

Financial reporting developments  
*A comprehensive guide*

# Foreign currency matters

June 2023

# To our clients and other friends

The world's economies have become increasingly interdependent since the guidance on accounting for foreign currency matters was initially issued over 40 years ago. World markets, including the trade of commodities and services and the flow of international capital, continue to become more integrated. Since the guidance on foreign currency matters was issued, more and more companies have discovered that to stay competitive and keep their companies growing, they must compete on a global level.

Companies operating internationally must address a number of financial reporting issues, including determining the appropriate functional currencies, accounting for foreign currency transactions and converting the financial statements of their subsidiaries into the parent company's currency for them to be consolidated, among others.

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (ASC or Codification), interpretive guidance and examples. Guidance on accounting for foreign currency-related derivatives and hedging activities, the effects of foreign currency matters on the presentation of the statement of cash flows and the accounting for income taxes can be found in our separate Financial reporting developments (FRD) publications.

We hope this publication will help you understand and apply the accounting for foreign currency matters. EY professionals are prepared to assist you in your understanding and are ready to discuss your particular concerns and questions.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

June 2023

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**Notice to readers:**

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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# 1 Overview

## 1.1 Introduction

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Overall

##### *Objectives*

##### **830-10-10-1**

Financial statements are intended to present information in financial terms about the performance, financial position, and cash flows of a **reporting entity**. For this purpose, the financial statements of separate entities within a reporting entity, which may exist and operate in different economic and currency environments, are consolidated and presented as though they were the financial statements of a single reporting entity. Because it is not possible to combine, add, or subtract measurements expressed in different currencies, it is necessary to translate into a single **reporting currency** those assets, liabilities, revenues, expenses, gains, and losses that are measured or denominated in a **foreign currency**. Paragraph 830-10-55-1 discusses the meaning of measurement in a foreign currency.

##### **830-10-10-2**

The unity presented by such **translation** does not alter the underlying significance of the results and relationships of the constituent parts of the reporting entity. It is only through the effective operation of its constituent parts that the reporting entity as a whole is able to achieve its purpose. Accordingly, the translation of the financial statements of each component entity of a reporting entity should accomplish both of the following objectives:

- a. Provide information that is generally compatible with the expected economic effects of a rate change on a reporting entity's cash flows and equity
- b. Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. generally accepted accounting principles (GAAP).

##### *Implementation Guidance and Illustrations*

##### **830-10-55-1**

To measure in **foreign currency** is to quantify an **attribute** of an item in a unit of currency other than the **reporting currency**. Assets and liabilities are denominated in a foreign currency if their amounts are fixed in terms of that foreign currency regardless of **exchange rate** changes. An asset or liability may be both measured and denominated in one currency, or it may be measured in one currency and denominated in another.

### 1.1.1 Overview of accounting models

ASC 830, *Foreign Currency Matters*, provides the accounting and reporting requirements for foreign currency transactions and the translation of financial statements from a foreign currency to the reporting currency. ASC 830 also applies to the translation of financial statements for purposes of consolidation, combination or the equity method of accounting.

The first step in the translation process is to identify the functional currency (refer to section 2.1, *Determining the functional currency*, for further guidance) for each entity included in the financial statements of the reporting entity. An entity's functional currency might be the currency of the country in which the entity is located (the local currency or LC), the reporting currency of the entity's parent or the currency of another country.

### 1.1.2 Foreign currency transactions and remeasurement

Once the functional currency of an entity is identified, the account balances that are not denominated in the entity's functional currency should then be remeasured into its functional currency by applying ASC 830's requirements of accounting for foreign currency transactions.

These transactions may be (1) purchases or sales of goods or services where prices are stated in a foreign currency or (2) loans payable or receivable in a foreign currency, among others. If the entity's accounting records are maintained in the local foreign currency, and its functional currency is something other than its local currency (e.g., the reporting currency of its parent), the entity's accounting records should be remeasured into its functional currency.

For example, if a Mexican entity's accounting records are maintained in Mexican pesos but its functional currency is US dollars (USD), the Mexican entity's accounting records should be remeasured from Mexican pesos to USD. The remeasurement process should produce the same result as if the entity's accounting records had been maintained in the functional currency. Adjustments resulting from the remeasurement process are generally recorded in net income.

### 1.1.3 Translation of foreign currency financial statements

After the remeasurement process is complete and the entity's financial statements are stated in its functional currency, the entity's financial statements are translated to the reporting currency of its parent using the current rate method (refer to section 4, *Translation of financial statements*, for further guidance). Resulting translation adjustments are recorded in a separate component of stockholders' equity. If the entity's functional currency is the reporting currency, translation from the functional currency to the reporting currency is not necessary.

### 1.1.4 Difference between remeasurement and translation

There is an important distinction in ASC 830 between remeasurement and translation. Remeasurement is a process to measure financial statement amounts that are denominated or stated in another currency into the functional currency of the reporting entity. Translation is the process used for expressing the financial results of a separate entity so that it may be included in the parent entity's consolidated financial statements when the separate entity's functional currency is different from that of the parent. Remeasurement affects earnings and translation affects equity.

With respect to the first objective under ASC 830-10-10-2, when a given entity's functional currency is the same as the reporting currency of its parent (e.g., the USD for the US parent), there is a presumption that the effect of exchange rate changes on the entity's foreign-denominated individual monetary assets and liabilities will directly affect the reporting entity's cash flows. Therefore, the adjustments that result from the remeasurement of monetary assets and liabilities denominated in a currency other than its functional currency are generally recorded directly in net income. However, when the entity's local currency is the functional currency, exchange rate changes do not directly affect the parent entity's cash flows. Rather, such changes affect the entity's net assets and, hence, the parent entity's net investment in the entity. Accordingly, the effect of exchange rate changes is reported in equity in such cases.

The second overall objective of ASC 830-10-10-2 is satisfied because the translation process does not change the functional currency measurements of the individual consolidated entities. Mechanically, this result occurs because functional currency amounts are multiplied by a constant, current exchange rate between the functional currency and the reporting currency. Thus, the translated financial statements retain functional currency financial relationships such as gross margin percent and working capital ratio. Further, if the functional currency financial statements reflect a profit, the translated financial statements retain that result.

## 1.2 Key definitions

### 1.2.1 Foreign currency and foreign currency statements

The definitions of foreign currency and foreign currency financial statements are straightforward. A foreign currency is a currency other than the functional currency of the entity being referred to. For example, for a Japanese entity that determines the Japanese yen is its functional currency, any currency other than Japanese yen would be considered a foreign currency. Similarly, foreign currency statements are financial statements that employ as the unit of measure a functional currency that is not the reporting currency of the reporting entity. For example, a US parent (i.e., the reporting entity) may have USD as its reporting currency while the functional currency of its French subsidiary is the euro. The financial statements of the French subsidiary that uses euro as the unit of measure would be considered foreign currency statements to the reporting entity.

### 1.2.2 Foreign entity and reporting entity

#### Foreign entity

ASC 830 defines a foreign entity as an operation (e.g., subsidiary, division, branch, joint venture, etc.) whose financial statements are both (a) prepared in a currency other than the reporting currency of the reporting entity and (b) combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.

An entity might have more than one distinct and separable operation that may be considered a separate foreign entity with a different functional currency if those operations are conducted in different economic environments. Refer to section 2.1.1, *Distinct and separable operation*, for further guidance on distinct and separable operations.

An operation that is distinct and separable has characteristics such as assets, liabilities, revenues and expenses that are segregated from those of other operations, as well as goods and services that are managed separately from other goods and services. In theory, a formal business plan exists for the operation and a separate management team is in place to conduct its business. In addition, management should be capable of producing standalone financial statements for the operation. In other words, the entity should have the appropriate recordkeeping and financial reporting systems and processes so that it could prepare financial statements.

Appropriately identifying foreign entities within an organization is essential in determining the functional currencies of those foreign entities. Refer to section 2.1, *Determining the functional currency*, for further guidance.

#### Reporting entity

A reporting entity is an entity or group whose financial statements are being referred to. As an example, a reporting entity may be a standalone US entity. A reporting entity may also be a US entity that is a parent of various consolidated subsidiaries and reports its financial statements on a consolidated basis.

## 1.3 Scope and scope exceptions

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Overall

#### *Scope and Scope Exceptions*

#### *830-10-15-1*

The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the **Foreign Currency Matters** Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Foreign Currency Matters Topic.



**830-10-15-2**

The guidance in the Foreign Currency Matters Topic applies to all entities.

**830-10-15-3**

The guidance in the Foreign Currency Matters Topic applies to all **foreign currency transactions** in financial statements of a **reporting entity** and all **foreign currency statements** that are incorporated in the financial statements of a reporting entity by consolidation, combination, or the equity method of accounting.

**830-10-15-4**

For convenience, this Topic assumes that the reporting entity uses the U.S. dollar as its reporting currency. However, a currency other than the U.S. dollar may be the **reporting currency** in financial statements that are prepared in conformity with U.S. generally accepted accounting principles (GAAP). For example, a **foreign entity** may report in its **local currency** in conformity with U.S. GAAP. If so, the requirements of this Topic apply.

**830-10-15-5**

The **functional currency** approach applies equally to **translation** of financial statements of foreign investees whether accounted for by the equity method or consolidated. Therefore, the foreign currency statements and the foreign currency transactions of an investee that are accounted for by the equity method shall be translated in conformity with the requirements of this Topic in applying the equity method.

**830-10-15-6**

The functional currency approach also applies to translation after a business combination or a combination accounted for by a **not-for-profit entity**. See paragraph 830-30-45-11 for guidance.

**830-10-15-7**

Translation of financial statements from one currency to another for purposes other than consolidation, combination, or the equity method is beyond the scope of this Topic. For example, this Topic does not cover translation of the financial statements of a reporting entity from its reporting currency into another currency for the convenience of readers accustomed to that other currency.

**Foreign Currency Matters – Foreign Currency Transactions*****Scope and Scope Exceptions*****830-20-15-2**

The guidance in this Subtopic applies to all **foreign currency transactions** with the exception of the following:

- a. Derivative instruments, for guidance see Topic 815.

ASC 830 applies to the financial statements of all entities prepared in conformity with US GAAP, whether the USD or a foreign currency is the reporting currency. For example, a Japanese entity whose reporting currency is the Japanese yen but reports in conformity with US GAAP should follow the requirements of ASC 830.

Pursuant to ASC 830-10-15-7, ASC 830 does not apply to translation of financial statements for purposes other than consolidation, combination or the equity method. For example, it does not establish standards for translating the financial statements of an entity from its reporting currency into another currency for the convenience of readers accustomed to that other currency.



### FASB proposal

In U.S. Securities and Exchange Commission (SEC) Release No. 33-10532, *Disclosure Update and Simplification*, the SEC referred certain of its disclosure requirements that overlap with, but require incremental information to, generally accepted accounting principles (GAAP) to the FASB for potential incorporation into the Codification. In May 2019, the FASB proposed amendments as a result of its considerations of those referred disclosures. The proposed Accounting Standards Update (ASU) would amend the scope of ASC 830 by amending ASC 830-10-15-3 and ASC 830-10-15-7 to clarify the applicability of the translation provisions to a reporting entity that reports its financial statements in a currency other than its functional currency. Under the proposal, the application of the translation provisions of ASC 830 will not be limited for purposes of consolidation, combination, or the equity method. We encourage readers to monitor developments in this area.

Additionally, pursuant to ASC 830-20-15-2(a), ASC 830 does not apply to transactions involving derivative instruments. See ASC 815, *Derivatives and Hedging*, and our Financial reporting developments (FRD) publication, *Derivatives and hedging*, for guidance.

## 1.3.1

### Equity method investees

Pursuant to ASC 830-10-15-5, foreign currency financial statements of a foreign investee accounted for by the equity method should be translated to the reporting currency in the same manner as the financial statements of a consolidated foreign investee.

First, the functional currency of the equity method investee should be determined and transactions denominated in currencies other than its functional currency should be remeasured. Then, if the functional currency of the equity method investee is different from the reporting currency of the equity method investor, the financial statements of the investee should be translated into the reporting currency at the current rate before determining the balance of the investor's equity investment.

The portion of the investor's equity investment in the investee that pertains to the separate component of stockholders' equity (i.e., equity adjustment from translation) should be allocated to that account in the investor's financial statements as shown below.

#### Illustration 1-1: Equity method investments (translation)

A US company owns 30% of a company located in Japan. The financial statements of the investee are translated into USD under the current rate method. The following are relevant details before and after translation (for simplicity, basis differences, intra-entity transactions and income tax effects are ignored):

	Stockholders' equity – Investee's balance sheet (Exchange rate: \$1 = ¥100)		
	Beginning of year		End of year
	Prior to translation	After translation	
Common stock	¥ 30,000,000	\$ 300,000	\$ 300,000
Paid-in capital	15,000,000	150,000	150,000
Retained earnings	60,000,000	600,000	900,000 <sup>(A)</sup>
AOCI from translation	–	250,000	450,000 <sup>(B)</sup>
	¥ 105,000,000	\$ 1,300,000	\$ 1,800,000

<sup>(A)</sup> Assumes \$300,000 of net income for the year.

<sup>(B)</sup> Assumes \$200,000 of equity adjustment from translation for the year.

The US company's equity method investment in the foreign investee at the beginning of the year is \$390,000 (or 30% x \$1,300,000), of which \$75,000 (or 30% x \$250,000) relates to accumulated other comprehensive income (AOCI) from translating the financial statements of the foreign investee in prior years.

To record its equity method earnings and other comprehensive income (OCI) at the end of the year, the US company would make the following entry:

	<u>Debit</u>	<u>Credit</u>
<b>Equity method investment in foreign entity</b>		
30% x (\$1,800,000 – \$1,300,000) <sup>(C)</sup>	\$ 150,000	
<b>Equity method income of foreign investee</b>		
30% x \$300,000 <sup>(A)</sup>		\$ 90,000
<b>Equity method adjustment from translation</b>		
30% x (\$450,000 – \$250,000) <sup>(D)</sup>		60,000
	<u>\$ 150,000</u>	<u>\$ 150,000</u>

<sup>(C)</sup> This represents the investor's equity interest in the change in the shareholders' equity of the investee after translation.

<sup>(D)</sup> This represents the investor's equity interest in the change in accumulated translation adjustment attributed to the foreign entity's translated financial statements.

# 2 Functional currency and exchange rates

## 2.1 Determining the functional currency

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Overall

#### *Other Presentation Matters*

#### **830-10-45-2**

The assets, liabilities, and operations of a foreign entity shall be measured using the functional currency of that entity. An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash.

#### **830-10-45-3**

It is neither possible nor desirable to provide unequivocal criteria to identify the functional currency of foreign entities under all possible facts and circumstances and still fulfill the objectives of **foreign currency translation**. Arbitrary rules that might dictate the identification of the functional currency in each case would accomplish a degree of superficial uniformity but, in the process, might diminish the relevance and reliability of the resulting information.

#### **830-10-45-4**

Multinational reporting entities may consist of entities operating in a number of economic environments and dealing in a number of foreign currencies. All foreign operations are not alike. To fulfill the objectives in paragraph 830-10-10-2, it is necessary to recognize at least two broad classes of foreign operations:

- a. In the first class are foreign operations that are relatively self-contained and integrated within a particular country or economic environment. The day-to-day operations are not dependent on the economic environment of the parent's functional currency; the foreign operation primarily generates and expends foreign currency. The **foreign currency** net cash flows that it generates may be reinvested or converted and distributed to the parent. For this class, the foreign currency is the functional currency.
- b. In the second class are foreign operations that are primarily a direct and integral component or extension of the parent entity's operations. Significant assets may be acquired from the parent entity or otherwise by expending dollars and, similarly, the sale of assets may generate dollars that are available to the parent. Financing is primarily by the parent or otherwise from dollar sources. In other words, the day-to-day operations are dependent on the economic environment of the parent's currency, and the changes in the foreign entity's individual assets and liabilities impact directly on the cash flows of the parent entity in the parent's currency. For this class, the dollar is the functional currency.

#### **830-10-45-6**

The functional currency of an entity is, in principle, a matter of fact. In some cases, the facts will clearly identify the functional currency; in other cases they will not. For example, if a foreign entity conducts significant amounts of business in two or more currencies, the functional currency might not be clearly identifiable. In those instances, the economic facts and circumstances pertaining to a particular foreign operation shall be assessed in relation to the stated objectives for foreign currency translation (see paragraphs 830-10-10-1 through 10-2). Management's judgment will be required to determine the functional currency in which financial results and relationships are measured with the greatest degree of relevance and reliability.

Determining the functional currency is important because ASC 830's remeasurement and translation provisions are both based on the functional currency of the entity.

Pursuant to ASC 830-10-45-2, an entity's functional currency is the currency of the primary economic environment in which the entity operates. It is normally the currency of the environment in which an entity primarily generates and expends cash. Recognizing that all foreign operations are not alike, ASC 830-10-45-4 discusses two broad classes of foreign operations to assist reporting enterprises in identifying the functional currency.

Foreign operations that fall into the first class are those that are relatively self-contained and integrated within a particular country or economic environment. The daily operations of the foreign entity are independent from the economic environment of the parent's functional currency. The foreign operation's cash flows are primarily received and paid in a foreign currency and do not directly affect the parent's cash flows. The foreign currency is the functional currency for this foreign operation.

Foreign operations in the second class are primarily a direct extension or integral component of the parent company's operations. The foreign operation's cash flows are primarily in the parent company's functional currency. Its daily operations are integrated with its parent and the foreign entity's cash flows directly affect the cash flows of the parent. For this class of foreign operations, ASC 830-10-45-4 states that the parent's functional currency is the functional currency of the foreign operations.

While ASC 830 states that, in principle, the functional currency is essentially a matter of fact, many foreign operations will not fit neatly into either of the two classes discussed above. For example, the foreign entity might conduct significant amounts of business in two or more currencies, or the foreign entity might complete the manufacturing process for parent-produced sub-assemblies and sell some products in its country and others in the parent country.

As the facts become more varied and complex, determining the functional currency becomes increasingly difficult. In those cases, management's judgment will be required and crucial in properly determining the appropriate functional currency. As ASC 830-10-55-4 indicates, management's judgment is essential and paramount in determining the functional currency, provided only that it is not contradicted by the facts.

To assist in determining the functional currency, ASC 830-10-55-5 identifies six economic factors for management to consider, which are listed in Illustration 2-1. There is no hierarchy among the indicators, and management will have to decide which of the factors is most important for a given foreign entity.

In addition, an entity should give greater weight to long-term considerations rather than short-term considerations in determining the functional currency. That is because an entity's functional currency should not be changed unless sufficient evidence exists to indicate significant changes in economic facts and circumstances (refer to section 2.2, *Changing the functional currency*, for further guidance).

Because the application of ASC 830's remeasurement and translation provisions is based on the appropriate determination of the functional currency, we believe an entity should clearly document how it reached the decision about its functional currency. This documentation should include, for example, an identification of the important economic factors listed in Illustration 2-1 that an entity considered in determining its functional currency.

**Illustration 2-1: Factors in determining the functional currency**

ASC 830-10-55-5 states the following economic factors, and possibly others, should be considered both individually and collectively when determining the functional currency:

*Cash flow indicators*

1. Foreign currency. Cash flows related to the foreign entity's individual assets and liabilities are primarily in the foreign currency and do not directly affect the parent entity's cash flows.
2. Parent's currency. Cash flows related to the foreign entity's individual assets and liabilities directly affect the parent's cash flows currently and are readily available for remittance to the parent entity.

*Sales price indicators*

1. Foreign currency. Sales prices for the foreign entity's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.
2. Parent's currency. Sales prices for the foreign entity's products are primarily responsive on a short-term basis to changes in exchange rates; for example, sales prices are determined more by worldwide competition or by international prices.

*Sales market indicators*

1. Foreign currency. There is an active local sales market for the foreign entity's products, although there also might be significant amounts of exports.
2. Parent's currency. The sales market is mostly in the parent's country or sales contracts are denominated in the parent's currency.

*Expense indicators*

1. Foreign currency. Labor, materials, and other costs for the foreign entity's products or services are primarily local costs, even though there also might be imports from other countries.
2. Parent's currency. Labor, materials, and other costs for the foreign entity's products or services continually are primarily costs for components obtained from the country in which the parent entity is located.

*Financing indicators*

1. Foreign currency. Financing is primarily denominated in foreign currency, and funds generated by the foreign entity's operations are sufficient to service existing and normally expected debt obligations.
2. Parent's currency. Financing is primarily from the parent or other dollar-denominated obligations, or funds generated by the foreign entity's operations are not sufficient to service existing and normally expected debt obligations without the infusion of additional funds from the parent entity. Infusion of additional funds from the parent entity for expansion is not a factor, provided funds generated by the foreign entity's expanded operations are expected to be sufficient to service that additional financing.

*Intra-entity transactions and arrangements indicators*

1. Foreign currency. There is a low volume of intra-entity transactions and there is not an extensive interrelationship between the operations of the foreign entity and the parent entity. However, the foreign entity's operations may rely on the parent's or affiliates' competitive advantages, such as patents and trademarks.
2. Parent's currency. There is a high volume of intra-entity transactions and there is an extensive interrelationship between the operations of the foreign entity and the parent entity. Additionally, the parent's currency generally would be the functional currency if the foreign entity is a device or shell corporation for holding investments, obligations, intangible assets, and so forth, that could readily be carried on the parent's or an affiliate's books.

Illustration 2-2 provides examples of situations in which the functional currency of a foreign operation might be the same as that of its parent.

**Illustration 2-2: Examples where the functional currency of a foreign operation might be the same as that of its parent**

1. A foreign sales branch or subsidiary of a US manufacturer that (a) primarily takes orders from foreign customers for US manufactured goods, (b) bills and collects from foreign customers in USD and (c) might have a warehouse to provide for timely delivery of the product to those foreign customers (in substance, this foreign operation may be the same as the export sales department of a US manufacturer)
2. A foreign division, branch or subsidiary that primarily manufactures a sub-assembly that is shipped to a US plant for inclusion in a product that is sold to customers located in the US
3. A foreign shipping subsidiary that primarily transports from a US company's foreign mines to the US for processing in US company's smelting plants
4. A foreign subsidiary that is primarily a conduit for Eurodollar borrowings to finance operations in the US

**Illustration 2-3: Functional currency of an intermediate treasury operation – an extension of the parent**

A US parent with USD functional currency sets up a foreign operation in Germany to carry out the treasury functions in euros for its European operations. All European operations are wholly owned subsidiaries of the US parent, and the US parent funded the foreign operation with euro-denominated equity. All the funding made by the foreign operation to the various European operations is sourced from this euro-denominated equity, and the foreign operation does not enter into any borrowings in the local market. The US parent controls the level of funding made by the foreign operation to the various European operations on a daily basis and may contribute more euros in the form of equity, if necessary, or request that excess euros be returned as a dividend to the US parent.

ASC 830-10-55-5(f)(2) states that "the parent's currency generally would be the functional currency if the foreign entity is a device or shell corporation for holding investments, obligations, intangible assets, and so forth, that could readily be carried on the parent's or an affiliate's books." In this example, the US parent controls the daily activities of the foreign operation in Germany (i.e., euro-denominated funding to various European operations), and the only source of funding comes from the euro-denominated equity contributed by the US parent.

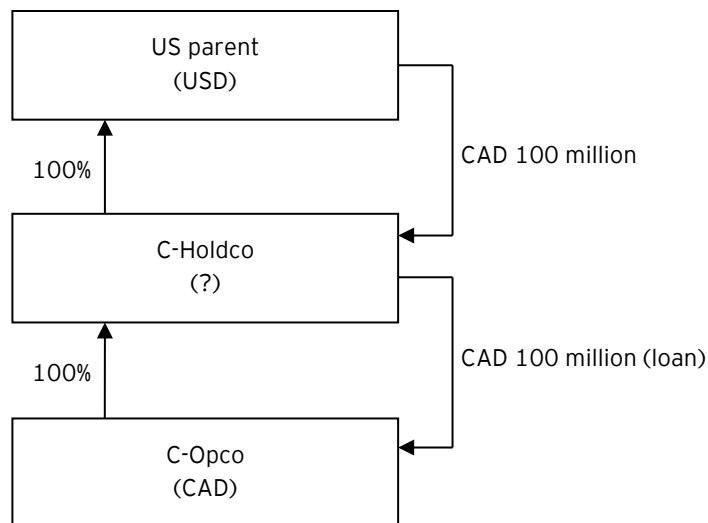
Since the US parent could readily carry out the euro-denominated treasury function itself rather than through a foreign operation it has set up in Germany, the foreign operation in Germany is considered an extension of the parent, and its functional currency would be that of its parent (i.e., USD).

ASC 830-10-55-7 clarifies that a foreign operation's functional currency is not necessarily that of its parent solely because the parent controls it, or in the case of an equity method investee, exercises significant influence over it. Furthermore, the parent's currency may be used in various decision-making processes by management. However, neither of these factors determines, per se, that the parent's currency is the functional currency for the foreign operation. Rather, the foreign operation's functional currency should be based on the economic factors described in Illustration 2-1.

The functional currency could also be that of another foreign country. For example, a British subsidiary of a US parent may designate the euro as its functional currency, based on an analysis of the factors in ASC 830-10-55-5. In that case, the entity's accounting records, if maintained in the local currency, would be first remeasured from UK pound sterling into euro (its functional currency) with an adjustment to net income and then translated to USD with an adjustment to stockholders' equity.

#### Illustration 2-4: Functional currency of an intermediate holding company

A US parent with USD functional currency establishes a Canadian holding company (C-Holdco) and finances it entirely with share capital in the amount of \$100 million Canadian dollars (CAD). C-Holdco in turn owns 100% of a Canadian operating company (C-Opco) whose functional currency is Canadian dollars. C-Holdco loans \$100 million Canadian dollars to C-Opco. There are no routine or recurring transactions between the US parent and C-Opco. What is the functional currency of C-Holdco?

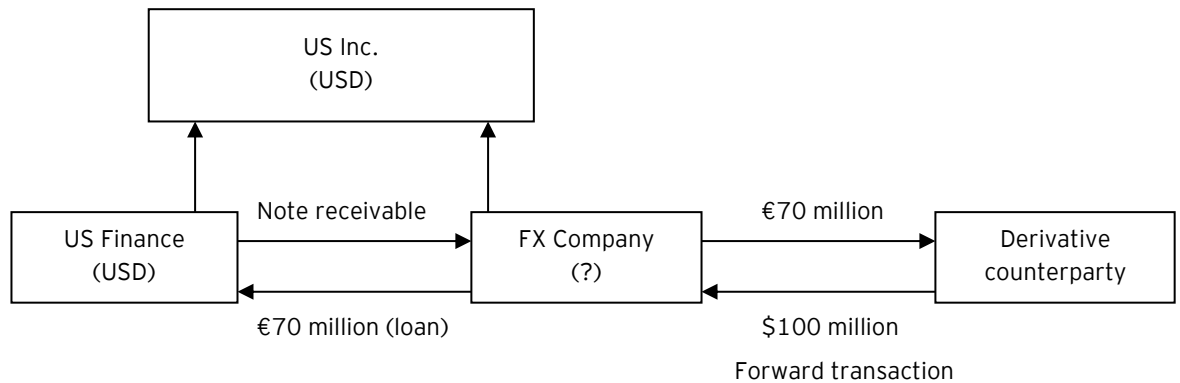


The functional currency of an intermediate holding company is most often the same functional currency as its parent. In the above scenario, C-Holdco is not functioning in any role in which its US parent itself could not function. That is, the US parent could have converted USD into Canadian dollars and loaned them directly to C-Opco. Accordingly, C-Holdco should generally be considered to be an extension of the US parent's operations and C-Holdco's functional currency should be the same as that of its parent, USD.



**Illustration 2-5: Functional currency of a limited-purpose wholly owned subsidiary**

US Inc., with USD functional currency, establishes a wholly owned foreign subsidiary (FX Company). US Inc. capitalizes FX Company with \$100 million USD. The sole purpose of the FX Company is to enter into a financing arrangement with US Inc.'s finance company (US Finance). FX Company enters into a note receivable agreement with US Finance, and loans 70 million euro to US Finance (i.e., the note is denominated in euro). Concurrently, FX Company enters into a foreign currency forward transaction to sell 70 million euro for USD at the note's maturity date. Through this foreign currency hedge transaction, FX Company effectively hedges its currency exposure on the eventual repayment of the euro-denominated note receivable from US Finance. FX Company does not enter into any other transactions. What is the functional currency of the FX Company?



FX Company's net foreign currency exposure is entirely oriented to USD through the execution of the foreign currency forward transaction (that is, on a net basis, FX Company is not exposed to the exchange rate fluctuations of the euro). Furthermore, FX Company's capitalization is entirely in USD through its parent (US Inc.), and US Inc. could have easily carried out the same financing arrangement with US Finance on its own. Therefore, FX Company should be considered an extension of its parent (US Inc.) and pursuant to ASC 830-10-45-4(b), the functional currency of FX Company is USD.

## 2.1.1

**Distinct and separable operation****Excerpt from Accounting Standards Codification****Foreign Currency Matters – Overall****Other Presentation Matters****830-10-45-5**

An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

**Implementation Guidance and Illustrations****830-10-55-6**

In some instances, a foreign entity might have more than one distinct and separable operation. For example, a foreign entity might have one operation that sells parent-entity-produced products and another operation that manufactures and sells foreign-entity-produced products. If they are conducted in different economic environments, those two operations might have different functional currencies. Similarly, a single subsidiary of a financial institution might have relatively self-contained and integrated operations in each of several different countries. In those circumstances, each operation may be considered to be an entity as that term is used in this Subtopic, and, based on the facts and circumstances, each operation might have a different functional currency.

The functional currency determination is not necessarily made on a legal entity basis. In cases where a company's economic factors indicate that it conducts its operations in more than one economic environment and one functional currency, each operation may be considered a "foreign entity" with a different functional currency for purposes of applying ASC 830. When determining whether an operation is distinct and separable, entities should consider whether the operation manages its own activities, assets and liabilities so that it can produce meaningful standalone financial statements and whether these activities, assets and liabilities are clearly distinguishable from other operations.

Based on the Research Report issued by the FASB in 1986 in connection with the issuance of Statement of Financial Accounting Standards No. 52 (FAS 52), *Foreign Currency Translation* (now codified in ASC 830), the most common reason given to justify this practice (i.e., splitting a foreign entity into two or more functional currencies) was that a segment of a foreign entity dealt primarily with a third country or the US parent, resulting in the selection of the third country's currency or the US dollar as the functional currency for that segment, whereas the local currency was selected as the functional currency for the foreign entity's other operations.

While ASC 830 provides that a single entity may have more than one operation with different functional currencies, it does not require accounting records to be disaggregated for purposes of applying its provisions. It simply may not be practical for the entity to account for its operations in more than one functional currency. In that case, management should identify the currency of the economic environment that most clearly reflects the entity's financial results and relationships.

Refer to section 1.2.2, *Foreign entity and reporting entity*, for further guidance on the definition of a foreign entity and related interpretive guidance.

#### **Illustration 2-6: Entity with more than one functional currency**

A division within a Mexican subsidiary of a US parent carries out the headquarters operations of its US parent (e.g., acts as a distribution center for its US parent-sourced products). Another division within the same Mexican subsidiary is self-supported and manufactures and sells locally produced products to its Mexican consumers.

Because the economic factors indicate that the division that carries out the headquarters operations of its US parent and the division that caters to the local market conduct their operations in more than one economic environment, this Mexican subsidiary consists of two distinct and separable operations for the purposes of determining the functional currencies (i.e., dual functional currency). The division that carries out the headquarters operation of its US parent would have the USD as its functional currency while the division that caters to the local market would have the Mexican peso as its functional currency.

#### **Illustration 2-7: Functional currency after the merger of foreign subsidiaries**

ABC Holdings is domiciled in Bermuda and has three subsidiaries: ABC Bermuda Ltd. (domiciled in Bermuda); ABC Europe GmbH; and its subsidiary, ABC Service GmbH (both domiciled in Germany). The functional currency of ABC Bermuda Ltd. is USD, and the functional currencies of the two subsidiaries in Germany are the euro.

During 20X0, ABC Europe GmbH was re-domiciled and merged into ABC Bermuda Ltd. for tax reasons, and ABC Service GmbH became a subsidiary of ABC Bermuda Ltd. However, there were no substantive changes in the way ABC Bermuda Ltd., ABC Europe GmbH and ABC Service GmbH each operate. The operations in Germany continue to be managed by ABC Service GmbH, and major transactions continue to be denominated in euro.

Since there have been no substantial changes to the ways in which ABC Europe GmbH operates after being merged into ABC Bermuda Ltd., we believe that the operations of ABC Europe GmbH would constitute a “distinct and separable operation” within ABC Bermuda Ltd. and the functional currency of the European operations would continue to be the euro, assuming that management continues to have the ability to produce separate financial statements for the operations of ABC Europe GmbH and its assets, liabilities, revenues and expenses are segregated from those of ABC Bermuda Ltd. Accordingly, ABC Bermuda Ltd. would be considered to have more than one functional currency because its non-ABC Europe GmbH operations would continue to have USD as its functional currency.

#### **Illustration 2-8: Functional currency of a branch office with a treasury function**

A London branch of Europe Bank (functional currency is UK pound sterling) takes deposits in a variety of foreign currencies (e.g., Japanese yen, euro and USD). Instead of managing the currency risks on a net basis, London branch’s treasury group manages its various currency risks by each currency (e.g., invests euro deposits into euro assets). Although the London branch does not establish separate legal entities for each currency, specific personnel within the treasury group are assigned to manage a specific currency, and the London branch prepares separate income statement ledgers for each treasury function by currency.

Each of the separate treasury functions by currency within the London branch’s treasury group would not be considered a “distinct and separable operation.” While separate income statement ledgers may be prepared for each of the treasury functions by currency, the overriding activity of each of the treasury functions is to manage the overall foreign currency risk of the London branch relative to the UK pound sterling. Furthermore, the nature of the activity that each treasury function by currency performs is the same; each invests deposits into like-currency assets.

#### **Illustration 2-9: Ability to disaggregate an entity into more than one foreign entity**

A US company (USD functional currency) has insurance operations in the US and a branch in Japan (Japanese yen functional currency). Within the Japanese branch, the US company maintains an investment portfolio of USD-denominated securities on behalf of the US operations (i.e., the investment portfolio held by the Japanese branch is funded by the US operations). Although the US company’s management views the investment portfolio held by the Japanese branch as an extension of the US operations’ treasury/investment function, the investment portfolio rolls up into the local Japanese branch statutory filing and is maintained by the Japanese branch.

We generally do not believe the functional currency can be determined at a level lower than the Japanese branch in the above scenario (i.e., at the investment portfolio basis). Although the USD-denominated investment portfolio may be funded by the US operations, it still rolls up into the Japanese branch statutory filing and is maintained by the Japanese branch. Therefore, the USD-denominated investment portfolio does not constitute a “distinct and separable operation.”

## 2.1.2

### **Functional currency of an equity method investee**

Pursuant to ASC 830-10-55-7, the functional currency of an equity method investee should not be based solely on the functional currency of the equity method investor. Instead, the functional currency of an equity method investee should be evaluated in the same manner as that of a consolidated entity, considering the economic factors provided in ASC 830-10-55-5, which are included in Illustration 2-1.

## 2.2

## Changing the functional currency

**Excerpt from Accounting Standards Codification****Foreign Currency Matters – Overall***Other Presentation Matters***830-10-45-7**

Once the functional currency for a foreign entity is determined, that determination shall be used consistently unless significant changes in economic facts and circumstances indicate clearly that the **functional currency** has changed. Previously issued financial statements shall not be restated for any change in the functional currency.

**830-10-45-8**

See paragraph 250-10-45-1 for guidance on adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring. Paragraphs 830-10-45-15 through 45-16 discuss changes related to highly inflationary economies.

**830-10-45-9**

If the functional currency changes from the **reporting currency** to a foreign currency, the adjustment attributable to current-rate translation of nonmonetary assets as of the date of the change shall be reported in other comprehensive income.

**830-10-45-10**

If the functional currency changes from a foreign currency to the reporting currency, **translation adjustments** for prior periods shall not be removed from equity and the translated amounts for nonmonetary assets at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods. This guidance shall be used also to account for a change in functional currency from the foreign currency to the reporting currency when an economy becomes highly inflationary.

An entity's functional currency should be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. ASC 830 does not provide guidance on identifying significant changes in economic facts and circumstances. We believe changes in economic facts and circumstances that are deemed "significant" are infrequent, and a resulting change in functional currency is rare.

Situations that may necessitate the functional currency to change include:

- ▶ A foreign entity that sells only parent-produced products assumes all manufacturing functions itself.
- ▶ A foreign entity that sells its products only to its parent establishes a significant local sales market for those products.
- ▶ The currency mix of the revenue for a given foreign entity changes. For example, assume a Mexican operation started up in 20X0 and its long-term plans indicated that the Mexican peso would be the functional currency. However, in 20X1, management decided that the Mexican operation would sell its products and incur its expenses primarily in the USD. In this scenario, the functional currency of the Mexican operation would change from Mexican peso to USD.
- ▶ An entity with predominantly USD-based revenue changes to predominantly euro-based revenue due to the shift in targeted consumer groups.

## 2.2.1 SEC staff views

The Securities and Exchange Commission (SEC) staff has stated that registrants with foreign operations that have experienced economic turmoil should evaluate whether significant changes in economic facts and circumstances have occurred to warrant reconsideration of the operation's functional currency. This evaluation should focus on factors that adversely affect the cash flows of a self-contained foreign operation, and not cash flows of a foreign operation that is an integral component or extension of the parent company's operations. The SEC staff generally will be skeptical that currency exchange rate fluctuations alone would cause a self-contained foreign operation to become an extension of the parent company.

The SEC staff also observed that while ASC 830 does not provide specific disclosures about a change in functional currency, disclosures in the financial statements and management's discussion and analysis may be necessary to permit an investor to understand the foreign operations and their effect on the registrant's results of operations, liquidity and cash flows.<sup>1</sup>

## 2.2.2 Change in functional currency due to significant changes in facts

While ASC 830 does not provide specific guidance on how to identify a significant change in economic facts and circumstances, ASC 250-10-45-1 provides that the adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is not an accounting change. Thus, functional currency changes caused by significant changes in facts and circumstances should not be accounted for or reported as a change in accounting principle.

### Illustration 2-10: Change in functional currency

Company A established a foreign subsidiary that functions as a local manufacturer of the Company A's products. All the manufacturing and distribution costs are incurred in the country where the subsidiary is incorporated, and all sales are made in the local market. The foreign subsidiary is viewed as a profit center, and most of the earnings are retained locally. As a result, management of Company A determines that the functional currency of the subsidiary is its local currency.

After five years of the foreign subsidiary's operation, Company A decides to restructure its manufacturing facilities such that the subsidiary will no longer locally manufacture Company A's products. Instead, it will act as a foreign sales and marketing office, and, therefore, no material, labor or other manufacturing costs will be incurred locally. The inventory to be sold will be sourced from the parent company in US dollars, and any earnings will be remitted back to the parent at the end of the period. Any local sale, marketing and distribution costs will be financed by the parent.

These changes in the nature of the foreign subsidiary's operations indicate a different set of economic facts and circumstances. Management of Company A should perform an analysis to determine whether the foreign subsidiary's functional currency remains appropriate or requires a change.

## 2.2.3 Change from reporting currency to foreign currency

ASC 830-10-45-9 does not apply to circumstances in which the functional currency changes from the reporting currency to a foreign currency because the economy ceases to be considered highly inflationary. Instead, ASC 830-10-45-15 should be followed in such a circumstance. Refer to section 5.1, *Functional currency of a highly inflationary economy*, for further guidance.

<sup>1</sup> Refer to SEC, Staff Publications, *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, Sec. 1-D, "Changes in Functional Currency."

**Illustration 2-11: Accounting for a change in functional currency from the reporting currency to a foreign currency**

A US company operates a foreign subsidiary in South America with USD as its functional currency. A significant change in operations and circumstances occurs during the last quarter of the financial year ended 31 December 20X8, which indicates that, going forward, USD should no longer be the functional currency of the foreign subsidiary. Management decides that the local currency (LC) should be the functional currency of its foreign operation effective at the beginning of 20X9.

Assume that the foreign subsidiary purchased a machine with a 10-year life for LC100,000 on 1 January 20X4. On that date, the exchange rate was LC10.00 = US\$1. As a result, the USD equivalent cost of the machine was \$10,000. On 31 December 20X8, the machine has a net book value after straight-line depreciation of LC50,000 (LC100,000 (LC cost basis) – (LC10,000 (annual depreciation) x 5 years)) in the subsidiary's local books, and a book value of \$5,000 after remeasurement to the USD at the historical exchange rate (refer to section 3.2, *Remeasurement at historical or current exchange rates*, for further guidance) of LC10.00 = US\$1. On 31 December 20X8, the exchange rate was LC20.00=US\$1.

Pursuant to ASC 830-10-45-9, if the functional currency changes from the reporting currency to a foreign currency, the adjustment attributable to current-rate translation of nonmonetary assets as of the date of the change shall be reported in other comprehensive income. The accounting is as follows:

- ▶ The new carrying value of the machine is LC50,000, which is the same as if the foreign currency had always been the functional currency.
- ▶ Upon consolidation into the US reporting entity, the foreign currency carrying value is translated at the current exchange rate of LC20.00 = US\$1.
- ▶ The new USD equivalent carrying value of the machine in the consolidated financial statements of the US reporting entity after translation is US\$2,500 (LC50,000 / 20).

The difference between the machine's carrying value in the consolidated financial statements of the US reporting entity as of 31 December 20X8 and its carrying value as of 1 January 20X9 after the change in functional currency of the foreign subsidiary (i.e., US\$5,000 – US\$2,500) is reported as a debit in the cumulative translation adjustment (CTA) in shareholders' equity.

For guidance on when the functional currency changes from a foreign currency to the reporting currency, refer to section 5.1.1, *Functional currency changes from a foreign currency to the reporting currency*.

## 2.3

### Exchange rates

Transactions denominated in a currency other than the entity's functional currency should be remeasured into the entity's functional currency pursuant to ASC 830-20's guidance on accounting for foreign currency transactions. Refer to section 3, *Foreign currency transactions*, for further guidance.

After the remeasurement process is complete and the entity's financial statements are stated in its functional currency, the entity's financial statements are translated to the reporting currency of its parent using the current rate method. Refer to section 4, *Translation of financial statements*, for further guidance.

## 2.3.1 Use of averages or other methods of approximation

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Overall

#### *Implementation Guidance and Illustrations*

##### **830-10-55-10**

Literal application of the standards in this Subtopic might require a degree of detail in record keeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Accordingly, it is acceptable to use averages or other methods of approximation. For example, because **translation** at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Likewise, the use of other time- and effort-saving methods to approximate the results of detailed calculations is permitted.

##### **830-10-55-11**

Average rates used shall be appropriately weighted by the volume of functional currency transactions occurring during the accounting period. For example, to translate revenue and expense accounts for an annual period, individual revenue and expense accounts for each quarter or month may be translated at that quarter's or that month's average rate. The translated amounts for each quarter or month should then be combined for the annual totals.

Under the current rate method, assets and liabilities are translated at the exchange rate on the balance sheet date. Income statement items are translated at the exchange rate on the date they are recognized. Generally, it would be impractical for companies to translate all individual items of revenue and expense at the rates on the date they are recognized. Instead, they may use a weighted average exchange rate to translate these items. The weighted average exchange rate can also be applied to accounting allocations such as depreciation, cost of sales and amortization of deferred revenues and expenses. Furthermore, since the change in retained earnings for the period represents translated net income for the period, it should be translated at the weighted average exchange rate for the period.

A company should use the method of averaging that most closely approximates the exchange rates on the date that the foreign currency amounts were recognized. For example, the monthly or quarterly income statements could be translated at the average rate for those periods, then such translated statements would be added to arrive at the annual income statement.

ASC 830 does not indicate the exchange rate a company should use to translate adjustments reflected in a foreign entity's income statement. We believe the translation rate used should depend on the nature of the adjustment. If the adjustment pertains to a period of time, the weighted average exchange rate for the period should be used. For example, if a physical inventory adjustment is estimated to have occurred over the period since the last physical inventory, the weighted average exchange rate for that period should be used to translate the adjustment.

If an adjustment relates to a specific event, the rate at the date the event occurred should be used. For example, adjustments for damaged inventory should be translated at the rate on the date the loss occurred. A write-off of a significant uncollectible receivable should be translated at the rate on the date the account is determined to be uncollectible.

Pursuant to ASC 830-20-30-4, the weighted average exchange rate may also be applied to remeasure foreign-currency-denominated transactions.

## 2.3.2 Subsequent change in exchange rate

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Foreign Currency Transactions

##### *Subsequent Measurement*

##### **830-20-35-8**

A reporting entity's financial statements shall not be adjusted for a rate change that occurs after the date of the reporting entity's financial statements.

#### Foreign Currency Matters – Translation of Financial Statements

##### *Other Presentation Matters*

##### **830-30-45-16**

A reporting entity's financial statements shall not be adjusted for a rate change that occurs after the date of the reporting entity's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the reporting entity.

Although the financial statements should not be adjusted for a rate change that occurs after the date of the reporting entity's financial statements, disclosure of significant effects on unsettled foreign currency transactions of a rate change may be necessary. Refer to section 6.2, *Effect of rate changes*, for further guidance.

## 2.3.3 Exchange rate when exchangeability is lacking temporarily

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Overall

##### *Glossary*

##### **830-10-20**

##### *Exchange Rate*

The ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time.

#### Foreign Currency Matters – Foreign Currency Transactions

##### *Initial Measurement*

##### **830-20-30-2**

If exchangeability between two currencies is temporarily lacking at the **transaction date** or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Subtopic. If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the reporting entity shall be carefully considered.



## Foreign Currency Matters – Translation of Financial Statements

### *Other Presentation Matters*

#### **830-30-45-9**

If exchangeability between two currencies is temporarily lacking at the **transaction date** or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Subtopic. If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the reporting entity shall be carefully considered. Example 1 (see paragraph 830-30-55-1) illustrates the application of this paragraph.

### *Implementation Guidance and Illustrations*

#### **830-30-55-1**

This Example illustrates the appropriate **exchange rate** to be used for translating financial statements when foreign exchange trading is temporarily suspended at year-end. The following are facts involving a **reporting entity** that had a significant subsidiary in Israel:

- a. On December 29, 1988, the currency market was open and foreign currencies were traded. The exchange rate was FC 1.68 = USD 1.00.
- b. On December 30, 1988, Israeli banks were officially open but foreign exchange trading was suspended until January 2, 1989. A devaluation to occur on January 2, 1989, was announced. Most businesses were closed for the holidays.
- c. On December 31, 1988, banks were closed.
- d. On January 1, 1989, banks were closed.
- e. On January 2, 1989, foreign exchange transactions were executed but left unsettled until the following day when a new rate was to be established.
- f. On January 3, 1989, a new exchange rate of FC 1.81 = USD 1.00 was established and was effective for transactions left unsettled the previous day.

Thus, exchangeability was temporarily lacking and the rate established as of January 3, 1989, the first subsequent rate, is the appropriate rate to use for translating the December 31, 1988, financial statements.

If exchangeability between two currencies is temporarily lacking at the transaction date or balance sheet date, ASC 830-20 and ASC 830-30 (remeasurement and translation, respectively) require use of the first subsequent rate at which exchanges could be made. ASC 830-20 and ASC 830-30 also state that if this condition is other than temporary, the propriety of consolidating, combining or accounting for the foreign operation by the equity method should be carefully considered.

According to ASC 810-10-15-10, a majority-owned subsidiary should not be consolidated if control does not rest with the majority owner. For instance, control may not rest with the majority owner if the subsidiary operates under foreign exchange restrictions, controls or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary. The limitations under which a majority-owned subsidiary should not be consolidated should also be applied as limitations to the use of the equity method (see ASC 323-10-25-2).

Generally, lack of exchangeability in itself is not sufficient to support the deconsolidation of a majority-owned subsidiary or cessation of equity method accounting. In some rare cases foreign exchange restrictions, controls or other governmentally imposed uncertainties may be so severe that they cast significant doubt on the parent's ability to control a subsidiary or an investor's ability to exercise significant influence of a

foreign entity investee. See section 11.3.1 of our FRD publication, *Consolidation*, for further guidance on foreign currency exchange restrictions when evaluating control of a foreign entity. See section 3.4.1 of our FRD, *Equity method investments and joint ventures*, for further guidance on foreign currency exchange restrictions when evaluating significant influence of a foreign entity.

#### Question 2.1 Does a low volume of trading constitute a temporary lack of exchangeability?

No. Pursuant to the January 2002 discussions on Argentina<sup>2</sup> in the AICPA International Practices Task Force Meeting Highlights,<sup>3</sup> a low volume of trading would not constitute a temporary lack of exchangeability. The Task Force was concerned that “it would not be possible, nor appropriate, to develop guidance that would delay the conclusion about exchangeability until there was a greater volume of activity. Any such guidance would be subjective and likely applied inconsistently.”

Therefore, unless the low volume of trading leads to a halt in the market activity that then prevents additional transactions to be processed, a lack of exchangeability is not considered to exist.

#### Question 2.2 How should the phrase “the first subsequent rate at which exchanges could be made” be applied after temporary lack of exchangeability has been resolved?

Pursuant to the January 2002 discussions on Argentina in the AICPA International Practices Task Force Meeting Highlights, the phrase “the first subsequent rate at which exchanges could be made” should not be read literally to mean the “first” exchange transaction. Instead, management should use its judgment to determine the appropriate exchange rate to apply, such as the closing rate on the day the market resumes its trading activities.

## 2.3.4 Preference or penalty rates

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Translation of Financial Statements

##### *Other Presentation Matters*

##### *830-30-45-7*

If unsettled intra-entity transactions are subject to and translated using preference or penalty rates, translation of foreign currency statements at the rate applicable to dividend remittances may cause a difference between intra-entity receivables and payables. Until that difference is eliminated by settlement of the intra-entity transaction, the difference shall be treated as a receivable or payable in the reporting entity’s financial statements.

Certain foreign governments regulate foreign exchange markets and provide that conversion of local currency into certain foreign currencies and vice versa is permitted or required at rates other than the prevailing free market rate. Such pre-determined rates set by the foreign governments may be favorable (i.e., a preferential rate) or unfavorable (i.e., a penalty rate) compared to rates that would be applicable to other transactions. For example, a foreign government may impose an exchange rate of LC2 to \$1 for essential goods while the free market rate at the time is LC8 to \$1 for everything else.

<sup>2</sup> Refer to minutes of this meeting at <http://thecaq.org/november-2001-iptf-joint-meeting-highlights>.

<sup>3</sup> The Center for Audit Quality SEC Regulations Committee’s International Practices Task Force (IPTF) meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The IPTF publishes highlights that summarize issues discussed at the meetings. However, the highlights are not authoritative positions or interpretations issued by the SEC or its staff and, therefore, do not constitute an official statement of the views of the SEC or its staff.

### Question 2.3 **Prior to actually accessing a preferential or penalty rate for conversion, should financial statements give effect to preference or penalty exchange rates?**

Assume a foreign government provides that foreign exchange transactions are permitted or required to be made at rates other than the prevailing free market rate (i.e., at preference or penalty exchange rates). The difference between the free market rate and the preference rate or penalty rate is akin to a subsidy or tax, respectively, by the foreign government.

Due to the complexities, each situation should be analyzed individually. General guidance concerning the use of preference and penalty exchange rates follows:

- ▶ The free market rate, rather than a preference rate, should generally be used unless there is satisfactory evidence that demonstrates the foreign government's ability and intention to honor the conversion at the preference rate
- ▶ Losses upon conversion of foreign currency assets into the local currency at penalty rates should generally be recognized contemporaneous with the conversion as foreign exchange losses
- ▶ If material, disclosure should be made of the unrealized incremental effect from using preference and penalty exchange rates

### Question 2.4 **Can an entity use the black-market rate to remeasure foreign currency transactions?**

Assume a foreign government in a particular country regulates its foreign exchange market and does not allow for its currency to float freely, and a black-market rate is considered to best reflect the economic reality of this particular exchange rate.

A black-market rate is not a legal rate. Pursuant to the 25 November 2008 IPTF meeting minutes, "US GAAP does not permit the use of a black-market exchange rate since such a rate is not objective or determinable." Therefore, although it may best reflect the economic reality of a particular exchange rate in certain circumstances, it is not appropriate for an entity to use a black-market rate for remeasurement or translation purposes under ASC 830.

## 2.3.5 **Multiple exchange rates**

ASC 830-20-30-3 requires that a foreign currency transaction be remeasured at the applicable rate at which a particular transaction could be settled on the transaction date. In contrast, ASC 830-30-45-6 requires that in the absence of unusual circumstances, the exchange rate used to translate foreign currency financial statements should be the rate available for dividend remittances. The FASB believes that this rate is more meaningful than any other rate because the reporting entity's net investment in the foreign entity could be realized only by converting cash flows using this rate. Use of different rates can result in unusual results, such as balances reported in an entity's financial statements that differ from their underlying denominated values.

To illustrate, assume a US entity's foreign subsidiary (with a local currency (LC) functional currency) has \$10 million USD-denominated cash and a \$10 million USD-denominated trade payable. The foreign country offers a preference rate of 6 LC per USD to import inventory, which is the rate at which the trade payable can be settled. At period end, the dividend remittance rate is 3 LC per USD. After remeasuring all foreign-currency-denominated transactions using the 6:1 preference rate, the cash and trade payable balances would each be 60 million LC. After the foreign subsidiary's financial statements are translated into the parent's reporting currency (USD), the 60 million LC cash and trade payable balances would be converted to \$20 million USD (using the 3:1 dividend remittance rate).

Some reporting entities have interpreted the existence of dual exchange rates as constituting an “unusual circumstance” and have asserted that the same exchange rate should be used both to remeasure a foreign-currency-denominated transaction and to translate the financial statements of a foreign operation. In contrast, others believe that the use of different exchange rates for remeasurement and translation is appropriate and is required under ASC 830. These reporting entities refer to paragraph 121 in the Basis for Conclusions of FAS 52, which notes that the Board concluded that gains or losses resulting from foreign currency transactions have a different economic nature than those resulting from translating foreign currency financial statements.

This issue was last addressed in July 2010 by the Emerging Issues Task Force (EITF) in response to questions regarding certain foreign currency issues related to investments in Venezuela. The EITF discussed whether it may be appropriate to use different exchange rates for (1) remeasurement of a foreign-currency-denominated transaction and (2) translation of a foreign subsidiary’s financial statements in an economy with multiple exchange rates. The EITF did not reach a consensus on this issue but directed the FASB staff to (1) further analyze what constitutes “unusual circumstances,” as described in ASC 830-30-45-6 and (2) identify related current practice issues involving entities in Venezuela.

At its September 2010 meeting, the EITF decided to delay any further deliberation of these issues. In reaching this conclusion, the EITF noted that this issue was raised in the context of Venezuela and before the Venezuelan economy was deemed highly inflationary. There have been no further deliberations of this matter.

Refer to section 6.3, *Multiple foreign currency exchange rates – SEC staff guidance*, for further guidance on disclosure considerations when multiple foreign currency exchange rates exist.

# 3 Foreign currency transactions

## 3.1 Overview

Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. As a result, identifying a foreign currency transaction first requires the entity's functional currency to be determined. Foreign currency transactions arise when a reporting entity:

- ▶ Buys or sells goods or services on credit for prices denominated in a foreign currency
- ▶ Borrows or lends money denominated in a foreign currency
- ▶ Is a party to an unperformed forward exchange contract
- ▶ Acquires or disposes assets denominated in a foreign currency
- ▶ Incurs or settles liabilities denominated in a foreign currency

For example, a US company with USD functional currency that has a euro-denominated loan payable has a monetary liability that is denominated in a foreign currency and is a foreign currency transaction.

At the date a foreign currency transaction is recognized, each asset, liability, revenue, expense, gain or loss arising from the transaction should be measured initially in the functional currency of the recording entity by use of the exchange rate in effect at that date. An appropriately weighted average exchange rate may be used to remeasure revenues and expenses. Subsequently, at each balance sheet date, balances related to certain of these transactions should be adjusted to reflect the current exchange rate, which is the rate at which the related receivable or payable could be settled at that date (refer to section 3.2, *Remeasurement at historical or current exchange rates*, for further guidance).

Transaction gains and losses are based on the change in exchange rates between the functional currency and the currency in which the foreign currency transaction is denominated. Said differently, an increase or decrease in (1) the actual functional currency cash flows realized upon settlement of foreign currency transactions and (2) the expected functional currency cash flows on unsettled foreign currency transactions drive foreign currency transaction gains and losses.

Transaction gains and losses are generally recognized in earnings in the period in which the exchange rate changes, except in certain cases such as when they are designated as economic hedges of a net investment in a foreign entity or are intercompany and of a long-term-investment nature. These exceptions are discussed in more detail later in this section.

## 3.2 Remeasurement at historical or current exchange rates

### Excerpt from Accounting Standards Codification

Foreign Currency Matters – Overall

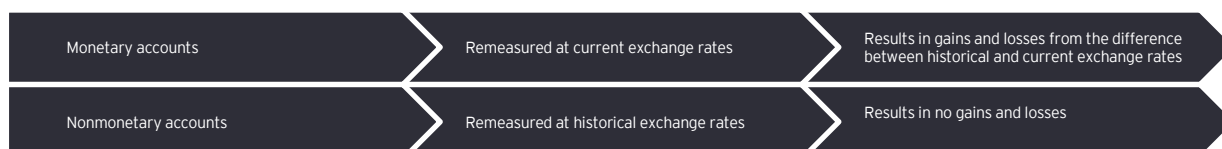
*Other Presentation Matters*

**830-10-45-17**

If an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. If a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation. The remeasurement of and subsequent accounting for

transactions denominated in a currency other than the functional currency shall be in accordance with the requirements of Subtopic 830-20. The remeasurement process is intended to produce the same result as if the entity's books of record had been maintained in the functional currency. To accomplish that result, it is necessary to use historical exchange rates between the functional currency and another currency in the remeasurement process for certain accounts (the current rate will be used for all others), and this guidance identifies those accounts. To accomplish that result, it is also necessary to recognize currently in income all exchange gains and losses from remeasurement of monetary assets and liabilities that are not denominated in the functional currency (for example, assets and liabilities that are not denominated in dollars if the dollar is the functional currency).

Pursuant to ASC 830-10-45-17, an entity uses historical exchange rates when remeasuring nonmonetary assets and liabilities and current exchange rates when remeasuring monetary assets and liabilities.



ASC 830-10-45-18 lists the following as common balance sheet and income statement accounts that should be remeasured using historical rates:

- ▶ Debt securities not intended to be held until maturity<sup>4</sup>
- ▶ Equity securities without a readily determinable fair value accounted for in accordance with ASC 321-10-35-2 (i.e., the measurement alternative)<sup>5</sup>
- ▶ Inventories carried at cost
- ▶ Prepaid expenses such as insurance, advertising and rent
- ▶ Property, plant and equipment
- ▶ Accumulated depreciation on property, plant and equipment
- ▶ Patents, trademarks, licenses and formulas
- ▶ Goodwill
- ▶ Other intangible assets
- ▶ Deferred charges and credits, except policy acquisition costs for life insurance companies
- ▶ Deferred income
- ▶ Common stock
- ▶ Preferred stock carried at issuance price
- ▶ Revenues and expenses related to nonmonetary items, for example:
  - ▶ Cost of goods sold
  - ▶ Depreciation of property, plant and equipment
  - ▶ Amortization of intangible items, such as patents, licenses and so forth
  - ▶ Amortization of deferred charges or credits, except policy acquisition costs for life insurance entities

Exchange gains and losses from the remeasurement of monetary assets and liabilities should be recognized currently in net income because they represent changes in the amount of the functional currency cash flows necessary to settle the transaction. ASC 830 does not clearly define monetary assets and liabilities, but ASC 255's implementation guidance (see ASC 255-10-55-1 through 55-13) lists examples of assets and liabilities and their respective classification as monetary or nonmonetary.

<sup>4</sup> See section 3.3.1 for further guidance regarding foreign-currency-denominated debt securities classified as trading or available-for-sale

<sup>5</sup> See section 3.3.2 for further guidance regarding foreign-currency-denominated equity securities

ASC 255 defines monetary assets as money or claim to receive a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods or services. Beyond the preceding list of nonmonetary items, ASC 255's implementation guidance is helpful in distinguishing monetary and nonmonetary items that are not specifically addressed.

In Questions 3.1 through 3.7 below, we apply the above guidance to specific items in analyzing whether they should be considered monetary or nonmonetary.

### **Question 3.1 Is an asset retirement obligation (ARO) a monetary or nonmonetary liability?**

ASC 410-20 applies to all entities (including not-for-profit entities) that incur legal obligations for the retirement of tangible long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset.

Several alternative views regarding the interaction of the guidance in ASC 830 and ASC 410-20 were expressed by the FASB staff in a 4 May 2005 EITF Agenda Committee Report. Significant diversity in practice has developed, with some ARO obligations being accounted for under ASC 830 as monetary liabilities, and others as nonmonetary liabilities. Moreover, unless the company has a legal obligation to satisfy the obligation in a currency other than its functional currency, some view the ARO as outside the scope of ASC 830 such that all changes in the liability should be accounted for pursuant to ASC 410-20.

While ASC 410-20 addresses the accounting for changes in the timing or amount of estimated undiscounted cash flows associated with an ARO, it does not address revisions that result solely from changes in foreign currency exchange rates. Additionally, Statement 143, *Accounting for Asset Retirement Obligations* (mostly codified in ASC 410), when issued, did not amend the guidance on foreign currency matters with respect to the accounting for remeasurement of an ARO.

Based on discussions with the FASB staff, we believe AROs are most appropriately considered monetary liabilities for purposes of remeasurement under the guidance on foreign currency matters in ASC 830. Accordingly, under this view pursuant to ASC 830, the exchange gain or loss on remeasurement of the ARO should be recognized currently in earnings, unless that obligation is expected to be settled in the functional currency.

The FASB staff previously indicated that they intend to continue internal discussions of the interaction of the guidance in ASC 830 and ASC 410-20. However, the FASB has not pursued the issuance of any further guidance on this issue, and until they do, we believe that alternate interpretations (e.g., the ARO is not a monetary liability) will continue to exist and will be acceptable so long as applied consistently.

### **Question 3.2 Are advances to suppliers and customers and prepaid expenses monetary or nonmonetary items?**

Pursuant to ASC 255-10-55-1, advances to suppliers that are not related to a fixed-price contract are considered to be rights to receive credit for a sum of money, not claims to a specified quantity of goods or services and are considered to be monetary items. In contrast, non-refundable advances to suppliers related to a fixed-price contract are classified as nonmonetary items because they are in effect claims for future goods and services and are recorded using the historical exchange rate.

Prepaid expenses may be considered monetary or nonmonetary assets, depending on the nature of the prepaid expense. ASC 255-10-55-1 distinguishes between prepaid expenses that represent claims to future services (nonmonetary) from those that are a "fixed-money offset" (monetary). Prepayments that are deposits, advance payments or receivables are monetary when they do not obtain a given quantity of future services.

### **Question 3.3 Are proceeds from the sale of future foreign currency revenues a monetary or nonmonetary item?**

Proceeds from the sale of future revenues are monetary liabilities if they are classified as debt and are nonmonetary if they are classified as deferred income. Deferred income is generally considered a nonmonetary item because an obligation to furnish goods or services exists.

ASC 470-10-25-2 provides that the classification of proceeds as deferred income or debt depends on specific facts and circumstances and includes a number of factors to consider in making this determination. For additional guidance on the classification, refer to section 2.2.6.8 of our FRD, *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or our FRD, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*.

**Question 3.4** Are foreign-currency-denominated dividends considered monetary or nonmonetary items once they are declared?

Because dividends are recorded as liabilities once declared, a foreign-currency-denominated dividend liability is a monetary item. Therefore, this dividend liability should be remeasured and any related foreign currency gains and losses should be recorded in net income.

**Question 3.5** Are contract assets, contract liabilities and refund liabilities considered monetary or nonmonetary items?

Pursuant to ASC 606, a contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

A contract asset may represent a conditional or unconditional right to consideration. If an entity has an unconditional right to receive consideration from the customer, the contract asset is accounted for as a receivable and presented separately from other contract assets. A right is unconditional if nothing other than the passage of time is required before the payment is due. Receivables are monetary assets and should be remeasured using the current exchange rate at each reporting date. A contract asset would be conditional, for example, when an entity first must satisfy another performance obligation in the contract before it is entitled to payment from the customer. Most contract assets are settled by a payment of a fixed or determinable amount of cash for goods or services already transferred and, therefore, generally are monetary assets.

In contrast, similar to deferred income, a contract liability is generally settled through the transfer of a good or service to the customer and, therefore, is considered a nonmonetary liability. Nonmonetary assets and liabilities are remeasured at historical rates.

Pursuant to ASC 606, an entity records a refund liability if it receives consideration from a customer and expects to refund some or all of that consideration to the customer. As discussed in the Basis for Conclusions of Accounting Standards Update (ASU) 2016-20,<sup>6</sup> *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, an entity should determine whether a refund liability should be characterized as a contract liability based on the specific facts and circumstances of the arrangement. We believe that a refund liability will not typically meet the definition of a contract liability because it generally does not represent an obligation to transfer goods or services in the future (see Question 10-4 of our FRD, *Revenue from contracts with customers (ASC 606)*). When a refund liability is determined not to be a contract liability, it should be presented separately from contract liabilities and would represent a monetary liability that should be remeasured using the current exchange rate at each reporting date. If an entity were to conclude, based on its specific facts and circumstances, that a refund liability did represent an obligation to transfer goods or services in the future, it would be a contract liability (and, therefore, a nonmonetary liability).

ASC 606 requires a contract asset and a contract liability related to a single contract with a customer to be presented on a net basis on the balance sheet (see Question 10-1 of our FRD, *Revenue from contracts with customers (ASC 606)*). For example, a contract could contain a performance obligation that is in a contract asset position and another performance obligation in a contract liability position. Under ASC 606, an entity would not separately recognize an asset or liability for each performance obligation within a contract but aggregate them into a single contract asset or liability. This net contract asset or liability would exclude any receivables and refund liabilities determined not to be contract liabilities and should be

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<sup>6</sup> Paragraph BC37 of ASU 2016-20.



split into its current or noncurrent components, if applicable, in a classified balance sheet in accordance with ASC 210. We believe this presentation requirement under ASC 606 does not affect the recognition and measurement of the contract asset or contract liability under ASC 830. Therefore, we believe the application of ASC 830 should be applied on a gross basis. That is, for a single contract, an entity should remeasure a contract asset on a gross basis at the current exchange rate even in circumstances where the contract asset is aggregated with a contract liability (i.e., a nonmonetary liability remeasured using the historical exchange rate) for presentation purposes.

**Question 3.6 Are right-of-use assets considered monetary or nonmonetary items?**

A right-of-use asset is an asset that represents a lessee's right to use an underlying asset for the lease term. Pursuant to ASC 842-20-55-10, a right-of-use asset is a nonmonetary asset while the lease liability is a monetary liability. Therefore, when accounting for a lease that is denominated in a foreign currency, the right-of-use asset is remeasured using the exchange rate as of the lease commencement date (i.e., the historical exchange rate), while the lease liability is remeasured using the current exchange rate at each reporting date. Therefore, the subsequent remeasurement of the right-of-use asset will not equal the lease liability for operating leases denominated in a foreign currency.

For more information, refer to section 4.8.3, *Leases denominated in a foreign currency*, of our FRD, [Lease Accounting – ASC 842, Leases](#).

**Question 3.7 Is the unguaranteed residual value of property owned by a lessor and leased under direct financing, sales-type, and leveraged leases monetary or nonmonetary items?**

Prior to the adoption of ASU 2016-02, *Leases*, ASC 255-10-55-7 details that the minimum lease payments are monetary items because they are claims to fixed sums of money. The residual value is not a claim to a fixed sum of money, so it is a nonmonetary item. Some assets and liabilities, of which the net investment in the lease is a good example, are combinations of claims to (or obligations of) fixed amounts and claims to (or obligations of) variable amounts. Ideally, those claims should be separated for purposes of classifying them as monetary and nonmonetary. However, if the information necessary to make the separation is not available or is impracticable to obtain, such items need not be divided into monetary and nonmonetary components and would be classified according to their dominant element. If the net investment in leases is principally claims to fixed amounts, it would be classified as monetary; it would be classified as nonmonetary if it is principally claims to residuals.

Subsequent to the adoption of ASU 2016-02, ASC 255-10-55-7A details that the lease receivable arising from a sales-type lease or a direct financing lease is a monetary item because it is a claim to a fixed sum of money. The unguaranteed residual asset arising from a sales-type lease or a direct financing lease is not a claim to a fixed sum of money, so it is a nonmonetary item. Some assets and liabilities, of which the net investment in the lease is a good example, are combinations of claims to (or obligations of) fixed amounts and claims to (or obligations of) variable amounts. Because the net investment in a sales-type or direct financing lease is predominantly a claim to a fixed sum of money, it should be classified as monetary. In accordance with ASC 842-30, a lessor includes the unguaranteed residual asset as part of its net investment in the lease. Consequently, the unguaranteed residual asset is accounted for in the same manner as a monetary item so long as it is part of the net investment in the lease. If the lessor sells the lease receivable but retains an interest in the unguaranteed residual asset, the remaining unguaranteed residual asset is accounted for as a nonmonetary item after the sale of the lease receivable.

### 3.2.1 Remeasuring inventory not recorded in the functional currency

Inventory measured using the subsequent measurement guidance in ASC 330-10 in an entity's books of record that are maintained in a foreign currency requires a unique application of ASC 830.

First, inventory carried at cost in the foreign currency should be remeasured to the functional currency using historical exchange rates.

Next, the historical cost in the functional currency should be evaluated for impairment through application of ASC 330-10's subsequent measurement guidance using the functional currency, which may require a write-down in the functional currency financial statements even if a write-down would not otherwise be required in the foreign currency books of record. Similarly, any write-downs taken in the foreign currency books of record would need to be reversed in the functional currency financial statements whenever the application of the subsequent measurement guidance using the functional currency does not require a write-down. If inventory has been written down in the functional currency financial statements, that functional currency amount should continue to be the carrying amount in the functional currency financial statements until the inventory is sold or a further write-down is necessary.

The following cases illustrate the application of ASC 330-10's subsequent measurement guidance in the remeasurement of inventory measured using the last-in, first-out (LIFO) method and which is not recorded in the functional currency.

### Illustration 3-1: Write-down of inventory measured using last-in, first-out (LIFO)

#### General assumptions:

- ▶ The reporting entity measures inventory using LIFO.
- ▶ The books of record are maintained in UK pound sterling (GBP).
- ▶ The functional currency (FC) is the US dollar (USD).
- ▶ On 1 September 20X0, a foreign subsidiary (or US entity) purchases a unit of inventory at GBP 500.
- ▶ On 1 September 20X0, the exchange rate is GBP 1 = USD 2.40.
- ▶ On 31 December 20X0, the reporting date, the exchange rate is GBP 1 = USD 2.00.
- ▶ The replacement cost and net realizable value reduced by a normal profit margin in GBP is assumed in each case (in all cases replacement cost is assumed to be less than net realizable value before reduction for a normal profit margin).

Case	Historical cost	Current replacement cost	Net realizable value (NRV) reduced by a normal profit margin	Conclusion <sup>1</sup>
A	GBP 500 x 2.40 = USD 1,200	GBP 560 x 2.00 = USD 1,120	GBP 550 x 2.00 = USD 1,100	<ol style="list-style-type: none"> <li>1. Current replacement cost exceeds NRV reduced by a normal profit margin, so market is based on current replacement cost. (\$1,120 &gt; \$1,100)</li> <li>2. Historical cost exceeds market, so an inventory write-down of USD 80 is required. (\$1,200 - \$1,120 = \$80)</li> </ol>
B	GBP 500 x 2.40 = USD 1,200	GBP 620 x 2.00 = USD 1,240	GBP 550 x 2.00 = USD 1,100	<ol style="list-style-type: none"> <li>1. Current replacement cost exceeds NRV reduced by a normal profit margin, so market is based on current replacement cost. (\$1,240 &gt; \$1,100)</li> <li>2. Historical cost does not exceed market, so an inventory write-down is not required. (\$1,200 &lt; \$1,240)</li> </ol>

C	GBP 500 x 2.40 = USD 1,200	GBP 560 x 2.00 = USD 1,120	GBP 640 x 2.00 = USD 1,280	<ol style="list-style-type: none"> <li>1. NRV reduced by a normal profit margin exceeds current replacement cost, so market is based on NRV reduced by a normal profit margin. (<math>\\$1,280 &gt; \\$1,120</math>)</li> <li>2. Historical cost does not exceed market, so an inventory write-down is not required. (<math>\\$1,200 &lt; \\$1,280</math>)</li> </ol>
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<sup>1</sup> ASC 330 requires inventory measured using LIFO (or the retail inventory method) to be subsequently measured at the lower of cost or market. In this context, market means current replacement cost (by purchase or by reproduction, as the case may be) provided that (1) market shall not exceed the net realizable value, and (2) market shall not be less than net realizable value reduced by an allowance for an approximately normal profit margin (refer to the Master Glossary of the Codification).

ASC 330 requires that inventory, other than that accounted for under the LIFO or retail method, be measured at the lower of cost and net realizable value.

The following example illustrates how inventory measured using the first-in, first-out (FIFO) method and not recorded in an entity's functional currency should be remeasured.

#### Illustration 3-1(a): Write-down of inventory measured using FIFO

##### General assumptions:

- ▶ Same as in Illustration 3-1 above, except that the reporting entity measures inventory using FIFO.

Case	Historical cost	Net realizable value (NRV)	Conclusion
A	GBP 500 x 2.40 = USD 1,200	GBP 560 x 2.00 = USD 1,120	Historical cost exceeds NRV, so an inventory write-down of USD 80 is required. ( $\$1,200 - \$1,120 = \$80$ )
B	GBP 500 x 2.40 = USD 1,200	GBP 620 x 2.00 = USD 1,240	Historical cost does not exceed NRV, so an inventory write-down is not required. ( $\$1,200 < \$1,240$ )

This basic principle of evaluating inventory for possible write-downs using all functional-currency-equivalent inputs may be applicable to assets other than inventory that are carried at historical cost and evaluated for impairment. For example, a write-down of building cost to contracted sales value may have been required in the local currency. However, that write-down should be reversed in the remeasurement process if the foreign currency sales price as remeasured in the functional currency exceeds the functional currency cost of the property.

#### Illustration 3-2: Reversing a write-down of held-for-sale real estate

Assume Company A, whose functional currency is USD, maintains its books in its local currency (LC). On 31 December 20X8, Company A purchases a building at LC1,000,000 which is classified as held-for-sale. The exchange rate at the time of purchase was LC1=\$1 (the original functional currency cost of the building is \$1,000,000). On 31 December 20X9, Company A enters into an agreement to sell the building at LC700,000 and writes-down the cost of the building to this contracted sales value on its local currency books. The exchange rate on 31 December 20X9 is LC1=\$1.5. Since the foreign currency sales price as remeasured in the functional currency ( $LC700,000 \times \$1.5 = \$1,050,000$ ) exceeds the functional currency cost of the building ( $\$1,000,000$ ), the write-down should be reversed in the remeasurement process.

## 3.3

**Recognition and subsequent measurement****Excerpt from Accounting Standards Codification****Foreign Currency Matters – Foreign Currency Transactions***Recognition***830-20-25-1**

At the date a **foreign currency transaction** is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be recorded in the **functional currency** of the recording entity.

**830-20-25-2**

Paragraphs 830-10-55-3 through 55-7 provide guidance on the determination of a reporting entity's functional currency. Paragraph 830-10-45-17 states that if an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required before **translation** into the reporting currency. That paragraph provides further guidance on remeasurement of books and records.

*Initial Measurement***830-20-30-1**

At the date a **foreign currency transaction** is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured initially in the **functional currency** of the recording entity by use of the **exchange rate** in effect at that date.

**830-20-30-3**

For a foreign currency transaction, the applicable rate at which a particular transaction could be settled at the transaction date shall be used to translate the transaction.

ASC 830 defines foreign currency transactions as transactions denominated in a currency other than the entity's functional currency. Each asset, liability, revenue, expense, gain or loss arising from the transaction should be measured and recorded in the functional currency of the entity using the exchange rate in effect at the date the foreign transaction is recognized.

In accordance with ASC 830-20-30-4, an appropriately weighted average exchange rate may be used to measure and record certain revenue and expense items in the functional currency of the recording entity. Refer to section 2.3, *Exchange rates*, for further guidance.

**Excerpt from Accounting Standards Codification****Foreign Currency Matters – Foreign Currency Transactions***Subsequent Measurement***830-20-35-1**

A change in exchange rates between the **functional currency** and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency **transaction gain or loss** that generally shall be included in determining net income for the period in which the **exchange rate** changes.

**830-20-35-2**

At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date. Paragraphs 830-20-30-2 through 30-3 provide more information about exchange rates.

**Derecognition****830-20-40-1**

A **transaction gain or loss** (measured from the **transaction date** or the most recent intervening balance sheet date, whichever is later) realized upon settlement of a **foreign currency transaction** generally shall be included in determining net income for the period in which the transaction is settled. The exceptions to this requirement for inclusion in net income of transaction gains and losses are set forth in paragraph 830-20-35-3 and pertain to certain intra-entity transactions and to transactions that are designated as, and effective as, economic hedges of net investments.

Subsequently, at each balance sheet date, balances related to monetary assets and liabilities (e.g., accounts receivable and payable) should be adjusted to reflect the current exchange rate (i.e., the rate at which the related receivable or payable could be settled at that date). Any adjustments resulting from this remeasurement procedure are made directly to income. Balances related to nonmonetary assets and liabilities (e.g., fixed assets) and related revenues and expenses should continue to be remeasured at the historical exchange rate.

A transaction that is in a foreign currency should first be remeasured in the entity's functional currency (adjustment to income) and then translated to the reporting currency (adjustment to stockholders' equity) for consolidated reporting purposes. If the transaction is already denominated in the foreign entity's functional currency, only translation is necessary.

The remeasurement process required by ASC 830 for foreign currency transactions will give rise to a consolidated gain or loss.

The following illustrates the remeasurement process for an unsettled foreign currency transaction.

**Illustration 3-3: Remeasurement of foreign-currency-denominated loan payable**

A US company with USD functional currency has a loan payable to a bank located in a foreign country. The loan is denominated in the foreign bank's local currency (LC). The following are the relevant facts:

Amount of loan	LC	100,000,000
Exchange rate at transaction date		0.00455
Exchange rate at balance sheet date		0.00465
Loan balance at:		
Transaction date (LC100,000,000 x \$.00455)	\$	455,000
Balance sheet date (LC100,000,000 x \$.00465)	\$	<u>465,000</u>
Difference – recognized in income as an exchange loss for the period	\$	<u>10,000</u>

**Illustration 3-4: Remeasurement of foreign-currency-denominated intercompany payable followed by translation**

Assume that a US parent advances \$1,000,000 to its foreign subsidiary when the exchange rate is LC1=\$0.50. The advance is expected to be repaid at the end of three years. There haven't been exchange rate fluctuations, and functional currency retained earnings are a deficit of LC2,000,000 (\$1,000,000). All other assets and liabilities offset. On the balance sheet date following the advance, the exchange rate is LC1=\$0.40.

Remeasurement to the functional currency would be as follows:

Due to parent (\$1,000,000 / 0.40)	LC 2,500,000
Other net assets	–
Retained earnings deficit	LC 2,500,000
Beginning retained earnings deficit	LC 2,000,000
Net loss from remeasurement of intercompany account	LC 500,000
Ending retained earnings deficit	<u>LC 2,500,000</u>

Translation from the foreign currency financial statements to the reporting currency (i.e., USD) would be as follows in the consolidated financial statements:

Due to parent (LC2,500,000 x 0.40)	\$ 1,000,000
Other net assets	–
Equity deficit	<u>\$ 1,000,000</u>

The deficit consists of the following components:

	Accumulated deficit	Translation component	Total
Beginning balance	\$ 1,000,000	\$ –	\$ 1,000,000
Net loss for period	200,000*		200,000
Translation adjustment to OCI		(200,000)**	(200,000)
Ending balance	<u>\$ 1,200,000</u>	<u>\$ (200,000)</u>	<u>\$ 1,000,000</u>

\* \$200,000 = LC500,000 x 0.40 (LC1 = \$0.40).

The foreign subsidiary's loss for the period (assumed to consist only of the LC500,000 loss from remeasuring the intercompany account) should be translated to USD using the average exchange rate for the period, which for simplicity is assumed to equal the end-of-period rate, or LC1 = \$0.40.

\*\* Translation adjustment on opening net liability (LC2,000,000 x (0.50 – 0.40) = \$200,000).

As illustrated above, the remeasurement process results in foreign currency transaction gains/losses that are carried forward to the consolidated financial statements (i.e., \$200,000 net loss for the period).

The comprehensive examples presented in Appendix A of this publication illustrate the application of the remeasurement process to the financial statements of a foreign entity with a USD functional currency.

### 3.3.1 Foreign-currency-denominated debt securities classified as trading or available for sale

For purposes of ASC 830, foreign-currency-denominated debt securities classified as trading or available for sale under ASC 320-10 are treated as nonmonetary assets and do not result in transaction gains and losses. However, at each reporting date, these securities are measured at fair value. Changes in the fair value of foreign-currency-denominated debt securities classified as trading (including the portion attributed to changes in foreign exchange rates) are reflected in net income. Changes in the fair value of foreign-currency-denominated debt securities classified as available for sale depends on whether the entity has adopted ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, as detailed below.

ASU 2016-13 is effective for entities that are SEC filers and that are not smaller reporting companies for fiscal years beginning after 15 December 2019, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2022 and interim periods therein.

### 3.3.1.1 Available-for-sale debt securities before the adoption of ASU 2016-13

#### Excerpt from Accounting Standards Codification

Investments – Debt and Equity Securities – Overall

##### *Subsequent Measurement*

##### **320-10-35-36**

The entire change in the fair value of foreign-currency-denominated available-for-sale debt securities shall be reported in other comprehensive income.

##### **320-10-35-37**

An entity holding a foreign-currency-denominated available-for-sale debt security is required to consider, among other things, changes in market interest rates and foreign exchange rates since acquisition in determining whether an other-than-temporary impairment has occurred.

Foreign Currency Matters – Foreign Currency Transactions

##### *Subsequent Measurement*

##### **830-20-35-6**

Paragraph 320-10-35-36 requires that the entire change in the fair value of foreign-currency-denominated available-for-sale debt securities be reported in other comprehensive income.

Before the adoption of ASU 2016-13, the entire change in the fair value of a foreign-currency-denominated available-for-sale debt security due to both market factors (i.e., interest rate, credit risk) and the foreign currency exchange rate fluctuations should be recorded in other comprehensive income. Further, an entity holding a foreign-currency-denominated available-for-sale debt security is required to consider, among other things, changes in market interest rates and foreign exchange rates since acquisition when determining whether an other-than-temporary impairment has occurred.

Refer to our FRD, *Certain investments in debt and equity securities*, for further classification and measurement guidance.

### 3.3.1.2 Available-for-sale debt securities after the adoption of ASU 2016-13

#### Excerpt from Accounting Standards Codification

Investments – Debt and Equity Securities – Overall

##### *Subsequent Measurement*

##### **320-10-35-36**

#### **Pending Content:**

**Transition Date:** (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-1

The change in the fair value of foreign-currency-denominated available-for-sale debt securities, excluding the amount recorded in the allowance for credit losses, shall be reported in other comprehensive income. See Subtopic 326-30 for measuring credit losses on available-for-sale debt securities. In accordance with the guidance in Subtopic 326-30, an entity shall report credit losses on available-for-sale debt securities in the statement of financial performance as credit loss expense.

## Foreign Currency Matters – Foreign Currency Transactions

### *Subsequent Measurement*

830-20-35-6

#### **Pending Content:**

**Transition Date:** (P) December 16, 2019; (N) December 16, 2022 | **Transition Guidance:** 326-10-65-1

Paragraph 320-10-35-36 requires that the entire change in the fair value of foreign-currency-denominated available-for-sale debt securities not related to the allowance for credit losses be reported in other comprehensive income. See Subtopic 326-30 for guidance on measuring credit losses for available-for-sale debt securities.

ASU 2016-13 amends the impairment model for debt securities and requires an entity to recognize an allowance for credit losses on available-for-sale debt securities rather than an other-than-temporary impairment that reduces the cost basis of the investment.

In accordance with ASC 830-20-35-6 and ASC 320-10-35-36, the entire change in the fair value of foreign-currency-denominated available-for-sale debt securities, excluding the amount recorded in the allowance for credit losses, should still be reported in other comprehensive income. That is, the change in fair value of a foreign-currency-denominated available-for-sale debt security due to market interest rate and foreign currency exchange rate fluctuations should be recorded in other comprehensive income. Additionally, entities should report credit losses on available-for-sale debt securities as credit loss expense.

See section 3.6 of our FRD, *Credit impairment under ASC 326*, for further information.

## 3.3.2

### **Foreign-currency-denominated equity securities**

Under ASC 321, an entity must measure all equity investments (except those accounted for under the equity method, those that result in consolidation of the investee and certain other investments) at fair value and recognize any changes in fair value (including the portion attributable to changes in foreign exchange rates) in net income. However, for equity investments that don't have readily determinable fair values and don't qualify for the existing practical expedient in ASC 820 to estimate fair value using the net asset value per share (or its equivalent) of the investment, the guidance provides a new measurement alternative. Entities that elect the measurement alternative must measure those investments at cost, less any impairment. If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it must measure its equity investment at fair value in accordance with ASC 820 as of the date that the observable transaction occurred.

Foreign-currency-denominated equity investments measured using the measurement alternative are nonmonetary items that should be remeasured using their historical exchange rate (i.e., the exchange rate as of the later of the acquisition date or the most recent date on which the equity security was adjusted to fair value in accordance with ASC 321-10-35-2 through 35-3). Whenever a carrying value adjustment to reflect the investment's current fair value is required due to the application of the measurement alternative (due to an observable price in an orderly transaction for the same or similar security of the same issuer) or because of an impairment, an entity must use the exchange rate on the date of that adjustment to remeasure the fair value into the functional currency and recognize the entire change in the carrying amount in earnings. The exchange rate on the date of that adjustment will then become the "new" historical rate at which the equity investment will be remeasured in subsequent periods or until another adjustment is made.



### Question 3.8 **Should the effects of currency exchange rate movements on foreign-currency-denominated mezzanine instruments be accounted for through income or through equity?**

While foreign-currency-denominated “mezzanine” instruments (i.e., instruments classified in temporary stockholders’ equity) have both debt and equity characteristics, neither ASC 830 nor the related SEC staff guidance on redeemable equity in ASC 480-10-S99-3A (formerly part of EITF Topic D-98) provides specific guidance on accounting for the effects of foreign currency exchange rate movements on such instruments.

Even though there is no specific guidance, we believe the carrying value of the mezzanine instrument should be adjusted for the effects of currency exchange rate movements. However, how a company chooses to do so, while also respecting the SEC staff’s guidance on redeemable equity, is a matter of judgment that we believe should be applied consistently.

Pursuant to the SEC staff’s guidance, increases or decreases in the carrying amount of a redeemable instrument other than common stock generally reduce or increase income available to common stockholders in the calculation of earnings per share (EPS). Paragraph 16(e) in the SEC staff’s measurement guidance further indicates that the amount presented in temporary equity can be no less than the initial amount reported in temporary equity for the instrument (in other words, the initial reported amount is a “floor,” such that reductions in the carrying amount are appropriate only to the extent there were previously recorded increases). Yet this guidance does not contemplate whether and how the effects of currency exchange rate movements should be considered.

We believe that the effects of changes in the current foreign currency exchange rate on foreign-currency-denominated mezzanine instruments should generally be reflected in equity. Companies should apply judgment in determining whether, and if so, how, the “floor” in the SEC staff’s guidance should be applied for decreases related to the foreign currency element, which should be consistently applied as an accounting policy election.

Paragraph 20 through 23 of the SEC staff’s guidance on redeemable equity also details the effect of the measurement of redeemable instruments on the issuer’s EPS. For a redeemable equity instrument denominated in a foreign currency, whether, and if so, how, a measurement floor is applied to the foreign currency effect should be carefully considered in the related EPS calculation.

The guidance above is intended only for “mezzanine” instruments. For legal equity instruments accounted for as liabilities, such as mandatorily redeemable preferred stock when classified as a liability in accordance with ASC 480-10-25-4, the effects of currency exchange rate movements must be accounted for through income.

## 3.4 **Subsequent measurement – exceptions**

### **Excerpt from Accounting Standards Codification**

#### **Foreign Currency Matters – Foreign Currency Transactions**

##### *Subsequent Measurement*

##### **830-20-35-3**

Gains and losses on the following **foreign currency transactions** shall not be included in determining net income but shall be reported in the same manner as **translation adjustments**:

- a. Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date (see Subtopic 815-35)

- b. Intra-entity foreign currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements.

#### **830-20-35-4**

Intra-entity transactions and balances for which settlement is not planned or anticipated in the foreseeable future are considered to be part of the net investment. This might include balances that take the form of an advance or a demand note payable provided that payment is not planned or anticipated in the foreseeable future.

#### **830-20-35-5**

The accounting for a gain or loss on a foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) is addressed by paragraph 815-20-25-58.

There are exceptions to ASC 830's general rule to record exchange adjustments from remeasuring foreign currency transactions in net income. The exceptions apply to certain foreign currency intercompany and hedging transactions, as discussed in the following sections.

For further guidance on how this exception applies to certain foreign currency hedging transactions, refer to our FRD, *Derivatives and hedging*.

### **3.4.1 Intercompany transactions**

If an intercompany foreign currency transaction is of a "long-term investment" nature, foreign currency transaction gains and losses are reported in other comprehensive income rather than through income, when the entities to the transaction are consolidated, combined or accounted for by the equity method in the reporting entity's financial statements.

These intercompany foreign currency transactions that are of a long-term-investment nature are transactions that are considered to be part of the net investment. More specifically, they are intercompany accounts for which settlement is not planned or anticipated in the foreseeable future. In general, if settlement is planned or anticipated, even though no time period is specified, it is presumed that settlement will occur in the "foreseeable future."

For example, assume US Company makes a demand loan to Japan Company. US Company foresees a number of circumstances in which it would need to demand repayment of the loan from Japan Company (e.g., a liquidity need to reinvest the cash in a different expanding business), and it has not made any representation about the loan being indefinite in nature. However, at the same time, US Company also does not plan or anticipate that the loan be repaid at any particular point in time. In such a scenario, even though no time period is specified, it is presumed that settlement will occur in the "foreseeable future."

#### **3.4.1.1 Determining intercompany long-term investment accounts**

Companies should evaluate the substance of intercompany accounts to determine whether they are of a long-term-investment nature. Considerations may include the business purpose and the long-term plans of the intercompany transactions.

Long-term investment accounts might include, for example, advances and demand notes that the company does not plan to settle in the foreseeable future. A debt instrument with a specified due date may also be considered a part of the net investment if sufficient evidence exists to overcome a presumption of planned or anticipated settlement. Long-term investment accounts could also include transactions with specific payment terms that the company does not plan to settle. Intention alone is not sufficient to overcome a

presumption of planned or anticipated settlement; the existence of a compelling business purpose for maintaining an intercompany account that is of a long-term nature, a past history of not settling similar intercompany accounts and the ability to control whether repayment will be made should also be considered.

Certain companies may have only one intercompany account between the parent and the foreign entity in which all intercompany transactions are recorded. Components of this one intercompany account could include trade balances, short-term financing balances and long-term investment balances. In these cases, individual receivables or payables constituting the long-term investment component should be identified and segregated to determine the amount of the foreign currency transaction gains and losses that should be reported in other comprehensive income.

Companies often control intercompany trading accounts so the aggregate intercompany receivables or payables balance always exceeds a minimum level. In effect, the minimum balance may be thought of by management as part of the parent's long-term financing of the foreign operation.

We understand that the FASB believes that the nature of intercompany foreign currency transactions should be determined on an individual transaction basis. As such, minimum balances should not be accounted for as "long-term investments" if individual invoices comprising the balance are settled and the related transaction gain or loss affects functional currency cash flows. Nonetheless, an individual intercompany transaction comprising an aggregate balance may be considered to be of a long-term-investment nature if its settlement is not planned or anticipated in the foreseeable future.

Furthermore, although prior settlements of intercompany transactions do not necessarily preclude a determination that an existing intercompany balance is a long-term investment, a pattern of prior settlements may be relevant in evaluating whether settlement of an existing intercompany balance is planned or anticipated.

Generally, the parties to intercompany transactions of a long-term-investment nature will be the US parent and the foreign entity.

Because of the varying nature of structures and ASC 830's remeasurement process results in a consolidated gain or loss on intercompany accounts that are not of a long-term-investment nature, companies should carefully evaluate the nature of those accounts. The impact of intermediary entities also needs to be considered. Accounts that are not of a long-term-investment nature will be exposed to the risk of exchange rate changes, and companies will have to decide whether to bear that risk, to hedge it or to eliminate it via timely settlement of balances.

#### **Illustration 3-5: Intercompany loan that is of a long-term-investment nature**

Assume a US parent has a loan denominated in USD to its foreign subsidiary whose functional currency is the local currency. The loan does not have a stated maturity date, and the US parent does not intend to seek repayment in the foreseeable future. Therefore, this intercompany loan qualifies as an intercompany transaction of a long-term-investment nature.

Since this loan is denominated in USD, the US parent does not deem this loan to be a foreign currency transaction on its books. However, since the functional currency of the foreign entity is its local currency while the loan is denominated in USD, the foreign entity deems this loan to be a foreign currency transaction.

In the standalone financial statements of the foreign entity, the foreign currency transaction gain or loss related to this intercompany loan is recorded in income. However, the transaction gain or loss would be reclassified as a translation adjustment and recorded in other comprehensive income in the US parent's consolidated financial statements since both parties to the intercompany transaction are included in the US parent's consolidated financial statements.

**Question 3.9** May gains and losses on intercompany foreign currency transactions that are of a long-term-investment nature be reported in other comprehensive income and included as a component of accumulated other comprehensive income in the separate stand-alone financial statements of the subsidiary or other investees?

No. Such accounting is permitted only when the entities to the transactions are consolidated, combined or accounted for by the equity method in the reporting entity's financial statements (as shown in Illustration 3-5). However, if financial statements and summary financial information relating to the subsidiary or investee constitute disaggregated information in the consolidated financial statements of the reporting entity, foreign currency transaction gains or losses on qualifying intercompany transactions are treated in the same manner as in the reporting entity's statements (i.e., in OCI).

### 3.4.1.2 Settlement of intercompany foreign currency transaction of a long-term-investment nature

A change in circumstances may lead to a change in the nature of an intercompany transaction from a long-term investment to one for which settlement becomes planned or anticipated. Foreign currency transaction gains and losses that have been recorded as a component of other comprehensive income during the period for which settlement was not planned or anticipated remain in that account, until partial or complete sale or complete or substantially complete liquidation of the investment in the foreign entity, depending on the accounting treatment of the investment. Refer to section 4.4.3, *Disposition of cumulative translation adjustment*, for further guidance. Going forward, the foreign currency transaction gains and losses of an intercompany transaction that are no longer considered long-term in nature should be recorded in income.

### 3.4.1.3 Forgiveness of intercompany foreign currency transactions of a long-term-investment nature

An intercompany balance that qualifies as being of a long-term-investment nature must continually meet the condition that settlement is neither planned nor anticipated in the foreseeable future. The decision to forgive the loan does not result in an exchange of cash flows and is therefore fundamentally different from the decision to settle the loan. Accordingly, foreign currency gains and losses from remeasurement of this balance, now classified as a capital contribution, would continue to be reported in CTA rather than in income.

### 3.4.1.4 Interest receivable and payable on an intercompany loan

Even if the underlying intercompany loan is considered to be of a long-term nature, the related interest receivable and payable would not qualify to be considered as such when the terms of the intercompany loan require periodic payments of interest. Therefore, the effects of foreign currency exchange rate fluctuations on such interest receivable and payable should be recorded in income.

## 3.5 Debt-for-equity swap

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Foreign Currency Transactions

#### *Implementation Guidance and Illustrations*

#### **830-20-55-1**

This guidance applies to a transaction with all of the following characteristics:

- a. In a secondary-market transaction, a U.S. entity purchases – at less than the face amount – some dollar-denominated debt due from a foreign government or an entity that operates in that foreign country.
- b. Simultaneously, the U.S. entity exchanges the debt with the foreign country's government in a transaction denominated in the foreign currency.

- c. The **exchange rate** used to obtain the **foreign currency** is the official exchange rate (less a transaction fee).
- d. The U.S. entity is required by the foreign government to invest the foreign currency proceeds in the entity's subsidiary operating in that foreign country. (The intent of the foreign government may be to induce the U.S. entity to make an investment in long-lived assets in the foreign country.)

#### **830-20-55-2**

The amount by which the **local currency** proceeds translated at the official exchange rate exceed the purchase cost of the loan (referred to as the excess) shall be used to reduce the basis of the long-lived assets acquired or constructed to comply with the arrangement. If the arrangement does not specifically require the acquisition or construction of long-lived fixed assets, or if the excess exceeds the cost of the assets, the excess shall be used to reduce the carrying amount of existing long-lived assets other than goodwill. The excess shall be applied first to reduce the basis of the fixed asset with the longest remaining life. If that asset is reduced to zero, the remaining excess shall be applied to reduce the basis of the fixed asset with the next longest remaining life. If the cost of all fixed assets is reduced to zero, the remaining excess shall be reported as a bargain purchase as required by Subtopic 805-30.

#### **830-20-55-3**

This guidance is applicable also to a debt-for-equity swap with both of the following characteristics (resulting in the excess being reported as a bargain purchase as required by Subtopic 805-30):

- a. The foreign branch has no significant assets or liabilities other than local currency debt and has an accumulated deficit.
- b. The proceeds from the debt-for-equity swap are used to extinguish the debt.

The guidance in ASC 830-20-55-2 was finalized in EITF Issue No. 87-12, *Foreign Debt-for-Equity Swaps*. In reaching that consensus, the EITF concluded that the intent of a government to participate in a debt-for-equity transaction is to incentivize foreign investors to make investments in long-lived assets in its country. Therefore, the EITF reached a consensus that the credit that arises from a debt-for-equity transaction should be used to reduce the basis of the long-lived assets acquired or constructed to comply with the arrangement.

#### **Illustration 3-6: Debt-for-equity swap**

A US company (Company) with operations in Mexico, through a Mexican subsidiary (Subsidiary), purchases a USD-denominated loan from a financial institution for \$5 million (the loan's secondary market value). The loan's principal is \$10 million and is owed by a Mexican entity. The Mexican government purchases the loan from the Company for Mexican pesos worth \$8.5 million (at current currency exchange rates). Upon its purchase of the loan, the Mexican government requires that the Company remit the newly obtained pesos to the Subsidiary, and the Subsidiary issues capital stock to the Company. An agreement with the Mexican government restricts redemption of the stock, dividend payments on the stock and sales of the stock to Mexicans for a stated period of time.

All of these provisions are designed to retain the pesos in the Mexican economy. Also, the agreement requires the pesos to be used for a specified purpose in the Mexican operation (such as to make a capital expenditure). A \$3.5 million credit arises in the Company's consolidated financial statements because its Mexican subsidiary's net assets increased \$8.5 million while the Company "invested" only \$5 million to achieve such an increase.

# 4 Translation of financial statements

## 4.1 Overview

ASC 830 generally requires entities to apply two separate processes for reporting foreign currency balances. Remeasurement, as discussed in the previous section, is the process of measuring and recognizing the foreign currency transactions of an entity in the entity's functional currency. Translation is the process used for expressing the functional currency financial statements of an entity in the reporting currency for purposes of preparing the reporting entity's (parent's) consolidated financial statements when the entity's functional currency is different from that of the parent.

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Overall

##### *Glossary*

##### **830-10-20**

##### *Foreign Currency Translation*

The process of expressing in the reporting currency of the reporting entity those amounts that are denominated or measured in a different currency.

#### Foreign Currency Matters – Translation of Financial Statements

##### *Overview and Background*

##### **830-30-05-1**

This Subtopic provides guidance for translating **foreign currency statements** that are incorporated in the financial statements of a **reporting entity** by consolidation, combination, or the equity method of accounting.

## 4.2 Exchange rates

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Translation of Financial Statements

##### *Other Presentation Matters*

##### **830-30-45-3**

All elements of financial statements shall be translated by using a current exchange rate as follows:

- a. For assets and liabilities, the exchange rate at the balance sheet date shall be used.
- b. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used.

This guidance also applies to accounting allocations (for example, depreciation, cost of sales, and amortization of deferred revenues and expenses) and requires translation at the current exchange rates applicable to the dates those allocations are included in revenues and expenses (that is, not the rates on the dates the related items originated).

##### **830-30-45-4**

For purposes of translation of financial statements referred to in this Subtopic, the current exchange rate is the rate as of the end of the period covered by the financial statements or as of the dates of recognition in those statements in the case of revenues, expenses, gains, and losses.

**830-30-45-6**

In the absence of unusual circumstances, the exchange rate applicable to **conversion** of a currency for purposes of dividend remittances shall be used to translate foreign currency statements.

**830-30-45-7**

If unsettled intra-entity transactions are subject to and translated using preference or penalty rates, translation of foreign currency statements at the rate applicable to dividend remittances may cause a difference between intra-entity receivables and payables. Until that difference is eliminated by settlement of the intra-entity transaction, the difference shall be treated as a receivable or payable in the reporting entity's financial statements.

**830-30-45-8**

If a **foreign entity** whose balance sheet date differs from that of the reporting entity is consolidated or combined with or accounted for by the equity method in the financial statements of the reporting entity, the current rate is the rate in effect at the foreign entity's balance sheet date for purposes of applying the requirements of this Subtopic to that foreign entity.

ASC 830 is silent about the exchange rate that entities should use to translate the foreign entity's capital accounts (for example, common stock and paid-in capital). However, it is implicit in ASC 830 that these should be translated at historical rates. This is necessary to accomplish the elimination of the parent's investment and the subsidiary's capital accounts when consolidating. Capital transactions (such as dividends and investments) should be translated at exchange rates on the date they are recognized by both the parent and subsidiary, which presumably would be the same date. Translated retained earnings under the current rate method is the amount at the beginning of the period, plus or minus amounts for income, dividends and other items translated as indicated above.

Foreign currency financial statements should be translated at the rate applicable to conversion of a currency for purposes of dividend remittances. The FASB believes that this rate is more meaningful than any other rate because the reporting entity's net investment in the foreign entity could be realized only by converting cash flows using this rate.

If use of this rate causes differences between the translated intercompany accounts of two entities, the difference is treated as a receivable or payable in the consolidated financial statements until settlement of the transaction. Such differences may arise in instances where unsettled intercompany transactions are subject to and translated using preference or penalty rates, while the foreign currency statements are translated at the rate applicable to dividend remittances.

The following example illustrates the application of ASC 830-30-45-7:

**Illustration 4-1: Unsettled intercompany transaction remeasured using penalty rate**

On 27 December 20X1, Company A, a calendar year-end US company (with USD (\$) as its functional currency) sells laptops for \$5,000 to its foreign subsidiary, Company B, whose functional currency is the Euro (€). The government of the country where Company B is incorporated applies a penalty rate of \$1 = €1 for imports of electronic equipment into the country, including laptops. The general exchange rate of \$1 = €0.89 applies to the dividend remittances from 27 December 20X1 to 31 December 20X1, the balance sheet date. This intercompany transaction remains unsettled as of the balance sheet date.

On 27 December 20X1, Company A will record a receivable of \$ 5,000, and Company B will record a payable of €5,000 (\$ 5,000 x the penalty rate of \$1 = €1).

On 31 December 20X1, Company B will translate its payable to \$5,618 using the exchange rate applicable to dividend remittances on 31 December 20X1 (\$1 = €0.89).

The intercompany payable (\$ 5,618) and Company A's corresponding intercompany receivable (\$ 5,000) are eliminated as part of consolidation, and the difference of \$618 is shown as a payable in the consolidated financial statements until settlement.

Refer to section 2.3, *Exchange rates*, for further guidance.

## 4.2.1 Translation after a business combination

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Translation of Financial Statements

##### *Other Presentation Matters*

##### **830-30-45-11**

After a business combination, the amount assigned at the acquisition date to the assets acquired and the liabilities assumed (including goodwill or the gain recognized for a bargain purchase in accordance with Subtopic 805-30) shall be translated in conformity with the requirements of this Subtopic.

Goodwill resulting from a business combination, and any fair value adjustments to the amounts assigned at the acquisition date to the assets acquired and liabilities assumed of a foreign entity, should be translated in accordance with ASC 830-30-45, regardless of whether the purchase accounting adjustments are pushed down to the acquired entity. As a result, these balances should be measured in the functional currency of the acquired entity and subsequently translated to the reporting currency of the parent (if the functional currency of the acquired entity is different from the reporting currency) at the current exchange rate. Any resulting translation adjustments would be included in cumulative translation adjustment (CTA), even if the balances were not pushed down to the books of the acquired entity.

To illustrate, assume that on 1 January 20X1, ABC Company (a US dollar functional currency entity) paid €1,000,000 (€1 = \$1; \$1,000,000) to acquire 100% of Company X (a euro functional currency entity). Company X's identifiable net assets at the date of acquisition were €900,000. The excess of the fair value of the entity over the values assigned to the net identifiable assets acquired (€1,000,000 – €900,000 = €100,000) was recognized as goodwill by ABC Company.

At 31 December 20X1, the US dollar to euro exchange rate ratio depreciates to \$1 per €0.94. As a result, the US dollar equivalent value of goodwill becomes \$106,383 (€100,000 x (\$1/€0.94)). The \$6,383 translation gain is included in CTA.

Refer to our FRD, *Intangibles – Goodwill and other*, for further guidance.

## 4.3 Elimination of intra-entity profits

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Translation of Financial Statements

##### *Other Presentation Matters*

##### **830-30-45-10**

The elimination of intra-entity profits that are attributable to sales or other transfers between entities that are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements shall be based on the exchange rates at the dates of the sales or transfers. The use of reasonable approximations or averages is permitted.



ASC 830 states that translation of intercompany profits and the elimination of such intercompany profits on sales or transfers between entities should be based on the exchange rates at the dates of sale or transfer. The intercompany profits should then be eliminated from the asset sold or transferred until it is subsequently sold or otherwise disposed of by the consolidated group.

Since the elimination of intercompany profits should be based on the exchange rates at the dates of sale or transfer, subsequent changes in the exchange rates should not affect such elimination process. The Basis for Conclusions in the original FAS 52 states that the effect of subsequent changes in exchange rates on the transferred asset or the related expense is viewed as being the result of changes in exchange rates rather than being attributable to intercompany profits.

The following example illustrates how intercompany profits should be eliminated.

#### **Illustration 4-2: Elimination of intra-entity profits**

##### **Facts:**

- ▶ On 15 January 20X9, a US parent sells inventory for \$300,000 (cost \$200,000) to a UK subsidiary whose functional currency is the pound.
- ▶ As a result of the sale, the US parent realizes an intercompany profit of \$100,000 (\$300,000 – \$200,000).
- ▶ The exchange rate on the date of sale was \$1=£0.5.
- ▶ The UK subsidiary records the inventory at £150,000 (\$300,000 x (£0.5/\$1.0)).
- ▶ As of 31 March 20X9, the inventory has not yet been sold.
- ▶ On 31 March 20X9, the exchange rate is \$1=£0.8.

To properly compute the intercompany profit amount to be eliminated in consolidation, the inventory recorded in the UK subsidiary's books needs to be separated into two components.

The inventory recorded in the UK subsidiary: £150,000

- ▶ Cost component: £100,000 (\$200,000 x (£0.5/\$1.0))
- ▶ Intercompany profit component: £50,000 (\$100,000 x (£0.5/\$1.0))

Since ASC 830 provides that translation of intercompany profits and the elimination of such intercompany profits on sales or transfers between entities should be based on the exchange rates at the dates of sale or transfer, the exchange rate of \$1=£0.5 as of 15 January 20X9 is used.

Therefore, the intercompany profit component of £50,000 is translated at the historical rate into \$100,000 which equals the intercompany profit amount recognized by the US parent. These two balances are then fully eliminated in consolidation until the sale is realized outside of the consolidated group.

The cost component of £100,000 is translated at the current exchange rate as of 31 March 20X9. This results in the inventory amount of \$125,000 (£100,000 / (£0.8/\$1.0)) that is recognized in the consolidated balance sheet.

A literal application of ASC 830's requirements for eliminating intercompany profits may be a computational burden for some companies. However, ASC 830 provides that companies may use averages and approximations to translate and eliminate intercompany profits. Any computational method that approximates results that would be achieved by a more precise method is appropriate.

## 4.4 Reporting translation adjustments

Pursuant to ASC 830-30-45-12, if an entity's functional currency is a foreign currency, translation adjustments resulting from translating the entity's financial statements into the reporting currency are reported in other comprehensive income. This treatment contrasts with the treatment of foreign exchange gains and losses that result from remeasurement of foreign-currency-denominated transactions, which are recorded directly in income. For guidance on reporting foreign-currency-related components of other comprehensive income, refer to ASC 220.

### 4.4.1 Cumulative translation adjustment in impairment tests

#### Excerpt from Accounting Standards Codification

##### Foreign Currency Matters – Translation of Financial Statements

##### *Other Presentation Matters*

##### **830-30-45-13**

An entity that has committed to a plan that will cause the cumulative translation adjustment for an equity method investment or a consolidated investment in a foreign entity to be reclassified to earnings shall include the cumulative translation adjustment as part of the carrying amount of the investment when evaluating that investment for impairment. The scope of this guidance includes an investment in a foreign entity that is either consolidated by the reporting entity or accounted for by the reporting entity using the equity method. This guidance does not address either of the following:

- a. Whether the cumulative translation adjustment shall be included in the carrying amount of the investment when assessing impairment for an investment in a foreign entity when the reporting entity does not plan to dispose of the investment (that is, the investment or related consolidated assets are held for use)
- b. Planned transactions involving foreign investments that, when consummated, will not cause a reclassification of some amount of the cumulative translation adjustment.

##### **830-30-45-14**

In both cases, paragraph 830-30-40-1 is clear that no basis exists to include the cumulative translation adjustment in an impairment assessment if that assessment does not contemplate a planned sale or liquidation that will cause reclassification of some amount of the cumulative translation adjustment. (If the reclassification will be a partial amount of the cumulative translation adjustment, this guidance contemplates only the cumulative translation adjustment amount subject to reclassification pursuant to paragraphs 830-30-40-2 through 40-4.)

##### **830-30-45-15**

An entity shall include the portion of the cumulative translation adjustment that represents a gain or loss from an effective hedge of the net investment in a foreign operation as part of the carrying amount of the investment when evaluating that investment for impairment.

Accumulated foreign currency translation adjustments are reclassified to net income only when realized upon sale or upon complete or substantially complete liquidation of the investment in the foreign entity (see ASC 830-30-40-1 through 40-4 for additional guidance).

ASC 830-30-45-13 requires an entity that has committed to a plan that will cause the CTA for an equity method investment or a consolidated investment in a foreign entity to be reclassified to earnings to include the CTA as part of the carrying amount of the investment when evaluating that investment for impairment, regardless of whether the CTA is a debit or credit balance.

The following example illustrates the application of ASC 830-30-45-13:

**Illustration 4-3: Evaluating a foreign entity that is committed to a plan to sell for impairment**

On 1 January 20X4, Company A (a US dollar (\$) functional currency entity) invests \$650 for a 25% ownership interest in Company B (a euro (€) functional currency entity), which will be accounted for as an equity method investment. For simplicity, the investment cost equals 25% of Company B's net book value.

Company A recognizes its share of (1) Company B's net income for the year ended 31 December 20X4 (\$192) and (2) the adjustment arising from the translation of Company B's financial statements from the euro to the US dollar (debit of \$23). A roll-forward of the equity method investment account from the initial investment to the balance at 31 December 20X4 follows:

Initial investment	\$ 650
Share of 20X4 net income	192
Share of translation adjustment	<u>(23)</u>
	<u>\$ 819</u>

On 31 December 20X4, Company A commits to a plan to sell its equity method investment in Company B for \$775. The investment is sold on 15 March 20X5 for \$775. Company A's impairment loss at 31 December 20X4 is calculated as follows:

Carrying amount of investment in Company B	\$ 819
Add: CTA debit balance <sup>(A)</sup>	<u>23</u>
Adjusted carrying amount	842
Fair value	<u>(775)</u>
Impairment loss	<u>\$ 67</u>
Carrying amount before impairment write-down	\$ 819
Impairment write-down	<u>(67)</u>
Carrying amount of investment in Company B at December 20X4	<u>\$ 752</u>
<b>Accounting at date of sale (15 March 20X5)</b>	
Sale proceeds	\$ 775
Less asset carrying amount	(752)
CTA reclassification entry	<u>(23)</u>
Loss on disposal	<u>\$ 0</u>

<sup>(A)</sup> This entry is used only for measuring impairment. In accordance with ASC 830-30-40-1, CTA is reclassified into earnings only upon a sale or upon a complete or substantially complete liquidation of the foreign entity.

## 4.4.2

### Analysis of changes in cumulative translation adjustment

ASC 830-30-45-18 addresses presentation matters pertaining to the changes in cumulative translation adjustments. It provides that an analysis of CTA changes reported in equity during the period should be reported in any of the following ways:

- ▶ In a separate financial statement
- ▶ In notes to financial statements
- ▶ As part of a statement of changes in equity

### 4.4.3 Disposition of cumulative translation adjustment

#### Excerpt from Accounting Standards Codification

##### Foreign Currency Matters – Translation of Financial Statements

###### *Derecognition*

###### **830-30-40-1**

Upon sale or upon complete or substantially complete liquidation of an investment in a **foreign entity**, the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be both:

- a. Removed from the separate component of equity
- b. Reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs.

###### **830-30-40-1A**

A sale shall include:

- a. The loss of a controlling financial interest in an investment in a foreign entity resulting from circumstances contemplated by Subtopic 810-10 (see paragraph 810-10-55-4A for related implementation guidance)
- b. An acquirer obtaining control of an acquiree in which it held an equity interest, accounted for as an equity method investment that is a foreign entity, immediately before the acquisition date in a business combination achieved in stages (see paragraphs 805-10-25-9 through 25-10).

###### **830-30-40-2**

If a **reporting entity** sells part of its ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the accumulated translation adjustment component of equity attributable to that equity method investment shall be recognized in measuring the gain or loss on the sale. If the sale of part of an equity method investment that is a foreign entity results in the loss of significant influence, see paragraphs 323-10-35-37 through 35-39 for guidance on how to account for the pro rata portion of the accumulated translation adjustment component of equity attributable to the remaining investment. For guidance if an entity sells a noncontrolling interest in a consolidated foreign entity, but still retains a controlling financial interest in the foreign entity, see paragraph 810-10-45-23 through 45-24.

###### **830-30-40-3**

Although partial liquidations by a parent of net assets held within a foreign entity may be considered similar to a sale of part of an ownership interest in the foreign entity if the liquidation proceeds are distributed to the parent, extending pro rata recognition (release of the cumulative translation adjustment into net income) to such partial liquidations would require that their substance be distinguished from ordinary dividends. Such a distinction is neither possible nor desirable. For those partial liquidations, no cumulative translation adjustment is released into net income until the criteria in paragraph 830-30-40-1 are met.

###### **830-30-40-4**

Under Subtopic 220-20, a gain or loss on disposal of part or all of a net investment may be recognized in a period other than that in which actual sale or liquidation occurs. Paragraph 830-30-40-1 does not alter the period in which a gain or loss on sale or liquidation is recognized under existing generally accepted accounting principles (GAAP).

ASC 830-30-40 describes the circumstances and provides the following guidance for reclassifying translation adjustments accumulated as a separate component of shareholders' equity:

#### **Sale or liquidation of an investment in a foreign entity**

Upon sale or complete or substantially complete liquidation of an investment in the foreign entity, as defined in ASC 830 (refer to section 1.2.2, *Foreign entity and reporting entity*, for further guidance), the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be removed from the separate component of equity and reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs. A sale of an investment in a foreign entity includes (1) events that result in the loss of a controlling financial interest in a foreign entity (that is, irrespective of any retained investment) and (2) an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (i.e., step acquisitions).

We believe that to qualify as a substantially complete liquidation, generally at least 90% of the assets and liabilities of a foreign entity should be liquidated. When a company liquidates its foreign entity through multiple transactions, the determination of whether the liquidation qualifies as a substantially complete liquidation should be based on the amount of assets and liabilities of the foreign entity at the time that management committed to the plan that, pursuant to ASC 830-30-45-13, will cause the CTA to be reclassified to earnings. An entity that has committed to a plan to sell at least 90% of a foreign entity's assets and liabilities is also required to include the related CTA as part of the carrying amount of the investment when evaluating that investment for impairment (refer to ASC 830-30-45-13 through 45-15 for further guidance).

The variety of ownership and managerial structures complicates determinations of whether a substantially complete liquidation has occurred. Because the definition of a foreign entity contemplates internal organizational attributes and legal ownership form, we believe that determinations as to whether substantially complete liquidation has occurred should be considered from both substance and form perspectives, as it is not necessarily aligned with legal entity ownership interests.

Refer to Illustrations 4-3, 4-3(a), 4-4, 4-5 and 4-6 for additional implementation guidance.

#### **Partial sale of ownership interest**

Upon the partial sale of an ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the CTA should be released into earnings. When a reporting entity sells a portion of an equity method investment that is a foreign entity that results in the loss of significant influence, any CTA remaining after the pro rata release into earnings should become part of its carrying value in the investment at the time significant influence is lost in accordance with ASC 323-10-35-37 through 35-39.

After the remaining CTA becomes part of the investment's carrying value, companies should evaluate the appropriate accounting treatment of the financial asset because further adjustments to the carrying value may be necessary at the transaction date (see section 7.4 of our FRD, *Equity method investments and joint ventures*, and chapter 3 of our FRD, *Certain investments in debt and equity securities*, for additional guidance and illustrations).

Refer to Illustrations 4-7 and 4-7(a) for additional implementation guidance.

ASC 830-30-40-3 explains further that the pro rata recognition concept should not be extended to partial net asset liquidations by a subsidiary through a sale and distribution to a parent or otherwise as it might not be possible or desirable to make distinctions between such partial liquidations and ordinary dividends.

When there is a change in a noncontrolling interest in a consolidated foreign entity, but the parent still retains a controlling financial interest in the foreign entity, a pro rata share of the CTA should be reallocated between the controlling interest and the noncontrolling interest in accordance with ASC 810-10-45-23 through 45-24.

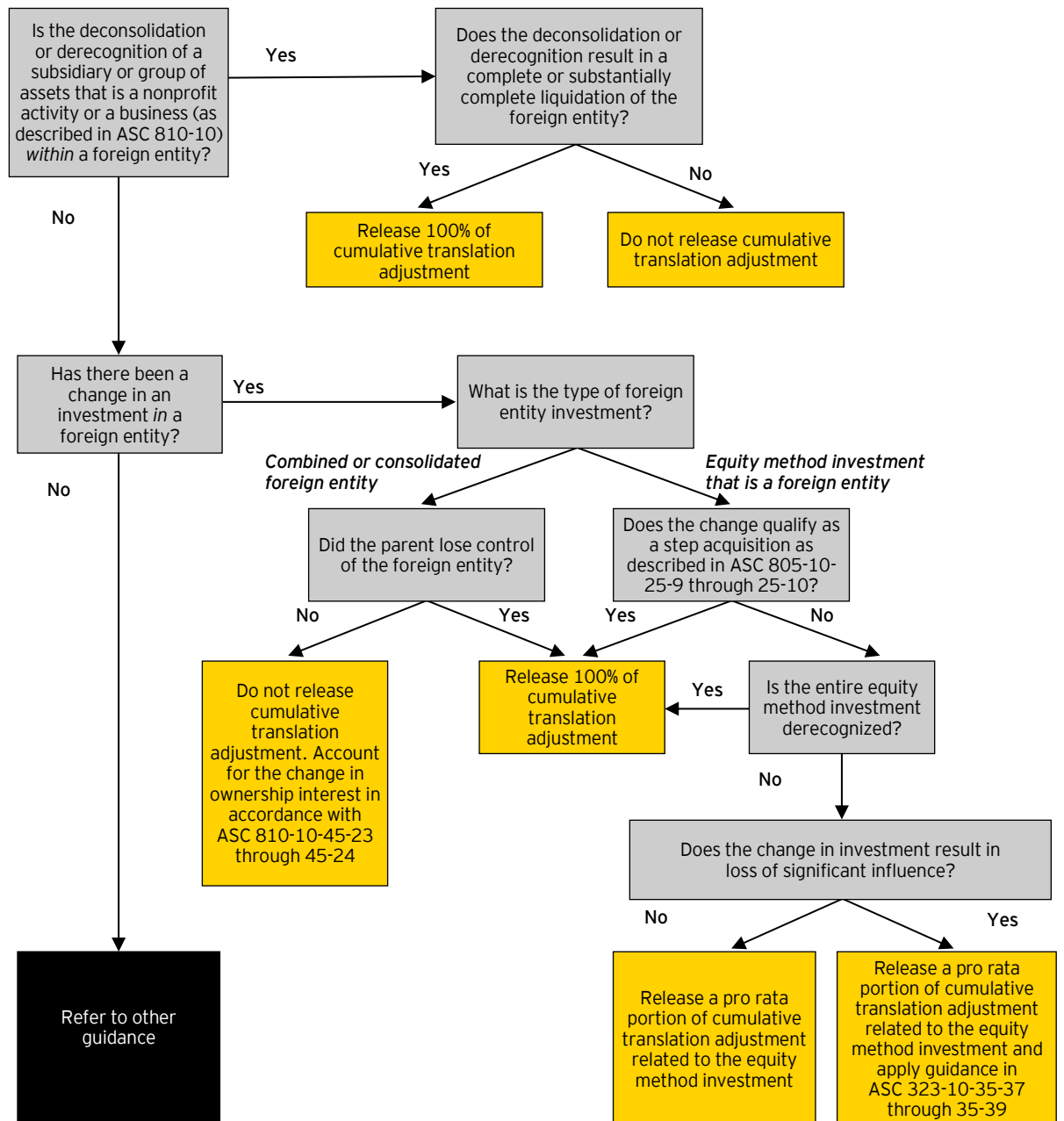
Refer to section 4.4.4, *Cumulative translation adjustments attributable to noncontrolling interests*, for further guidance.

## Implementation guidance

To apply the provisions for determining when CTA should be released into earnings, entities must determine whether a transaction involves derecognition of a part of a foreign entity (i.e., derecognition of net assets *within* a foreign entity) or derecognition of an entire foreign entity (i.e., derecognition of an investment *in* a foreign entity).

The following decision tree illustrates the CTA derecognition guidance in ASC 830-30-40-1 through 40-4 for derecognition of certain subsidiaries or groups of assets within a foreign entity and for changes in an investment in a foreign entity;<sup>7</sup> however, it is not intended to illustrate all derecognition events that could be within or outside the scope of ASC 830-30:

## Release of cumulative translation adjustment decision tree



<sup>7</sup> See also Illustration 4-8.

**Illustration 4-4: Liquidation of a group of assets within a foreign entity**

A parent company owns and consolidates an integrated operation (which meets the definition of a foreign entity) in a particular functional currency environment other than the functional currency of the parent. Five entities have been established or acquired over time to legally hold the various integrated assets of the foreign operation. Based on certain strategic and technical decisions about the direction of the foreign operation, the parent sells substantially all of the assets of one of the five entities. Proceeds of the sale are either distributed to the parent or reinvested into the other four. In either case, the foreign operation continues as an ongoing consolidated operation.

Even though substantially all of the assets of one of the operation's legal entities (with a functional currency other than that of the parent) have been sold, it would generally not be appropriate to recognize the cumulative translation adjustment associated with the sold assets because the overall foreign operation is ongoing. Accordingly, the parent should not conclude that a substantially complete liquidation has occurred.

**Illustration 4-4(a): Liquidation of a foreign entity that results in cumulative translation adjustments being reclassified into earnings**

Assume the same facts as those included in Illustration 4-4 above, except the parent company decides to cease the operations of the foreign entity (i.e., all of the five legal entities representing the integrated operation) and directs local management to sell more than 90% of the integrated operation's net assets. The remaining net assets will be disposed of in future periods. The sale proceeds are remitted to the parent company and the parent company has no intention of reinvesting in similar activities.

In this instance, the sale represents a substantially complete liquidation of the foreign entity. As a result, the entire cumulative translation adjustment (CTA) related to the foreign operation should be removed from the separate component of equity and reported as part of the gain or loss on liquidation of the foreign entity.

Additionally, the effect of future exchange rate changes on the remaining monetary assets and liabilities not denominated in the functional currency of the parent company (the reporting entity) should be reported in net income, not CTA. This is because the substantially complete liquidation of the foreign entity essentially results in a change in its functional currency from the foreign currency to the reporting currency. The translated amounts of nonmonetary assets and liabilities at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods (see ASC 830-10-45-10).

**Illustration 4-5: Accounting for a sale of an investment in a foreign entity**

A US company sells 100% of its investment in a wholly owned subsidiary that is a foreign entity for \$5,000,000. The company's equity in the subsidiary at the date of sale is \$6,000,000 and the cumulative translation adjustment in stockholders' equity related to the subsidiary is a credit of \$2,000,000. The gain on sale of the subsidiary (ignoring any tax effects) would be calculated as follows:

Investment in foreign entity	\$ 6,000,000
Cumulative translation adjustment in stockholders' equity	(2,000,000)
Net amount	<u>4,000,000</u>
Sales price	<u>5,000,000</u>
Net gain	<u><u>\$ 1,000,000</u></u>

The \$2,000,000 adjustment to the translation component of stockholders' equity should be separately disclosed in the analysis of changes to the translation component of equity for the year of the sale (see ASC 830-30-50-1 and ASC 830-30-45-20). If the parent company had sold other investments in foreign entities in the same year, all such adjustments would be aggregated and disclosed as one amount in the analysis of changes in the cumulative translation adjustment (CTA).

However, the \$2,000,000 adjustment should not be included in the disclosure of the aggregate transaction gain or loss for the period (see ASC 830-20-50-1), if any. This is because transaction gains and losses result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated, not the sale or liquidation of an investment in a foreign entity.

Companies should maintain records of the portion of the consolidated translation component included in equity pertaining to each foreign entity. This is necessary to properly adjust the consolidated translation component pertaining to each foreign entity upon its sale or liquidation.

#### **Illustration 4-6: Accounting for a sale of a complete or substantially complete liquidation of a second-tier subsidiary**

Company A has a foreign entity subsidiary, Subsidiary B, which in turn has its own subsidiary, Subsidiary C. Company A is considering whether a sale or a complete or substantially complete liquidation of Subsidiary C (a second-tier subsidiary) has occurred and whether the related cumulative translation adjustment (CTA) should be recognized in income.

The decision to release CTA depends on whether Subsidiary C is a separate foreign entity from its parent (i.e., whether Subsidiary C's operation is "distinct and separable" from that of Subsidiary B). Such analysis depends on various factors that are discussed in sections 1.2.2, *Foreign entity and reporting entity*, and 2.1.1, *Distinct and separable operation*, including:

- ▶ How the proceeds from the sale or liquidation of Subsidiary C will be used
- ▶ The similarity between the operations of Subsidiary C and Subsidiary B
- ▶ The functional currencies of Subsidiary C and Subsidiary B
- ▶ Whether Subsidiary C has the ability to prepare its own separate financial statements
- ▶ Whether the activities of each entity are managed separately

If Subsidiary B and Subsidiary C were considered a single foreign entity and Subsidiary C were sold and the proceeds remitted to Company A, the CTA would generally not be released unless the sale of Subsidiary C represents a complete or substantially complete liquidation of the single foreign entity.

If Subsidiary C is considered a separate foreign entity (i.e., separate from Subsidiary B), CTA would be released in its entirety if the event results in the loss of a controlling financial interest in Subsidiary C. Refer to ASC 830-30-45-17 or section 4.4.4, *Cumulative translation adjustments attributable to noncontrolling interests*, for further guidance on accounting for CTA attributable to changes in noncontrolling interests.



**Illustration 4-7: Release of cumulative translation adjustment in a step acquisition**

UK Company holds a 40% ownership interest in an equity method investment that is a foreign entity. Subsequent to the initial investment, UK Company acquires an additional 30% ownership interest in the equity method investee, and as a result, now controls and consolidates the foreign entity.

ASC 830-30-40-1A clarifies that the sale of an equity method investment that is a foreign entity includes events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (i.e., step acquisitions). ASC 805-10-25-10 states that if the step acquisition relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss upon initial consolidation shall include any foreign currency translation adjustment related to that previously held investment. Accordingly, any CTA related to the foreign equity method investment should be released into net income upon the acquisition by UK Company of the additional 30% interest.

**Illustration 4-8: Accounting for partial sale of an ownership interest in an equity method investment**

A US entity with USD functional currency sells a portion of its 40% ownership interest in an equity method investee with euro functional currency. At the time of sale the carrying value of the investment is \$5 million and the related cumulative translation adjustment (CTA) is a debit balance of \$100,000.

Assuming the US entity's ownership interest in the foreign equity method investee is reduced from 40% to 20% (retaining significant influence), a proportionate share of the CTA (i.e., \$50,000 = \$100,000 x 50% (the reduction in ownership interest)) associated with this equity method investment should be recognized in income in accordance with ASC 830-30-40-2.

**Illustration 4-8(a): Accounting for partial sale of an ownership interest in an equity method investment that results in the investor no longer retaining significant influence**

Assume the same facts as in Illustration 4-8, except the US entity's ownership interest is instead reduced from 40% to 10%, resulting in a loss of significant influence and retention of an investment accounted for at fair value or the measurement alternative, if eligible under ASC 321-10.

Similar to first scenario, the US entity should recognize a proportionate share of the CTA in income. In this case, 75% of the CTA balance should be released into earnings. Additionally, because the US entity lost significant influence, ASC 323-10-35-39 requires the remaining CTA balance to become part of the retained investment's carrying value<sup>1</sup> at the time significant influence is lost. To the extent that the CTA offset results in a carrying value of the retained investment that is less than zero (i.e., because the CTA credit balance exceeds the investment's carrying value), ASC 323-10-35-39 requires the investor to both reduce the carrying value of the investment to zero and record the remaining balance in income.

In this example, 75% of the CTA balance would be released into earnings and the remaining debit balance of \$25,000 (\$100,000 – \$75,000) would be offset against the carrying value of investment calculated as follows:

Carrying value of the equity method investment prior to sale	\$ 5,000,000
Carrying value allocated for disposal (\$5,000,000 x 75%)	<u>3,750,000</u>
Retained balance	1,250,000
Related CTA balance adjustment	<u>25,000</u>
Carrying value of retained investment <sup>1</sup>	<u>\$ 1,275,000</u>

<sup>1</sup> After the remaining CTA becomes part of the investments carrying value, companies should evaluate the appropriate accounting treatment of the financial asset because further adjustments to the carrying may be necessary at the transaction date. See chapter 3 of our FRD, *Certain investments in debt and equity securities*, and section 7.4 of our FRD, *Equity method investments and joint ventures*, for additional guidance and illustrations.

**Illustration 4-9: Sale of an equity method investment that is not a foreign entity**

Parent Co, a USD functional currency reporting entity, consolidates Sub Co, a Mexican peso functional currency entity. Sub Co meets the definition of a foreign entity for purposes of ASC 830. Sub Co owns an equity method investment, which also has a Mexican peso functional currency and which represents 30% of Sub Co's net assets. The entire equity method investment is sold, but Parent Co retains control of Sub Co.

In accordance with ASC 830-30-40-1A, derecognition or deconsolidation of a subsidiary or group of assets that is a nonprofit activity or a business *within* a foreign entity results in release of 100% of the related CTA only if the derecognition or deconsolidation event results in a complete or substantially complete liquidation of the foreign entity. In this example, because the derecognition of the equity method investment, which is only a component of a larger foreign entity (i.e., Sub Co), represents only 30% of the foreign entity's net assets, no CTA would be released into earnings since the sale does not result in a complete or substantially complete liquidation of the foreign entity.

**Question 4.1**

**Would the pro rata spin-off of a foreign entity (the spinnee) that constitutes a business under ASC 805 result in the cumulative translation adjustment (CTA) attributable to that foreign entity to be reclassified and recognized in earnings of the spinnor?**

No. A pro rata spin-off of a foreign entity that is a consolidated subsidiary or equity method investee that meets the definition of a business under ASC 805 is a nonreciprocal transfer that is recorded based on the carrying value (after reduction for an indicated impairment, if necessary) of the foreign entity. That is, no gain or loss is recognized on a pro rata spin-off by the spinnor (see ASC 845-10-30-10 and ASC 505-60-25-2). Consistent with this guidance, any CTA associated with the foreign entity should be reclassified as part of the net adjustment to stockholders' equity rather than recognized in earnings of the spinnor. CTA is reclassified into earnings only upon a sale or liquidation of an investment in a foreign entity. The guidance in ASC 830-30-40-1 through 40-4 does not apply to nonreciprocal transfers.

**4.4.4****Cumulative translation adjustments attributable to noncontrolling interests****Excerpt from Accounting Standards Codification****Foreign Currency Matters – Translation of Financial Statements*****Other Presentation Matters******830-30-45-17***

Accumulated translation adjustments attributable to noncontrolling interests shall be allocated to and reported as part of the noncontrolling interest in the consolidated reporting entity.

The above guidance clarifies that cumulative translation adjustments recorded in other comprehensive income should be reclassified to "noncontrolling interests," reducing accumulated other comprehensive income proportionately in accordance with the percentage ownership interest of the noncontrolling (minority) shareholder.

**Question 4.2**

**Would the sale of a noncontrolling interest in a consolidated foreign entity (or sale of additional shares by a consolidated foreign entity that is a business) require a proportionate disposal of related cumulative translation adjustment (CTA) into income?**

For transactions within the scope of ASC 810, ASC 810-10-45-23 states that changes in a parent's ownership interest while the parent retains its controlling financial interest in its consolidated foreign entity shall be accounted for as equity transactions; therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. Accordingly, if the sale of a noncontrolling interest in a consolidated foreign entity, or issuance of additional shares by the consolidated foreign entity, that is a business (resulting in a noncontrolling interest) does not result in the parent losing control of the consolidated foreign entity, no amount of the related CTA should be released and recognized in income. Instead, a pro rata share of the CTA should be reallocated between the controlling interest and the noncontrolling interest in accordance with ASC 810-10-45-23 through 45-24.

On the other hand, if the change in ownership interest causes the parent to lose control of the foreign entity and is within the scope of ASC 810, it is no longer considered an equity transaction. Rather, the parent would deconsolidate the foreign entity in accordance with ASC 810-10-40-5 and derecognize the carrying amount of assets and liabilities, including any noncontrolling interest and amounts previously recognized in OCI related to the foreign entity. ASC 810-10-40-4A clarifies that for transactions within its scope, the amounts previously recognized in OCI that are reclassified and included in the calculation of gain or loss should include any CTA related to that foreign entity. Refer to ASC 830-30-40 for guidance on derecognizing the CTA recorded in OCI.

# 5 Highly inflationary economies

## 5.1 Functional currency of a highly inflationary economy

### Excerpt from Accounting Standards Codification

Foreign Currency Matters – Overall

#### *Other Presentation Matters*

##### **830-10-45-10**

If the functional currency changes from a foreign currency to the reporting currency, **translation adjustments** for prior periods shall not be removed from equity and the translated amounts for nonmonetary assets at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods. This guidance shall be used also to account for a change in functional currency from the foreign currency to the reporting currency when an economy becomes highly inflationary.

##### **830-10-45-11**

The financial statements of a foreign entity in a highly inflationary economy shall be remeasured as if the functional currency were the reporting currency. Accordingly, the financial statements of those entities shall be remeasured into the reporting currency according to the requirements of paragraph 830-10-45-17. For the purposes of this requirement, a highly inflationary economy is one that has cumulative inflation of approximately 100 percent or more over a 3-year period.

##### **830-10-45-14**

Example 3 (see paragraph 830-10-55-23) illustrates the application of this guidance.

##### **830-10-45-15**

If an entity's subsidiary's functional currency changes from the reporting currency to the **local currency** because the economy ceases to be considered highly inflationary, the entity shall restate the functional currency accounting bases of nonmonetary assets and liabilities at the date of change as follows:

- a. The reporting currency amounts at the date of change shall be translated into the local currency at current exchange rates.
- b. The translated amounts shall become the new functional currency accounting basis for the nonmonetary assets and liabilities.

Example 1 (see paragraph 830-10-55-12) illustrates the application of this guidance.

#### *Implementation Guidance and Illustrations*

##### **830-10-55-12**

This Example illustrates the application of paragraph 830-10-45-15.

**830-10-55-13**

A foreign subsidiary of a U.S. entity operating in a highly inflationary economy purchased equipment with a 10-year useful life for 100,000 **local currency** (LC) on January 1, 19X1. The exchange rate on the purchase date was LC 10 to USD 1, so the U.S. dollar equivalent cost was USD 10,000. On December 31, 19X5, the equipment has a net book value on the subsidiary's local books of LC 50,000 (original cost of LC 100,000 less accumulated depreciation of LC 50,000) and the current **exchange rate** is LC 75 to the U.S. dollar. In the U.S. parent's financial statements, annual depreciation expense of USD 1,000 has been reported for each of the past 5 years, and at December 31, 19X5, the equipment is reported at USD 5,000 (foreign currency basis measured at the historical exchange rate).

**830-10-55-14**

As of the beginning of 19X6, the economy of the subsidiary ceases to be considered highly inflationary. Under paragraph 830-10-45-15, a new functional currency accounting basis for the equipment would be established as of January 1, 19X6, by translating the **reporting currency** amount of USD 5,000 into the functional currency at the current exchange rate of LC 75 to the U.S. dollar. The new functional currency accounting basis at the date of change would be LC 375,000. For U.S. reporting purposes, pursuant to this Subtopic, the new functional currency accounting basis and related depreciation would subsequently be translated into U.S. dollars at current and average exchange rates, respectively.

ASC 830 requires a change in functional currency when a country becomes highly inflationary because a reasonably stable measuring unit is necessary to provide meaningful financial reporting using historical cost accounting. For example, in a highly inflationary economy, assets carried at historical cost become relatively smaller when compared with assets acquired recently at higher price levels due to inflation.

The FASB also recognized that translating foreign currency financial statements of operations in highly inflationary economies may produce unrealistic results if the current exchange rate is used to translate all assets and liabilities. This is because relative rates of inflation are an important contributing factor to currency exchange rate changes. Historically, the currencies of most highly inflationary economies have, in fact, weakened significantly against the USD. Applying the current rate method under such inflationary circumstances generally would result in a substantial downward revaluation of balance sheet amounts of long-lived assets, notably property, plant and equipment.

For example, assume equipment was acquired on 1 January 20X0 by a subsidiary operating in a foreign country for LC10 million (assume LC2.5 = \$1 at the time; LC10 million = \$4 million). The equipment has a useful life of 10 years and is depreciated on a straight-line basis. On 31 December 20X0, the carrying value of the equipment is LC9 million (LC10 million/10 years = LC1 million depreciation per year).

Assume the local currency has weakened significantly against the USD since the beginning of the year, and the exchange rate at 31 December 20X0 is LC5 = \$1. Therefore, the equipment with the carrying value of LC9 million translates into \$1.8 million using the current rate method. Had the exchange rate remained the same as that of the beginning of the year, the carrying value of LC9 million would have translated into \$3.6 million. Operating income, on the other hand, would be improved if the current exchange rate method is used because of much lower depreciation charges.

Pursuant to ASC 830-10-45-11, the financial statements of a foreign entity in a highly inflationary economy should be remeasured as if the functional currency were the reporting currency. The remeasurement process is intended to produce the same results as if the entity's books of record had been maintained in the reporting currency. Because the new functional currency will be the same as the reporting currency of the parent, translation of the financial statements into the reporting currency will no longer be necessary.

### 5.1.1 Functional currency changes from a foreign currency to the reporting currency

Pursuant to ASC 830-10-45-10, if the functional currency changes from a foreign currency to the reporting currency (for whatever reason, including a change prompted by a change to a highly inflationary economy), translation adjustments for prior periods should not be removed from equity, and the translated amounts for nonmonetary assets and liabilities at the end of the prior period become the accounting basis for those assets in the period of the change and subsequent periods (i.e., the exchange rate on the date of the change, which occurs at the beginning of a period, becomes the historical rate for the subsequent remeasurement of nonmonetary assets and liabilities).

For example, assume a USD reporting currency company has a fixed asset with a net book value of LC1,200 in its LC functional foreign subsidiary. If the exchange rate is LC6/\$1 USD at 31 December 2009, the fixed asset will be translated into \$200 USD. \$200 will then become the new accounting basis in the opening balance sheet of the foreign subsidiary for the first financial statements prepared in recognition of the local currency's highly inflationary status. Depreciation expense from 1 January 2010 will be calculated using the new accounting basis of \$200.

Note that a change in an entity's functional currency caused by inflation rate fluctuations is not considered a change in accounting. Paragraph 45 from the original Appendix A in FAS 52 stated that the change either to or from a hyperinflationary status would not be a change in accounting. The change, in this case, results from economic factors (e.g., inflation) not a change in accounting policy or method. If a change will have a material impact on future operations, it is appropriate to disclose the change in functional currency in the notes to the financial statements.

### 5.1.2 Functional currency changes from the reporting currency to a foreign currency

Pursuant to ASC 830-10-45-15, if the functional currency changes from the reporting currency to the local foreign currency because the economy is no longer considered highly inflationary, nonmonetary assets (e.g., inventories, fixed assets) and liabilities previously remeasured into the reporting currency at historical exchange rates are converted into new local currency "cost" bases for US GAAP reporting purposes using the current exchange rate as of the date of change to non-hyperinflationary status. Subsequently, the new LC bases of these assets and liabilities are translated into the reporting currency at the then-current exchange rates with the effects of exchange rate fluctuations reflected in the translation component of equity.

Assuming USD is the reporting currency, monetary assets and liabilities denominated in the local currency that previously were "remeasured" into USD using current exchange rates are "translated" into USD at the same current rates with the effects of subsequent exchange rate fluctuations reflected in a separate component of stockholders' equity. Equity accounts expressed in local currency are increased resulting from the change in the local currency cost bases of assets previously remeasured at historical exchange rates. However, the USD equivalents of these same equity accounts are unaffected by the change to non-hyperinflationary status (i.e., shareholders' equity, expressed in USD, is unaffected at the time of a change to non-hyperinflationary status). All income statement accounts are translated at average exchange rates. Also, depreciation, amortization, cost of sales accounts, etc., now reflect the new LC cost basis of assets discussed previously.

With the change away from hyperinflationary status, entities should reassess their respective foreign exchange hedging strategies. For example, assume USD was the reporting currency and hence the functional currency of a foreign entity in a highly inflationary economy. Once the highly inflationary accounting is no longer applicable, intercompany accounts denominated in USD will become "foreign currency" denominated transactions to a foreign affiliate with the local currency as its functional currency.

Foreign exchange gains and losses on intercompany balances will now be reflected in income although net equity expressed in USD will be unaffected because of an offsetting debit or credit in the translation component of equity. Other USD-denominated transactions such as bank loans also expose affiliates to exchange rate risk if the USD is no longer the functional currency.

Also, if the local currency is the functional currency, a foreign entity's net equity in USD may now be more significantly affected by exchange rate movements because the entity's entire net asset position, including both monetary and nonmonetary assets and liabilities, now are translated at current exchange rates.

The following matters should be considered when changing from the reporting currency to a local functional currency:

- ▶ Subsequent inventory impairment calculations will be completed in local currency and no longer in the reporting currency.
- ▶ While it no longer will be necessary to maintain separate fixed asset/depreciation records based on historical foreign exchange rates, certain changes may be necessary in the way such detailed registers are maintained. Such changes result because there likely will be differences in the US GAAP basis (after adjustment) and the local basis of such assets since inflation accounting or indexation may be required under local standards. There may also continue to be differences caused by different depreciation methods and asset lives.

Note that when a local currency is no longer considered hyperinflationary, it is not required that an entity switch to the local currency as its functional currency if the ASC 830 criteria to determine an entity's functional currency indicate that the reporting currency (or any other currency) should be the functional currency.

## 5.2 Identifying a highly inflationary economy

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Overall

#### *Other Presentation Matters*

#### **830-10-45-12**

The determination of a highly inflationary economy must begin by calculating the cumulative inflation rate for the three years that precede the beginning of the reporting period, including interim reporting periods. If that calculation results in a cumulative inflation rate in excess of 100 percent, the economy shall be considered highly inflationary in all instances. However, if that calculation results in the cumulative rate being less than 100 percent, historical inflation rate trends (increasing or decreasing) and other pertinent economic factors should be considered to determine whether such information suggests that classification of the economy as highly inflationary is appropriate. Projections cannot be used to overcome the presumption that an economy is highly inflationary if the 3-year cumulative rate exceeds 100 percent.

#### **830-10-45-13**

The definition of a highly inflationary economy is necessarily an arbitrary decision. In some instances, the trend of inflation might be as important as the absolute rate. The definition of a highly inflationary economy shall be applied with judgment.

**Implementation Guidance and Illustrations****830-10-55-23**

The following Cases illustrate the application of paragraph 830-10-45-12:

- The cumulative 3-year inflation rate exceeds 100 percent (Case A).
- The cumulative 3-year inflation rate drops below 100 percent but no evidence suggests that drop is other than temporary (Case B).
- The cumulative 3-year inflation rate drops below 100 percent after having spiked above 100 percent (Case C).

**Case A: Cumulative 3-Year Inflation Rate Exceeds 100 Percent****830-10-55-24**

Country A's economy at the beginning of 19X9 continues to be classified as highly inflationary because the cumulative 3-year rate is in excess of 100 percent (see the following table). The recent trend of declining inflation rates should not be extrapolated to project future rates to overcome the classification that results from the calculation.

Fiscal Year	<u>X1</u>	<u>X2</u>	<u>X3</u>	<u>X4</u>	<u>X5</u>	<u>X6</u>	<u>X7</u>	<u>X8</u>
Annual inflation rate	9%	8%	12%	17%	33%	52%	30%	15%
Cumulative three-year rate <sup>(a)</sup>			32%	42%	74%	137%	163%	127%

<sup>(a)</sup> Amounts are calculated as a compounded three-year inflation rate.

**Case B: Cumulative 3-Year Inflation Rate Drops Below 100 Percent****830-10-55-25**

Country B's economy at the beginning of 19X9 should continue to be classified as highly inflationary even though the cumulative 3-year rate is less than 100 percent (see the following table) because there is no evidence to suggest that the drop below the 100 percent cumulative rate is other than temporary and the annual rate of inflation during the preceding 8 years has been high.

Fiscal Year	<u>X1</u>	<u>X2</u>	<u>X3</u>	<u>X4</u>	<u>X5</u>	<u>X6</u>	<u>X7</u>	<u>X8</u>
Annual inflation rate	15%	28%	46%	41%	35%	29%	23%	21%
Cumulative three-year rate <sup>(a)</sup>			115%	164%	178%	146%	114%	92%

<sup>(a)</sup> Amounts are calculated as a compounded three-year inflation rate.

**Case C: Cumulative 3-Year Inflation Rate Drops Below 100 Percent After Spike****830-10-55-26**

Country C's economy at the beginning of 19X9 should no longer be classified as highly inflationary because the cumulative 3-year rate is less than 100 percent (see the following table) and the historical inflation rates suggest that the prior classification resulted from an isolated spike in the annual inflation rate.

Fiscal Year	<u>X1</u>	<u>X2</u>	<u>X3</u>	<u>X4</u>	<u>X5</u>	<u>X6</u>	<u>X7</u>	<u>X8</u>
Annual inflation rate	5%	6%	4%	7%	12%	55%	18%	6%
Cumulative three-year rate <sup>(a)</sup>			16%	18%	25%	86%	105%	94%

<sup>(a)</sup> Amounts are calculated as a compounded three-year inflation rate.



ASC 830 defines a highly inflationary economy as one having cumulative inflation of *approximately* 100% or more over a three-year period. If the calculation of the three-year cumulative inflation rate results in a cumulative inflation rate in excess of 100%, the economy should be considered highly inflationary in all cases. Projections of future inflation rates cannot be used to overcome the presumption that an economy is highly inflationary if the three-year cumulative inflation rate exceeds 100%. However, if that calculation results in a cumulative inflation rate that is less than 100%, judgment should be applied to determine whether the economy should be considered highly inflationary. In making that determination, management should consider the historical inflation rate trend and other pertinent economic factors. The FASB indicates that in some instances, the trend of inflation might be as important as the absolute rate in making this decision.

For example, an economy with a cumulative three-year rate of 90% or 95% could have been experiencing increasing inflation, and indicators may point to a continuation of that trend. It would appear that such an economy is moving to cumulative three-year inflation in excess of 100%. In that case, remeasurement into the reporting currency might produce more meaningful results.

It also is important to note that management should decide whether a foreign entity's local economy is highly inflationary only after it has decided that the local currency is the functional currency. For many foreign operations in unstable economies, the USD (or other reporting currency) might be the functional currency in any case.

The cumulative three-year inflation rate for a given economy should be determined by comparing the currency's price level (or index) at the end of the three-year period to that at the beginning of the first year of the period. The cumulative three-year rate is not the sum of annual inflation rates. In fact, an annual inflation rate of about 26% for three years would result in a cumulative rate of 100%. However, the cumulative rate is not difficult to calculate, regardless of whether annual indices or only annual inflation rates are available.

#### International Practices Task Force

The Center for Audit Quality (CAQ) SEC Regulations Committee and its International Practices Task Force (Task Force) periodically accumulates and discusses certain inflation data. In an effort to facilitate greater consistency, the Task Force developed a framework for compiling inflation data to assist registrants in monitoring inflation statistics in connection with their determination of the inflationary status of countries in which they have operations. A discussion document that represents the accumulation of information that was used to facilitate a discussion among the Task Force members is available on the CAQ's website. The discussion document categorizes the countries based on their cumulative inflation rates and implementation guidance in ASC 830. The countries included in the discussion document are those for which the inflation data is available from the source used by the Task Force.

However, there may be other countries with cumulative inflation rates of 100% or more that should be monitored that are not mentioned in the Task Force discussion document because the sources used by the Task Force do not include inflation data for all countries. Accordingly, companies should closely monitor the inflation rates in economies in which they operate.

#### **Illustration 5-1: Calculation of cumulative three-year inflation rate**

The following example illustrates the calculation of the cumulative three-year inflation rate for a foreign country for the period 2008 – 2010 using annual inflation rates (based on the change in each year's average consumer price index for the year). In the example, 2007 is set as the base year with a price-level index of 100. Each subsequent year's index is one plus the inflation rate for that year, multiplied by the index for the previous year. The cumulative inflation rate is then calculated by applying the following formula:

$$\frac{2010 \text{ index} - 2007 \text{ index}}{2007 \text{ index}}$$

The actual calculations for the foreign country are:

<u>Year</u>	<u>Annual inflation rate</u>	<u>Calculated index</u>
2007		100 (base year)
2008	38.7%	138.7
2009	52.7%	211.8
2010	82.8%	387.2

Using this information, the foreign country's cumulative three-year inflation rate is determined to be 287%, or

$$\frac{387.2 - 100}{100}$$

If annual indices were available, they would be substituted for the calculated index and only the last step in the above calculation would be necessary. For example, assume the actual indices for the foreign country (2005 base year) are 790.2 for 2010 and 204.1 for 2007. Using these, the cumulative three-year rate of 287% is calculated as follows:

$$\frac{790.2 - 204.1}{204.1}$$

Alternatively, the cumulative three-year inflation rate of 287% can be calculated on a compounded basis as shown below and illustrated in the cases in ASC 830-10-55-23 through 55-26:

$$[(1.387 \times 1.527 \times 1.828) - 1] \times 100 = 287\%$$

## 5.2.1 Determining the three-year period

ASC 830-10-45-12 states that the three-year period that precedes the beginning of the reporting period (including interim reporting periods) should be used in determining whether the cumulative inflation rate is in excess of 100%.

For example, assume a calendar-year US multinational company with USD as its reporting currency owns a foreign subsidiary whose functional currency is its local currency. Also assume that the foreign country where this subsidiary is located becomes highly inflationary as of 1 December 2009, based on the cumulative inflation for the period from 1 December 2006 through 30 November 2009 exceeding 100%.

In this example, the US parent will be required to change the functional currency of its foreign subsidiary from its local currency to USD at the beginning of its next reporting period (that is, 1 January 2010). The financial statements for the year ended 31 December 2009 would continue to be prepared with the foreign subsidiary having its local currency as its functional currency, translated into USD for consolidated financial reporting.

### Question 5.1

**If a country becomes highly inflationary in the middle of the fiscal year, when should a public reporting entity apply highly inflationary accounting?**

Whether a foreign economy is highly inflationary is assessed each accounting period or quarter giving consideration to the trend and the three-year cumulative inflation rate. For public reporting entities, highly inflationary accounting is applied as of the beginning of the quarter following the period in which the country becomes highly inflationary. For example, if a country becomes highly inflationary as of 1 November 2009, and continues to be so through 31 December 2009, a calendar-year-end registrant would apply highly inflationary accounting as of 1 January 2010. See Question 5.2 for the application of highly inflationary accounting to a nonpublic reporting entity.

**Question 5.2** **If a country becomes highly inflationary in the middle of the fiscal year, when should a nonpublic reporting entity that does not prepare interim financial statements apply highly inflationary accounting?**

ASC 830-10-45-12 states that the determination of a highly inflationary economy must begin by calculating the cumulative inflation rate for the three years that precede the beginning of the reporting period, including interim reporting periods. Therefore, we believe a nonpublic reporting entity that does not prepare interim financial statements is required to analyze for highly inflationary status only as of the beginning of its annual reporting period.

For example, even if a foreign country becomes highly inflationary on 1 November 20X0, a nonpublic reporting entity with 30 June year-end that does not prepare interim financial statements would analyze the country's highly inflationary status as of 30 June 20X1, based on the preceding three years, with application of highly inflationary status, if so determined, at 1 July 20X1. However, if a nonpublic company prepares interim or monthly financial statements that are fully compliant with US GAAP, a nonpublic company may apply highly inflationary accounting as of an interim date.

**Question 5.3** **How should highly inflationary accounting be applied when one of the countries in which a multilayered entity operates becomes highly inflationary?**

For a multilayered entity, the requirement that the financial statements of a foreign entity in a highly inflationary economy be remeasured as if the functional currency were the reporting currency of the parent should be applied on a "bottoms-up" basis. Therefore, the reporting currency of the immediate parent to the foreign entity in a highly inflationary economy should be used as if it were the foreign entity's functional currency (assuming the immediate parent is not in a highly inflationary economy).

For example, assume a US reporting entity with USD reporting currency has a subsidiary in Chile whose reporting and functional currency is the Chilean peso. The Chilean subsidiary in turn has a subsidiary in Venezuela, and Venezuela becomes highly inflationary. In this example, the Venezuelan subsidiary's financial statements should first be remeasured into Chilean pesos and consolidated into the Chilean subsidiary's financial statements. The Chilean subsidiary's financial statements would then be translated and consolidated into the US parent's financial statements.

**Question 5.4** **Is an entity considered to operate in a highly inflationary economy when it does not use the local currency of the highly inflationary economy as its functional currency?**

No. If an entity in a highly inflationary economy had determined that a currency other than the local currency to be its functional currency (and its functional currency is also not that of a highly inflationary economy), the entity is not considered to operate in a highly inflationary economy.

For example, assume a subsidiary of a euro parent operates in Country X, which is considered to be a highly inflationary economy and the subsidiary's functional currency is the USD rather than the local currency. The parent's functional currency and reporting currency is the euro. Even though Country X is considered a highly inflationary economy, the subsidiary is not considered to operate in a highly inflationary economy since its functional currency is the USD, which is not of a highly inflationary economy. Accordingly, the subsidiary does not apply highly inflationary accounting and does not remeasure its financial statements into euro.


**Question 5.5** **What indices should be used in determining a country's three-year cumulative inflation rate?**

General price indices similar to the US Consumer Price Index (CPI), such as those reported by foreign governments to the International Monetary Fund (IMF), normally are used in determining rates of inflation in most countries. In general, use of another published index that may be specific to a particular industry or a company is not appropriate. If the inflation index in a given country is not realistic (e.g., it includes only items with government-controlled prices), it may be necessary to prepare an internally generated inflation index.

**Question 5.6**

**Would the existence of a fixed exchange rate allow an entity to avoid having to account for a country that is in a highly inflationary economy under ASC 830?**

No, a fixed exchange rate does not determine whether a country is highly inflationary. A fixed exchange rate is an exchange rate that is tied to the currency of another country. If a country's cumulative rate of inflation over three years exceeds 100%, it is considered a highly inflationary economy, and the accounts of the foreign operation should be remeasured as if the functional currency were the reporting currency of the parent.



# 6

## Disclosures

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Foreign Currency Transactions

##### *Other Presentation Matters*

##### **830-20-45-1**

The aggregate **transaction gain or loss** included in determining net income for the period shall be disclosed in the financial statements or notes thereto (see paragraph 830-20-50-1).

### Pending Content:

**Transition Date:** (P) December 16, 2020; (N) December 16, 2021 | **Transition Guidance:** 105-10-65-6

The aggregate transaction gain or loss included in determining net income for the period shall be presented in the financial statements or disclosed in the notes thereto (see paragraph 830-20-50-1).

##### **830-20-45-2**

Certain entities, primarily banks, are dealers in foreign exchange. Although certain gains or losses from dealer transactions may fit the definition of transaction gains or losses in this Subtopic, they may be disclosed as dealer gains or losses rather than as transaction gains or losses.

##### **830-20-45-3**

When the **reporting currency** (not the **foreign currency**) is the functional currency, remeasurement of a reporting entity's deferred foreign tax liability or asset after a change in the **exchange rate** will result in a transaction gain or loss that is recognized currently in determining net income. The preceding paragraph requires disclosure of the aggregate transaction gain or loss included in determining net income but does not specify how to display that transaction gain or loss or its components for financial reporting. See paragraph 830-740-45-1 for further guidance.

##### **830-20-45-5**

Subtopic 740-10 requires income tax expense to be allocated among income from continuing operations, discontinued operations, adjustments of prior periods (or of the opening balance of retained earnings), and direct entries to other equity accounts. Some transaction gains and losses are reported in other comprehensive income. Any income taxes related to those transaction gains and losses shall be allocated to other comprehensive income.

##### *Disclosure*

##### **830-20-50-1**

If not disclosed in the financial statements as discussed in paragraph 830-20-45-2, the aggregate **transaction gain or loss** included in determining net income for the period shall be disclosed in notes to financial statements.

### Pending Content:

**Transition Date:** (P) December 16, 2020; (N) December 16, 2021 | **Transition Guidance:** 105-10-65-6

If not presented in the financial statements as discussed in paragraph 830-20-45-1, the aggregate transaction gain or loss included in determining net income for the period shall be disclosed in notes to financial statements.

## Foreign Currency Matters – Translation of Financial Statements

### *Other Presentation Matters*

#### **830-30-45-20**

At a minimum, the analysis shall disclose all of the following (see paragraph 830-30-50-1):

- a. Beginning and ending amount of cumulative translation adjustments
- b. The aggregate adjustment for the period resulting from translation adjustments (see paragraph 830-30-45-12) and gains and losses from certain hedges and intra-entity balances (see paragraph 830-20-35-3).
- c. The amount of income taxes for the period allocated to translation adjustments (see paragraph 830-30-45-21)
- d. The amounts transferred from cumulative translation adjustments and included in determining net income for the period as a result of the sale or complete or substantially complete liquidation of an investment in a foreign entity (see paragraph 830-30-40-1).

### *Disclosure*

#### **830-30-50-1**

If not provided in a separate financial statement or as part of a statement of changes in equity, an analysis of the changes during the period in the accumulated amount of **translation adjustments** reported in equity shall be provided in notes to financial statements. At a minimum, the analysis shall disclose the items enumerated in paragraph 830-30-45-20.

## Foreign Currency Matters – Income Taxes

### *Other Presentation Matters*

#### **830-740-45-1**

As indicated in paragraph 830-20-45-3, when the **reporting currency** (not the **foreign currency**) is the functional currency, remeasurement of an entity's deferred foreign tax liability or asset after a change in the **exchange rate** will result in a **transaction gain or loss** that is recognized currently in determining net income. Paragraph 830-20-45-1 requires disclosure of the aggregate transaction gain or loss included in determining net income but does not specify how to display that transaction gain or loss or its components for financial reporting. Accordingly, a transaction gain or loss that results from remeasuring a deferred foreign tax liability or asset may be included in the reported amount of deferred tax **benefit** or expense if that presentation is considered to be more useful. If reported in that manner, that transaction gain or loss is still included in the aggregate transaction gain or loss for the period to be disclosed as required by that paragraph.

Pursuant to ASC 830-20-45-1, companies should disclose the aggregate transaction gain or loss included in the determination of net income for the period. The aggregate transaction gain or loss includes all foreign-currency-related remeasurement gains and losses, regardless of the line items under which they are presented in the financial statements (e.g., interest income and expense, sales, cost of goods sold). That is, this amount includes foreign currency gains and losses on forward exchange contracts and dealer transactions, among other things, that may be displayed under a separate line item.

While ASC 830 requires that companies disclose the aggregate transaction gain or loss included in the determination of net income for the period, it does not provide specific guidance on the classification of individual foreign currency exchange gains and losses on the face of the income statement. Given this, the SEC staff often requests that registrants disclose the nature of the transactions denominated in

foreign currency that result in foreign currency gains and losses, the classification of such foreign currency gains and losses by line item on the face of the income statement, basis for the chosen classification(s) and the amount of foreign currency gains and losses included in each line item (to the extent that they are material).

## 6.1 Suggested supplemental disclosures by the SEC staff

Pursuant to SEC Codified Financial Reporting Releases, Section 501.09.b, *Disclosure Considerations* (SEC FRR, Section 501.09.b), the SEC staff encourages registrants to disclose such information as the functional currencies used to measure significant foreign operations, the degree of exposure to exchange rate risks, exceptions made for operations in highly inflationary economies (if applicable) and whether translation adjustments impacted cash flows or have been realized.

Within SEC FRR, Section 501.09.b, the SEC staff includes two specific situations where registrants are encouraged to provide explanatory disclosures:

- ▶ Financial data of significant foreign operations are measured in a currency other than the reporting currency:
  - ▶ If there is an indication that all or some of those operations' cash flows are generally not available to meet the company's other short-term needs for cash, discuss those operations in a disaggregated manner in order to meaningfully address liquidity and capital resource considerations.
  - ▶ Also discuss the company's intracompany financing practices.
  - ▶ If those foreign cash flows are generally available to meet the parent's cash needs, and the local functional currency determinations result from a preponderance of the other relevant factors specified by ASC 830, include discussion of that fact to facilitate understanding of the registrant's operations.
- ▶ The registrant conducts significant foreign operations in highly inflationary economies:
  - ▶ Due to the pragmatic solution adopted by ASC 830 to the problems arising from the lack of a stable measuring unit (i.e., the requirement that the financial statements of a foreign entity in a highly inflationary economy be remeasured as if the functional currency were the reporting currency), the remeasurement effects of rate changes are included in net income even when the operations may be relatively self-contained or have other environmental characteristics such that remittances to the parent are unlikely.
  - ▶ In such cases, further discussion other than disclosures related only to consolidated (or even reporting currency) liquidity and capital resources would be helpful.

While the determination of whether to include the above suggested disclosures depends on an entity's specific facts and circumstances and is subject to materiality considerations, the SEC staff believes such information enables investors and others to assess how a registrant's foreign operations may be affected by foreign currency exchange rate fluctuations.

The SEC staff does not specify the location or the nature of the particular disclosures to be made. It recognizes that certain information "such as a display of net investments by major functional currency or an analysis of the translation component of equity (either by significant functional currency or by geographical areas used for segment disclosure purposes) will not always be practicable." However, the SEC staff still encourages registrants to make informative and "narrative" disclosures as suggested above to enable investors to assess how a registrant's financial statement is affected by the foreign currency exchange rate fluctuations.

## 6.2 Effect of rate changes

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Foreign Currency Transactions

##### *Disclosure*

##### **830-20-50-2**

Disclosure of a rate change that occurs after the date of the reporting entity's financial statements and its effects on unsettled balances pertaining to **foreign currency transactions**, if significant, may be necessary. If disclosed, the disclosure shall include consideration of changes in unsettled transactions from the date of the financial statements to the date the rate changed. In some cases it may not be practicable to determine these changes; if so, that fact shall be stated.

##### **830-20-50-3**

Management is encouraged to supplement the disclosures required by this Subtopic with an analysis and discussion of the effects of rate changes on the reported results of operations. This type of disclosure might include the mathematical effects of translating revenue and expenses at rates that are different from those used in a preceding period as well as the economic effects of rate changes, such as the effects on selling prices, sales volume, and cost structures. The purpose is to assist financial report users in understanding the broader economic implications of rate changes and to compare recent results with those of prior periods.

#### Foreign Currency Matters – Translation of Financial Statements

##### *Disclosure*

##### **830-30-50-2**

Disclosure of a rate change that occurs after the date of the reporting entity's financial statements or after the date of the **foreign currency statements** of a **foreign entity** if they are consolidated, combined, or accounted for by the equity method in the financial statements of the **reporting entity** and its effects on unsettled balances pertaining to **foreign currency transactions**, if significant, may be necessary.

As detailed in section 2.3.2, *Subsequent change in exchange rate*, entities should not adjust the financial statements for the effects of a rate change occurring after the balance sheet date of the reporting entity or after the balance sheet date of a foreign entity included in the financial statements. However, disclosure of a rate change that occurs after the date of the financial statements and its effect on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary. If it is not practical to determine the amounts, that fact should be disclosed.

We understand that this disclosure is not required if there are no unsettled foreign currency transactions. The disclosure applies only to unsettled foreign currency transactions of a foreign entity with a foreign functional currency.

A subsequent rate change that affects the remeasurement of unsettled balances pertaining to foreign currency transactions results in cash flow and net income fluctuations. However, a subsequent rate change that affects only the translation process does not have the same impact (i.e., translation adjustments are recorded in equity). Therefore, disclosure of a subsequent rate change that affects only the translation process is not considered necessary.



## 6.3 Multiple foreign currency exchange rates – SEC staff guidance

### Excerpt from Accounting Standards Codification

#### Foreign Currency Matters – Translation of Financial Statements

##### *SEC Materials*

##### Announcements Made by SEC Staff at Emerging Issues Task Force (EITF) Meetings

##### **830-30-S99-1**

This SEC staff announcement provides the SEC staff's views on Foreign Currency Issues.

The SEC staff has received a number of inquiries regarding certain foreign currency issues related to investments in Venezuela. This announcement is in response to those inquiries that have been received by the SEC staff on the issues described below.

Amongst other requirements, current restrictions of foreign currency exchange in Venezuela provide that entities use the official rate of exchange (official rate) to exchange funds. The official rate is set by the Venezuelan government and in order to use the official rate to exchange currency, entities seek the ability to utilize the official rate from Venezuela's Commission for Administration of Foreign Currencies (CADIVI).

As an alternative to the use of the official rate it may also be legal to utilize the parallel rate. It is possible that the parallel rate provides entities with a more liquid exchange and entities can access the parallel rate using a series of transactions via a broker. The parallel rate has recently been significantly different from the official rate.

#### **Reported Balances in an Entity's Financial Statements That Differ from Their Underlying U.S. Dollar Denominated Values**

With respect to accounting for a subsidiary in Venezuela in cases where the parent's reporting currency is the U.S. dollar and the Venezuelan subsidiary's functional currency is the Venezuelan Bolivar ("Bolívar" or "BsF"), the staff has recently become aware of the following fact pattern: In years prior to 2010, certain entities may have used the parallel rate to remeasure certain U.S. dollar denominated balances that the Venezuelan subsidiary held and then subsequently translated the Venezuelan subsidiary's assets, liabilities, and operations using the official rate. The effect of this accounting treatment resulted in reported balances in an entity's financial statements that differed from their underlying U.S. dollar denominated values. (The staff notes that these differences arise when different rates are used for remeasurement and translation.) In order to illustrate the impact that these differences may have on different accounts within the financial statements, two illustrations are provided below.

First, assume that at a period end prior to January 1, 2010 (for a calendar year entity), a U.S. entity's Venezuelan subsidiary held \$10 million of cash denominated in U.S. dollars. Further assume that at the period end, the parallel rate was 5 Bolívars to every 1 U.S. dollar and the official rate was 2 Bolívars to every 1 U.S. dollar. Upon the remeasurement of the U.S. denominated cash to Bolívars and the subsequent translation of the Venezuelan subsidiary's financial statements, an entity would have reported cash of \$25 million for financial reporting purposes. (The \$25 million is calculated as follows: First, the \$10 million of cash is remeasured using the parallel rate to 50 million BsF; subsequently, the 50 million BsF is translated back to U.S. dollars using the official rate of 2 Bolívars to 1 U.S. dollars, resulting in a translated reported balance of \$25 million.)

Second, assume that at a period end prior to January 1, 2010 (for a calendar year entity), a U.S. entity's Venezuelan subsidiary held \$15 million of accounts payable denominated in U.S. dollars (also assume the exchange rates are the same as in the example above). Upon the remeasurement of the

U.S. denominated accounts payables to Bolivars and the subsequent translation of the Venezuelan subsidiary's financial statements, an entity would have reported accounts payable of \$37.5 million for financial reporting purposes. (The \$37.5 million is calculated as follows: First, the \$15 million of accounts payable is remeasured using the parallel rate to 75 million BsF; subsequently, the 75 million BsF is translated back to U.S. dollars using the official rate of 2 Bolivars to 1 U.S. dollars, resulting in a translated reported balance of \$37.5 million.)

Finally, the staff has noted that Venezuela has met the thresholds for being considered highly inflationary and accordingly, calendar year entities that have not previously accounted for their Venezuelan investment as highly inflationary will begin applying highly inflationary accounting beginning January 1, 2010.

### Disclosures

The staff believes that in cases where reported balances for financial reporting purposes differ from the actual U.S. dollar denominated balances (such as in the illustrations above), a registrant should make disclosures that inform users of the financial statements as to the nature of these differences. When material, the disclosures in both annual and interim financial statements should, at a minimum, consist of the following (The staff is aware that certain registrants have already filed their 2009 Form 10-K's and accordingly the staff would not necessarily expect these specific disclosures to be included in these registrant's 2009 Form 10-K's.):

- ▶ Disclosure of the rates used for remeasurement and translation.
- ▶ A description of why the actual U.S. dollar denominated balances differ from the amounts reported for financial reporting purposes, including the reasons for using two different rates with respect to remeasurement and translation.
- ▶ Disclosure of the relevant line items (e.g. cash, accounts payable) on the financial statements for which the amounts reported for financial reporting purposes differ from the underlying U.S. dollar denominated values.
- ▶ For each relevant line item, the difference between the amounts reported for financial reporting purposes versus the underlying U.S. dollar denominated values.
- ▶ Disclosure of the amount that will be recognized through the income statement (as well as the impact on the other financial statements) as part of highly inflationary accounting beginning in 2010 (see below).

### Impact of Highly Inflationary Accounting on Differences between Amounts Recorded for Financial Reporting Purposes versus the Underlying U.S. Dollar Denominated Values

The staff notes that upon application of highly inflationary accounting (January 1, 2010 for calendar year registrants), registrants must follow the accounting outlined in paragraph 830-10-45-11, which states that "the financial statements of a foreign entity in a highly inflationary economy shall be remeasured as if the functional currency were the reporting currency."

Accordingly, upon the application of highly inflationary accounting requirements, a U.S. reporting currency parent and subsidiary effectively utilize the same currency (U.S. dollars) and accordingly there should no longer be any differences between the amounts reported for financial reporting purposes and the amount of any underlying U.S. dollar denominated values that are held by the subsidiary. Therefore, the staff believes that any differences that may have existed prior to applying highly inflationary accounting requirements between the reported balances for financial reporting and the U.S. dollar denominated balances should be recognized in the income statement, unless the registrant can document that the difference was previously recognized as a cumulative translation adjustment (in which case the difference should be recognized as an adjustment to the cumulative translation adjustment).

Furthermore, the staff believes that these differences should be recognized at the time of adoption of highly inflationary accounting.

**Other**

The SEC staff is aware that the EITF will be discussing certain issues related to foreign currency, including the accounting for multiple exchange rates in Venezuela, and accordingly the guidance in this staff announcement is intended to be interim guidance pending the EITF completing its deliberations.

Note that the above SEC Staff Announcement is applicable only in circumstances where there are multiple legal exchange rates used to translate and remeasure, as was observed in Venezuela in 2009 and prior years.

# A Comprehensive examples

The financial statements and supporting calculations presented in this Appendix illustrate the application of ASC 830 to a foreign company under two different assumptions: (1) USD functional currency (Illustration 1) and (2) local functional currency (LC) (Illustration 2). Under both assumptions, USD is the reporting currency. Details of exchange rates used in the example are provided in footnotes to the financial statements.

Illustration 1 shows the financial statement effects of remeasuring foreign-currency-denominated transactions into the entity's functional currency (USD). Illustration 2 demonstrates how to translate the LC functional currency financial statements into the entity's reporting currency (in this case, USD).

For purposes of illustration, the examples are relatively simple. However, they include two USD-denominated accounts (a certificate of deposit and an intercompany account) and demonstrate how ASC 830 results in gain or loss when the functional currency is the foreign currency but not when the USD is the functional currency.

For both functional currency assumptions, the examples include balance sheets at 31 December 2009 and 2010, a statement of income and retained earnings for 2010, an analysis of the transaction gain recorded in income, and an analysis of the accumulated translation adjustments component of stockholders' equity for 2010.

## Comparison of results

The following examples demonstrate that reported net earnings of a foreign entity can differ significantly, depending on the entity's functional currency. There are several major reasons why net income under the LC functional currency assumption in our example is almost twice the amount of net income under the USD functional currency assumption. Because the LC weakened against the USD during 2010, cost of sales and depreciation translated at the current rate were significantly lower than those amounts translated at historical rates under the USD functional currency assumption. This difference was partially offset by two factors: (1) the exchange loss on the foreign entity's USD-denominated assets, which is recognized in consolidated income only under the LC functional currency assumption; and (2) the exchange gain attributable to the effect of the weakening LC on the net monetary liability position, which is recognized in income under the USD functional currency assumption.

Overseas Company Balance Sheet 31 December 2009		Reporting Currency USD				
		Illustration 1			Illustration 2	
		Amounts shown in local currency (LC)	Functional currency USD		Functional currency LC	
Exchange rate <sup>(1)</sup>	USD		Exchange rate <sup>(1)</sup>	USD		
Assets						
Current assets:						
Cash	LC 575,000	.510	\$ 293,250	.510	\$ 293,250	
Certificate of deposit	1,960,784 <sup>(4)</sup>	.510	1,000,000	.510	1,000,000	
Accounts receivable	1,685,000	.510	859,350	.510	859,350	
Inventories	1,600,000	.534 <sup>(3)</sup>	854,400	.510	816,000	
	<u>5,820,784</u>		<u>3,007,000</u>		<u>2,968,600</u>	
Property and equipment	2,250,000	.529 <sup>(2)</sup>	1,190,250	.510	1,147,500	
Less: accumulated depreciation	260,000	.529 <sup>(2)</sup>	137,540	.510	132,600	
	<u>1,990,000</u>		<u>1,052,710</u>		<u>1,014,900</u>	
	<u>LC 7,810,784</u>		<u>\$ 4,059,710</u>		<u>\$ 3,983,500</u>	
Liabilities and stockholders' equity						
Current liabilities:						
Accounts payable	LC 1,745,625	.510	\$ 890,269	.510	\$ 890,269	
Due to parent	2,941,176 <sup>(4)</sup>	.510	1,500,000	.510	1,500,000	
	<u>4,686,801</u>		<u>2,390,269</u>		<u>2,390,269</u>	
Long-term debt	2,000,000	.510	1,020,000	.510	1,020,000	
Deferred income taxes	45,000	.510	22,950	.510	22,950	
Stockholders' equity:						
Capital stock	600,000	.529 <sup>(2)</sup>	317,400	.529 <sup>(2)</sup>	317,400	
Paid-in capital	200,000	.529 <sup>(2)</sup>	105,800	.529 <sup>(2)</sup>	105,800	
Retained earnings	278,983		203,291		203,291	
Equity adjustment from translation	-		-		(76,210)	
	<u>1,078,983</u>		<u>626,491</u>		<u>550,281</u>	
	<u>LC 7,810,784</u>		<u>\$ 4,059,710</u>		<u>\$ 3,983,500</u>	

Overseas Company Balance Sheet 31 December 2010		Reporting Currency USD			
		Illustration 1		Illustration 2	
		Amounts shown in local currency (LC)	Functional currency USD		Functional currency LC
Exchange rate <sup>(1)</sup>	USD		Exchange rate <sup>(1)</sup>	USD	
Assets					
Current assets:					
Cash	LC 530,000	.450	\$ 238,500	.450	\$ 238,500
Certificate of deposit	2,222,222 <sup>(4)</sup>	.450	1,000,000	.450	1,000,000
Accounts receivable	1,400,000	.450	630,000	.450	630,000
Inventories	1,500,000	.435 <sup>(6)</sup>	652,500	.450	675,000
Prepaid expenses	75,000	.415 <sup>(5)</sup>	31,125	.450	33,750
	<u>5,727,222</u>		<u>2,552,125</u>		<u>2,577,250</u>
Property and equipment	2,400,000	<sup>(7)</sup>	1,252,500	.450	1,080,000
Less: accumulated depreciation	410,000	<sup>(8)</sup>	215,750	.450	184,500
	<u>1,990,000</u>		<u>1,036,750</u>		<u>895,500</u>
	<u>LC 7,717,222</u>		<u>\$3,588,875</u>		<u>\$3,472,750</u>
Liabilities and stockholders' equity					
Current liabilities:					
Accounts payable	LC 1,570,000	.450	\$ 706,500	.450	\$ 706,500
Due to parent	3,333,333 <sup>(4)</sup>	.450	1,500,000	.450	1,500,000
	<u>4,903,333</u>		<u>2,206,500</u>		<u>2,206,500</u>
Long-term debt	1,600,000	.450	720,000	.450	720,000
Deferred income taxes	60,000	.450	27,000	.450	27,000
Stockholders' equity:					
Capital stock	600,000	.529 <sup>(2)</sup>	317,400	.529 <sup>(2)</sup>	317,400
Paid-in capital	200,000	.529 <sup>(2)</sup>	105,800	.529 <sup>(2)</sup>	105,800
Retained earnings	353,889		212,175		241,723
Equity adjustment from translation	-		-		(145,673) <sup>(10)</sup>
	<u>1,153,889</u>		<u>635,375</u>		<u>519,250</u>
	<u>LC 7,717,222</u>		<u>\$3,588,875</u>		<u>\$3,472,750</u>

		Amounts shown in local currency (LC)		Reporting Currency USD			
				Illustration 1		Illustration 2	
				Functional currency USD		Functional currency LC	
		Exchange rate <sup>(1)</sup>	USD	Exchange rate <sup>(1)</sup>	USD		
Sales	LC	7,800,000	.457	\$ 3,564,600	.457	\$ 3,564,600	
Other income		31,250	.457	14,281	.457	14,281	
		<u>7,831,250</u>		<u>3,578,881</u>		<u>3,578,881</u>	
Costs and expenses:							
Cost of goods sold		6,200,000	<sup>(6)</sup>	2,989,600	.457	2,833,400	
General and administrative		650,000	.457	297,050	.457	297,050	
Depreciation		150,000	<sup>(8)</sup>	78,210	.457	68,550	
Interest		220,000	.457	100,540	.457	100,540	
		<u>7,220,000</u>		<u>3,465,400</u>		<u>3,299,540</u>	
		611,250		113,481		279,341	
Transactions gain (loss)		(130,719) <sup>(4)</sup>		76,574 <sup>(9)</sup>	.457	(59,738)	
Income before income taxes		480,531		190,055		219,603	
Income taxes:							
Current		290,625	.457	132,816	.457	132,816	
Deferred		15,000	.457	6,855	.457	6,855	
		<u>305,625</u>		<u>139,671</u>		<u>139,671</u>	
Net income		174,906		50,384		79,932	
Retained earnings at beginning of year		278,983		203,291		203,291	
		453,889		253,675		283,223	
Less dividends paid		100,000	.415 <sup>(5)</sup>	41,500	.415 <sup>(5)</sup>	41,500	
Retained earnings at end of year	LC	<u>353,889</u>		<u>\$ 212,175</u>		<u>\$ 241,723</u>	

**Overseas Company****Footnotes**

(1) Rate table:

Time period	Exchange rate
30 September 2007	0.529
31 December 2009	0.510
30 June 2010	0.415
31 December 2010	0.450
Average 2010	0.457
Average Q4 2010	0.435

Except as otherwise indicated, exchange rates are as follows:

- ▶ Balance sheet – rate on the balance sheet date
  - ▶ Income statement – average rate for 2010
  - ▶ Estimated rates were used for the last quarter of 2010
- (2) Exchange rate at 30 September 2007, the date capital stock and long-term debt were issued, and property and equipment were acquired.
- (3) Average exchange rate for production period – assumes first-in, first-out method.
- (4) LC amounts are calculated as follows:

31 December 2009:

Certificate of deposit      \$1,000,000 ÷ 0.510 = LC1,960,784  
 Due to parent                \$1,500,000 ÷ 0.510 = LC2,941,176

31 December 2010:

Certificate of deposit      \$1,000,000 ÷ 0.450 = LC2,222,222  
 Due to parent                \$1,500,000 ÷ 0.450 = LC3,333,333

The change in the remeasured LC amounts is the LC transaction loss for 2010, calculated as follows:

Gain on certificate of deposit:

Balance, 31 December 2010	LC 2,222,222	
Balance, 31 December 2009	<u>1,960,784</u>	LC 261,438

Loss on due to parent:

Balance, 31 December 2010	LC 3,333,333	
Balance, 31 December 2009	<u>2,941,176</u>	<u>(392,157)</u>

Aggregate transaction loss		LC (130,719)
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In the example, tax effects of transaction adjustments and translation adjustments are ignored.



(5) Exchange rate at 30 June 2010, the date prepaid expenses were incurred, additional property and equipment were purchased, and a dividend was declared.

(6) Cost of goods sold (on a historical cost basis) computed as follows:

	<u>LC</u>	<u>Exchange rate</u>	<u>USD</u>
Inventories at 1 January 2010	LC 1,600,000	.534 <sup>(3)</sup>	\$ 854,400
Cost of 2010 production	6,100,000	.457 <sup>(1)</sup>	2,787,700
	<u>7,700,000</u>		<u>3,642,100</u>
Less inventories at 31 December 2010	1,500,000	.435 <sup>(*)</sup>	652,500
Cost of 2010 goods sold	<u>LC 6,200,000</u>		<u>\$ 2,989,600</u>

(\*) Based on LC information, inventory represents approximately three months of production [LC6,100,000 ÷ 12 months = LC508,333 per month; LC1,500,000 ÷ LC508,333 = 2.95 months]. The estimated average exchange rate for the last three months of 2010 was 0.435.

(7) Property and equipment (on a historical cost basis) computed as follows:

	<u>LC</u>	<u>Exchange rate</u>	<u>USD</u>
Purchased in 2007	LC 2,250,000	.529 <sup>(2)</sup>	\$ 1,190,250
Purchased in 2010	150,000	.415 <sup>(5)</sup>	62,250
	<u>LC 2,400,000</u>		<u>\$ 1,252,500</u>

(8) Depreciation expense and accumulated depreciation (on a historical cost basis) computed as follows:

	<u>LC</u>	<u>Exchange rate</u>	<u>USD</u>
2010 depreciation expense:			
Purchased in 2007	LC 140,000	.529 <sup>(2)</sup>	\$ 74,060
Purchased in 2010	10,000	.415 <sup>(5)</sup>	4,150
Total 2010 expense	<u>150,000</u>		<u>78,210</u>
Accumulated depreciation – beginning of year	260,000	.529 <sup>(2)</sup>	137,540
Accumulated depreciation – end of year	<u>LC 410,000</u>		<u>\$ 215,750</u>

(9) Proof of transaction gain (USD functional currency):

**Computation of transaction gain or loss on foreign-denominated monetary assets and liabilities**

**(A) Remeasurement of monetary items as of the reporting date 31 December 2010:**

		Balance 31-Dec-10	Exchange rate 31-Dec-10	Exchange rate 31-Dec-09	Change	Balance 31-Dec-10
Cash	LC	530,000	0.450	0.510	(0.060)	\$ (31,800)
Accounts receivable	LC	1,400,000	0.450	0.510	(0.060)	\$ (84,000)
Accounts payable	LC	(1,570,000)	0.450	0.510	(0.060)	\$ 94,200
Long-term debt	LC	(1,600,000)	0.450	0.510	(0.060)	\$ 96,000
Deferred taxes	LC	(60,000)	0.450	0.510	(0.060)	\$ 3,600
		<u>LC (1,300,000)</u>				<u>\$ 78,000</u>

**(B) Adjustment for increase / (decrease) in monetary account balances since 2009:**

		Balance change	Exchange rate 31-Dec-09	Exchange rate average <sup>(*)</sup>	Change	Balance change
Cash	LC	(45,000)	0.510	0.457	0.053	\$ (2,385)
Accounts receivable	LC	(285,000)	0.510	0.457	0.053	\$ (15,105)
Accounts payable	LC	175,625	0.510	0.457	0.053	\$ 9,308
Long-term debt	LC	400,000	0.510	0.457	0.053	\$ 21,200
Deferred taxes	LC	(15,000)	0.510	0.457	0.053	\$ (795)
		<u>LC 230,625</u>				<u>\$ 12,223</u>

**(C) Adjustment for increase in net monetary items attributed to other foreign currency transactions:**

		2010 amount	Exchange rate 30-Jun-10	Exchange rate average <sup>(*)</sup>	Change	2010 amount
Additional property and equipment	LC	150,000	0.415	0.457	(0.042) <sup>(**)</sup>	\$ (6,300)
Cash dividends paid	LC	100,000	0.415	0.457	(0.042) <sup>(**)</sup>	\$ (4,200)
Prepaid expenses	LC	<u>75,000</u>	0.415	0.457	(0.042) <sup>(**)</sup>	<u>\$ (3,150)</u>
		<u>LC 325,000</u>				<u>\$ (13,650)</u>
					Rounding	\$ 1

**Foreign currency transaction gain \$ 76,574**

Footnotes:

(\*) Average exchange rate during 2010

(\*\*) Difference between rate originally used to measure the monetary item and rate required by ASC 830

(10) Analysis of accumulated translation adjustments component of stockholders' equity (LC functional currency):

Balance at 1 January 2010	\$ (76,210)
Aggregate translation adjustment for the year	(69,463)
Balance at 31 December 2010	<u>\$ (145,673)</u>

**Computation of 2010 translation adjustment**

	<u>Debit/(Credit)</u>		
Net assets at beginning of year	LC (1,078,983)	0.060 <sup>(D)</sup>	\$ (64,739)
Net income for the year	LC (174,906)	0.007 <sup>(E)</sup>	(1,224)
Dividend paid	LC 100,000	(0.035) <sup>(F)</sup>	(3,500)
Opening adjustment to stockholders' equity			<u>\$ (69,463)</u>

(D) Difference between rate originally used to translate item (beginning of year) and rate at end of year:  $0.510 - 0.450 = 0.060$

(E) Difference between rate originally used to translate item (2010 average) and rate at end of year:  $0.457 - 0.450 = 0.007$

(F) Difference between rate originally used to translate item (30 June 2010) and rate at end of year:  $0.415 - 0.450 = (0.035)$

# **B**      **Summary of important changes**

This FRD has been changed since our previous edition primarily to clarify our existing guidance and update references to external content and our other publications.

# C Glossary

This appendix defines terms used in ASC 830, which are also included in the ASC Master Glossary.

<b>Attribute</b>	The quantifiable characteristic of an item that is measured for accounting purposes. For example, historical cost and current cost are attributes of an asset.
<b>Conversion</b>	The exchange of one currency for another.
<b>Exchange Rate</b>	The ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time.
<b>Foreign Currency</b>	A currency other than the functional currency of the entity being referred to (for example, the dollar could be a foreign currency for a foreign entity). Composites of currencies, such as the <b>Special Drawing Rights</b> , used to set prices or denominate amounts of loans, and so forth, have the characteristics of foreign currency.
<b>Foreign Currency Statements</b>	Financial statements that employ as the <b>unit of measure</b> a functional currency that is not the reporting currency of the reporting entity.
<b>Foreign Currency Transactions</b>	Transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions arise when a reporting entity does any of the following: <ol style="list-style-type: none"><li>Buys or sells on credit goods or services whose prices are denominated in foreign currency</li><li>Borrows or lends funds and the amounts payable or receivable are denominated in foreign currency</li><li>Is a party to an unperformed forward exchange contract</li><li>For other reasons, acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currency.</li></ol>
<b>Foreign Currency Translation</b>	The process of expressing in the reporting currency of the reporting entity those amounts that are denominated or measured in a different currency.
<b>Foreign Entity</b>	An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both: <ol style="list-style-type: none"><li>Prepared in a currency other than the reporting currency of the reporting entity</li><li>Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.</li></ol>

<b>Functional Currency</b>	An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. (See paragraphs 830-10-45-2 through 830-10-45-6 and 830-10-55-3 through 830-10-55-7.)
<b>Local Currency</b>	The currency of a particular country being referred to.
<b>Noncontrolling Interest</b>	The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.
<b>Not-for-Profit Entity</b>	<p>An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:</p> <ol style="list-style-type: none"> <li>Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return</li> <li>Operating purposes other than to provide goods or services at a profit</li> <li>Absence of ownership interests like those of business entities.</li> </ol> <p>Entities that clearly fall outside this definition include the following:</p> <ol style="list-style-type: none"> <li>All investor-owned entities</li> <li>Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.</li> </ol>
<b>Reporting Currency</b>	The currency in which a reporting entity prepares its financial statements.
<b>Reporting Entity</b>	<p>An entity or group whose financial statements are being referred to. Those financial statements reflect any of the following:</p> <ol style="list-style-type: none"> <li>The financial statements of one or more foreign operations by combination, consolidation, or equity accounting</li> <li>Foreign currency transactions.</li> </ol>
<b>Special Drawing Rights</b>	Special Drawing Rights on the International Monetary Fund are international reserve assets whose value is based on a basket of key international currencies.
<b>Transaction Date</b>	The date at which a transaction (for example, a sale or purchase of merchandise or services) is recorded in accounting records in conformity with generally accepted accounting principles (GAAP). A long-term commitment may have more than one transaction date (for example, the due date of each progress payment under a construction contract is an anticipated transaction date).

<b>Transaction Gain or Loss</b>	<p>Transaction gains or losses result from a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated. They represent an increase or decrease in both of the following:</p> <ol style="list-style-type: none"><li>a. The actual functional currency cash flows realized upon settlement of foreign currency transactions</li><li>b. The expected functional currency cash flows on unsettled foreign currency transactions.</li></ol>
<b>Translation</b>	See <b>Foreign Currency Translation</b> .
<b>Translation Adjustments</b>	Translation adjustments result from the process of translating financial statements from the entity's functional currency into the reporting currency.
<b>Unit of Measure</b>	The currency in which assets, liabilities, revenues, expenses, gains, and losses are measured.

# D Abbreviations used in this publication

Abbreviation	Standard
ASC 210	FASB ASC Topic 210, <i>Balance Sheet</i>
ASC 220	FASB ASC Topic 220, <i>Income Statement – Reporting Comprehensive Income</i>
ASC 250	FASB ASC Topic 250, <i>Accounting Changes and Error Corrections</i>
ASC 255	FASB ASC Topic 255, <i>Changing Prices</i>
ASC 320	FASB ASC Topic 320, <i>Investments – Debt Securities</i>
ASC 321	FASB ASC Topic 321, <i>Investments – Equity Securities</i>
ASC 323	FASB ASC Topic 323, <i>Investments – Equity Method and Joint Ventures</i>
ASC 326	FASB ASC Topic 326, <i>Financial Instruments – Credit Losses</i>
ASC 330	FASB ASC Topic 330, <i>Inventory</i>
ASC 410	FASB ASC Topic 410, <i>Asset Retirement and Environmental Obligations</i>
ASC 470	FASB ASC Topic 470, <i>Debt</i>
ASC 480	FASB ASC Topic 480, <i>Distinguishing Liabilities from Equity</i>
ASC 505	FASB ASC Topic 505, <i>Equity</i>
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