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FOREIGN CURRENCY TRANSLATION METHODS AND THEIR EFFECTS ON FINANCIAL STATEMENTS OF NIGERIAN LISTED MULTINATIONAL CORPORATIONS

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ABSTRACT

The precision of translating financial statements that are denominated in foreign currencies into the reporting currency, typically the Nigerian Naira, becomes increasingly crucial as Nigeria's economy grows and more multinational corporations become listed. This study, through a comparative analysis, aims to examine the foreign currency translation methods employed by NLMCs and evaluate their impact on financial statements. This study utilized an ex post facto research design, gathering data from the annual reports and financial statements of Nigerian multinational companies. It focused on ten multinational companies listed on the Nigerian Exchange Group (NGX) as of December 31, 2022, employing a census sampling approach due to the small size of the population. The data covered an eleven-year period from 2012 to 2022. Both descriptive and inferential statistics were used for the analysis. The regression analysis indicated that both the current rate method and the temporal rate method had a statistically significant positive effect on the financial statements of listed multinational corporations in Nigeria. Conversely, the functional currency method exhibited a statistically insignificant negative influence on their financial statements. This suggests that although the current rate and temporal rate methods are associated with improved financial performance, the functional currency method does not significantly impact the financial results of listed multinational companies in Nigeria. These results underscore the substantial influence of the chosen foreign currency translation method on the financial performance of these companies. As a recommendation, this study suggests that multinational corporations in Nigeria contemplate adopting either the current rate method or the temporal rate method for currency translation to enhance their financial performance.

Keywords: Foreign currency translation methods, Current rate method, Temporal rate method. Functional rate method, Financial statements.

1. INTRODUCTION

Foreign currency translation is essential for the financial reporting of multinational corporations (MNCs), particularly those operating in diverse global markets. As companies engage in cross-border transactions and maintain subsidiaries in multiple countries, they encounter various foreign exchange risks that can significantly impact their financial statements. The selection of a foreign currency translation method employed by MNCs do have profound effects for reported financial results, affecting key metrics such as revenues, expenses, assets, and liabilities. Understanding the

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effects of different translation methods on financial statements is essential for investors, analysts, regulators, and other stakeholders in evaluating the financial performance and risk exposure of multinational entities (Bartov et al., 2005; Bhattari, 2018).

In Nigeria, a burgeoning economy with a growing number of listed multinational corporations, the adoption of appropriate foreign currency translation methods assumes heightened significance (Abubakar, 2020). Nigerian listed multinational corporations (NLMCs) operate in diverse industries and geographic regions, conducting transactions in various foreign currencies. Therefore, the exchange of foreign currency-denominated financial statements into the reporting currency (usually the Nigerian Naira) requires careful consideration of the methodological approaches and their implications (Ahmad et al., 2020; Ndayako et al., 2022).

This comparative study aims to investigate the foreign currency translation methods utilized by Nigerian listed multinational corporations and assess their effects on financial statements. By examining the practices of NLMCs operating in different sectors and geographic locations, this research seeks to provide valuable understanding into the obstacles, complexities, and outcomes linked with foreign currency translation in the Nigerian multinational corporations. By shedding light on the foreign currency translation practices of Nigerian listed multinational corporations, this study adds to the existing body of knowledge on international accounting and enhances our understanding of the complexities inherent in global financial reporting.

2. LITERATURE REVIEW

2.1 Conceptual Review

Foreign Currency Translation Methods

Foreign currency translation methods are techniques adopted by multinational companies to convert financial statements from the currency of one country to another for reporting purposes. Each method has its advantages and disadvantages, and the choice of method depends on factors such as the nature of the foreign operations, the stability of exchange rates, and reporting requirements (Owoeye & Ogunmakin, 2013). Foreign currency translation methods are of importance in multinational companies' financial reporting, facilitating the conversion of financial statements from the currency of one country to another. These methods enable companies to present their financial performance and position accurately to stakeholders across different geographical regions (Santosa, 2019). Understanding the benefits and drawbacks of each foreign currency translation method is crucial for companies to settle for informed decisions about which method to use. Several factors, such as the nature of the foreign operations, exchange rate stability, and reporting requirements, influence this choice. For example, companies with mainly monetary assets and liabilities might prefer the Current Rate Method due to its simplicity and accuracy in reflecting the current financial position (Elhussein & Osaman, 2019). Conversely, in situations with high exchange rate volatility, the Temporal Method might be more appropriate to reduce earnings volatility. Foreign currency translation methods are vital for multinational companies to create accurate financial statements. Recognizing the advantages and understanding the limitations of each method is crucial for making well-informed decisions based on operational nature, exchange rate stability, and reporting needs (Nydahi, 1999).

Current Rate Method

In this method, assets and liabilities are converted using the current exchange rate, while income and expenses are translated at the average exchange rate for the period. Any resulting translation adjustment is recorded in equity. According to Choi et al. (2019), this approach provides a more accurate reflection of the current financial position and performance. However, it may lead to volatility in reported earnings due to fluctuations in exchange rates (Oladipupo & Onotaniyohuwo, 2011).

Temporal Method

This method follows the principle of translating monetary assets and liabilities at the current exchange rate, while non-monetary items are translated at historical rates. Income and expenses are translated based on the exchange rates applicable at the time they were incurred. Warren et al. (2020) notes that while this approach offers simplicity and consistency, it may not fully reflect economic reality, especially in environments with highly volatile exchange rates (Omeke, 2010).

Functional Currency Method

This method involves determining the functional currency of the foreign entity and translating its financial statements into the reporting currency using exchange rates that represent the economic conditions in which the entity operates (Opaluwa et al., 2012). Shim and Siegel (2019) explain that the functional currency method aligns financial reporting with the economic realities of transactions and improves comparability across entities in different countries.

Financial Statements

Financial statements are official records that outline the financial activities and condition of a business, organization, or individual. They provide critical information about an entity's financial performance, position, and cash flows over a specific period (Owolabi & Adegbite, 2017). The main types of financial statements typically include:

Income Statement (Profit and Loss Statement): This statement outlines the revenues, expenses, and net income (or loss) of an entity for a specific period, such as a quarter or a year. It shows whether the entity has made a profit or incurred a loss by comparing total revenues with total expenses (Akinadewo et al., 2023).

Balance Sheet (Statement of Financial Position): The balance sheet offers a snapshot of an entity's financial position at a specific point in time, typically at the end of a reporting period. It lists assets, liabilities, and equity, where assets indicate what the entity owns, liabilities represent its debts, and equity reflects the owners' interest in the entity’s assets after deducting liabilities (Akinadewo et al., 2023).

Cash Flow Statement: This statement outlines the cash inflows and outflows of an entity over a specific period, categorizing them into operating, investing, and financing activities. It provides insight into how the entity generates and uses cash, shedding light on its liquidity, solvency, and ability to fund operations and investments (Akinadewo et al., 2023).

Statement of Changes in Equity: This statement shows the changes in an entity's equity over a specific period, detailing contributions from and distributions to owners, along with other changes resulting from transactions and events that impact equity (Akinadewo et al., 2023). These financial statements are compiled following generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS). They are crucial for stakeholders such as investors, creditors, regulators, and management to assess the financial health, performance, and future prospects of an entity (Akinadewo et al., 2023).

Translation Currency Exchange Methods and Financial Statements

Currency translation methods are vital for preparing financial statements for multinational companies, enabling the conversion of financial data between currencies for reporting purposes. These methods are crucial for accurately depicting the financial position, performance, and cash flows of entities across different regions. Understanding the various ways of choosing the appropriate translation method is crucial for multinational companies to adhere to accounting standards and provide relevant information to stakeholders. The selected method can significantly influence a company's reported financial results. Choi et al. (2019) highlight the Current Rate Method, which translates assets and liabilities at current exchange rates while converting income and expenses at average exchange rates for the period. Although this method offers a current view of financial status and performance, it may lead to earnings volatility due to fluctuations in exchange rates.

Another method described by Shim and Siegel (2019) is the Temporal Method, which translates monetary items at current exchange rates and non-monetary items at historical rates. This approach provides simplicity and consistency but may not fully capture the economic reality, especially in environments with volatile exchange rates. Additionally, the Functional Currency Method, as discussed by Warren et al. (2020), involves identifying the functional currency of foreign entities and converting their financial statements into the reporting currency using exchange rates that reflect the economic conditions of the operational environment. This method improves comparability by aligning financial reporting with the economic substance of transactions. Financial statements, including the income statement, balance sheet, cash flow statement, and statement of changes in equity, are essential for conveying an entity's financial performance and position. These statements are prepared using the chosen currency translation method and are critical for stakeholders such as investors, creditors, and regulators to assess the entity's financial health and make informed decisions (Abubakar, 2020). Understanding the advantages and limitations of each translation method is vital for multinational companies to ensure accurate and transparent financial reporting (Ndayako et al., 2022).

2.2. Theoretical Framework

In conducting a study on the effects of foreign currency translation methods on the financial statements of Nigerian listed multinational corporations, an analysis hinged on Agency Theory provides valuable insights into the dynamics between shareholders and management. Agency Theory, introduced by Jensen and Meckling (1976), explores the principal-agent relationship in organizations, where shareholders (the principals) assign decision-making authority to management (the agents), which can lead to a misalignment of interests. In the context of foreign currency translation methods, this theoretical framework elucidates how management's choice of translation method may impact the alignment of interests between shareholders and management, particularly regarding financial performance reporting and transparency. Management's decision on the translation method can affect reported financial figures, thereby influencing shareholders' perceptions of firm's performance and value.

For example, if management selects a translation method that results in lower reported earnings due to exchange rate fluctuations, shareholders may perceive the company's financial performance negatively. Conversely, if management chooses a method that masks the impact of exchange rate changes, shareholders may not gain a precise understanding of the company's actual financial condition. A study applying Agency Theory could investigate how management's incentives, such as compensation structures or stock ownership, influence their choice of translation method. Additionally, it could explore how the transparency and disclosure of the translation method in financial statements affect shareholders' trust and confidence in management. Empirical studies that incorporate Agency Theory have shown its relevance in understanding corporate governance mechanisms and the relationship between shareholders and management (Fama & Jensen, 1983). By applying this theory to the analysis of foreign currency conversion methods in Nigerian listed multinational corporations, researchers can deepen their understanding of how corporate governance practices influence financial reporting decisions and ultimately impact shareholder value.

2.3 Empirical Review

Kennedy and Mweshi (2023) investigated the impact of foreign exchange rate fluctuations on the financial performance of Zambian mining companies, using both primary survey data and secondary data from the annual reports of First Quantum Minerals. Their study, which employed a mixed methods approach within a descriptive research design covering the period from 2018 to 2022, found a weak but positive correlation between transaction exposure, particularly trade receivables, and financial performance. Mate et al. (2022) investigated how interest rates affect the financial performance of listed manufacturing firms in Kenya, using the efficient market hypothesis and arbitrage pricing theory as frameworks. Their study, which utilized a descriptive correlational research design with panel data from 2015 to 2020, identified a significant negative effect of exchange rate fluctuations on return on assets (ROA). This impact was attributed to the depreciation of the Kenyan shilling and rising import costs. In a separate study, Hussain et al. (2021) explored the relationship between exchange rates and financial performance in Pakistani manufacturing companies from 1999 to 2015. Using both fixed effects and system GMM models, their research found a nuanced effect: exchange rates positively moderated the relationship between the cash conversion cycle and financial performance in static models but had a significant negative impact in dynamic models.

Setiawanta et al. (2020) investigated how a company's financial performance affects its value from an investor's perspective, with exchange rate fluctuations as a moderating factor. Analyzing data from 50 companies over four years using Eviews, they found that while capital structure had a significant impact on firm value, profitability did not. The study also found that exchange rates influenced the relationship between capital structure and firm value but did not affect the relationship between profitability and firm value. In contrast, Hossin and Mondol (2020) investigated the impact of exchange rate fluctuations on the financial performance of banks in Bangladesh. Their study, which used secondary data and descriptive statistics, identified a weak negative correlation between exchange rate fluctuations and financial performance, though inflation rates were found to have a positive effect on returns on assets. Egolum et al. (2020)

examined how exchange rate fluctuations affected Nigerian conglomerates and discovered a significant negative impact on Return on Capital Employed (ROCE) and Return on Equity (ROE), while the effect on Return on Assets (ROA) was minor and not statistically significant. Moyo and Türsoy (2020) analyzed the effects of inflation and exchange rates on South African commercial banks and found a strong negative relationship between inflation and return on equity, with only a weak relationship between exchange rates and return on equity.

Abubakar (2020) examined how exchange rate volatility affects the financial performance of deposit money banks in Nigeria, focusing on Return on Capital Employed (ROCE) and Return on Assets (ROA). Using an ex-post facto research design and secondary data from nine banks listed on the Nigerian Stock Exchange, the study applied multivariate regression analysis. The results showed that exchange rate volatility did not significantly affect ROA or ROCE, suggesting that exchange rate fluctuations might not be a crucial factor in determining these banks' financial performance. This highlights the need for additional research to identify other factors influencing bank performance. In contrast, Buabeng et al. (2019) studied the impact of exchange rate fluctuations on manufacturing firms in Ghana and found a significant negative relationship between exchange rates and performance. They also identified positive associations between performance and factors such as inflation, trade openness, and investment, recommending strategies for managing exchange rate fluctuations and promoting the use of local capital goods.

Osho and Efuntade (2019) found that exchange rate fluctuations significantly impact the performance of multinational companies in Nigeria, employing various economic theories and data analysis in their research, while Mulinya and Olweny (2019) found mixed effects of foreign exchange determinants on multinational companies in Kenya. The variations in these findings underscore the complex and context-specific nature of exchange rate impacts on financial performance across different sectors and countries.

Conceptual Framework

Figure 1 shows the interaction between the independent variable (Foreign Currency Translation Methods) and the dependent variable (Financial Statements).

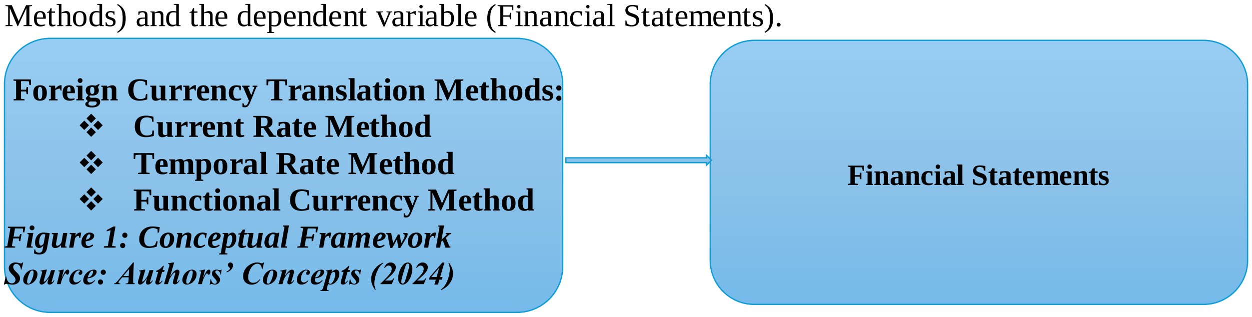

Figure 1: Conceptual Framework
Source: Authors' Concepts (2024)

3. METHODOLOGY

This study utilized an ex post facto research design and gathered data from annual reports and financial statements of multinational companies listed in Nigeria. The total population comprised ten multinational companies listed on the Nigerian Exchange Group (NGX) as of 31st December 2022. Census sampling techniques were utilized to examine the entire population as the sample size, given the relatively small size of the population. Data were gathered over eleven years, from 2012 to 2022. Analysis of the data involved both descriptive and inferential statistics.

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Model Specification

The econometric model utilized in this study was delineated in accordance with the prior research conducted by Buabeng et al. (2019), and it was articulated in the following manner:

$FS = \beta_0 + \beta_1 CRM + \beta_2 TRM + \beta_3 FCM + \varepsilon it$

Where:

FP = Financial Statements
CRM = Current Rate method
TRM = Temporal Rate Method
FCM = Functional Currency Method
εit = Error term

β0 = Intercept, β1, β2, β3 = The Coefficients of the unknown variables.

The *a-priori* expectation = β1, β2, β3, > 0, this implies that a positive correlation is anticipated between the explanatory variables and the dependent variable.

Table 1: Operationalization of Variables

Variable	Type	Source	Description and Measurements of Variables	Reference
Financial Statements (FS)	Dependent	Audited Annual report	Expressed as the percentage of changes between the total value and currency exchange differential value.	Buabeng et al. (2019)
Current Rate Method (CRM)	Independent	Audited Annual report	Expressed as the rates employed by a company to convert its currency values into the reporting currency at the balance sheet or reporting dates, designated an index number of 1 for the firm utilizing this approach.	Choi et al. (2019)
Temporal Rate Method (TRM)	Independent	Audited Annual report	Expressed as the rates employed by a company to convert its currency values into the reporting currency at the time of recognition or transaction dates, designated an index number of 2 for the firm utilizing this approach.	Warren et al. (2020)
Functional Currency Rate Method (FCM)	Independent	Audited Annual report	Expressed as the rates employed by a company to convert its currency values consistent with the economic environment in which the entity operates, designated an index number of 3 for the firm utilizing this approach.	Shim and Siegel (2019)

Source: Authors' Compilation (2024)

4. DATA ANALYSIS AND DISCUSSION OF FINDINGS

Descriptive Statistics

The descriptive statistics presented in Table 2 provide a detailed overview of both the dependent variable, Financial Statements (FS), and the independent variable, Foreign Currency Translation Method, which encompasses the current rate method (CRM), temporal rate method (TRM), and functional currency method (FCM). These statistics are given for both transformed and untransformed data, focusing on listed multinational firms in Nigeria. For CRM, the average value is 0.0435122, with a standard deviation of 0.0224498 and a variance of 0.000252, reflecting the dispersion around the mean. The range of values is indicated by the minimum and maximum statistics, with skewness at 1.1227964 showing positive asymmetry and kurtosis at 5.254498 indicating a pronounced peak.

For TRM, the mean is 0.3394944, with a standard deviation of 0.1360884 and a variance of 0.009260. The range is represented by the minimum and maximum values, with a kurtosis of 5.510724 suggesting a high peak. The FCM method has a mean of 0.2130076, a standard deviation of 0.1877046, and a variance of 0.017616. The range is indicated by the minimum and maximum values, with skewness at 2.5313140 showing significant asymmetry and kurtosis at 7.314454 indicating a sharp peak. Finally, for FS, the mean is 0.2846086, with a standard deviation of 0.0781440 and a variance of 0.0030494. The range is defined by the minimum and maximum values, with skewness close to zero (-0.0660158) and kurtosis at 5.142862, showing a moderate peak.

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std Dev	Variance	Min	Max	Skewness	Kurtosis
CRM	110	0.0435122	0.0224498	0.000252	0.0038608	0.1001412	1.1227964	5.254498
TRM	110	0.3394944	0.1360884	0.009260	0.0130398	0.6517596	-0.1623360	5.510724
FCM	110	0.2130076	0.1877046	0.017616	0.0261960	0.7742520	2.5313140	7.314454
FS	110	0.2846086	0.0781440	0.0030494	0.0878730	0.4475290	-0.0660158	5.142862

Source: Authors' Computation (2024)

Foreign Currency Translation Methods and Financial Statements

The regression analysis detailed in Table 3 assesses the impact of various foreign currency translation methods namely the current rate method (CRM), temporal rate method (TRM), and functional currency method (FCM) on financial statements. Statistical tests were conducted to ensure model validity, including the Durbin-Watson test for autocorrelation (which indicated positive autocorrelation) and the Breusch-Pagan/Cook-Weisberg test for heteroskedasticity (revealing heteroskedasticity with a p-value < 0.05). The analysis confirmed no multicollinearity (with Variance Inflation Factor below 10) and used generalized least squares regression to manage autocorrelation and heteroskedasticity. Despite a significant Hausman test and support for random effects, the presence of autocorrelation and heteroskedasticity led to the use of GLS regression, with the Wald chi-square test showing that 79.46% of the variance was explained by the model, which was deemed efficient (p-value = 0.0000). Regarding the coefficients, CRM had a significant positive coefficient of 0.0324174, suggesting a direct relationship with financial statements (FS), supported by a p-value of 0.040. TRM also had a significant positive coefficient of 0.1022757, indicating a notable increase in FS, with a p-value of 0.016. Conversely, FCM showed a negative coefficient of -0.1139212, suggesting a decrease in FS, though this relationship was not statistically significant (p-value = 0.074).

Table 3: GLS Estimate on Effect of Foreign Currency Translation Method on Financial Statements

Variables	GLS		
	Coefficient	t-value	p-value
CRM	0.0324174	1.97	0.040
TRM	0.1022757	6.33	0.016
FCM	-0.1139212	3.56	0.074
Constant	0.2006481	2.20	0.052
Wald Chi2(3)	79.46		
Probability	0.0000		
Durbin-Watson	6.2416494		
Breusch-Pagan/Cook-Weisberg test (p-value)	0.04(2.56629)		
Hausman fixed random (p-value)	18.06(0.9117)		
Breusch-Pagan Lagrangian Multiplier test (p-value)	84.71(0.0000)		
VIF (mean)	2.79		

Source: Authors' computation, (2023)

Discussion of Findings

In Nigeria, a burgeoning economy with a growing number of listed multinational corporations, the adoption of appropriate foreign currency translation methods assumes heightened significance. Nigerian listed multinational corporations (NLMCs) operate in diverse industries and geographic regions, conducting transactions in various foreign currencies. Therefore, the translation of foreign currency-denominated financial statements into the reporting currency (usually the Nigerian Naira) requires careful consideration of the methodological approaches and their implications. This comparative study aimed to investigate the foreign currency translation methods utilized by Nigerian listed multinational corporations and assess their effects on financial statements. The regression analysis results indicated that both the current rate method and the temporal rate method had a statistically significant positive impact on the financial statements of listed multinational companies in Nigeria. This result differs from the findings of Moyo and Türsoy (2020), who reported a significant negative correlation between inflation and return on equity, with only a weak association between exchange rates and return on equity.

In contrast, the functional currency method demonstrated a statistically insignificant negative effect on the financial statements of these companies. This finding is consistent with Egolum et al. (2020), who noted that exchange rate fluctuations had a significant negative impact on Return on Capital Employed (ROCE) and Return on Equity (ROE), but a positive yet insignificant effect on Return on Assets (ROA). It also aligns with Osho and Efuntade (2019), who reported a significant impact of exchange rate fluctuations on the performance of multinational companies in Nigeria. The study suggests that while the current rate and temporal rate methods are associated with improved financial performance, the functional currency method does not significantly influence financial outcomes for listed multinational companies in Nigeria. This result contradicts Mulinya and Olweny (2019), who found that both the balance of payments and inflation had a negative and statistically significant effect on return on equity.

5. CONCLUSION AND RECOMMENDATIONS

This study examined how different foreign currency translation methods affect financial statements of listed multinational companies in Nigeria. The results showed that both the current rate method and the temporal rate method had a positive and significant effect on the financial statements, while the functional currency method had a negative and insignificant impact. These findings emphasize the crucial role of choosing the right foreign currency translation method in influencing the financial performance of multinational companies in Nigeria. Specifically, adopting the current rate method and the temporal rate method is linked to improved financial outcomes, whereas the functional currency method does not have a significant effect on financial statements. This highlights the importance of selecting an appropriate translation method to enhance the accuracy of financial reporting and support better decision-making.

Based on the results of the study, the following recommendations can be made:

i. Multinational companies in Nigeria should consider adopting either the current rate method or the temporal rate method for currency translation to optimize financial performance.

ii. Further research should be conducted to explore the reasons behind the insignificant impact of the functional currency method and identify potential strategies to mitigate its negative effects.

iii. Regulatory authorities should provide clear guidelines and standards regarding the selection and application of foreign currency translation methods to promote consistency and comparability in financial reporting.

This study adds to the existing literature by offering empirical evidence on the effect of different foreign currency translation methods on the financial statements of listed multinational companies in Nigeria. The findings offer insights into the importance of currency translation decisions and their implications for financial reporting and decision-making. Additionally, the study enhances understanding of the factors influencing financial performance in a multinational context, thereby informing both academic research and practical applications in the field of international accounting and finance.

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