Don’t Get Lost in Translation

Foreign Currency Accounting for Not-for-Profit Organizations

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Not-for-profit organizations increasingly are capitalizing on a world of opportunity by expanding into operations overseas. The trend is particularly prevalent for professional associations, which are growing to meet the needs of an often global membership base, and institutions of higher education, which are opening satellite locations in additional countries.

This flurry of activity has the potential to elevate the brand and profile of not-for-profit organizations. However, also brings the added complexity of accounting for foreign currency transactions. Not-for-profit organizations must be aware of the financial reporting and accounting requirements for foreign currencies before entering markets overseas. Without a solid understanding of these guidelines, an organization’s leadership creates the risk of financial misstatements, regulatory scrutiny, and damage to the institution’s reputation.

Foreign Currency Translation: Areas That Matter Most

Following are several accounting areas with which an organization should become highly familiar before expanding internationally.

- **Establishing the organization’s functional and reporting currencies.** The accounting guidance for foreign currency translation hinges on the difference between an organization’s functional and reporting currencies. The functional currency is used in an organization’s day-to-day activities, and the reporting currency is used in a parent organization’s financial statements.

  Typically, an institution’s functional currency is the currency used in the country where an organization is headquartered; however, that isn’t always the case for organizations with operations overseas. For example, the Chinese location of a U.S.-based professional association likely would conduct business in the Yuan, the location’s functional currency. The Chinese office’s activities later would be translated and captured on the parent organization’s financial statements in U.S. dollars, the parent’s reporting currency.
Translating balances into an organization's reporting currency. When translating balances from a foreign location into a parent’s financial statements, an organization’s accounting department should be aware of requirements for determining the appropriate exchange rate. For example, for a foreign location whose balance sheet must be consolidated into a parent organization’s balance sheet, the exchange rate as of the balance sheet date must be used.

Of course, the requirements are different for consolidating an organization’s income statements. If an organization has largely steady, consistent operations month to month, it likely will use a 12-month average exchange rate at fiscal year-end to consolidate a foreign location’s income statements into the parent organization’s financial statement.

On the other hand, an organization with inconsistent or seasonal revenues might convert its foreign entities’ income statements based on a monthly average exchange rate. For example, if a university with satellite campuses overseas recognizes the majority of its revenue in the fall through spring months when students attend classes, the institution might use a monthly average translation rate applied to each month’s respective activity for consolidating the entity’s income statement. Similarly, a trade association that holds one or more large events a year likely would use a monthly average translation rate because revenues recognized would peak in the month that each event is held or vary monthly based on the relative size of different events.

One exception would be for unusually large transactions, for which an organization typically would use the exchange rate as of the day of the transaction to translate the entry into the parent organization’s financial activities. This practice helps organizations maintain the accuracy of their financial statements and typically is done only when necessary, as translating individual purchases or expenditures can be time-consuming and can increase the likelihood of error because the process usually is performed manually.

Managing interorganization balances. Inevitably, an organization with locations overseas will have accounts payable and receivable between the foreign locations and parent organization. It is important for an organization to clarify the currency in which payables and receivables will be disbursed and received so both the parent organization and its foreign locations properly can record entries.

For example, a U.S. association with a location in Brazil might have an intercompany balance on its books for a receivable from the location. If the two entities record different currencies for the same transaction in their general ledgers, the accounts receivable (on the books of the parent organization in the U.S.) and accounts payable (on the books of the subsidiary organization in Brazil) will not eliminate properly during the consolidation process. Organizations that rarely have intercompany balances likely would be able to quickly identify this type of misstep, but those that have frequent internal transactions could find it more difficult to discover what went wrong.
The best approach for managing intercompany balances is to establish a consistent practice. U.S.-based organizations for which the U.S. dollar is the reporting currency and the currency in which transactions typically take place can simplify the process by always settling intercompany transactions in dollars.

**Converting consolidated statements of cash flows.** The correct method for creating a consolidated cash flow statement for an organization with one or more foreign entities can be laborious. U.S. generally accepted accounting principles dictate that the statement of cash flows should use the exchange rate in effect on the date the cash flows took place and that organizations can use an average rate for the period if the average rate reasonably reflects the timing of cash flows.

Many organizations instead create an indirect statement of cash flows, using the difference between the current and prior periods’ consolidated balance sheets to come up with a cash flow statement. This approach is simple but incorrect. In this approach, the consolidated balance sheets are prepared using exchange rates as of the date of the balance sheet; the cash flow statement, on the other hand, should reflect the average exchange rate over the course of the period. The difference in exchange rates significantly can affect the cash flow statement.

An organization with one or more entities abroad must create a cash flow statement for each functional currency and then translate those statements into the reporting currency for the organization using the average exchange rate for the period.

**Managing Exchange Rate Fluctuations**

Exchange rates can fluctuate from period to period, which might create unexpected volatility in financial statements. Some institutions turn to forward contracts to manage risk associated with volatility in exchange rates.

A U.S.-based not-for-profit professional association with a location in London might protect itself against variations in the exchange rate of the U.S. dollar versus the British pound by purchasing a forward contract, making a commitment to buy a certain quantity of pounds at a fixed exchange rate. An organization should be aware that these types of contracts need to be marked-to-market on the parent organization’s balance sheet, and if the exchange rate improves beyond the locked-in rate, the organization will need to show a liability on its balance sheet. If the rate moves in the organization’s favor, then the organization would need to show an asset on its statement of financial position.

Overall, the management of any program designed to hedge foreign currency risk should be left to an expert on the subject. Dabbling in complex financial instruments can expose an organization to a significant amount of unnecessary risk.
Proactive Preparation for Growth

After organizations become aware of the accounting areas most relevant to foreign currency transactions, several steps should be taken to prepare for pending overseas expansion:

1. **Analyze the organization’s information systems.** An organization that intends to transact in multiple currencies will have an easier time managing the translation process if its system is able to maintain separate balances in different currencies and denote and track various currencies in the system. Accounting teams using a “black box” system that automatically manages currency translation and consolidates foreign locations’ financial statements must understand exactly how those calculations are made. Examining this type of system will help make certain that there are not any accounting issues with the automatic translation process that the system will fail to identify on its own.

2. **Create clear accounting policies for foreign currency transactions.** To avoid common mistakes, it is critical for an organization to adopt clear accounting policies and that all members of the accounting team understand them. A framework for foreign currency transactions should cover items like identifying which currencies need to be translated and determining whether the statement of activity will be translated on a monthly or quarterly basis.

   In addition, an organization should identify a consistent source of published exchange rates to use. A variety of sources exist for exchange rates and can vary slightly. The difference of a few pennies between exchange rates can add up and cause significant discrepancies, so it is important that all members of the accounting team rely on the same source for exchange rates.

3. **Implement strong controls.** Organizations need internal controls specifically designed to prevent errors in financial reporting related to foreign currency transactions. Controls should establish who reviews large and unusual transactions and assign responsibility for manually translating balances and reviewing and posting entries associated with foreign currency translation.

Plan to Go the Distance

Expanding a not-for-profit or higher education institution into overseas markets can foster growth and allow an organization to reach more people with its mission. Members of management will find that thoughtfully incorporating foreign currency accounting principles into their organization’s expansion plan will help ease the transition to an international institution.

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