

# Foreign Operations

## 38.2 OVERVIEW

The financial statements of a foreign company should be translated from the functional currency to U.S. dollars using the current rate method. Adjustments resulting from the translation process should be reflected as a separate component of other comprehensive income and not as a part of the determination of net income. If the records of a foreign company are not maintained in that company's functional currency, they must first be remeasured into the functional currency before translation into U.S. dollars. Transaction gains or losses should be included in determining results of operations unless the transaction hedges a foreign currency commitment or net investment in a foreign company.

## 38.3 MEASUREMENT PRINCIPLES

### 38.3.1 Translation of Foreign Currency Financial Statements

Translation of foreign currency financial statements is necessary when:

- The foreign financial statements are to be consolidated or combined with those of a U.S. company.
- The foreign financial statements will not be consolidated but will be presented separately for U.S. users.
- A U.S. company is required to account for its investment in a foreign entity on the equity method.

Translation of foreign financial statements should accomplish the following objectives:

- Provide information that is generally compatible with the expected economic effects of an exchange rate change on the foreign company's cash flows and equity.
- Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in the currencies of the primary economic environments in which they operate (functional currency) in conformity with U.S. GAAP.

### **Functional currency.**

A foreign company's functional currency is the currency of the primary economic environment in which it operates. Normally, that will be the currency of the country in which the company generates and expends cash. Before foreign financial statements can be translated into U.S. dollars, they must be stated in the functional currency of the foreign company.

Not all foreign operations are alike. Essentially, there are two major categories of foreign companies:

- Those that are relatively self-contained and their operations are integrated within a particular country. For such a company, the local foreign currency is its functional currency.
- Those that are primarily a direct and integral part or extension of the parent company's operations. Significant assets may be acquired from the parent, and the sale of assets may generate funds that are available to the parent. The day-to-day operations of such companies are dependent on the economic environment of the parent's currency, and changes in the foreign company's financial position have a direct impact on the cash flow of the parent in the parent's currency. For these companies, the U.S. dollar is the functional currency.

In some cases, the facts will clearly identify the functional currency; in other cases they will not. Where the functional currency is not clearly evident, management should use its judgment to determine as the functional currency the one that best achieves the objectives of translation. Following are factors that help identify a particular foreign company's functional currency:

- *Cash flow indicators:*
  - — *Foreign currency*—Cash flows related to the foreign entity's individual assets and liabilities are primarily in a foreign currency and do not have a direct impact on the parent company's cash flows.
  - — *Parent's currency*—Cash flows related to the foreign entity's individual assets and liabilities have a direct impact on the parent's cash flows on a current basis and are readily available for remittance to the parent company.
- *Sales price indicators:*
  - — *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.
  - — *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:*
  - — *Foreign currency*—There is an active local sales market for the foreign entity's products, although there also might be significant amounts of exports.
  - — *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:*
  - — *Foreign currency*—Labor, materials, and other costs for the foreign entity's products or services are primarily local costs, even though they also might be imports from other countries.
  - — *Parent's currency*—Labor, materials, and other costs for the foreign entity's products or services, on a continuing basis, are primarily costs for components obtained from the country in which the parent company is located.
- *Financing indicators:*
  - — *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.
  - — *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 company. Infusion of additional funds from the parent company 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.
- *Intercompany transactions and arrangements indicators:*
  - — *Foreign currency*—There is a low volume of intercompany transaction and there is not an extensive interrelationship between the operations of the foreign entity and the parent company. However, the foreign entity operations may rely on the parent's or affiliates' competitive advantages, such as patents and trademarks.
  - — *Parent's currency*—There is a high volume of intercompany transaction and an extensive interrelationship between the operations of the foreign entity and the parent company. 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.

A foreign company may have more than one distinct and separable operation, and each operation, if conducted in different economic environments, may have a different functional currency. A foreign subsidiary of a U.S. bank may have relatively self-contained operations in more than one country and therefore have a different functional currency for each separate operation.

Once the functional currency has been determined, it should not be changed unless there are significant changes in economic facts and circumstances that clearly indicate that the functional currency has changed. (Note that if such a change occurs, previously issued statements should not be restated because it is not considered an accounting change within the guidelines of APB No. 20 .)

If the functional currency of a foreign company changes from a foreign currency to U.S. dollars, the translation adjustment for prior years should not be removed from stockholders' equity. The translated amounts for nonmonetary assets at the end of the prior year become the accounting basis for those assets in the period of change and subsequent periods. If the change is from U.S. dollars to a foreign currency, the adjustment attributable to current-rate translation of nonmonetary assets as of the date of the change should be reported in other comprehensive income.

## Exchange rates.

SFAS No. 52 requires that all accounts in foreign financial statements be translated using the current exchange rate. The current exchange rate, however, is applied differently for the various elements of financial statements as follows:

Financial statement item	Application of current exchange rate
Assets	The rate in effect as of the date of the financial statements (spot rate)
Liabilities	The spot rate
Revenues	Weighted average exchange rate for the period

Expenses	Weighted average exchange rate for the period
Gains and losses	Weighted average exchange rate for the period
Accounting allocations (e.g., depreciation, cost of sales, amortization of deferred revenue and expenses)	The rate in effect when the allocations are made; not the rate on the date that the related item originated
Capital stock and additional paid-in capital	The rate in effect when the related shares issued (historical rate)
Retained earnings	The translated amount at the beginning of the period plus the translated amount for net income less the translated amount of dividends; dividends translated at the rate in effect at declaration

Some countries have different exchange rates for different transactions (for example, one rate for import and export of goods, another rate for loans, and still another for dividend payments by a foreign company). When more than one rate exists, the rate to be used in translation is the rate at which the foreign currency can be converted to U.S. dollars for the purpose of dividend payments (conversion rate). Note that if exchangeability between two currencies is temporarily unavailable at the balance sheet (or at a transaction date), the first subsequent rate at which changes could have been made should be used.

The use of a weighted average or other methods of approximation may be used to save time and effort.

### **Translation adjustment.**

Fluctuations in exchange rates of a particular foreign currency cause a translation adjustment. This translation adjustment should not be included in determining results of operations; instead, it should be reported (and accumulated from period to period) as an element of comprehensive income (see Section 25A , comprehensive income).

When part or all of a company's ownership interest in a foreign entity is sold, a pro rata portion of the accumulated translation adjustment attributable to that entity should be recognized in determining any gain or loss on the sale.

### **Example 1. Translation of Foreign Financial Statements**

#### **FACTS**

Assume that the Derek Company, Ltd. is a foreign subsidiary of Client Company, Inc. Also assume that the financial statements for Derek are expressed in its functional currency (FC) and in U.S. dollars after translation using the following translation rates during 20X2:

- Exchange rate in effect on December 31, 20X2: FC=\$0.50 (50 cents)
- Weighted average rate for 20X2: FC=\$0.48 (48 cents)
- Exchange rate in effect on December 31, 20X1: FC=\$0.53 (53 cents)

- Derek's common stock issued on April 4, 20X0, when exchange rate was FC=\$0.40 (40 cents)
- Exchange rate in effect when 20X2 dividends were declared: FC= \$0.47 (47 cents)

**THE DEREK COMPANY, LTD.**

**BALANCE SHEETS**

*As of December 31, 20X2*

	<b>Foreign currency</b>	<b>Translation rate</b>	<b>U.S. dollars</b>
Cash	FC 290,000	.50	\$145,000
Accounts receivable	840,000	.50	420,000
Marketable securities	260,000	.50	130,000
Inventory	1,370,000	.50	685,000
Land	900,000	.50	450,000
Equipment	700,000	.50	350,000
(Accumulated depreciation)	<u>(240,000)</u>	.50	<u>(120,000)</u>
	<u>FC 4,120,000</u>		<u>\$2,060,000</u>
Accounts payable	FC 860,000	.50	\$430,000
Notes payable	320,000	.50	160,000
Accrued expenses	180,000	.50	90,000
Income taxes payable	120,000	.50	60,000
Long-term debt	500,000	.50	250,000
Deferred income taxes	190,000	.50	95,000
Common stock	400,000	.40	160,000
Additional paid-in capital	80,000	.40	32,000
Retained earnings	1,470,000	(a)	663,600
Translation adjustment		(b)	<u>119,400</u>
	<u>FC 4,120,000</u>		<u>\$2,060,000</u>

(a) See statement of income and retained earnings.

(b) The translation adjustment of \$119,400 is calculated as follows:

Assets in dollars	\$2,060,000
Less: Liabilities in dollars	<u>(1,085,000)</u>
	975,000
Equity in dollars	<u>(855,600)</u>
	<u>\$119,400</u>

**THE DEREK COMPANY, LTD.**

**STATEMENT OF INCOME AND RETAINED EARNINGS**

*For the year ended December 31, 20X2*

	<b>Foreign currency</b>	<b>Translation rate</b>	<b>U.S. dollars</b>
Sales	<u>FC 1,400,000</u>	.48	<u>\$672,000</u>
Costs and expenses:			
Costs of goods sold	500,000	.48	240,000
General and administrative	100,000	.48	48,000
Selling	200,000	.48	96,000
Interest	120,000	.48	57,600
Other	<u>40,000</u>	.48	<u>19,200</u>
	<u>960,000</u>		<u>460,800</u>

Income before taxes	<u>440,000</u>		<u>211,200</u>
Income taxes:			
Current	120,000	.48	57,600
Deferred	<u>190,000</u>	.48	<u>91,200</u>
	<u>310,000</u>		<u>148,800</u>
Net income	130,000		62,400
Retained earnings at 12/31/X1	1,430,000	(a)	643,500
Dividends	<u>90,000</u>	.47	<u>42,300</u>
Retained earnings at 12/31/X2	<u>FC 1,470,000</u>		<u>\$663,600</u>

(a) Retained earnings at 12/31/X1 represents the amount in U.S. dollars calculated as the U.S. dollar amount at 12/31/X0 plus translated 20X1 net income less 20X1 translated dividends.

In 20X3, the translation process will be identical (using the appropriate rates for that year). The translation adjustment will also be determined in the same manner.

In this example, the translation adjustment is a credit, that is, an increase in stockholders' equity. This is caused by the strengthening of the foreign currency against the U.S. dollar. As a result, the U.S. dollar amount of Derek's equity is increased. If the foreign currency had weakened in relation to the U.S. dollar, the translation adjustment would have been a debit.

The method of determining the translation adjustment illustrated in Example 1 has the practical advantage of automatically producing the cumulative translation adjustment to be reported as part of stockholders' equity. Conceptually, the balance at any point represents the balance from the previous year increased or decreased by the current year's effect. Note that the adjustment is not recorded on the books of the foreign subsidiary or its U.S. parent; it is an amount that arises only in the translation process.

## Example 2. Disposition of Foreign Subsidiary

### FACTS

Assume the same information as in Example 1. Also assume that Client Company, Inc. sells 35% of its investment in Derek on January 1, 19x3 for \$400,000 when the balance in the investment account was \$855,600 (Derek's equity in dollars of \$975,000 minus the translation adjustment of \$119,400).

### SOLUTION

The gain on the sale is computed as:

Selling price	\$400,000
Investment in Derek (Derek's equity in dollars of \$975,000 × 35%)	(341,250)
Translation adjustment (\$119,400 × 35%)	<u>41,790</u>
Gain on sale	<u>\$100,540</u>

Note that the gain comprises two elements: (1) the gain of \$58,750 on the sale of 35% of the investment itself before taking account of the translation adjustment (\$400,000 – \$341,250), plus (2) \$41,790, which is the portion of the translation adjustment that must be eliminated upon the sale.

### Example 3. Consolidation of a Foreign Subsidiary

#### FACTS

Assume that Client Company, Inc. acquired 80% of Brittany, PLC, a British company on December 31, 20X 1 at a cost of U.S. \$1,600,000. On that date, the book value and fair value of Brittany's net assets were equal. Brittany's functional currency is the British pound. The exchange rate in effect on December 31, 20X1 is LFC 1 = \$1.50. On December 31, 20X2, the exchange rate is \$1.40; the average rate for 20X2 is \$1.45; and the exchange rate on December 1, 20X2, when Brittany paid a dividend of 100,000, is \$1.43. Brittany's condensed balance sheet appeared as follows at December 31, 20X1, the date of acquisition:

	FC	Translation Rate	U.S. Dollars
Assets	FC 4,000,000	1.50	\$6,000,000
Liabilities	<u>3,000,000</u>	1.50	<u>4,500,000</u>
Equity (including FC 100,000 of common stock)	<u>FC 1,000,000</u>	1.50	<u>\$1,500,000</u>

Also assume that Brittany's condensed financial statements appear as follows for 20X2:

	FC	Translation Rate	U.S. Dollars
Sales	FC 2,000,000	\$ 1.45	\$2,900,000
Expenses	<u>1,400,000</u>	1.45	<u>2,030,000</u>
Net income	600,000		\$870,000
Retained earnings at 12/21/X1	900,000	1.50	1,350,000
Dividends	<u>100,000</u>	1.43	<u>143,000</u>
Retained earnings at 12/31/X2	<u>FC 1,400,000</u>		<u>\$2,077,000</u>
Assets	FC 4,300,000	1.40	\$6,020,000
Liabilities	<u>2,800,000</u>	1.40	<u>3,920,000</u>
Common stock	100,000	1.50	150,000
Retained earnings	1,400,000	computed	2,077,000
Translation adjustment	=		<u>(127,000)</u>
Total equity	<u>FC 1,500,000</u>		<u>\$2,100,000</u>

#### SOLUTION

Before consolidating Brittany's 20X2 U.S. dollar translated financial statements, Client Company should apply the equity method of accounting to its investment. At December 31, 20X 1, the date of acquisition, the balance in the investment account would have been \$1,600,000. Following is an analysis of the investment account for 20X2:

Balance at 12/31/X1	\$1,600,000
Dividends received on 12/31/X2:	
[(LFC 100,000 × 80%) × \$1.43]	(114,400)
Investment income (\$870,000 × 80%)	696,000
Balance at 12/31/X2	<u>\$2,181,600</u>

In consolidation, however, the effect of the decline in exchange rates on goodwill must be considered. To compute this effect, it is necessary to determine original goodwill in

pounds sterling. In U.S. dollars at December 31, 20X1, goodwill is computed as \$400,000, representing the excess of the purchase price of \$1,600,000 over Client Company's 80% share of the net assets acquired translated at the \$1.50 exchange rate of \$1,200,000 [(LFC 1,000,000 × 80%) × \$1.50]. In sterling, goodwill at the date of acquisition is FC 266,667 (\$400,000 / \$1.50). An unrealized loss of \$26,667 arises on the \$.10 decline in rates applied to goodwill at December 31, 20X2 computed as follows:

Goodwill at 12/31/X1	FC 266,667
Decline in spot rate (\$1.50 – \$1.40)	<u>× .10</u>
Unrealized loss	<u>\$ 26,667</u>

Investment income of \$696,000 for 20X2 on the equity method consists of Client Company's 80% share of Brittany's reported net income of \$870,000. Relevant amounts appearing in the consolidated financial statements are calculated as follows:

<i>Goodwill</i>	
Balance at 12/31/X1	\$400,000
Unrealized loss on unamortized goodwill	<u>(26,667)</u>
Balance at 12/31/X2	<u>\$373,333</u>

<i>Translation Adjustment</i>	
From translating Brittany's financial statements	\$(127,000)
Add: Unrealized loss on unamortized goodwill	<u>(26,667)</u>
Balance at 12/31/X2	<u>\$(153,667)</u>

Note that, for presentation purposes, the unrealized exchange rate loss on goodwill is combined with the cumulative translation adjustment.

<i>Minority interest (balance sheet)</i>	
Balance at 12/31/X1 (\$1,500,000 × 20%)	\$300,000
Proportionate share of Brittany's reported net income (\$870,000 × 20%)	174,000
Proportionate share of Brittany's dividends paid (\$143,000 × 20%)	<u>(28,600)</u>
Balance at 12/31/X2	<u>\$445,400</u>

The consolidating workpaper at December 31, 20X2 would appear as follows (with some amounts assumed for Client Company, Inc.):

	Client		Consolidated Adjustments		Consolidated
	Company, Inc.	Brittany PLC	Dr	Cr	
Assets	\$9,000,000	\$6,020,000			\$15,020,000
Investment in Brittany	2,181,600	—		(a) 1,600,000 (b) 581,600	—
Goodwill	—	—	(a) 400,000	(b) 26,667	373,333
	<u>11,181,600</u>	<u>6,020,000</u>	<u>400,000</u>	<u>2,208,267</u>	<u>15,393,333</u>
Liabilities	5,000,000	3,920,000			8,920,000
Minority interest	—	—	(b) 28,600	(a) 300,000 (b) 174,000	445,400
Common stock	2,000,000	150,000	(a) 150,000		2,000,000

Retained earnings	4,181,600	2,077,000 *	2,220,000 *	143,000	4,181,600
Translation adjustment	=	(127,000) (b)	26,667		(153,667)
	<u>11,181,600</u>	<u>6,020,000</u>	<u>2,245,267</u>	<u>617,000</u>	<u>\$15,393,333</u>
Sales	\$10,000,000	\$2,900,000			\$12,900,000
Expenses	8,000,000	2,030,000 (b)			10,068,667
Investment	696,000	— (b)	696,000		—
Minority interest	=	= (b)	174,000		174,000
Net income	<u>\$2,696,000</u>	<u>\$870,000</u> *	<u>870,000</u>		<u>\$2,657,333</u>
Retained earnings at 12/31/X1	\$1,685,600	\$1,350,000 (a)	1,350,000		\$1,685,000
Net income	2,696,000	870,000	870,000		2,696,000
Dividends	<u>200,000</u>	<u>143,000</u>		(b) <u>143,000</u>	<u>200,000</u>
Retained earnings at 12/31/X2	<u>\$4,181,600</u>	<u>\$2,077,000</u> *	<u>2,220,000</u> *	<u>143,000</u>	<u>\$4,181,600</u>

Consolidating entry (a) eliminates Client Company's investment in Brittany and Brittany's equity at December 31, 20X1. It also establishes goodwill and the minority interest at the date of acquisition. Entry (b) eliminates investment income and the activity in the investment account in 20X2. Entry (b) also establishes the minority interest in Brittany's net income and dividends and takes into account the unrealized exchange rate loss on goodwill. (See Section 32 , consolidated and combined statements.)

## Remeasurement into functional currency.

When a foreign company's books and records are not kept in its functional currency, remeasurement is required before translation. If the foreign company's functional currency is the reporting currency (e.g., U.S. dollars), remeasurement is, in effect, a translation. The remeasurement process is intended to produce the same result as if the company's books were maintained in its functional currency. In order to accomplish this, it is necessary to use historical exchange rates for certain accounts to be remeasured as follows:

- Debt securities carried at cost
- 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 deferred income taxes and policy acquisition costs for life insurance enterprises
- Deferred income
- Common stock
- Preferred stock carried at issuance price
- Examples of revenues and expenses related to nonmonetary items:
  - — Cost of goods sold
  - — Depreciation of property, plant, and equipment
  - — Amortization of intangible items such as goodwill, patents, licenses, and so forth
  - — Amortization of deferred charges or credits except deferred income taxes and policy acquisition costs for life insurance companies

When remeasurement into the functional currency is made, it is also necessary to include any gain or loss from remeasurement in determining the current results of operations.

Remeasurement of inventory into the functional currency poses a special situation. Inventory at cost on the books in a currency other than the functional currency should first be remeasured to cost on the functional currency using historical exchange rates. Then, historical cost, as remeasured, is compared with market in the functional currency. Application of the lower-of-cost-or-market may require a write-down, if market is lower than cost, in the functional currency financial statement, even though no such write-down would be necessary on the books that have been maintained on another currency. Conversely, a write-down may have been necessary on the books of another currency but is not now necessary on remeasurement, because market as stated in the functional currency is higher than the remeasured cost. If inventory is written down to market in the functional currency statements, that written-down amount should continue to be the carrying amount in future functional currency statements until the inventory is sold or a further write-down is necessary.

If the value of the currency in which the books are maintained declines in relation to the functional currency between the date the inventory was locally acquired and the date of the financial statements, such a write-down to market in the functional currency financial statements may be required. The write-down may not be necessary, however, if the replacement cost or selling price in the currency in which the books are maintained has increased sufficiently for market to exceed historical cost as measured in the functional currency. Example 4 illustrates application of the lower-of-cost-or-market rule.

#### **Example 4. Applying the Lower-of-Cost-or-Market Rule to Remeasured Inventory**

##### **FACTS**

Assume the following situations with regard to inventory. In each case, the books are maintained in a currency other than the foreign company's functional currency. The functional currency is considered to be the U.S. dollar.

	<b>Situation</b>		
	<b>1</b>	<b>2</b>	<b>3</b>
Date of financial statements	<u>12/31/X1</u>	<u>12/31/X1</u>	<u>12/31/X1</u>
Date inventory acquired	<u>5/1/X1</u>	<u>5/1/X1</u>	<u>5/1/X1</u>
Exchange rate at date inventory acquired	<u>FC=\$2.00</u>	<u>FC=\$2.00</u>	<u>FC=\$2.00</u>
Exchange rate at 12/31/X1	<u>FC=\$1.60</u>	<u>FC=\$1.60</u>	<u>FC=\$1.60</u>
Cost of inventory:			
FC	<u>FC 1,000</u>	<u>FC 1,000</u>	<u>FC 1,000</u>
U.S. dollars	<u>\$2,000</u>	<u>\$2,000</u>	<u>\$2,000</u>
Current replacement cost as 12/31/X1:			
FC	<u>FC 1,120</u>	<u>FC 1,250</u>	<u>FC 1,120</u>
U.S. dollars	<u>\$1,792</u>	<u>\$2,000</u>	<u>\$1,792</u>
Net realizable value:			
FC	<u>FC 1,260</u>	<u>FC 1,260</u>	<u>FC 1,466</u>
U.S. dollars	<u>\$2,016</u>	<u>\$2,016</u>	<u>\$2,346</u>
Net realizable value less an allowance for normal profit margin:			
FC	<u>FC 1,096</u>	<u>FC 1,096</u>	<u>FC 1,440</u>
U.S. dollars	<u>\$1,754</u>	<u>\$1,754</u>	<u>\$2,304</u>

## **SOLUTION**

The solutions for Situations 1 through 3 are determined as follows.

### **SITUATION 1**

Current replacement cost as measured in the functional currency (U.S. dollars) of \$1,792 is less than the \$2,000 historical cost; therefore, a write-down of \$208 (\$2,000 – \$1,792) is required in the U.S. dollar financial statement. Note that current replacement cost exceeds historical cost in the foreign currency. The write-down is necessitated because of the decline in the exchange rate from FC = \$2.00 at the date the inventory was acquired to FC = \$1.60 at the date of the financial statements.

### **SITUATION 2**

Because market as measured in U.S. dollars (replacement cost of \$2,000) is equal to historical cost in U.S. dollars (\$2,000), no write-down is required in the U.S. dollar financial statements.

### **SITUATION 3**

In this case, replacement cost in U.S. dollars of \$1,792 is less than the net realizable value reduced by an allowance for normal profit margin in U.S. dollars of \$2,304; therefore, the market is \$2,304, which exceeds historical cost of \$2,000, and a write-down is not necessary in the U.S. dollar financial statements.

### **Example 5. Remeasurement of Financial Statements Into the Foreign Entity's Functional Currency (U.S. Dollars)**

#### **FACTS**

Assume that the Morocco Company, S.A. is a foreign subsidiary of Client Company, Inc. Also assume that Morocco's books and records are maintained in the local foreign currency (LFC). The U.S. dollar, however, is determined to be Morocco's functional currency. Morocco's financial statements that follow are expressed in its local foreign currency and in U.S. dollars after remeasurement. The relevant exchange rates are as follows:

- Exchange rate in effect on December 31, 20X2: LFC = \$2.00
- Weighted average rate for 20X2: LFC = \$1.90
- Historical rate when marketable securities were acquired: LFC = \$1.82
- Historical rate in 20X1 when property and equipment was acquired: LFC = \$1.80
- Historical rate in 20X2 when property and equipment was acquired: LFC = \$1.84
- Average historical rate applicable to inventory on hand at December 31, 20X2: LFC = \$1.94
- Average historical rate applicable to inventory on hand at December 31, 20X1: LFC = \$1.88
- Historical rate when common stock was issued: LFC = \$1.78
- Exchange rate in effect when 20X2 dividends were declared: LFC = \$1.98

Also assume that the property and equipment was acquired as follows:

- On January 2, 20X1 at a cost of LFC 200,000

- On January 2, 20X2 at a cost of LFC 150,000

Morocco uses straight-line depreciation and none of the property and equipment has salvage value; the useful life of all property is five years.

### SOLUTION

Morocco's financial statements expressed in LFC and remeasured into U.S. dollars as of and for the year 20X2 would appear as follows:

<b><u>THE MORROCO COMPANY, S.A.</u></b>			
<b><u>BALANCE SHEETS</u></b>			
<b><u>As of December 31, 20X2</u></b>			
	<b>Local foreign currency</b>	<b>Remeasurement rate</b>	<b>U.S. dollars (functional currency)</b>
Cash	LFC 300,000	2.00	\$600,000
Accounts receivable	290,000	2.00	580,000
Marketable securities	120,000	1.82	218,400
Inventory	780,000	1.94	1,513,200
Property and equipment	350,000	(a)	636,000
(Accumulated depreciation)	<u>(110,000)</u>	(b)	<u>(199,200)</u>
	<u>LFC 1,750,000</u>		<u>\$3,348,000</u>
Accounts payable	LFC 240,000	2.00	\$480,000
Notes payable	200,000	2.00	400,000
Accrued expenses	120,000	2.00	240,000
Income taxes payable	80,000	2.00	160,000
Long-term debt	100,000	2.00	200,000
Deferred income taxes	70,000	2.00	140,000
Common stock	350,000	1.78	623,000
Additional paid-in capital	50,000	1.78	89,000
Retained earnings	<u>520,000</u>	(c)	<u>1,016,400</u>
	<u>LFC 1,750,000</u>		<u>\$3,348,400</u>

(a) Property and equipment is remeasured as follows:

20X1 acquisition (LFC 200,000 × 1.80)	\$360,000
20X2 acquisition (LFC 150,000 × 1.84)	<u>276,000</u>
	<u>\$636,000</u>

(b) Accumulated depreciation is remeasured as follows: The balance of LFC 110,000 consists of:

Depreciation on 20X1 acquisition (LFC 200,000 ÷ 5 years)	LFC 40,000
Depreciation on 20X1 acquisition in 20X2	40,000
Depreciation in 20X2 acquisition (LFC 150,000 ÷ 5 years)	<u>30,000</u>
	<u>LFC 110,000</u>

The balance of accumulated depreciation on 12/31/X2 is remeasurable at the following rates:

On 20X1 acquisition (LFC 80,000 × 1.80)	\$144,000
On 20X2 acquisition (LFC 30,000 × 1.84)	<u>55,200</u>
	<u>\$199,200</u>

(c) Retained earnings is computed as:

Total of remeasured assets	\$3,348,400
Less: Total of remeasured liabilities	(1,620,000)
Total of remeasured common stock and additional paid-in capital	<u>(712,000)</u>
Amount necessary to balance	<u>\$1,016,400</u>

**THE MORROCO COMPANY, S.A.**  
**STATEMENT OF INCOME AND RETAINED EARNINGS**  
**For the year ended December 31, 20X2**

	Local foreign currency	Remeasurement rate	U.S. dollars (functional currency)
Sales	LFC 2,000,000	1.90	\$3,800,000
Costs and expenses:			
Cost of goods sold			
Inventory at 12/31/X1	650,000	1.88	1,222,000
Purchases	1,200,000	1.90	2,280,000
Inventory at 12/31/X2	<u>780,000</u>	1.94	<u>1,513,200</u>
	1,070,000		1,988,000
General and administrative	280,000	1.90	532,000
Selling	170,000	1.90	323,000
Depreciation	70,000	(d)	127,200
Interest	40,000	1.90	76,000
Others	<u>10,000</u>	1.90	<u>19,000</u>
	<u>1,640,000</u>		<u>3,066,000</u>
Income before taxes	<u>360,000</u>		<u>734,000</u>
Income taxes:			
Current	80,000	1.90	152,000
Deferred	<u>70,000</u>	1.90	<u>133,000</u>
	<u>150,000</u>		<u>285,000</u>
Gain from remeasurement		(g)	38,700
Net income	210,000		449,000
Retained earnings at 12/31/X1	370,000	(e)	647,500
Dividends	<u>60,000</u>	1.98	<u>118,800</u>
Retained earnings 12/31/X2	<u>LFC 520,000</u>	(f)	<u>\$1,016,400</u>

(d) Depreciation expense for 20X2 is remeasured as follows:

On 20X1 acquisition of property (LFC 40,000 × 1.80)	\$72,000
On 20X2 acquisition of property (LFC 30,000 × 1.84)	<u>55,200</u>
	<u>\$127,200</u>

(e) Retained earnings at the beginning of the year is assumed in this example. When 20X1 financial statements were remeasured, the ending balance in retained earnings was computed in the same manner as it is in this example.

(f) The balance in retained earnings at 12/31/X2 in the statement of retained earnings is the amount determined in (c) above in connection with remeasurement of the balance sheet.

(g) The remeasurement loss is computed as the amount necessary so that net income in U.S. dollars plus beginning retained earnings in U.S. dollars less dividends in U.S. dollars equals ending retained earnings in U.S. dollars. Following is the required computation:

Retained earnings at 12/31/X1	\$647,500
Dividends	(118,800)
Retained earnings at 12/31/X2	<u>1,016,400</u>
Net income required	\$(487,700)
Income before remeasurement gain	
(\$3,800,000 – \$3,066,000 – \$285,000)	<u>449,000</u>
Gain from remeasurement	<u>\$38,700</u>

Note that in Example 1 , the translation adjustment was not considered in determining net income in U.S. dollars; instead, it was a component of stockholders' equity. In Example 4 , however, the translation adjustment (termed remeasurement gain or loss) is a part of results of operations. Conceptually, both arise from the effects of exchange rates in the current year when compared to prior years.

## **Foreign operations in a highly inflationary economy.**

Where the foreign currency is subject to high inflation, translated amounts become meaningless and outdated very quickly. Financial statements of a foreign company that operates in a highly inflationary economy, therefore, should be remeasured in U.S. dollars. This, of course, obviates the necessity for further translation. The FASB defines a highly inflationary economy as one that has cumulative inflation of about 100% or more over a three-year period. In some instances, the trend of inflation may be as important as the absolute rate. The definition of a highly inflationary economy thus requires judgment on the part of management.

The FASB Staff believes 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 (using a compounded three-year rate). If that calculation results in a cumulative inflation rate in excess of 100%, the economy should be considered highly inflationary in all instances. However, if that calculation results in the cumulative rate being less than 100%, the staff believes that 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. The staff believes that projections of future inflation rates cannot be used to overcome the presumption that an economy is highly inflationary if the three-year cumulative rate exceeds 100%.

The necessity of remeasurement (using historical rates where required) rather than translation (using the spot rate) is illustrated in Example 6 .

## Example 6. Effects of High Inflation on Translation

### FACTS

Assume that the Cucara Company, S.A., a foreign subsidiary of a U.S. company, operates in a highly inflationary economy. During 20X2, Cucara acquires equipment for FC 300,000. At the date of acquisition, the exchange rate is FC = \$2.00. The equipment has a 10-year life with no salvage value and is being depreciated on the straight-line method. On December 31, 20X2, the exchange rate is FC = \$1.00.

### SOLUTION

When foreign financial statements are translated, the spot rate is used; when they are remeasured, however, equipment and the related depreciation are shown in U.S. dollars at the historical rate as follows:

	FC	Translated	Remeasured
Equipment (asset)	FC 300,000	\$300,000	\$600,000
Accumulated depreciation	<u>(30,000)</u>	<u>(30,000)</u>	<u>(60,000)</u>
Book value	<u>FC 270,000</u>	<u>\$270,000</u>	<u>\$540,000</u>

When translated using the spot rate of \$1.00, the book value of the asset is only \$270,000 and depreciation expense is \$30,000. This does not reflect the reality of the situation. When remeasured, the book value is \$600,000 and depreciation expense is \$60,000 for 20X2. Remeasurement is intended to produce the same results as would have been obtained if Cucara's books were kept in U.S. dollars; if they had been, depreciation would have been based on the historical cost of \$600,000 (FC 300,000 × \$2.00). When exchange rates fluctuate severely, translation using the spot rate does not produce these results.

## Elimination of intercompany profits.

Just as in the case of domestic subsidiaries (or other equity-method investees), unrealized intercompany profit arising from transactions between a foreign subsidiary and its U.S. parent should be eliminated in consolidation. The amount eliminated is based on the exchange rate in effect at the date of the transaction.

## Example 7. Elimination of Intercompany Profit in Inventory

### FACTS

Assume that Client Company, Inc. sells inventory to La Jook, a French subsidiary, for \$40,000 on September 1, 20X2. The cost to Client Company was \$25,000. On the date of sale the exchange rate was French franc (F) = \$0.20 (20 cents). La Jook, therefore, records the purchase of the inventory at F200,000 (\$40,000 / \$0.20). On December 31, 20X2, all of the inventory remains on hand, and the exchange rate is F = \$0.18 (18 cents).

### SOLUTION

All of the \$15,000 unrealized profit must be eliminated in consolidation for 20X2. Assuming that La Jook has no other inventory, the F200,000 would be consolidated at \$0.18 (the spot rate) on December 31, 20X2, or \$36,000. The intercompany profit would be eliminated as follows:

La Jook's inventory at the spot rate	\$36,000
Less: Intercompany profit	<u>(15,000)</u>
Inventory on the consolidated balance sheet	<u>\$21,000</u>

Note that the amount of inventory decreased by \$4,000 (\$25,000 original cost less \$21,000 after translation). This \$4,000 will contribute to the translation adjustment. It is attributable to the change in exchange rates from \$0.20 to \$0.18 as follows:

Cost to La Jook on 9/1/X2 (in U.S. dollars)	\$40,000
Translated at the spot rate on 12/31/X2	<u>(36,000)</u>
Difference due to exchange rate fluctuation	<u>\$4,000</u>

By eliminating intercompany profit in the U.S. dollars based on the rate in effect on 9/1/X2, the amount to be eliminated is not influenced by rate change.

### **Effects of changes in exchange rates on cash.**

SFAS No. 95 requires that the effect of exchange rate changes on cash balances held in foreign currencies be reported separately within the body of the cash flow statement as part of the change in cash and cash equivalents for the period. (See Section 29 , statement of cash flows.)

The effect of exchange rate changes on cash is essentially a balancing figure used so that the translated (or remeasured) amount of cash in U.S. dollars at the beginning of the year plus translated (remeasured) amounts provided (or used) by operating, investing, and financing activities equals the translated (remeasured) amount in U.S. dollars at the end of the year. Such a balancing figure is needed because line items on the balance sheet and income statement are not all translated (remeasured) at the same rate. Thus, reporting the effect of changes in exchange rates on cash is not required in the cash flow statement of a foreign subsidiary presented in the LFC. The effect on cash may be viewed as that portion of the translation adjustment (or gain or loss on remeasurement) that has affected cash transactions.

The following example illustrates how the effect of exchange rate changes on cash is calculated.

#### **Example 8. Computation of Effect of Exchange Rate Changes on Cash**

##### **FACTS**

Assume that Brittany PLC is a wholly owned foreign subsidiary of Client Company, Inc. Brittany's functional currency is the LFC. Thus, for consolidation with Client Company, Brittany's financial statements are translated into U.S. dollars. Brittany's summarized cash flow statement is as follows:

	<b>In local foreign currency</b>	<b>In U.S. dollars</b>
<i>Operating activities:</i>		

Net income	LFC 116,000	\$232,000
Depreciation	198,000	396,000
Increase in accounts receivable	(85,000)	(170,000)
Increase in inventory	(225,000)	(450,000)
Decrease in accounts payable and accrued expenses	37,000	74,000
Decrease in interest and taxes payable	<u>(4,000)</u>	<u>(8,000)</u>
Net cash from operating activities	<u>37,000</u>	<u>74,000</u>
Investing activities:		
Proceeds from sale of equipment	275,000	533,500
Payments for purchase of equipment	<u>(600,000)</u>	<u>(1,182,000)</u>
Net cash used in investing activities	<u>(325,000)</u>	<u>(648,500)</u>
Financing activities:		
Proceeds from short-term debt	175,000	(367,500)
Proceeds from issuance of long-term debt	400,000	792,000
Repayment of long-term debt	(250,000)	(505,500)
Payment of dividends	<u>(50,000)</u>	<u>(101,500)</u>
Net cash from financing activities	<u>275,000</u>	<u>553,000</u>
Decrease in cash	(13,000)	(21,500)
Effect of exchange rates on cash		(7,400)
Cash at beginning of year	<u>38,000</u>	<u>77,900</u>
Cash at end of year	<u>LFC 25,000</u>	<u>\$49,000</u>

Also assume the following relevant exchange rates:

- Weighted average rate: LFC1 = \$2.00
- When equipment was sold: LFC1 = \$1.94
- When equipment was purchased: LFC1 = \$1.97
- When short-term debt was incurred: LFC1 = \$2.10
- When long-term debt was incurred: LFC1 = \$1.98
- When long-term debt was repaid: LFC1 = \$2.02
- When dividends were paid: LFC1 = \$2.03
- At the beginning of the year: LFC1 = \$2.05
- At the end of the year: LFC1 = \$1.96

## SOLUTION

In accordance with SFAS No. 52, net income and depreciation are translated at the weighted average rate of \$2.00. Because accounts receivable, inventory, accounts payable and accrued expenses, and interest and taxes payable all arise from *operating* activities, they too are translated at the weighted average rate. Specific investing and financing activities are translated at rates in effect at the time of the cash inflow or outflow. Also, in accordance with SFAS No. 52, cash at the beginning and end of the year are translated at rates in effect on those dates (i.e., at current rates).

The \$7,400 effect on cash from changes in exchange rates is a balancing figure that also can be calculated as follows:

Cash from operating activities at the rate in effect at the end of the year (LFC 37,000 × \$1.96)	\$72,520
Cash in U.S. dollars on the cash flow statement	<u>(74,000)</u>
Effect on cash from operating activities	<u>(1,480)</u>
Cash used in investing activities at the rate in effect at the end of the year (LFC 325,000 × \$1.96)	(637,000)
Cash in U.S. dollars on the cash flow statement	(648,500)
Effect on cash used in investing activities	<u>11,500</u>
Cash from financing activities at the rate in effect at the end of the year (LFC 275,000 × \$1.96)	539,000
Cash in U.S. dollars on the cash flow statement	<u>(553,000)</u>
Effect on cash from financing activities	<u>(14,000)</u>
Cash in local currency at the beginning of the year at the rate in effect at the beginning of the year (LFC 38,000 × \$2.05)	(77,900)
Cash in local currency at the beginning of the year at the rate in effect at the end of the year (LFC 38,000 × \$1.96)	<u>74,480</u>
Effect on beginning cash	<u>(3,420)</u>
Net effect on cash from changes in exchange rates	<u>\$(7,400)</u>

Note that the process is identical for determining the effect on cash when foreign financial statements are remeasured into U.S. dollars.

## Changes in functional currency from the U.S. dollar

If the functional currency changes from the U.S. dollar to the reporting currency, the adjustment resulting from applying the current-rate method as of the date of change to nonmonetary assets should be treated as a cumulative translation adjustment and included in other comprehensive income. The following example illustrates how this is done.

### Example 9. Change in Functional Currency From the U.S. Dollar to the Local Reporting Currency

#### FACTS

Assume that Client Company, Inc., has a foreign subsidiary that was organized on January 1, 20X1. On that date and for all of 20X1, the subsidiary's functional currency is the U.S. dollar. On January 1, 20X2, the subsidiary's functional currency changes to the local foreign currency (LFC) in which the subsidiary maintains its books and records. Relevant exchange rates are as follows:

- Exchange rate in effect on January 1, 20X1, when property and equipment was acquired and common stock was issued: LFC = \$1.60.
- Exchange rate in effect on December 31, 20X1, and January 1, 20X2: LFC = \$1.75.

Also assume that the subsidiary's property and equipment has a five-year estimated useful life. Finally, assume that the foreign subsidiary's 20X1 balance sheet expressed in LFC and *after* remeasurement into U.S. dollars appears as follows:

	LFC	Remeasurement Rate	U.S. Dollars
Cash and other monetary current assets	LFC 500,000	1.75	\$875,000
Property and equipment	400,000	1.60	640,000
Accumulated depreciation	<u>(80,000)</u>	1.60	<u>(128,000)</u>
	<u>820,000</u>		<u>1,387,000</u>
Monetary current liabilities	300,000	1.75	525,000
Common stock and additional paid-in capital	100,000	1.60	160,000
Retained earnings	<u>420,000</u>	Computed	<u>702,000</u>
LFC	<u>820,000</u>		<u>\$1,387,000</u>

## SOLUTION

For 20X1, because the functional currency is the U.S. dollar but books and records are kept in the local foreign currency, the subsidiary's financial statements must be remeasured (not translated) into U.S. dollars. Pursuant to the remeasurement process, nonmonetary assets (i.e., property and equipment) and their related allocation (i.e., accumulated depreciation) are converted at historical rates. Retained earnings in U.S. dollars is the amount necessary to balance when subtracting remeasured liabilities and paid-in capital from remeasured assets.

On January 1, 20X2, when the functional currency changes to the local reporting currency, nonmonetary assets are *translated* at the current rate. Thus, the subsidiary's balance sheet on that date expressed in LFC and in U.S. dollars would be:

	LFC	Translation Rate	U.S. Dollars
Cash and other monetary current assets	LFC 500,000	1.75	\$875,000
Property and equipment	400,000	1.75	700,000
Accumulated depreciation	<u>(80,000)</u>	1.75	<u>(140,000)</u>
	<u>820,000</u>		<u>1,435,000</u>
Monetary current liabilities	300,000	1.75	525,000
Common stock and additional paid-in capital	100,000	1.60	160,000
Retained earnings	420,000	Carried forward	702,000
Translation adjustment	=	Computed	<u>48,000</u>
	<u>LFC 820,000</u>		<u>\$1,435,000</u>

Note that retained earnings at January 1, 20X2, is carried forward at the *remeasured* amount of \$702,000. Property and equipment (and related accumulated depreciation) are translated at the current rate. The translation process thus gives rise to a translation adjustment, which is computed as the amount necessary to make the balance sheet balance after subtracting (in dollars) liabilities and paid-in capital from assets.

## Change in functional currency when an economy ceases to be considered highly inflationary and vice versa.

The Emerging Issues Task Force has addressed the situation in which an entity has a foreign subsidiary operating in a country whose economy has ceased being highly

inflationary. During the period of high inflation, the parent's reporting currency was used as the subsidiary's functional currency.

The EITF reached a consensus that when an economy is no longer considered highly inflationary and thus the local foreign currency becomes the functional currency, the accounting bases of nonmonetary assets and liabilities should be restated at the date of the change. This should be done by translating the reported currency amounts into local currency at current exchange rates, with the translated amounts becoming the new functional currency accounting bases for the nonmonetary assets and liabilities.

Example 10 illustrates application of this consensus.

### **Example 10. Functional Currency Change—Operating Economy No Longer Highly Inflationary**

#### **FACTS**

Assume that Client Company, Inc., has a foreign subsidiary in a country whose economy was deemed to be highly inflationary during the years 20X1 and 20X2. Accordingly, the subsidiary's functional currency during those years was the U.S. dollar. As of January 1, 20X3, the economy of the country is no longer considered to be highly inflationary, and the subsidiary changes to the local currency (LFC) as its functional currency. Also assume that, on January 1, 20X1, the foreign subsidiary acquired equipment for LFC 1,000,000. The equipment has a five-year estimated useful life. On the date of purchase, the exchange rate was LFC1 = \$1.00. The exchange rate on January 1, 20X3 is LFC 10 = \$1.00, the average rate for 20X3 is LFC 9 = \$1.00, and the spot rate on December 31, 20X3 is LFC 8 = \$1.00.

#### **SOLUTION**

When acquired, the equipment had a U.S. dollar cost of \$1,000,000. At December 31, 20X2, after *remeasurement*, the U.S. dollar cost would still be \$1,000,000, and accumulated depreciation (assuming the straight-line method) would be \$400,000. Thus, on December 31, 20X2, the book value of the equipment is \$600,000. To comply with the EITF consensus, the accounting basis of the equipment and its related accumulated depreciation on January 1, 20X3 are:

Equipment (\$1,000,000 × LFC 10)	LFC 10,000,000
Accumulated depreciation (\$400,000 × LFC 10)	<u>(4,000,000)</u>
Book value	<u>LFC 6,000,000</u>

For 20X3, when the local currency is the functional currency, the translation process rather than the remeasurement process is applied. Depreciation expense is LFC 2,000,000 (LFC 6,000,000 ÷ the three-year remaining life), and accumulated depreciation is LFC 6,000,000 (LFC 4,000,000 + LFC 2,000,000). Expensed in U.S. dollars after translation, relevant amounts are as follows:

	LFC	Translation Rate	U.S. Dollars
Equipment	10,000,000	.1250	\$1,250,000
Accumulated depreciation	6,000,000	.1250	<u>750,000</u>
			<u>\$500,000</u>
Book value	2,000,000	.1111	<u>\$220,200</u>

As a result of applying the foregoing consensus, the functional currency bases generally will exceed the local currency bases of nonmonetary items. The excess represents a temporary difference under SFAS No. 109 for which a deferred tax liability must be recognized. The EITF reached a consensus that deferred taxes associated with this temporary difference should be reflected in other comprehensive income.

The FASB Staff believes that when the functional currency changes from a foreign currency to the reporting currency because the economy has become highly inflationary, translation adjustments for prior periods should 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. Moreover, in accordance with SFAS No. 109, deferred tax benefits attributable to indexing for tax purposes which occur *after* the change in functional currency to the reporting currency should be recognized when realized on the tax return and not before. Deferred tax benefits that were recognized for indexing *prior* to the change in functional currency to the reporting currency should be eliminated when the related indexed amounts are realized as deductions for tax purposes.

### **Selection of an exchange rate when trading is temporarily suspended.**

If exchangeability between two currencies can not occur at the transaction date or the balance sheet date, the first subsequent rate at which exchanges could be made should be used to translate (remeasure) transactions and balances.

### **Application of SFAS 109 in foreign financial statements restated for general price-level changes**

The EITF has addressed the issue of how SFAS No. 109, *Accounting for Income Taxes*, should be applied in foreign financial statements restated for general price-level changes in accordance with U.S. GAAP.

The EITF reached a consensus that when financial statements restated for general price-level changes are prepared using end-of-current-year purchasing power units, temporary differences under SFAS No. 109 should be determined on the basis of the difference between the indexed tax-basis amount of the asset or liability and the related restated price-level amount reported in the financial statements.

The EITF also reached a consensus that the deferred tax expense or benefit should be calculated as the difference between (1) deferred tax assets and liabilities reported at the end of the current year and (2) deferred tax assets and liabilities reported at the end of the prior year, remeasured to units of current general purchasing power at the end of the current year. The remeasurement of deferred tax assets and liabilities at the end of the prior year should be reported together with the remeasurement of all other assets and liabilities as a restatement of beginning equity.

The following example illustrates application of the foregoing consensus.

#### **Example 11. Computation of Deferred Tax in Price-Level Financial Statements**

##### **FACTS**

Assume that El Britto, a company operating in an economy that requires financial statements to be restated for general price level changes, acquires a nonmonetary asset (not subject to depreciation or amortization) on January 1, 20X1. The purchase price in local foreign currency is LFC 100,000. Also assume that, on December 31, 20X2, the amount in current purchasing power units is LFC 135,000 and that, for tax purposes, the indexed amount on that date is LFC 130,000. Finally, assume that during 20X3 the general price level rises by 30% but the tax index to be used is 24%. The income tax rate is 40%.

## SOLUTION

At December 31, 20X2, the deferred tax liability is computed as follows:

Amount in current purchasing power units	LFC 135,000
Indexed amounts for tax purposes	<u>(130,000)</u>
	5,000
Income tax rate	× .40
Deferred tax liability	<u>LFC 2,000</u>

At December 31, 20X3, the deferred tax liability is calculated as follows:

Amounts in current purchasing power units (LFC 135,000 × 1.30)	LFC 175,500
Indexed amount for tax purposes (LFC 130,000 × 1.24)	<u>(161,200)</u>
	14,300
Income tax rate	× .40
Deferred tax liability	<u>LFC 5,720</u>

Deferred tax expense for 20X3 is the difference between the restated liability at the end of 20X2 and the deferred tax liability at the end of 20X3, computed as follows:

Deferred tax liability at December 31, 20X3	LFC 5,720
Restated deferred tax liability at December 31, 20X2 (LFC 2,000 × 1.30)	<u>2,600</u>
Deferred tax expense	<u>LFC 3,120</u>

Opening equity on January 1, 20X3, would thus be restated by LFC 600, computed as the difference between the deferred tax liability at December 31, 20X2 (LFC 2000), and the amount of that year's liability restated for the 20X3 increase in purchasing power (LFC 2,600).

### 38.3.2 Foreign Currency Transactions

A foreign currency transaction is one that is denominated in other than the company's functional currency. For a U.S. company (whose functional currency presumably is the U.S. dollar), a transaction to be settled by the payment or receipt of a currency other than the U.S. dollar is a foreign currency transaction. Examples of foreign currency transactions are:

- Sale to a foreign company whereby the receivable will be collected in the foreign currency
- Purchase from a foreign company whereby the payable will be paid in the foreign currency

- Borrowing or lending transactions to be settled in the foreign currency
- Temporary investment in foreign stocks, bonds, and other securities whose market prices are quoted in the foreign currency
- Holding of cash of a foreign currency (e.g., the Canadian dollar, the German mark)

Any change in exchange rates between the foreign currency and the U.S. dollars from the original transaction date (e.g., the sale or purchase of goods) and the settlement date (e.g., the date of collection of the receivable or payment on a debt) will increase or decrease the amount of the foreign currency received or expended. The amount of the increase or decrease is a foreign currency transaction gain or loss to be included in determining results of operations for the period in which it occurs.

At the transaction date, the accounts involved should be recorded in U.S. dollars based on the exchange rate then in effect. At the settlement date, the accounts involved should be recorded in U.S. dollars at the exchange rate in effect at that time, and any resulting gain or loss should be recorded.

### Example 12. Foreign Currency Transaction Gain or Loss

#### FACTS

Assume that Client Company, Inc. enters into two transactions on May 1, 20X2 as follows:

- Sells merchandise to a West German customer. Payment is to be received on July 1, 20X2 in the amount of 120,000 deutsche marks (DM). On May 1, 20X2, the exchange rate is DM = \$0.40 (40 cents).
- Purchases merchandise from a West German supplier. Payment is to be made also on July 1, 20X2 in the amount of DM 120,000.

The exchange rate on July 1, 20X2 is DM = \$0.45 (45 cents).

#### SOLUTION

On May 1, 20X2, the transaction date, the journal entries to be made are:

Accounts receivable (DM 120,000 × \$0.40)	48,000	
Sales		48,000
Purchase (DM 120,000 × \$0.40)	48,000	
Accounts payable		48,000

On the settlement date, July 1, 20X2, when the exchange rate is DM = \$0.45, the following journal entries are made:

Cash (DM 120,000 × \$0.45)	54,000	
Accounts receivable		48,000
Foreign currency gain		6,000
Accounts payable	48,000	
Foreign currency loss	6,000	

Cash (DM 120,000 × \$0.45)	54,000
----------------------------	--------

Note that the \$6,000 gain and the \$6,000 loss both result from the exchange rate change of \$0.05 (\$0.45 – \$0.40). The transactions, originally recorded at \$48,000, have been changed by \$6,000 (DM 12,000 × \$0.05).

This example illustrates the accounting treatment required when the transaction date and the settlement date are in the same fiscal period. When financial statements are prepared during the intervening period, the accounts, as originally recorded on the transaction date, must be adjusted to reflect the exchange rate in effect at the balance-sheet date, as Example 10 illustrates.

**Example 13. Foreign Currency Transaction Gain or Loss at the Balance-Sheet Date**

**FACTS**

Assume the same facts as in Example 9 except that Client Company's fiscal year ends on May 31, 20X2, when the exchange rate was DM = \$0.42 (42 cents).

**SOLUTION**

On May 31, 20X2, accounts receivable and accounts payable must be adjusted to represent their U.S. dollar equivalent based on the exchange rate of DM = \$0.42 as follows:

Accounts receivable	2,400	
Foreign currency gain		2,400

The \$2,400 gain is computed as:

Accounts receivable at current rate (DM 120,000 × \$0.42)	\$50,000
Less: Balance per books as originally recorded	<u>(48,000)</u>
Foreign currency gain	<u>\$2,400</u>

Foreign currency loss	2,400	
Accounts payable		2,400

The \$2,400 loss is computed as:

Balance per books as originally recorded	\$48,000
Less: Accounts payable at current rate (DM 120,000 × \$0.42)	<u>(50,400)</u>
Foreign currency loss	<u>\$(2,400)</u>

On July 1, 20X2, when the transactions are settled, the gain or loss is calculated as:

	<b>Receivable</b>	<b>Payable</b>
Settlement amount (DM 120,000 × \$0.45)	\$54,000	\$(54,000)
Adjusted balance (computed above)	<u>(50,400)</u>	<u>50,400</u>
Foreign currency gain	<u>\$(3,600)</u>	

Foreign currency loss \$(3,600)

The journal entries on July 1, 20X2 are:

Cash (DM 120,000 × \$0.45)	54,000	
Accounts receivable		50,400
Foreign currency gain		3,600
Accounts payable	50,400	
Foreign currency loss	3,600	
Cash		54,000

The transactions still resulted in a \$6,000 gain and a \$6,000 loss; however, because financial statements were prepared during the intervening period, a portion (\$2,400) was recognized in Client Company's fiscal year ending May 31, 20X2, and a portion (\$3,600) was recognized in the following year.

### 38.3.3 Forward Exchange Contracts and Futures Contracts

A forward exchange contract is an agreement to exchange different currencies at a specified future date at a specified rate (the forward rate) in effect on the date of the agreement. If the forward rate is higher than the spot rate, the difference is a premium. Conversely, if the forward rate is lower than the spot rate, the difference is a discount. The reasons a company might enter into a forward exchange contract are:

- To minimize or offset the risk of exchange rate fluctuations (hedging) in connection with
  - — An identifiable firm foreign currency commitment
  - — An exposed net asset or liability position
- To speculate in the foreign currency market

Any gain or loss from hedging is computed as the difference between (1) the spot rate at the balance-sheet date and (2) the spot rate at the date the forward contract was entered into (or the spot rate last used to measure a gain or loss on that contract for an earlier period) multiplied by the foreign currency amount. The discount or premium on a forward contract (i.e., the foreign currency amount of the contract multiplied by the difference between the forward rate and the spot rate at the contract date) should be determined separately from the contract gain or loss.

The amount of gain or loss on a hedge against a firm foreign currency commitment should be deferred and included in the measurement of the related foreign currency transaction (e.g., the purchase or sale of equipment). A loss should not be deferred, however, if to do so would lead to recognizing future losses. In addition, any discount or premium on a hedge against a firm foreign commitment may be similarly deferred, or amortized over the term of the forward contract.

Any gain on a forward exchange contract is subject to U.S. income tax; therefore, the amount of the forward exchange contract necessary to completely offset an identifiable foreign currency commitment must be larger than the amount of the commitment. Any gain or loss relating to the excess of the hedge over the foreign currency commitment

should be deferred only to the extent that the transaction provides a hedge on an after-tax basis. Any additional gain or loss cannot be deferred. Further, any gain or loss attributable to a period after the settlement date of the commitment also cannot be deferred. The deferred gain or loss should be included as an offset to the related tax effects in the period in which such tax effects are recognized.

Any gain or loss from a hedge against an exposed net asset or liability position is not included in the determination of results of operations; instead it is reported in the same manner as a translation adjustment. Any related discount or premium may be either similarly treated or amortized over the term of the forward contract. Note, however, that any excess gain or loss on the hedging instrument over the net investment being hedged is recognized in income.

Any gain or loss from speculation (i.e., the forward contract does not hedge a commitment or exposure) is computed as the difference between the forward rate available for the remainder of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period) multiplied by the foreign currency amount. The following table summarizes the accounting treatment for the various types of forward exchange contracts.

Type of contract	Gain or loss	Discount or premium
Hedge against a net asset or liability exposure	Measured on the basis of change in the spot rate; deferred and reported in the same manner as translation adjustments	Measured by the difference between the forward rate and the spot rate at the inception of the contract; may be deferred and reported in the same manner as translation adjustments or amortized over the life of the contract
Hedge of an identifiable firm foreign currency commitment	Measured the same as above but is deferred in the basis of the related foreign currency transaction; any excess gain or loss offset against tax effects	Measured the same as above; may be amortized over the life of the contract or deferred and included in the basis of the related foreign currency transaction
Speculation	Measured by the difference between the forward rate available for the remaining term of the contract and the contracted forward rate (or the rate last used to measure gain or loss)	Not accounted for separately

Example 14 through Example 19 illustrate the appropriate treatment.

#### **Example 14. Hedge Against a Net Asset or Liability Position**

##### **FACTS**

Assume that Client Company, Inc., finds itself in an exposed net liability position with respect to its German subsidiary, the Klein Company, on November 1, 20X1. On that date, Client Company enters into a forward exchange contract with a currency broker for the delivery of 200,000 deutsche marks (DM 200,000) in 90 days. Exchange rates are:

- November 1, 20X1 — Spot rate: DM = \$0.40 (40 cents)
- November 1, 20X1 — Forward rate: DM = \$0.43 (43 cents)
- December 31, 20X1 — Spot rate: DM = \$0.44 (44 cents)
- February 1, 20X2 — Spot rate: DM = \$0.45 (45 cents)

## SOLUTION

The journal entry required on November 1, 20X1 is:

Due from currency broker (DM 200,000 × \$0.40)	80,000	
Premium (DM 200,000 × \$0.03)	6,000	
Due to currency broker (DM 200,000 × \$0.43)		86,000

At December 31, 20X1, the gain is calculated as follows:

Forward contract amount		DM 200,000
Spot rate at 12/31/X1	\$.44	
Spot rate at 11/1/X1	<u>\$.40</u>	
		× \$.04
Exchange gain		<u>\$8,000</u>

The journal entries on December 31, 20X1 are:

Due from currency broker	8,000	
Forward exchange gain		8,000

To record exchange gain.

Amortization of premium ( $\$6,000 \div 3 \text{ months} \times 2$ )	4,000	
Premium		4,000

To record premium amortization.

In the 20X1 consolidated financial statements, the \$8,000 gain is shown as a credit to the translation adjustment. The premium amortization is reported on the income statement. Alternatively, the \$6,000 premium could be deferred as an offset to the exchange gain and reported as part of the translation adjustment.

On February 1, the currency broker delivers the DM 200,000 to Client Company for the price of \$86,000 (as agreed on 11/1/X1). The spot rate on February 1, 20X2 is \$0.45; therefore, the gain on that date is measured as the difference between the spot rate at settlement and the spot rate at December 31, 20X1 as follows:

Forward exchange contract		DM 200,000
Spot rate at 2/1/X2	\$.45	
Spot rate at 12/31/X1	<u>.44</u>	
		× \$.01
Exchange gain		<u>\$2,000</u>

The journal entry to be made on February 1, 20X2 is:

Due to currency broker	86,000	
Amortization of premium	2,000	
Cash (DM 200,000 × \$0.45)	90,000	
Cash in U.S. dollars		86,000
Forward exchange gain		2,000
Due from currency broker (\$80,000 + previously recorded \$8,000 gain)		88,000
Premium		2,000

### Example 15. Hedge of a Net Investment Not Using a Derivative Instrument

#### FACTS

Assume that Client Company, Inc., forms a British subsidiary, Brit plc, on December 31, 20X1 by investing £500,000 when the exchange rate is £1 = \$1.65. On December 31, 20X2, Brit's relevant balance sheet amounts appear as follows:

Total assets	£800,000
Total liabilities	200,000
Common stock and additional paid-in capital	500,000
Retained earnings (20X2 net income)	100,000

The average rate during 20X2 was £1 = \$1.62, and the spot rate on December 31, 20X2 is £1 = \$1.60. Also assume that, on December 31, 20X1, Client Company issues debt in the amount of £600,000 to hedge its net investment in Brit. The pound is Brit's functional currency.

#### SOLUTION

Brit's 20X2 balance sheet is translated as follows:

Assets (£800,000 × \$1.60)	<u>\$1,280,000</u>
Liabilities (£200,000 × 1.60)	320,000
Common stock and additional paid-in capital (£500,000 × \$1.65)	825,000
Retained earnings (£100,000 × \$1.62)	<u>162,000</u>
	1,307,000
Translation adjustment (\$1,307,000 – \$1,280,000)	<u>(27,000)</u>
Total liabilities and equity	<u>\$1,280,000</u>

Client Company's pound-sterling denominated debt of £600,000 is equal to \$960,000 on December 31, 20X2 (using the spot rate of \$1.60). On December 31, 20X1, when the debt was issued, the U.S. dollar equivalent was \$990,000 (using the spot rate of \$1.65 on that date). Thus, Client Company's gain was \$30,000 (\$990,000 – \$960,000) attributable to the movement in exchange rates. The \$30,000 gain, however, exceeded the \$27,000 debit translation adjustment by \$3,000. Accordingly, only \$27,000 of the gain would offset the translation adjustment; the remaining \$3,000 is deemed a foreign currency *transaction* gain and recognized in income for 20X2.

### Example 16. Hedge Against a Foreign Currency Commitment

## FACTS

Assume that Client Company, Inc. agrees on November 1, 20X1, to purchase equipment from a West German manufacturer for DM 250,000. Payment and delivery are to be made on February 1, 20X2. Also on November 1, 20X1, Client Company enters into a forward exchange contract for delivery of DM 250,000 on February 1, 20X2. Exchange rates are:

- November 1, 20X1—spot rate: dm=\$0.40 (40 cents)
- November 1, 20X1—forward rate:dm=\$0.41 (41 cents)
- December 31, 20X1—spot rate: dm=\$0.42 (42 cents)
- February 1, 20X2—spot rate: dm=\$0.45 (45 cents)

## SOLUTION

The journal entry required on November 1, 20X1 is:

Due from currency broker (DM 250,000 × \$0.40)	100,000	
Premium (DM 250,000 × \$0.01)	2,500	
Due to currency broker (DM 250,000 × \$0.41)		102,500

On December 31, 20X1, the gain is calculated as follows:

Forward contract amount		DM 250,000	
Spot rate at 12/31/X1	\$ .42		
Spot rate at 11/1/X1	<u>.40</u>		
			<u>× \$.02</u>
Exchange gain			<u>\$5,000</u>

The \$5,000 gain is deferred on 12/31/X1 and the journal entry is:

Due from currency broker	5,000	
Deferred forward exchange gain		5,000

The \$2,500 premium may either be amortized into income for 20X1 in the amount of \$1,667 ( $\$2,500 \div 3 \text{ months} \times 2$ ) or deferred with the exchange gain. In this example, the assumption is that the premium is deferred.

When the equipment is delivered on February 1, 20X2, the gain is computed as follows:

Forward contract amount		DM 250,000	
Spot rate at 2/1/X1	\$ .45		
Spot rate at 12/31/X1	<u>.42</u>		
			<u>× \$.03</u>
Exchange gain			<u>\$7,500</u>

The journal entries at February 1, 20X2 are:

Due from currency broker	7500	
Deferred forward exchange gain		7500

Due to currency broker	102,500	
Cash		102,500

To record payment of amount due to broker.

Cash	112,500	
Due from currency broker (\$100,000 + \$5,000 gain at 12/31/X1 + \$7,500 gain at 2/1/X2)		112,500

To record payment from broker (DM 250,000 × \$0.45 spot rate).

Deferred forward exchange gain (\$5,000 + \$7,500)	12,500	
Equipment	102,500	
Premium		2,500
Cash (DM 250,000 × \$0.45)		112,500

As a result of the hedge, the cost of the equipment is fixed at the forward rate of \$102,500 (DM 250,000 × \$0.41). It can also be computed as the amount paid at 2/1/X2 of \$112,500 less the deferred gain of \$12,500 plus the premium of \$2,500.

**Example 17. Hedge Against a Foreign Currency Commitment on an After-Tax Basis**

**FACTS**

Assume the same facts as in Example 16 , except that Client Company seeks to hedge the commitment on an after-tax basis. Also assume that the U.S. income tax rate is 40%. On November 1, 20X1, Client Company enters into a forward exchange contract for delivery of DM 416,700 (computed as  $DM\ 250,000 \div (100\% - 40\%) = DM\ 416,667$  rounded to DM 416,700). The exchange rates are the same as in Example 16 .

**SOLUTION**

The journal entry required on November 1, 20X1 is:

Due from currency broker (DM 416,700 × \$0.40)	166,680	
Premium (DM 416,700 × \$0.01)		4,167
Due to currency broker (DM 416,700 × \$0.41)		170,847

On December 31, 20X1, the gain is calculated as follows:

Forward contract amount		DM 416,700
Spot rate at 12/31/X1	\$ .42	

Spot rate at 11/1/X1	<u>.40</u>	
Exchange gain		<u>× \$.02</u> <u>\$8,334</u>

The \$8,334 gain must be allocated between the portion attributable to the foreign currency commitment and the portion attributable to the related tax effects as follows:

Amount of contract related to commitment (DM 250,000)  
Total amount of contract (DM 416,700) = 60%

Amount of contract related to tax effects (DM 166,700)  
Total amount of contract (DM 416,700) = 40%

The journal entry to record the deferred gain is:

Due from currency broker	8,334	
Deferred forward exchange gain related to commitment (\$8,334 × 60%)		5,000
Deferred forward exchange gain related to tax effects (\$8,334 × 40%)		3,334

When the equipment is delivered on February 1, 20X2, the gain is \$12,500 computed as DM 416,700 × (\$0.45 – \$0.42). Again, on allocation, 60% (\$7,500) relates to the amount of the commitment and 40% (\$5,000) relates to the tax effects.

The journal entries at February 1, 20X2 are:

Due to currency broker	170,847	
Cash		170,847
Cash	187,514	
Due from currency broker (\$166,680 + \$8,334 + \$12,500)		187,514
Deferred forward exchange gain related to commitment (\$5,000 + \$7,500)	12,500	
Deferred forward exchange gain related to tax effects (\$3,334 + \$5,000)	8,334	
Equipment	102,500	
Premium		4,167
Cash (DM 250,000 × \$0.45)		112,500
Income tax expense		6,667

Note that the equipment cost of \$102,500 is exactly the same as in Example 19 . The deferred gain of \$8,334 is credited to income tax expense to offset the tax effects of the gain. The hedge on an after-tax basis has a zero effect:

Total gain (\$12,500 + \$8,334 – \$4,167)	\$16,667
Less: Income tax at 40%	(6,667)
Plus: Credit to income tax expense	<u>6,667</u>
Total gain	\$16,667

### Example 18. Foreign Currency Speculation

## FACTS

Assume that Client Company, Inc. enters into a forward contract for speculative purposes on November 1, 20X1. The contract calls for delivery from the currency broker to Client Company of DM 800,000 on February 1, 20X2 (90 days). Exchange rates are:

- November 1, 20X1—90-day forward rate: DM = \$0.44 (44 cents)
- December 31, 20X1—30-day forward rate: DM = \$0.42 (42 cents)
- February 1, 20X2—spot rate: DM = \$0.43 (43 cents)

## SOLUTION

In a speculative transaction, discount or premium is not separately computed. The journal entry on November 1, 20X1 is:

Due from currency broker (DM 800,000 × \$0.44)	352,000	
Due to currency broker		352,000

At December 31, 20X1, an exchange loss is calculated as follows:

Forward exchange contract		DM 800,000
90-day forward rate at 11/1/X1	\$ .44	
30-day forward rate at 12/31/X1	<u>.42</u>	
		× <u>\$.02</u>
Exchange loss		<u>\$16,000</u>

The journal entry required is:

Forward exchange loss	16,000	
Due from currency broker		16,000

The \$16,000 loss is recognized in 20X1. On February 1, 20X2, Client Company computes the gain as follows:

Forward exchange contract		DM 800,000
Spot rate at 2/1/X2	\$ .43	
30-day forward rate 12/31/X1	<u>.42</u>	
		× <u>\$.01</u>
Exchange gain		<u>\$8,000</u>

The entries required on February 1, 20X1 are:

Due to currency broker	352,000	
Cash		352,000

To record payment of amount due to broker.

Cash (DM 800,000 × \$0.43)	344,000	
Due from currency broker \$352,000 – \$16,000 loss + \$8,000 gain)		344,000

To record payment from broker.

The transaction resulted in a \$8,000 net loss: a \$16,000 loss at 12/31/X1 and an \$8,000 gain on 2/1/X2.

**Example 19. Hedging an Unsettled Foreign Currency Transaction with a Futures Contract**

**FACTS**

Assume that on December 1, 20X1, Client Company, Inc., wants to hedge a payable of one million Canadian dollars due to a supplier on May 31, 20X2. On December 1, Client Company buys ten *June* 20X2 futures contracts because that is the closest date to May 31, for which contracts are traded. Each contract is worth C \$100,000. On December 1, 20X1, the June futures price is .74 and the spot rate is .72. On December 31, 20X1, Client Company's year end, the spot rate is .75. On May 31, 20X2, to close out the contracts, Client Company *sells* ten Canadian dollar futures contracts. On that date, the price of June futures is .77 and the spot rate is .76.

**SOLUTION**

On December 1, 20X1, Client Company would make the following journal entry:

Due from futures broker (C\$1,000,000 × .72)	720,000	
Premium (C\$1,000,000 × .02)	20,000	
Due to futures broker (C\$1,000,000 × .74)		740,000

As with a forward rate agreement, the difference between the futures price and the spot rate at inception must be accounted for separately. Just as with a forward rate agreement, the receivable is based on the spot rate and the payable is based on the futures rate.

On December 31, 20X1, the following journal entries are made:

Due from futures broker (C\$1,000,000) × (.75 – .72)	30,000	
Foreign exchange gain		30,000
Amortization expense	3,333	
Premium		3,333

The gain is based on the \$.03 increase in spot rates from December 1 to December 31. The premium is amortized for one month's expense (\$20,000 × 1/6).

On May 31, 20X2, Client Company closes out the contracts by selling (i.e., reversing the original transaction) Canadian dollar futures contracts at .77. The journal entries to be made are:

Due from futures broker (C\$1,000,000) × (.77 — .75)	20,000	
Foreign exchange gain		20,000
Cash	30,000	
Due to futures broker	740,000	
Due from futures broker (\$720,000 + \$30,000 + \$20,000)		770,000
Amortization expense	16,667	
Premium		16,667

The foreign exchange gain of \$20,000 is based on the difference between the spot rate of .75 at December 31, 20X1 (the last measurement date), and the quoted price of .77 on May 31, 20X2, for June contracts, *not* the spot rate on May 31. The spot rate of .76 on that date is not relevant, because Client Company sold its contracts (which have not yet expired) at .77. Thus, it is at that rate that the gain is measured. The debit of \$740,000 to the liability is at the amount fixed at the futures rate of .74 at inception of the contracts. The credit to the receivable represents the balance in the account after adjustment for the \$30,000 gain at December 31, 20X1 and the \$20,000 gain on May 31. The debit to cash of \$30,000 is computed as the difference between the amount due from and the amount due to the futures broker. Note that one characteristic of a futures contract is that it can be reversed before delivery and thus only the cash *differential* changes hands.

The economic substance of this transaction simply is that the contracts were purchased for \$740,000 and sold for \$770,000, or a realized gain of \$30,000. This is reflected by the aggregate gain of \$50,000 (\$30,000 + \$20,000) minus the \$20,000 premium.

The spot rate on May 31, 20X2, is, of course, relevant when Client Company pays the Canadian supplier. At .76, Client Company would have to pay \$760,000. Thus taken together, the hedge and the related transaction resulted in a net cash outlay of \$730,000, calculated as the \$760,000 paid to the supplier less the \$30,000 gain on the futures contracts.

Gains and losses and premiums and discounts on futures contracts are included in income, deferred as part of the value of the related transaction, or offset against the translation adjustment in the same manner and under the same conditions as for forward rate agreements.

### 38.3.4 Currency Swaps

A currency swap is an exchange between two companies of the currencies of two different countries, with the understanding that there will be a reexchange of the currencies at the same rate of exchange at a specified future date. Currency swaps that are, in substance, the same as forward contracts should be accounted for as such (that is, measurement and recognition of the value of the forward contract using the exchange rate in effect on the balance sheet date).

A conceptual issue arises in connection with a currency swap related to debt. For example, a company whose functional currency is the U.S. dollar may issue debt with principal and interest payments to be made in a foreign currency. The company then enters into a currency swap contract with a bank under which the company will periodically receive foreign currency amounts equal to its principal and interest obligations and pay required amounts in U.S. dollars. Together, the debt, which is payable in a foreign currency, combined with the currency swap effectively result in a

U.S. dollar debt. Settlement is usually to be made only for the *net* change in the contract value.

The Emerging Issues Task Force has concluded that the accrued net change cannot be offset against the foreign currency debt because the right to set off these two amounts does not exist. The debt and the swap contract are separate legal transactions.

### **38.3.5 Foreign Debt for Equity Swaps**

Occasionally, in a secondary market transaction, a U.S. company purchases dollar-denominated debt at less than the face amount due from a foreign government or a company that operates in that foreign country. Simultaneously, the U.S. company exchanges the debt with the foreign country's government in a transaction denominated in the foreign currency. The exchange rate used to obtain the foreign currency is the official exchange rate (less a transaction fee). The U.S. company is required to invest the foreign currency proceeds in the company's subsidiary operating in that foreign country. The FASB Emerging Issues Task Force has considered the issue of how the U.S. company should report the difference, if any, between the U.S. dollar values of these two transactions.

The Task Force noted that the intent of the foreign government may be to induce the U.S. company to make an investment in long-lived assets in the foreign country. The Task Force reached a consensus that the amount by which the local currency proceeds translated at the official exchange rate exceed the purchase cost of the loan (the "excess") should 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 should be used to reduce the carrying amount of existing long-lived assets other than goodwill. The excess should 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 should 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 should be reported as negative goodwill.

### **38.3.6 Income Tax Consequences of Rate Changes**

A provision for deferred taxes is required for temporary differences related to transaction gains and losses. These timing differences arise when taxable gains or deductible losses are included in results of operations in different periods for tax and financial reporting purposes. In connection with transaction gains and losses being included in stockholders' equity as translation adjustments, any related taxes payable (current or deferred) should also be included in stockholders' equity. Translation adjustments resulting from translating foreign financial statements should be accounted for as temporary differences and allocated to that component of stockholders' equity. A provision for such deferred taxes, however, should not be made if a provision is not made for undistributed earnings of that subsidiary.

### **38.3.7 Hedging Against the Euro Currency**

The FASB Staff has advised that hedge accounting is appropriate for a foreign-currency-denominated firm commitment or a forecasted transaction if the hedging contract involves either one or two currencies that have participated in the euro conversion, provided that the hedge originated before January 1, 1999 (even though the hedged transaction will take place after that date). During the three-year transition period (i.e., between January 1, 1999, and December 31, 2001), hedge accounting may be applied whether the currency used as a hedge is the euro itself or a national currency that has converted to the euro.

## **38.4 DISCLOSURES**

The following disclosures should be made:

The aggregate exchange gain or loss included in determining net income. Gains and losses on certain forward exchange contracts are considered to be exchange gains or losses and must be included in determining the aggregate amount of exchange gain or loss.

An analysis of the changes during the period in the separate component of accumulated other comprehensive income for cumulative translation adjustments. An analysis of the changes may be provided as a separate statement, as a note, or as part of the analysis of changes in other equity accounts. The analysis must disclose:

- Beginning and ending amounts of cumulative translation adjustments.
- The aggregate adjustment for the period resulting from translation adjustments and gains and losses from certain hedges and intercompany balances.
- The amount of income taxes for the period allocated to translation adjustments.
- The amount transferred from cumulative amount of translation adjustment and included in determining net income for the period as a result of the sale or liquidation of an investment in a foreign entity.
- Rate changes and their effect occurring after the date of the financial statements.
- A summary of foreign assets, liabilities, income, and losses.

### **38.4.1 Examples**

## **Access Pharmaceuticals, Inc. (2005 Form 10-K)**

**Example .**

**NOTE 1 - NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Exchange Rate Translation**

For international operations, local currencies have been determined to be the functional currencies. We translate assets and liabilities to their U.S. dollar equivalents at rates in effect at the balance sheet date and record translation adjustments in *Shareholders' equity*. We translate statement of income accounts at average rates for the period. Transaction adjustments are recorded in *Other (income)/expense*.

Because we closed our Australian operations in 2005, \$44,000 of foreign currency translation adjustment was included as a component of discontinued operations in 2005.

## **Phillips-Van Heusen Corp. (2005 Form 10-K)**

Example .

### **1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Foreign Currency Translations** -The consolidated financial statements of the Company are prepared in United States dollars, as this is the currency of the primary economic environment in which the Company operates, and the vast majority of its revenue is received and expenses are disbursed in United States dollars. Where the functional currency of business units is not the United States dollar, balance sheet accounts are translated at the current exchange rate and income statement transactions are translated at the average exchange rate for the period. Adjustments resulting from translating the financial statements of business units which do not use the United States dollar as their functional currency are recorded in stockholders' equity as a component of accumulated other comprehensive loss.

### **12. COMPONENTS OF ACCUMULATED OTHER COMPREHENSIVE LOSS**

The following table sets forth the detail of accumulated other comprehensive loss, net of related taxes:

	<b>2005</b>	<b>2004</b>
Minimum pension liability adjustment	\$(33,729)	\$(31,887)
Foreign currency translation adjustment	<u>(266)</u>	<u>(137)</u>
Total	<u>\$(33,995)</u>	<u>\$(32,024)</u>

# **General Steel Holdings, Inc. (2005 Form 10-K)**

Example .

## **Note 2 - Summary of significant accounting policies**

### **Foreign currency translation**

The reporting currency of the Company is the US dollar. The Company uses their local currency, Renminbi (RMB), as their functional currency. Results of operations and cash flow are translated at average exchange rates during the period, and assets and liabilities are translated at the unified exchange rate as quoted by the People's Bank of China at the end of the period. Translation adjustments resulting from this process are included in accumulated other comprehensive income in the statement of shareholders' equity. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred.

Translation adjustments resulting from this process are included in accumulated other comprehensive income in the consolidated statement of shareholders' equity and amounted to \$399,188, \$0 and \$0 as of December 31, 2005, 2004 and 2003, respectively. The balance sheet amounts with the exception of equity at December 31, 2005 were translated at 8.06 RMB to \$1.00 USD as compared to 8.26 RMB at December 31, 2004. The equity accounts were stated at their historical rate. The average translation rates applied to income statement accounts for the years ended December 31, 2005, 2004 and 2003 were 8.18 RMB, 8.26 RMB and 8.26 RMB, respectively.

# **Avery Dennison Corporation (2005 Form 10-K)**

Example .

## **NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **Foreign Currency Translation**

**Asset and liability accounts of international operations are translated into U.S. dollars at current rates. Revenues and expenses are translated at the weighted-average currency rate for the fiscal year. Translation gains and losses of subsidiaries operating in hyperinflationary economies are included in net income in the period incurred. Operations in hyperinflationary economies consist of the Company's operations in Turkey and the Dominican Republic. Gains and losses resulting from foreign currency transactions are included in income in the period incurred. Transaction and translation losses of hyperinflationary operations decreased net income by \$2.2 million in 2005, \$5.3 million in 2004 and \$.9 million in 2003. Gains and losses resulting from hedging the value of investments in certain international operations and from translation of balance sheet accounts are recorded directly as a component of other comprehensive income.**

## **38.5 RELATED TOPICS**

Section 2 , Marketable Securities

Section 4 , Inventories

Section 6 , Investments in Less Than Majority Owned Companies

Section 21 , Income Taxes

Section 25A , Comprehensive Income

Section 28 , Business Combinations

Section 30 , Commitments

Section 32 , Consolidated and Combined Statements

Section 39 , Financial Instruments, Derivatives, and Hedging Activities

Section 51 , Segmented Reporting

Section 53 , Subsequent Events

Section 71 , International Financial Reporting Standards

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