

# EXCHANGE RATE DIFFERENCES-THE ACCOUNTING TREATMENT AND ITS INFLUENCE ON THE FINANCIAL PERFORMANCE OF AN ECONOMIC ENTITY

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## Abstract

*Currency rate differences arise when there are certain debt rights or obligations in foreign currency of an economic entity which are collected, i.e. paid for at a different course from the one displayed by the Romanian National Bank on the date of their establishment. Such differences, according to the situation, generate expenditure or revenue which affects a company's financial result and, consequently, the accountant result as well.*

*The results registered by an economic entity presented in the Profit and Loss Account provide information about its financial performance. This performance can be influenced by the favorable or unfavorable exchange rate differences existing when an economic entity carries out transactions or has incurred foreign currency loans having a significant share in the total amount of transactions or in capitals. The present paper shows the accounting treatment of the exchange rate differences and its impact on the financial performance.*

**Keywords:** *exchange rate differences, financial result, accounting result, financial performance.*

## Introduction

The relationships that economic units have with customers, suppliers and lenders generate debt rights and payment obligations or commitments. Depending on the field of activity, some or all transactions with customers and/or suppliers may be in foreign currency. Some economic units resort to foreign currency loans to finance their working activity. The accounting law stipulates that all transactions in foreign currencies be expressed in Romanian currency (lei), at the exchange rate displayed by the National Bank of Romania, an exchange rate that may undergo alterations from the date of lodging the claim/debt in foreign currency and the time of settlement. Therefore, exchange rate differences may appear.

The study undertaken aims at presenting the concept of exchange rate differences, the possible situations that arise, their recognition in accounting in accordance with the national rules in force, as well as their influence on the financial performance of an economic unit.

The importance of this study lies in highlighting the impact of exchange rate differences on the results obtained by an economic unit and presented through the profit and loss account indicators.

In order to highlight the impact of exchange rate differences on the accountant results and, consequently, on the performance of an economic

unit, we have analyzed the situation of a company having foreign currency long-term loans, receivables and payables to suppliers.

Regardless of the business field, an economic unit must be competitive in order to remunerate its production factors and ensure its development.

The term "performance", as supplied by general language dictionaries, is referred to as an accomplishment in a specific field of activity. At the level of an economic unit, performance include the ability to gain access to resources, to allocate and optimally use them with a view to make sufficient payments to cover the risk undertaken and to justify the interest, on the trajectory of future sustainable development<sup>1</sup>. Therefore, the economic performance of a unit lies in the efficiency and effectiveness with which resources are used and results are generated. Efficiency involves maximizing the results of an activity in relation to the resources used, while the effectiveness shows the degree of achievement for the scheduled objectives, as well as the relationship between the provisioned effect and the outcome of the activity carried out.

The assessment of the financial performance can be equally achieved by means of profitability indicators. The first step in the evaluation of profitability is to determine the results as the difference between the income and the consumption of resources pertaining to it. The main result indicators from the profit and loss account of an economic unit are the operation result, the financial result and the gross result of the exercise.

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<sup>1</sup> Monica Petcu, Economic and Financial Analysis of the Company. Problems, approaches, methods, applications, Ed. Economică, Bucharest, p. 313.

The operating result represents the difference between the operating revenue and the expenditure of the resources allotted to the operation, while the financial result is determined by deducting the financial expenditure from the financial revenue. The two results, the operation and the financial ones summed up, form the gross result of the exercise or the accounting result.

The accounting profit provides information relating to the company's ability to control costs and to achieve revenue that is higher than the expenditure.<sup>2</sup>

The exchange rate differences may be financial income or expenses, as appropriate. Therefore, their existence and amount influence the financial result and, consequently, the gross profit of the exercise.

#### Currency rate differences – accounting treatment

In order to carry out activity, some economic units make foreign currency transactions. Foreign currency represents any currency, but the national one.

In Romania accounting is held in the national currency, therefore foreign currency transactions must be initially recorded at the exchange rate communicated by the National Bank of Romania on the date of the transaction.

A foreign currency transaction is a transaction that is expressed in or requires settlement in a currency other than the national currency (lei), including transactions arising when an entity:

- buys or sells goods or services whose price is expressed in currency;
- borrows or loans funds, and the amounts to be paid or cashed are expressed in currency; or
- purchases or gives in assets in any other manner, contracts or pay debts denominated in foreign currency.<sup>3</sup>

The differences arising from the conversion of a certain number of units of a currency into another currency at different exchange rates represent exchange rate differences. The currency exchange rate refers to the exchange ratio between the two currencies.<sup>4</sup>

According to the accounting regulations in force, exchange differences arise:

- upon settlement of foreign currency receivables and payables to rates that were different from those at which they were initially recorded;
- upon evaluation at the end of each month of the

claims, debts in foreign currency, foreign currency availability and other treasury values, such as state currency titles, letters of credit and deposits in foreign currency at the exchange rate of the currency market, communicated by the National Bank of Romania in the last banking day of the month.

When the claims or liabilities in foreign currencies are settled in the same month in which they occurred, the resulting difference is recognized in that month. In the case when these claims or liabilities in foreign currencies are settled within a subsequent month, the difference is recognized in each month, which intervenes by the month of settlement and is to be determined taking into account the modification of exchange rates in the course of each month.

Exchange rate differences can be favorable and are recorded in accounting as income from the exchange rate differences or they can be unfavorable and are recognized as expenses from the exchange rate differences.

The change of the exchange rate may generate expenses from the exchange rate differences or income from the exchange rate differences depending on the type of the transaction as follows:

**Tabel 1**

Transaction in foreign currency	Exchange rate trend	
	Ascending	Descending
Incurring loans	Exchange rate differences expenses	Exchange rate differences revenue
Offered loans	Exchange rate differences revenue	Exchange rate differences expenses
Goods delivery/services	Exchange rate differences revenue	Exchange rate differences expenses
Purchase of goods	Exchange rate differences expenses	Exchange rate differences revenue
Bank deposits, deposits in the current account, cash	Exchange rate differences revenue	Exchange rate differences expenses

From the normal course of the activity of an economic unit there may result receivables and payables denominated in lei, whose settlement is to

<sup>2</sup>Tabără Neculai, Dincu Roxana-Mauela, "Performance Indicators in the Context of International Accounting Regulations", Al. I. Cuza University, Iași, p. 368.

<sup>3</sup>O.M.F.P. 1802/2014 ACCOUNTING REGULATIONS concerning the individual annual financial statements and the consolidated annual financial statements, art. 317, par. (1).

<sup>4</sup>O.M.F.P. 1802/2014 ACCOUNTING REGULATIONS concerning the individual annual financial statements and the consolidated annual financial statements, art. 317, par. (2).

be made depending on currency rates. At the time of the settlement of such claims and debts there may arise differences in value due to an exchange rate different from that at which they were originally recorded, differences which are to be recorded in the accounts as other financial expenses/revenue.

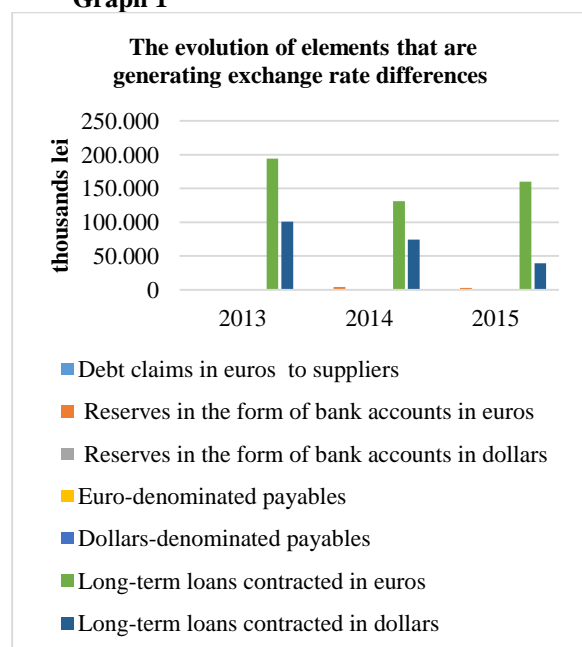
### The influence of the exchange rate differences on the financial performance of an economic unit

At the time of the settlement of foreign currency receivables and payables or on a monthly basis, both in their assessment and in the assessment of the foreign currency reserves at the exchange rate communicated by the National Bank of Romania, in accounting there can be registered expenses or income resulted from the exchange rate differences. These expenses, financial income affects the result respectively obtained an economic entity.

In order to analyze the influence of the exchange rate differences over the financial performance we have studied the case of economic unit with euro-denominated payables, debt claims in euros and dollars to suppliers, long-term loans contracted in euros and dollars, reserves in the form of bank accounts in euros and dollars.

The evolution of assets, payables and foreign currency deposits as well as the debt-items, i.e. debts to suppliers and long-term debts is presented as follows:

**Graph 1**



The euro and dollar currency exchange rate at the end of the 2013, 2014 and 2015 financial exercises varied as follows:

**Table 2**

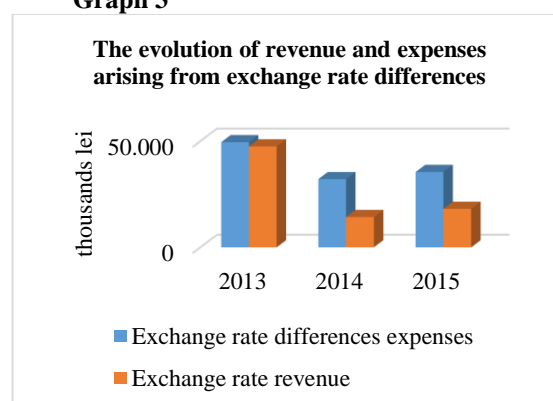
Currency	Financial exercise		
	2013	2014	2015
Dollar	3.26	3.69	4.15
Euro	4.48	4.48	4.52

As it can be noticed from the above table, the exchange rate had an ascending trend over the analyzed period for both currencies in which the economic unit made transactions.

The devaluation of the Romanian currency in comparison to the US dollar and the euro led to the recording of exchange rate differences expenses larger than the exchange rate differences income at the end of each year, as euro and dollars loans have the largest share in the total foreign currency transactions.

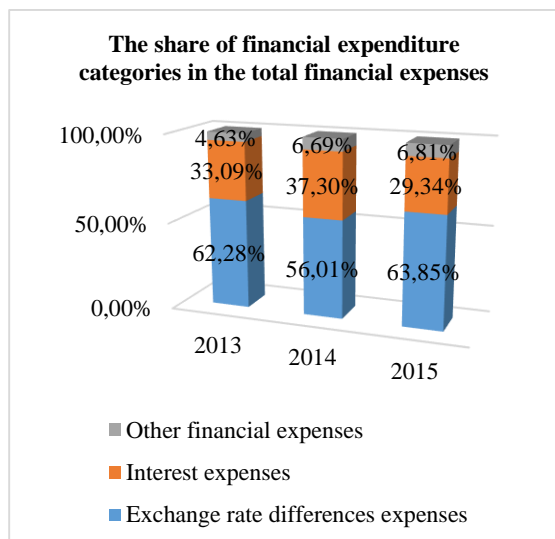
We present below the evolution of the expenditure and income from exchange rate differences:

**Graph 3**

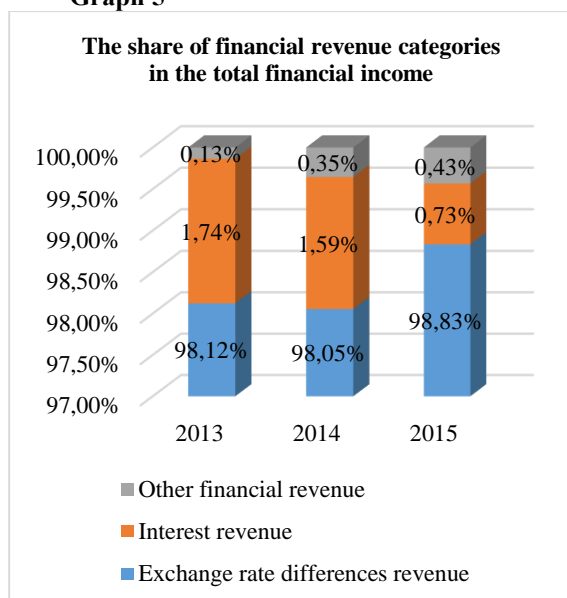


In addition to the expenses from the exchange rate differences, the determination of the financial outturn includes the interest expenses and the other financial expenses, but the former have the largest share in the total financial expenditure (Graph 4), consequently having a huge impact on the financial result.

**Graph 4**



The structure of financial income is as follows:  
**Graph 5**



The information presented above implies that both expenditure and income from the exchange rate differences hold the largest share among the items that participate in establishing the financial result, so that its evolution depends largely on the expenses and income from the exchange rate differences. Exchange rate fluctuations that are reflected in accounting as revenue and expenditure according to which the economic unit's results are determined, have a significant impact on its financial performance.

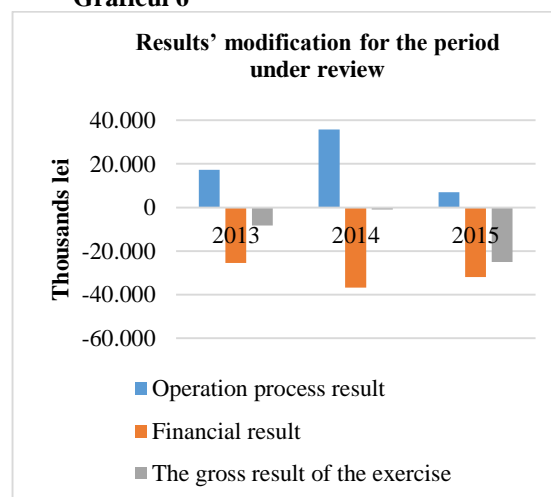
The elements of expenditure and revenue from the exchange rate differences negatively influence the evolution of the financial result because of the larger amount of the expenditure as compared to the revenue, due to unfavorable currency exchange rate evolution.

The operational activity of the economic unit, throughout the period under review, ended with profit, while the financial activity ended in loss. The loss from the financial activity was larger than the profit generated by the operational activity, therefore, the gross profit of the financial exercise, the accounting outcome, amounts to loss nevertheless.

**Table 3** - thousand lei-

Indicator	Financial exercise		
	2013	2014	2015
Operational activity result	17,248.84	35,795.33	6,949.34
Financial result	-	-36,735.07	-
The gross result of the exercise	-8,284.41	-939.74	24,982.12

**Graficul 6**



A business is competitive when it covers both its operating costs and the cost of capital. The economic unit studied through the positive operating result shows that it has the ability to cover its operating expenses, but the negative financial result indicates an inability to cover the cost of borrowed capital.

The long-term financing of a company can be made from its own resources or from borrowed resources. The respective company holds loans in foreign currency, so that the rate of foreign currency debt in permanent capital has a significant impact on its financial performance.

The capital of the company is represented by both its own capital subscribed and paid up by shareholders, legal reserves, reevaluation reserve and other reserves, as well as by the loan represented by long-term credits in lei and in foreign currency.

The structure of the permanent capital (the company's own capital and long-term debts) of the company is given in the tables below:

**Table 4** - thousand lei -

Indicator	Financial exercise		
	2013	2014	2015
Long-term debts in euro	194,390	131,191	160,062
Long-term debts in dollars	100,879	74,549	39,196
Company own capital	622,701	634,869	609,126
Permanent capital	917,971	840,610	808,384

**Table 5**

Indicator	Financial exercise		
	2013	2014	2015
Long-term debts in euro	21%	16%	20%
Long-term debts in dollars	11%	9%	5%
Company own capital	68%	76%	75%
Permanent capital	100%	100%	100%

Long-term credits in foreign currency generate costs, namely interest costs, but also expenditure caused by exchange rate fluctuations. These expenses are to be covered from the financial revenue and the operating profits. The extent to which the operating profit and the financial income have covered financial expenses:

**Table 6**

	Financial exercise		
	2013	2014	2015
The proportion of covering the expenditure from the operation process result and the financial income	88.79%	98.16%	50.23%

Throughout the period under review the company hasn't covered its financial expenditure on account of the profit from operations and the financial income, thus obtaining gross accounting loss at the end of each financial exercise.

We present below the value of the result from operations, financial income and the financial expense categories:

**Table 7** - thousand lei -

Indicator	Financial exercise		
	2013	2014	2015
Operational activity result	17,249	35,795	6,949
Financial revenues total	48,387	14,463	18,266
Exchange rate differences expenses	46,036	28,675	32,050
Interest costs	24,461	19,098	14,727
Other financial expenses	3,423	3,425	3,421
Financial expenses total	73,920	51,198	50,198

As shown in the table above, for each financial exercise, the operation profit and the financial income entirely covered the interest expenses and the other financial expenses and only partially the exchange rate differences expenses. Therefore, the revenues recorded by the company from both its operation activity as well as from the financial activity, cover the operation costs, the interest charges on loans' expenses, other financial expenses, but it does not entirely cover the unfavorable rate differences generated by the monthly assessment of loans, receivables, payables to suppliers and the amounts available in foreign currency.

In the case of the studied company the significant share of foreign currency loans in the total amount of patrimonial elements which give rise to differences in exchange rates linked with the evolution of the exchange rate has led to a high level of financial expenditure so as to generate a financial loss that is not covered in the exploitation result. In this way, differences in exchange rates have a significant impact on the financial performance of the economic unit.

### Conclusions

The economic units engaged in foreign currency transactions must record these in the national currency at the exchange rate communicated by the National Bank of Romania at the date of the transaction. Fluctuations in currency exchange rates between the transaction date and the settlement date give rise to exchange rate differences that are either favorable or unfavorable to the economic unit. These differences are recognized in accounting as follows: the favorable ones in the financial income accounts, and the unfavorable ones in the financial expenses accounts.

The debts and/or claims in foreign currencies can be settled in the month of their establishment or in a subsequent month. National accounting regulations stipulate that at the end of each month claims, debts, and liquidity reserves in foreign currency owned by the economic units are to be evaluated at the exchange rate communicated by the National Bank of Romania. As a result of this, exchange rate differences appear both on the settlement of claims/debts, as well as at the end of each month.

The competition for any market segment has become increasingly fierce, therefore the market position depends on the performance of economic units, including their financial performance.

The performance measurement indicators include the gross profit of the financial exercise or the accounting result. This result is determined by subtracting the total expenses from the total revenues recorded by a company over a period of time, a year, in most cases.

The accounting result is influenced by the operation result calculated as the difference between the revenues and expenses related to the operating activity and the financial result obtained by deducting the financial expenses from the financial revenues.

The exchange rate differences are recorded in the accounts as financial expenses when:

- the settlement of debts towards suppliers is carried out at an exchange rate higher than the one existing at the time of their incurrence;
- the monthly evaluation of debts to suppliers and/or foreign currency credits is to be made at an exchange rate higher than the one communicated by the National Bank of Romania upon their incurrence/establishment;
- the collection of receivables in foreign currency are to be carried out at an exchange rate lower than the one existing at the date of their establishment;
- the monthly assessment of claims and/or reserves in the bank accounts in foreign currency are to be carried out at an exchange rate lower than the one released by the National Bank of Romania at the time

of their establishment/of their previous assessment.

The exchange rate differences are registered in accounting as financial revenues when:

- the settlement of debts to suppliers is carried out at an exchange rate lower than the one existing at the date of their establishment;
- the monthly assessment of debt to suppliers and/or loans denominated in foreign currency must be carried out at an exchange rate lower than the one released by the National Bank of Romania on the date of their establishment/their commitment;
- the collection of receivables in foreign currency is to be carried out at an exchange rate higher than the one existing at the time of their formation;;
- the monthly assessment of claims and/or reserves of bank accounts in foreign currency is to be carried out at an exchange rate higher than the one released by the National Bank of Romania at the time of their establishment/ their previous assessment.

The larger the amount of the debt to the suppliers and foreign currency loans the higher the exchange rate differences expenses where the exchange rate has an ascending trend. The exchange rate differences expenses together with the other financial expenses such as interest expenses must be covered on account of the financial revenue, otherwise they will generate a loss from the financial activity. This loss must be compensated with a positive result from the operation activity in order to get the accounting profit.

Differences in exchange rates have a significant impact on the financial performance only in the case of companies that carry out transactions in foreign currency or hold foreign currency reserves, and they have a large share in the total transactions/availability.

In addition to exchange rate differences, the financial performance of an economic unit may also be influenced by other elements that have no direct link with the operation activity such as expenses/income from the re-evaluation of fixed assets. We consider it to be worth studying in further research.

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