is MNC. If the role of the branch is to contribute to the overall profitability of the MNC, then it is appropriate to use the parent company's currency to measure the performance. However, if the role is somewhat different (for example, there is a focus on R&D activities), then it is justifiable to opt for the local currency;

2. Distribution of responsibility for the currency risk management. If the authority for the currency risk management is centralized, then the local currency should be used to measure the performance of a foreign subsidiary. However, if the currency risk management is decentralized, with each subsidiary being autonomous, then it is reasonable to use the currency of the parent company for the purpose of evaluating their performance. The reason for this is in the fact that local subsidiaries cannot be held responsible for the effects of changing exchange rates on their profitability unless they have been assigned an authority of currency risk management. The circumstance that the parent company has authority for this area of responsibility implies that it, as such, bears responsibility for the gains and losses arising from the fluctuation in exchange rates.

2. Concept, Types and Accounting Treatment of Exchange Rate Differences

Enterprises involved in global business are facing the risk of loss due to the effect of exchange rate fluctuations. However, it is important to distinguish between foreign transactions and transactions in a foreign currency, since not all foreign transactions are necessarily denominated in a foreign currency (Shahrokh & Saudagaran, 2009). For example, an American company that exports goods to the Republic of Serbia and sends invoices in dinars has transactions in a foreign currency and faces exposure to the currency risk. On the other hand, a domestic company that purchases such goods does not have transactions in a foreign currency, since the invoice is expressed in the national currency.

It is also important to distinguish between transactional gains and losses from items of gain and loss made during the translation (so-called translation gains and losses) since the transaction's gains and losses affect the enterprise's cash flows. In rare circumstances, foreign receivables will be collected and foreign liabilities will be paid simultaneously with the recognition of the transactions. However, "it is reasonable to expect the existence of a time difference between the date of transaction and the date of payment, and consequently a change in the foreign exchange rate" (Bogićević et al., 2016).

To clarify facts, let us assume that the US company has sold goods to a domestic company, worth of 10 million dinars at a time when the exchange rate was 100 RSD / 1 USD on a six-month short-term loan. In the given case, the amount that the US company will receive depends on the exchange rate during the specified period. If, within a given time frame, the dollar appreciates against the dinar, for example, with the parity of RSD 105 / USD 1, then the US company will receive fewer dollars. On the contrary, if the dinar appreciates on the maturity date (RSD 98 / USD 1), the US company will receive a larger amount of US dollars. Consequently, an exchange rate difference could appear

which can be either positive or negative. The difference arising from reporting the same number of foreign currency units in the reporting currency at different exchange rates, is called *the exchange rate difference*. Therefore, in order for an exchange rate difference to appear, it is necessary for a transaction to be reported in a foreign currency, as well as that the change in the exchange rate occurs. The first scenario described represents a transaction exchange loss for the US company, while the other points to a transaction exchange gain for the US company. Since the invoice is denominated in a foreign currency for the US company – which is the dinar, the US company runs the risk of a fluctuation in the exchange rate. Within the given transaction, the domestic company is not, however, affected by the resulting changes in the foreign exchange rate, due to which its cash flows are fixed by invoice reporting in the national currency. The accounting treatment of transaction exchange profit or loss is unambiguous – it has to be included in the Profit and Loss Statement (P&L Statement) and as such it affects the result of the period in which it was created.

Positive exchange rate differences arise when the enterprise settles its foreign liabilities at an exchange rate lower than the one that was in place on the day when the liability was created, that is according to which the obligation was recognized within the Statement of financial position. Also, positive exchange differences appear when the foreign receivable is liquidated at a rate which is higher that the exchange rate on the day of the transaction, that is - the rate at which the claim was presented in the Statement of financial position, as well as in periods in which the enterprise disposes of foreign assets, while the foreign currency exchange rate increases. On the contrary, negative exchange rate differences occur when there is an increase in the foreign currency exchange rate, whereas the enterprise has some unpaid liabilities in that currency. Such an item is treated as a loss, in accordance with the IAS 21 (paragraphs 28-30), which is presented as a separate item in the Profit and Loss Statement (*Privredni savetnik*, 2004).

According to IAS 21, exchange rate differences arising from the monetary items that, by their nature, represent participation in the equity of a foreign company, are recorded as an integral part of that share (positive exchange differences increase the value of a share, whereas the negative ones contribute to a decrease in its value). Namely, the item whose settlement is not certain in the near future, or whose liquidation has not been planned, is essentially an increase or decrease in the value of a share in a foreign company. This means that those items are not included in the calculation of the net profit or loss of the period but, according to IAS 1 – *Presentation of Financial Statements*, they are expressed as an integral part of the *Statement of changes in equity* (Mirza & Holt, 2011).

3. Financial Statements of Foreign Operations

Domicile companies can operate abroad through their subsidiaries; these are joint ventures or branches. The method used to translate the financial statement of foreign operations is significantly influenced by the manner in which they are financed, as well as by the relationship with the reporting company. Precisely because of that it is important to make a distinction between foreign operations: for example, to distinguish foreign operations which make an integral part of the reporting entity, such as a business unit without a legal subjectivity, from those having a certain level of autonomy in relation to the company which compiles the financial statements. The foreign operations belonging to the first group

represent the expansion of the operations of the reporting entity (parent company), which is if they sell goods imported from the reporting company and at the same time allocate sales revenue, so they have a direct impact on the reporting entity's (parent company's) operational cash flows. In such circumstances, the exchange rate fluctuation between the reporting currency and the currency of the country where the operations were performed affects monetary items of the foreign operations. Hence, the financial statements of such operations are translated as if their transactions were concluded and realized by the reporting company. An analysis of the nature of each item is required for the translation of financial statements (whether an item has a monetary or non-monetary character). Monetary items are comprised of assets and liabilities to be received or paid in a fixed or determinable number of currency units. Non-monetary items are all those items that are not monetary (property, plant, equipment, intangible assets, inventory, etc.). The translation of non-monetary items weighed at historical cost requires the application of the exchange rate on the date of the transaction, while items weighed at fair value should be reported at the exchange rate that was valid when the fair value was determined (Krimpmann, 2015). For the translation of monetary items (funds, long-term receivables or payables, provisions, taxes and other), the closing rate should be applied. For practical reasons, "in conditions of stable exchange rates, the application of average weighted exchange rate for a certain period is allowed" (Mackenzie et al, 2013).

For the purposes of including the financial statements of foreign entity in the parent company's financial statements, in cases where the translation is performed using the current rate method, the following rules are applicable (Kirk, 2009):

- "Monetary assets and liabilities are translated at the closing exchange rate;
- Items of income and expenditure are translated at the exchange rate on the date of the transaction – that is the average weighted exchange rate, while in hyperinflationary conditions they are translated at the closing exchange rate;
- All the exchange differences arising from the translation of the financial statements of a foreign entity are recognized as a part of its own equity, in the Statement of changes in equity, and after being disposed - net investment is recognized as income or expenditures in the Profit and Loss Statement".

The presentation of financial statements of a foreign entity in the reporting currency results in the recognition of exchange rate differences arising from the translations of the above-said items. The circumstance that the differences do not affect the current and future cash flows resulting from the business activities of a foreign entity and of the reporting company, has caused them not to be recognized as income or expenditure of the period, but in accordance with IAS 7 - *Statement of Cash Flows,* to be presented as a separate item of the Cash Flow Statement. After the translation of the foreign entity's financial statements, which assures the comparability of certain elements of the financial statements of the members of the group of enterprises, which otherwise represents a preparatory measure for the consolidation, conventional consolidation procedures are applied, including the elimination of intergroup elements of financial statements (assets, liabilities, equity, etc.) relating to transactions between entities of the group are applied, in accordance with IFRS 10 - *Consolidated Financial Statements*.

In case of reclassification of foreign operations, the translation procedures for a new form are applied from the date of the classification change, therefore, prospectively. Otherwise, reclassification is necessary if there are significant changes in the way of

financing, as well as if the character of business relations between the foreign operations and the reporting entity changes. In case foreign operations which were treated in the previous period as an integral part of the reporting company take on the character of a foreign entity due to the reclassification, for example, because of the fact that a part of the share in a subsidiary or a joint venture was sold, the exchange rate differences arising from the translation of non-monetary assets on the date of reclassification are disclosed as part of equity (International Accounting Standard Board, 2012, IAS 21, par. 48).

Changes in a parent company's share in a subsidiary which do not result in a loss of control must be presented as an element of equity. In case of the loss of control, the recognition of the assets, liabilities and related equity components of the subsidiary ceases. Any resulting gains or losses must be included in the Profit and Loss Statement. Acquiring additional shares in the subsidiary after the acquisition of control is presented as an equity transaction with the owner. The above-said reclassifications actually represent changes in the scope of consolidation which determine the content of the consolidated annual financial report, putting its comparability into question, which requires additional disclosures (Škarić-Jovanović & Radovanović, 1998). Some multinational companies provide voluntary disclosures of the effects of exchange rate's fluctuations on their earnings, that are beyond the requirements of individual IFRSs so that users could better understand the presented – disclosed information (Sorensen et al., 2012).

4. THE CHOICE OF THE FUNCTIONAL AND THE PRESENTATION CURRENCY

The functional currency concept as defined in IAS 21 is the currency of the primary economic environment in which the entity operates. As such, a functional currency is the currency in which an entity measures the items of its financial statements, so as to reflect the economic essence of events and circumstances, to provide all the information about the company or the group of companies that is relevant for economic decision-making. It is customary for it to be the currency of the country in which the entity operates, that is, another currency which is very often used or has a rather important influence on the business operations, and all transactions presented in currencies other than the functional currency are to be considered foreign currencies. When it comes to the functional currency, it is necessary to determine whether it is equivalent to the currency of the country in which the entity operates or to another currency, considering that the choice is influenced by factors such as: the specific circumstances in which the business operates, the state of income, the possibility of the occurrence of unusual results, etc. By selecting a functional currency, the yield position (performance) of the branch is significantly affected, and therefore the content of the consolidated financial statements. Companies which have acquired resources in the local market, and sell their products to domestic consumers, denominate all their transactions in a local currency. In this case, the local currency can at the same time be a functional currency. However, this premise is almost inappropriate for a group of companies whose business operations are of a global character, since their cash flows are presented (disclosed) in different currencies, and different currencies can also affect their policy of selling prices and other aspects. Under such circumstances, determining a functional currency can be a very delicate matter. Hence the need for a clear distinction between a functional currency and a presentation currency (Elliott & Elliott, 2005):

- "The presentation (reporting) currency is the currency in which the segment of a business or an enterprise presents its financial statements;
- The functional currency is the currency in which the segment or enterprise measures its financial position and success".

According to IAS 21 (paragraphs 9-11), indicators that may have a decisive influence on the choice of a functional currency, which were shown within a hierarchical structure, include the following (Bakker et al., 2017; Revsine, 1984):

- *Sales market indicators:*
  – the currency that significantly determines the selling price of goods and services;
  – the currency of the country whose competitive forces and regulations primarily influence the sales prices;
- *Costs indicators:* currency that mainly affects labor costs, materials and other resources costs.

A secondary set of indicators to be considered under IAS 21 are as follows (Singh, 2014):

- *Financing indicators*: the currency in which a capital was presented, that is in which debt and equity instruments were issued;
- *Cash Flow indicators*: the currency into which the company converts the cash surpluses.

According to IAS 21 (paragraph 11), it is necessary to consider some additional factors in determining the functional currency of foreign operations and whether their functional currency is the same as that of the reporting entity – parent company (Bakker et al., 2017):

- Whether the foreign operations` activities are performed as an extension of the reporting entity (parent company), rather than performed with a significant degree of autonomy;
- Whether transactions with the reporting entity make for a huge or small portion of the foreign operation's activities;
- Whether cash flows from the foreign operations` activities directly affect the cash flows of the reporting entity – parent company; and whether they are available for a prompt remittance to the reporting entity; and
- Whether cash flows from the foreign operations` activities are sufficient to service the existing and normally expected debt obligations, without funds being made available by the reporting entity – parent company.

If, on the basis of the considered indicators, it is not possible to clearly identify the functional currency, its choice should be based on judgment that involves considering a larger spectrum of factors. In circumstances where these currencies are "different, elements of the financial position and success are initially assessed in a functional currency, and then translated into a presentation (reporting) currency on each reporting date, as follows: assets and liabilities are translated using the final - closing exchange rate, income and expenditure using the valid exchange rates on the dates of transactions", and any exchange rate differences resulting from these conversions are disclosed as a part of the total remaining result (Epstain et al., 2010).

IAS 21 requires the choice of a functional currency that must reflect the substance of transactions, events and circumstances specific to the business operations. Changes in the scope of the business operations and relocation of business operations are typical reasons for the change of the functional currency (Krimpmann, 2015). All items in that case are translated using the exchange rate on the date of the change. Exchange rate differences previously recognised as a part of equity are not recognised in the Profit and Loss Statement until the disposal of the business operations (Kirk, 2009).

Exchange rate fluctuation causes three forms of exposure: economic exposure that encompasses two categories: *operating exposure* that is the economic exposure occurring when the business operations generate a cash flow denominated in a foreign currency, and *transaction exposure* that is an economic exposure created when contractual obligations are denominated in a foreign currency. Finally, the *translation exposure* is an exposure that occurs when translating financial statements (Butler, 2016).

The transaction exposure relates to the period between entering and settling a contract. It is defined as a change in the value of monetary (contractual) cash flows caused by the change in exchange rates. The fact that the transaction exposure impacts on future cash flows and profitability, makes it the most visible exposure to the currency risk (Bhalla, 2014). Transaction exposure depends on current (outstanding) foreign receivables and/or foreign liabilities presented in the Statement of financial position, which will be charged/ settled after the exchange rate changes. Additionaly, its effects are also reflected in the Profit and Loss Statement as an exchange gain or loss, that is, positive or negative exchange rate differences (Bogićević et al., 2016).

From the accounting point of view, which implies the preparation of consolidated financial statements, the most important is the translation exposure, since the financial statements of foreign affiliates, as an integral part of the preparation for the consolidation, have to be translated into a reporting currency of the parent company (Škarić-Jovanović & Radovanović, 1998). The exposure resulting from the translation of the financial statements is also called the *accounting exposure* in the literature, since the value of net assets and the reported profit of the parent company and the group as a whole can be increased or reduced, not as a result of business transactions and the strategies implemented, but due to the exchange rates` fluctuation.

The degree of the accounting exposure when preparing consolidated financial statements can primarily be determined by the share of business operations performed through foreign operations, by the location of foreign subsidiaries, as well as by the applied accounting methods. In order to control the translation exposure, the parent company's management designs gains in all the foreign currencies and determines how the potential changes in the foreign exchange rate of individual currencies can affect not only the amount of the results of individual members of the group, but also the consolidated result and tax liabilities of the group as a whole. More precisely, the appreciation of a foreign currency, in relation to the reporting currency of a parent company will result in an increase in the consolidated result, and vice versa - in the period of depreciation of a foreign currency, the yield position (performance) of the group will be weakened (Madura, 2012).

In order to protect from the translation exposure, the parent company's management can opt for one of the following two strategies: hedging of financial statements. The hedging of the financial position statement is aimed at minimizing the translation exposure through an effort to achieve the equality of assets and liabilities which are denominated in a foreign currency. Thus, for example, the change in the exchange rate that results in an increase in the value of assets in the consolidated statement of financial position simultaneously leads to an increase in liabilities in the same amount; thereby nullifying the effect on the net assets of a group (Wang et al., 2009). The circumstance that positive exchange rate differences are reflected in the Profit and Loss Statement as an integral part of the financial revenues means that their occurrence is not undesirable, and as such they do not require protection measures.

Based on the fact that the amount of the result presented in the consolidated Profit and Loss Statement directly affects the prices of shares and compensation for the management, and that the changes in the parity between the foreign operations` functional currency and the reporting currency of the parent company (parent's presentation currency) affect the amount of numerous items in the consolidated financial report, a question arises as to whether the choice of a functional currency can be viewed in the context of the financial reporting policy. Namely, from the point of view of the users of financial information and the signaling role of the financial information, a management is propelled to put the selection of the currency in the context of the instrument for the realization of the defined goals.

When it comes to choosing a functional currency, it is important to highlight that this is not a matter of a management`s discretion, but is rather, as previously shown, based on professional judgement and taking into account material facts: economic circumstances, events and transactions. Although there is a possibility of changing a functional currency when there are valid reasons for that, IAS 21 requires its consistent application. The newly selected functional currency is applied prospectively, beginning with the date of change. If a company chooses to change the functional currency, as part of its efforts toward achieving the objectives of the financial reporting policy, it is quite unlikely that by doing so it would achieve its long-term desired effects. This is due to the fact that it is almost impossible to predict long-term changes in a currency. Possible increase in the group`s profit, stemming from changes in the functional currency, would not have a significant information value for the investors, since for the purposes of evaluation of an entity permanent components of the result are the most relevant.

The possibility for achieving goals of the financial reporting policy in the domain of presenting higher equity amount and avoiding sharper fluctuations in the result, exists in the domain of choosing the *translation method*, then choosing the *exchange rate*, as well as the *presentation currency*. When it comes to selecting the exchange rate, a parent company`s management can strategically choose the current, historical or average exchange rate, where such options exist, in accordance with the defined goals, affecting a financial position and the group`s profitability (Savić, 2011). When it comes to the translation method, research has shown that the application of a single rate method for translating financial reports of foreign affiliates (applies in case when the local currency is used as the functional currency of a foreign entity, that is when a foreign affiliate is relatively independent in conducting its business operations) implies the application of the *current exchange rate* on the items of the Statement on financial position, except for its own equity, and the application of the *historical exchange rate* for the items of equity. This translation method for the items in the Profit and Loss Statement uses the average exchange rate for the accounting period and at the same time it assures a higher amount of the result presented (business and net gain). On the other hand, the temporal rate method (e.g. historical method) is applied in conditions when the currency of the parent company is used as a functional currency of the subsidiary, which means that the activities of a subsidiary make for a direct extension of the parent company`s business operations. The aforementioned method is based on applying the historical rate for translating assets and liabilities that are measured by historical cost, and current exchange rate for items that are measured by the current cost or a market value. Monetary items are translated using the current exchange rate. This method assures the higher amount of equity, both of the affiliates whose financial reports are being translated, and of entire multinational company (Domanović & Bogićević, 2016). The problem,

however, is contained in the fact that the use of the temporal method increases the volatility of the result presented; also, the disclosed result is significantly lower then in conditions of application of the single rate method. On the other hand, the indicators of financial structure, as well as the indicators of liquidity, are significantly more favorable in case of the use of the temporal method (Dmitrović-Šaponja & Bogićević, 2012). The research results also suggest that foreign currency translation adjustments are significantly value relevant. The temporal method is preffered when compensation is based on stock options, and conversely, when compensation is a function of the reported earnings - managers tend to adopt the current rate method (Pinto, 2002).

The choice of the presentation currency is one of the prerequisites for the financial reports` comparability. This is particularly important for the members of the group which are located in different countries and use different national currencies or when the functional currencies of individual members differ from the parent's reporting currency. The functional currency of the parent company is most often used in practice as the presentation currency. In some jurisdictions, reporting in local currency is required, even when it differs from the functional currency of the parent company. Most often, this is one of the global currencies, which is of particular importance for the needs of acquiring additional capital in the stock exchange. According to IAS 21, however, an entity can present its financial statements in any currency. The change in a reporting currency is seen as a change in the accounting policy and hence it is applied retrospectively. Some of the potential reasons for the change can imply efforts to assure better disclosure of business activities of a multinational company and to improve the comparability of users' results in the global context. Additionally, in case of a change in the parity between the reporting and the functional currency, the parent company`s management may, by choosing or by changing the reporting currency, influence the amounts presented in the consolidated financial statements. The choice of the reporting value can be adjusted in such a way to affect the amount (value) of particular items. Finally, the hedging of financial statements can be viewed as an integral part of the financial reporting policy, since the initiation of certain transactions is consciously planned, in order to balance off receivables and liabilities denominated in a foreign currency. These transactions make for an integral part of the real earnings management, which deliberately shapes the financial structure in the consolidated financial position report. Unless there are adequate instruments against exposure to the currency risk, significant exchange rate fluctuations will result in a volatility of the results, which can leave the impression of a risky venture when it comes to investors and consequently increase the required rate of return (Chang et al., 2013), provided that there is some evidence that income smoothing reduces firm-specific exchange rate exposure.

CONCLUSION

Business operations in a global context bring about numerous challenges. Groups are faced with issues of proper selection of functional and reporting (presentation) currency, as well as of protection against the translation, transaction and economic exposure. Numerous studies prove the relevance of this issue and highlight the effects of the change in exchange rates on the value of the entity. More precisely, by the choice of the exchange rate, projections of their volatility, directing activities and resources into particular

segments whose business is included in the relevant currency, it is possible to influence the amount of the presented result and profit tax, and thus other important performance indicators. In this paper, special attention is paid to the issues of the translation exposure of entities, protection measures and consequential implications on the content of the consolidated financial statements.

Considering the significance of potential effects which may result from the translation of foreign currency transactions and financial reports of foreign subsidiaries, it is possible to use instruments aimed at the targeted design of financial statements, in the aforementioned reporting segment. When it comes to the choice of the functional currency, it cannot be viewed as a segment of the financial reporting policy. The reason lies in the fact that IAS 21 provides numerous guidelines regarding the choice of the functional currency, which is defined by the key transactions, events and circumstances in which the business operates. Therefore, a financial reporting policy can be discussed in the context of the choice of the translation method, currency exchange, where such an option exists, as well as in the context of the presentation currency. Namely, on the basis of the change in parity between a functional and a presentation currency, it is possible to influence the amount of key indicators in the consolidated financial statements. The hedging of financial statements can be observed as a part of a financial reporting policy in order to minimize the accounting exposure through initiating real transactions which will result in balancing the items of foreign receivables and foreign liabilities.

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KLJUČNA PITANJA PREVOĐENJA FINANSIJSKIH IZVEŠTAJA MULTINACIONALNIH KOMPANIJA

Intenziviranje međunarodne trgovine, razvoj različitih oblika poslovne saradnje van nacionalnih granica - koprodukcija, transfer tehnologije, zajednička ulaganja, strategijske alijanse, strane direktne investicije, kao i dinamične promene poslovnog okruženja, zahtevaju da menadžment preduzeća preusmeri poslovno razmišljanje sa lokalnog na globalni pristup. Multinacionalne kompanije predstavljaju nosioce poslovanja u globalnim okvirima. Cilj rada je da ukaže na ključne izazove sa kojima se menadžment multinacionalnih kompanija suočava prilikom prevođenja transakcija u stranoj valuti i finansijskih izveštaja inostranog poslovanja za potrebe sastavljanja konsolidovanih finansijskih izveštaja. Dodatno, u radu se istražuje da li je izbor funkcionalne valute i kursa razmene moguće posmatrati kao instrumente politike finansijskog izveštavanja.

Ključne reči: *konsolidovani finansijski izveštaji, MSFI, kurs razmene, računovodstvena izloženost.*