

# **Accounting for Foreign Currency**

# Accounting for Foreign Currency

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## Course Description

This course discusses the process of translating financial statements from foreign currency into U.S. dollars. It also covers a range of topics for the accounting and reporting of foreign currency transactions. For instance, forward contracts may be entered into for hedging or speculative purposes. A sale or liquidation of an investment in a foreign entity may occur. Foreign currency dealings may create a tax impact. Finally, footnote disclosures are discussed so readers can properly appraise a company's exposure in overseas operations to variability in foreign exchange rates.

<b>Field of Study</b>	Accounting
<b>Level of Knowledge</b>	Basic to Intermediate
<b>Prerequisite</b>	None
<b>Advanced Preparation</b>	None

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# Foreign Currency Accounting

## Learning Objectives:

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After completing this section, you should be able to:

1. Identify the different risks associated with foreign currency and exchange rates.
  2. Recognize the factors affecting the selection a company's functional currency
  3. Identify how different foreign currency transactions should to be reported.
  4. Recognized the terminology used in foreign currency transactions, and the requirements and objectives for remeasurement and translation.
  5. Recognize attributes of high inflationary environments and when foreign entities may be excluded from consolidated financial statements.
  6. Identify required disclosures for foreign currency translations
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Financial managers of multinational corporations (MNC) are faced with the dilemma of three different types of foreign exchange risk. They are:

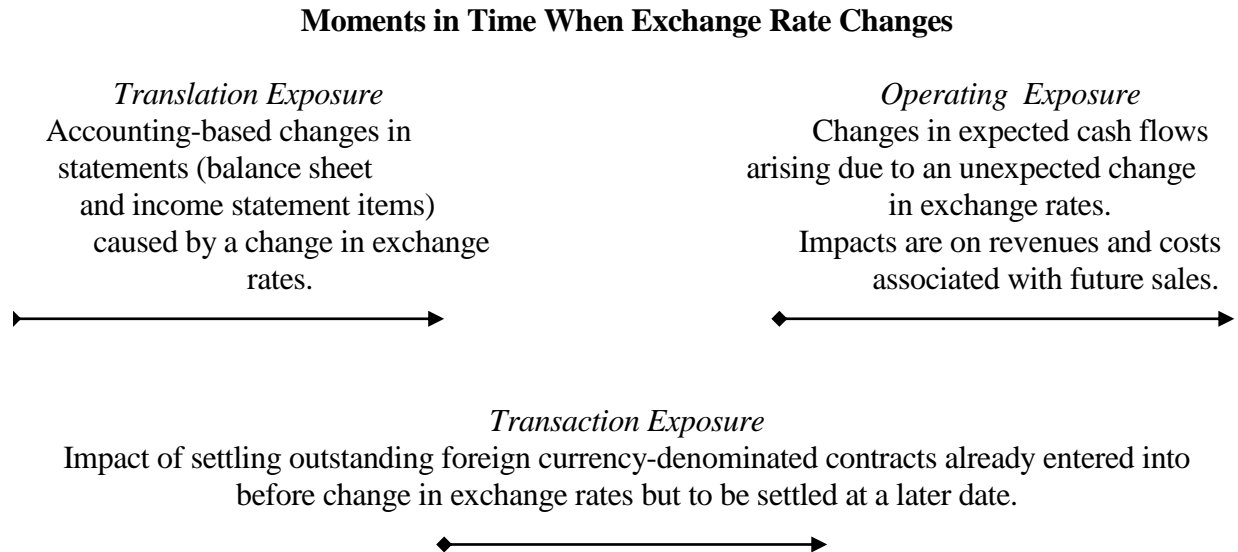
- *Translation exposure*, often called *accounting exposure*, measures the impact of an exchange rate change on the firm's financial statements. An example would be the impact of a Euro devaluation on a U.S. firm's reported income statement and balance sheet.
- *Transaction exposure* measures potential gains or losses on the future settlement of outstanding obligations (receivables and payables) that are denominated in a foreign currency. An example would be a U.S. dollar loss after the Euro devalues, on payments received for an export invoiced in Euros before that devaluation.
- *Operating exposure*, often called *economic exposure*, is the potential for the change in the present value of future cash flows due to an unexpected change in the exchange rate.

Exhibit 1 contrasts translation, transaction, and economic exposure.

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## EXHIBIT 1

### COMPARISON OF TRANSLATION, TRANSACTION, AND OPERATING EXPOSURE



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This course discusses the process of translating financial statements from foreign currency into U.S. dollars. It also covers:

- The accounting and reporting of foreign currency transactions.
- Forward contracts may be entered into for hedging or speculative purposes.
- A sale or liquidation of an investment in a foreign entity.
- The tax impact related to foreign currency dealings.
- Footnote disclosures are necessary so readers can properly appraise a company's exposure in overseas operations to variability in foreign exchange rates.

## **Accounting Standards Codification**

### **Objectives of Translation**

#### **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).

### **Measurement in a Foreign Currency**

#### **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.



ASC 830-10-15, *Foreign Currency Matters: Overall*, requires that the assets, liabilities, and operations of an entity be measured in the functional currency of that business. The pronouncement applies to:

- ☐ Foreign currency financial statements of divisions, branches, and other investees included in the financial statements of a U.S. company by consolidation, combination, or the equity method.
- ☐ Foreign currency transactions, including imports and exports denominated in a currency other than the company's functional currency.

An essential purpose in translating foreign currency is to preserve the financial performance and relationships expressed in the foreign currency. This is achieved by using the foreign entity's functional currency. The functional currency is then converted into the reporting entity's reporting currency. It is presumed under ASC 830-10-15 that the reporting currency for a company is U.S. dollars; however, it is possible that the reporting currency may be other than U.S. dollars.

A U.S. company should usually include the profits from foreign activities in its financial statements only to the degree that it receives funds in the United States or has unrestricted funds available to be transferred to the United States. If losses are expected, they should be provided for. In accounting and reporting of assets located in foreign countries, consideration should be given to possible problems of expropriation or restriction, if any exist.

ASC 946-830-05, *Financial Services—Investment Companies: Foreign Currency Matters*, deals with foreign currency accounting and financial statement presentation for investment companies.

## The Functional Currency

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### Accounting Standards Codification

#### 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.

*Reporting currency:* The currency used by the parent company to prepare its financial statements.

*Local currency:* The currency of a particular country.

*Functional currency:* An entity's functional currency is the currency of the primary economic environment in which the entity operates. See discussion and guidelines below.

It is important to determine the functional currency because remeasurement and translation are both based on the functional currency of the entity. In most instances, the functional currency is the currency of

the country in which the company is located. If a foreign subsidiary's activities are situated within one country, are basically self-contained, and do not rely on the parent's economic environment, the subsidiary's functional currency is the currency of the country in which it is located. For example, if a US company has a foreign subsidiary in France that is an independent entity and received cash and incurred expenses in euros, the euro is the functional currency.

In other instances, it may be the currency of another country. If the foreign subsidiary's daily activities are a direct and important element of the parent's operations and environment, the parent's currency will be the functional currency.

If the company carries out major operations in more than one currency, management must determine which currency to use as the functional currency. However, a company may have more than one distinct operation (e.g., branch, division). If conducted in different economic settings, each operation may have a different functional currency.

There should be consistent use of the functional currency unless significant economic changes required a change. A change in the functional currency is accounted for as a change in estimate. Previously issued financial statements are not restated for a change in the functional currency. Further, when there is a change in functional currency, the translation adjustments for previous years are still kept as a separate component of stockholders' equity.

The following guidelines are used to determine the functional currency of a foreign activity:

- ☐ *Sales Market.* The functional currency is the foreign currency when the foreign activity has a strong local sales market for products or services, even though a substantial amount of exports may also exist. The functional currency is the parent's currency when the foreign operation's sales market is primarily in the parent's country.
- ☐ *Financing.* The functional currency is the foreign currency if financing the foreign activity is in foreign currency and funds obtained by the foreign activity are adequate to meet debt obligations. The functional currency is the parent's currency when financing of foreign activity is provided by the parent or occurs in U.S. dollars. Funds received by the foreign activity are adequate to meet debt requirements.
- ☐ *Selling Price.* The functional currency is the foreign currency when the foreign operations' selling prices of products or services arise from local factors such as competition and government law. It is not because of changes in exchange rate. The functional currency is the parent's currency when the foreign operation's selling prices mostly apply in the short term to variability in the exchange rate owing to international reasons such as global competition.
- ☐ *Expenses.* The functional currency is the foreign currency when the foreign operation's manufacturing costs or services are typically incurred locally. However, some foreign imports may exist. The functional currency is the parent's currency when the foreign operations'

manufacturing and service costs are mostly component costs obtained from the parent's country.

- ☐ *Intercompany Transactions.* If there is a low number of intercompany transactions, the functional currency is the foreign currency—that is, when minor interrelationship occurs between the activities of the parent and foreign entity except for competitive advantages (e.g., patents, trademarks). Conversely, if there are many intercompany transactions, the functional currency is the parent's currency; that is, when a substantial interrelationship exists between the parent and foreign entity.
- ☐ *Cash Flow.* The functional currency is the foreign currency when the foreign operation's cash flows are mostly in foreign currency and do not directly impacting the parent's cash flow. The functional currency is the parent's currency when the foreign operation's cash flows directly affect the parent's cash flows and the cash flows are readily available for remittance via intercompany accounting settlement.

## Foreign Currency Transactions

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Foreign currency transactions may result in receivables or payables fixed in the amount of foreign currency to be received or paid. A foreign currency transaction requires payment in a currency other than the reporting entity's functional currency.

When a transaction is entered into, each asset, liability, revenue, expense, gain, or loss arising from that transaction should be measured and recorded based on the reporting company's functional currency at the exchange rate on that date. At each balance sheet date, balances that will be settled should be brought up to date at the current exchange rate.

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.

The change in expected functional currency cash flows is a foreign currency transaction gain or loss. The gain or loss is presented separately as an element of income from continuing operations in the income statement for the period in which the exchange rate changed. In other words, if the exchange rate changes between the date of a purchase or sale and the time of actual payment or receipt, a foreign exchange transaction gain or loss arises.

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### EXAMPLE

A transaction may result in a gain or loss when an Italian subsidiary has a receivable denominated in Euros from a Canadian customer. In other words, 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 should typically be included in deriving the net income for the period in which the transaction is settled.

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#### EXAMPLE

An exchange gain or loss takes place when the exchange rate changes between the purchase and payment dates. Merchandise is purchased for 300,000 Euros. The exchange rate is 3 Euros to 1 dollar. The journal entry is:

Purchases	\$100,000	
Accounts payable		\$100,000
$300,000 \text{ Euros} / 3 = \$100,000$		

When the goods are paid for, the exchange rate is 3.5 Euros to 1 dollar. The journal entry is:

Accounts payable	\$100,000	
Cash		\$85,714
Foreign exchange gain		14,286
$300,000 \text{ Euros} / 3.5 = \$85,714$		

The \$85,714, using an exchange rate of 3.5 to 1, can buy 300,000 Euros. The transaction gain is the difference between the cash required of \$85,714 and the initial liability of \$100,000.

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#### EXAMPLE

On January 15, 2X12, ABC Company, which uses a perpetual inventory system, shipped merchandise costing \$45,000 to XYZ Company, a German company, for 100,000 Euros. On February 15, 2X12, ABC Company received a draft for 100,000 Euros from XYZ Company. The draft was immediately converted. The spot rates were as follows:

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	<i>1 Euro =</i>	
	<i>Buying Rate</i>	<i>Selling Rate</i>
January 15, 2X12	0.60	0.65
January 31, 2X12	0.65	0.70
February 15, 2X12	0.55	0.60

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Assuming that monthly statements are prepared, ABC Company will make the following journal entries:

1/15/2X12 Accounts receivable		
[100,000 Euros × \$.60]	\$60,000	
Sales		\$60,000
1/15/2X12 Cost of goods sold	\$45,000	
Inventory		\$45,000
1/31/2X12 Accounts receivable	\$ 5,000	
[100,000 Euros × (\$.65 - \$.60)]		
Transaction gain or loss		\$ 5,000
2/15/2X12 Cash [100,000 Euros × 0.55]	\$55,000	
Transaction gain or loss	\$10,000	
Accounts receivable [\$60,000 + \$5,000]		\$65,000

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#### EXAMPLE

Klemer Corporation bought merchandise for 240,000 pesos when the exchange rate was 12 pesos to a dollar. The journal entry expressed in dollars follows:

Purchases	\$20,000	
Accounts payable		\$20,000

When the merchandise is paid for, the exchange rate changes to 15:1. The journal entry in dollars is:

Accounts payable	\$20,000	
Cash		\$18,667
Foreign exchange gain		\$ 1,333

At a 15:1 exchange rate the \$18,667 can buy 240,000 pesos. The difference between the \$18,667 and the initial liability of \$20,000 represents a foreign exchange gain. If payment is made when the exchange rate is below 12 pesos to a dollar, a foreign exchange loss would arise.

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#### EXAMPLE

On September 1, 2X12, a U.S. company bought foreign goods requiring payment in Euros in 30 days after their receipt. Title to the merchandise passed on November 15, 2X12. The goods were still in transit on November 30, 2X12, the fiscal year-end. The exchange rates were one dollar to 22 Euros, 20 Euros, and 21 Euros on September 1, November 15, and November 30, 2X12, respectively.

The transaction was recorded on November 15, 2X12, when title to the merchandise passed, and was recorded at an exchange rate of one dollar to 20 Euros (i.e., it would cost \$.05 to buy one Euro). At November 30, 2X12, the exchange rate increased to 21 Euros (it would cost less than \$.05 to buy one Euro). Because the dollar equivalent of the liability declined from November 15 to November 30, it gave rise to a gain included in income before extraordinary items.

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**Note:** A foreign transaction gain or loss needs to be determined at each balance sheet date on all recorded foreign transactions that have not been settled. The difference between the exchange rate that would have settled the transaction at the date it occurred and the exchange rate that could be used to settle the transaction at a later balance sheet date is the gain or loss to be recorded.

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**EXAMPLE**

A U.S. company sells merchandise to a customer in Italy on 10/1/2X12, for 20,000 Euros. The exchange rate is 1 Euro to \$.40. Hence, the transaction is valued at \$8,000 (20,000 Euros  $\times$  \$.40). The terms of sale require payment in four months. The journal entry for the sale is:

10/1/2X12		
Accounts receivable—Italy	\$8,000	
Sales		\$8,000

Accounts receivable and sales are measured in U.S. dollars at the transaction date using the spot rate. Even though the accounts receivable are measured and reported in U.S. dollars, the receivable is fixed in Euros. Hence, a transaction gain or loss can occur if the exchange rate changes between the date of sale (10/1/2X12) and the settlement date (2/1/2X12).

Because the financial statements are prepared between the transaction date (date of sale) and settlement date, receivables denominated in a currency other than the functional currency (U.S. dollar) must be restated to reflect the spot rate on the balance sheet date. On 12/31/2X12, the exchange rate is 1 Euro equals \$.45. Thus, 20,000 Euros are now valued at 9,000 (20,000  $\times$  \$.45). In consequence, the accounts receivable denominated in Euros should be increased by \$1,000.

The journal entry to do this on 12/31/2X12 is:

Accounts receivable—Italy	\$1,000	
Foreign exchange gain		\$1,000

The income statement for the year ended 12/31/2X12, shows an exchange gain of \$1,000. It should be pointed out that sales is not affected by the exchange gain because sales relates to operational activity.

On 2/1/2X12, the spot rate is 1 Euro equals \$.43. The journal entry is:

Cash	\$8,600*	
Foreign exchange loss	\$ 400	
Accounts receivable—Italy		\$9,000

\* 20,000 Euros  $\times$  \$.43 = \$8,600

The 2X12 income statement presents an exchange loss \$400.

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#### EXAMPLE

On September 14, 2X12, ABC Company bought goods from an unaffiliated foreign company for 30,000 units of the foreign company's local currency. On that date, the spot rate was \$.57. ABC paid the bill in full on March 27, 2X12, when the spot rate was \$.64. The spot rate was \$.68 on December 31, 2X12. ABC should report as a foreign currency transaction loss \$3,300 in its income statement for the year ended December 31, 2X12, calculated as follows:

Liability—12/31/2X12: 30,000 $\times$ \$.68	\$20,400
Liability—9/22/2X12: 30,000 $\times$ \$.57	17,100
Foreign currency transaction loss at 12/31/2X12: 30,000 $\times$ \$.11	\$ 3,300

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**Exception:** Gains or losses on some types of foreign currency transactions are not included in profit but rather are treated as translation adjustments. Such gains and losses include:

- Intercompany foreign currency transactions of a long-term investment nature (settlement is not planned or anticipated in the foreseeable future), when the entities to the transactions are consolidated, combined, or accounted for under the equity method in the reporting company's financial statements.
- Foreign currency transactions engaged in as economic hedges of a net investment in a foreign entity, beginning as of the designation date.

A foreign currency transaction is deemed a hedge of an identifiable foreign currency commitment provided both of the following two conditions exist:

1. The foreign currency commitment is firm.



2. The foreign currency transaction is intended as a hedge.

**Note:** A dealer in foreign exchange may account for transaction gains or losses as dealer gains or losses.

In conclusion, when the balance sheet falls between the transaction and final settlement dates, receivables/payables must be adjusted to the dollar equivalent as of the balance sheet date; the difference is an exchange gain or loss. Upon settlement of the transaction, there will be a further gain or loss based on the recorded balance at that time.

# Review Questions – Section 1

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1. In preparing consolidated financial statements of a U.S. parent company with a foreign subsidiary, the foreign subsidiary's functional currency is the currency

- A. In which the subsidiary maintains its accounting records.
- B. Of the country in which the subsidiary is located.
- C. Of the country in which the parent is located.
- D. Of the environment in which the subsidiary primarily generates and expends cash.

2. Fogg Co., a U.S. company, contracted to purchase foreign goods. Payment in foreign currency was due one month after the goods were received at Fogg's warehouse. Between the receipt of goods and the time of payment, the exchange rates changed in Fogg's favor. The resulting gain should be included in Fogg's financial statements as a(n)

- A. Component of income from continuing operations.
- B. Extraordinary item.
- C. Deferred credit.
- D. Item of other comprehensive income.

3. On September 22, 2X12, Yumi Corp. purchased merchandise from an unaffiliated foreign company for 10,000 units of the foreign company's local currency. On that date, the spot rate was \$.55. Yumi paid the bill in full on March 20, 2X13, when the spot rate was \$.65. The spot rate was \$.70 on December 31, 2X12. What amount should Yumi report as a foreign currency transaction loss in its income statement for the year ended December 31, 2X12?

- A. \$0
- B. \$500
- C. \$1,000
- D. \$1,500

4. Which of the following statements regarding foreign exchange gains and losses is true (where the exchange rate is the ratio of units of the functional currency to units of the foreign currency)?

- A. An exchange gain occurs when the exchange rate increases between the date a payable is recorded and the date of cash payment.

- B. An exchange gain occurs when the exchange rate increases between the date a receivable is recorded and the date of cash receipt.
- C. An exchange loss occurs when the exchange rate decreases between the date a payable is recorded and the date of the cash payment.
- D. An exchange loss occurs when the exchange rate increases between the date a receivable is recorded and the date of the cash receipt.

5. On October 1, 2X12, Mild Co., a U.S. company, purchased machinery from Grund, a German company, with payment due on April 1, 2X13. If Mild's 2X12 operating income included NO foreign currency transaction gain or loss, the transaction could have

- A. Resulted in an extraordinary gain.
- B. Been denominated in U.S. dollars.
- C. Caused a foreign currency gain to be reported as a contra account against machinery.
- D. Caused a foreign currency translation gain to be reported in other comprehensive income.

6. On October 1, 2X12, Velec Co., a U.S. company, contracted to purchase foreign goods requiring payment in euros 1 month after their receipt at Velec's factory. Title to the goods passed on December 15, 2X12. The goods were still in transit on December 31, 2X12. Exchange rates were one dollar to 1.06 euros, 1.04 euros, and 1.05 euros on October 1, December 15, and December 31, 2X12, respectively. Velec should account for the exchange rate fluctuation in 2X12 as

- A. A loss included in net income before extraordinary items.
- B. A gain included in net income before extraordinary items.
- C. An extraordinary gain.
- D. An extraordinary loss.

# Remeasurement

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Before financial statements from an entity's functional currency can be translated into the reporting currency, the foreign country figures may need to be remeasured in the functional currency.

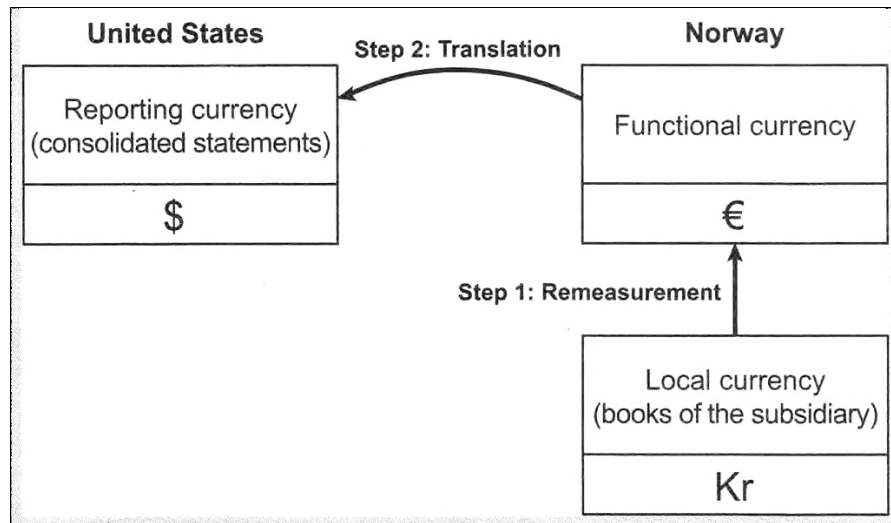
If the books of a foreign entity are maintained in a currency that is not the functional currency, foreign currency amounts must be *remeasured* into the functional currency. For example, the US dollar has been designated as the functional currency for a Mexican subsidiary, but the books at the subsidiary are recorded using the Mexican Peso. The objective of the remeasurement process is to generate the same result as if the company's books had been kept in the functional currency. The method used in this case is the **temporal method**. The temporal method is a methodology which assumes that the only assets that should be translated at the historical rate are those carried at past exchange prices. If necessary, they are then translated into the reporting currency using the **current method**. When a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation (remeasurement is necessary to account for timing differences).

- **Nonmonetary** balance sheet items and related revenue, expense, gain, and loss amounts are remeasured at the historical rate. Examples are (a) marketable securities carried at cost; (b) inventories carried at cost; (c) cost of goods sold; (d) prepaid expenses; (e) property, plant, and equipment; (f) depreciation; (g) intangible assets; (h) amortization of intangible assets; (i) deferred income; (j) common stock; (k) preferred stock carried at its issuance price; and (l) any noncontrolling interest.
- **Monetary** items are remeasured at the current rate. Examples of monetary items are (a) receivables, (b) payables, (c) inventories carried at market, and (d) marketable securities carried at fair value.
- Any **gain or loss** on remeasurement of monetary assets and liabilities is recognized in *current earnings as part of continuing operations*. This accounting treatment was adopted because gains or losses on remeasurement affect functional currency cash flows.

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## EXAMPLE

A U.S.-based conglomerate has a subsidiary in Norway that keeps its books using the krone (kr) (its local currency). But its primary operations involve Eurozone entities. Accordingly, to prepare the consolidated financial statements, the parent first must remeasure all unsettled transactions of the subsidiary from kroner to euros. It then must translate those remeasured amounts into dollars (\$), as shown below.



### EXAMPLE

Smith Co, a US company, has a Mexican subsidiary, XYZ, whose records are maintained in Mexican pesos, but due to other factors, the functional currency for the subsidiary is actually Canadian dollars. The accounts of the Mexican subsidiary, XYZ, must be remeasured into Canadian dollars before the financial statements are then translated into the reporting entity's currency (in this case, US dollars). An ensuing translation gain or loss from Mexican pesos to Canadian dollars is included in the remeasured net profit.

However, if the foreign entity's (XYZ's) functional currency was instead the Mexican peso, there is only a need to translate to the reporting currency (US dollars).

Finally, if the foreign entity's (XYZ's) functional currency was the same as that of the reporting entity, Smith Co., remeasurement is only from the Mexican peso to the reporting currency (US dollars).

### EXAMPLE

#### Remeasuring Accounts of a Foreign Subsidiary

FNC is a wholly owned German subsidiary of MNC. The functional currency is U.S. dollars. The following accounts, for year ended December 31, 2X12, are stated in Euros.

Rent expense	150,000
Allowance for doubtful accounts	60,000
Patent amortization expense*	85,000

\_\_\_\_\_  
\* Acquired on March 23, 2X10

The exchange rates for the Euros for various dates and time periods are as follows:

March 23, 2X10	0.65
December 31, 2X12	0.55
Average for year ended December 31, 2X12	0.6

The remeasured accounts in U.S. dollars are as follows:

	<i>Euros</i>	<i>Exchange Rate</i>	<i>U.S. Dollars</i>
Rent expense	150,000	0.60	\$ 90,000
Allowance for doubtful accounts	60,000	0.55	33,000
Patent amortization expense	85,000	0.65	55,250
	<u>295,000</u>		<u>\$178,250</u>

# Translation Process

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Translation of foreign currency statements is usually needed when a foreign subsidiary's statements or equity-method investee has a functional currency other than the U.S. dollar, and the subsidiary's results are to be included in a domestic company's financial statements, such as through consolidation or using the equity method.

A translation adjustment occurs only if the foreign entity's functional currency is different from that of the parent. If a foreign entity's functional currency is the U.S. dollar and the parent's currency is also the U.S. dollar, no translation adjustment is required.

The objectives of translation include:

- Preserving the operating results and relationships measured in the foreign currency. This is achieved by measuring assets, liabilities, and operating results in the foreign entity's functional currency and, when required, converting them to the parent's reporting currency.
- Providing information in consolidated financial statements about the financial performance of each foreign consolidated entity.
- Providing information on the anticipated effects of changes in exchange rates on cash flow and equity.

The following steps are required in translating the foreign country's financial statements into U.S. reporting requirements:

1. The foreign currency financial statements must be made to conform with U.S. GAAP before they are translated to the functional or reporting currency.
2. The functional currency of the foreign entity is ascertained.
3. The financial statements are remeasured in the functional currency, if required. Gain or loss from remeasurement is included in the remeasured net income.

**Note:** As mentioned in the previous section, if the foreign company keeps its records in a currency other than the functional or reporting currency, its balance sheet and income statement accounts have to be remeasured into the functional currency before translation into the reporting currency. For example, a parent maintains its financial statements in U.S. dollars and owns a foreign subsidiary whose functional currency is British pounds. If some or all of the foreign subsidiary's records are kept in Euros, its financial statements must be remeasured from Euros into British pounds before translation into U.S. dollars.

4. Foreign (functional) currency is converted into U.S. dollars (reporting currency). If a foreign company's functional currency is other than the reporting currency, translation into the reporting currency is necessary before the entity may be consolidated, combined, or accounted for on the equity method.

**Note:** A permanent impairment of a foreign investment must be provided for before translation and consolidation.

In the usual case, when the foreign currency is the functional currency, balance sheet items (assets and liabilities) are translated at the current exchange rate at the balance sheet date of the foreign entity. Capital accounts are translated using the historical exchange rate in effect when the foreign entity's stock was issued, or reacquired retained earnings are translated at the translated amount at year-end of the previous year, plus the translated amount of net income for the current year, less the translated amount of dividends during the current year. If the current exchange rate is unavailable at the balance sheet date, the first available exchange rate after that date should be used. The **current method** that translates at *current exchange rates* is required under ASC 830-10-45 (except when there is a highly inflationary environment, to be discussed shortly). The current method ensures that financial relationships remain the same in both local currency and U.S. dollars.

In the statement of cash flows, cash flows are translated based on the exchange rates in existence at the time of the cash flows. If reasonable and practical, a weighted-average rate for the year may be used, as long as the result is similar. Disclosure should be made in the statement of cash flows for the impact of any exchange rate changes on cash flow.

In the usual case (when high inflation does not exist), income statement items (revenue, expenses, gains, and losses) are translated at the exchange rate at the dates those items are recognized. Because translation at the exchange rates at the dates of many revenues, expenses, gains, and losses is usually impractical, a weighted-average exchange rate for the year is typically used in translating income statement items. However, average quarterly or monthly rates may be used if significant revenues and expenses occur at particular times during the year.

If a company's functional currency is a foreign currency, translation adjustments occur from translating the company's financial statements into the reporting currency. *Translation adjustments are unrealized.* Translation adjustments are gains and losses from translating financial statements from the functional to the reporting currency. They should be reported in other comprehensive income. They are not included in the determination of net income. A foreign currency transaction gain or loss ordinarily should be included as a component of income from continuing operations in the period in which the exchange rate changes. However, a gain or loss on a foreign currency transaction that hedges a net investment in a foreign entity is not included in the determination of net income but is reported in the same manner as a translation adjustment. Thus, the translation loss and the transaction gain should be reported in accumulated other comprehensive income. Translation adjustments shall not be included in net income unless and until there is a sale or liquidation of the investment in the foreign entity.



**Exception:** If remeasurement from the recording currency to the functional currency is needed before translation, the gain or loss is included in the income statement.

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**EXAMPLE**

Blake Company's wholly owned subsidiary, David Company, keeps its records in German marks. Because David Company's branch offices are located in Switzerland, its functional currency is the Swiss franc. Remeasurement of David Company's 2X12 financial statements resulted in an \$8,700 gain, and translation of its financial statements resulted in a \$9,200 gain. Blake should report as a foreign exchange gain \$8,700 in its income statement for the year ended December 31, 2X12. The translation gain of \$9,200 should be included in "other comprehensive income" and the cumulative translation adjustment, which is a separate component of stockholders' equity.

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# Highly Inflationary Environment in Foreign Country

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## Accounting Standards Codification

### 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.

## The Functional Currency in Highly Inflationary Economies

### 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.

### 830-10-45-12

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.

According to ASC 830-10-45-12, a highly inflationary environment is one with a cumulative inflation rate exceeding 100% over a three-year period. In other words, the inflation rate must be increasing at an average rate of about 26% per year for three consecutive years, given compounding. **Note:** The International Monetary Fund of Washington, D.C. publishes information about the international inflation rates. **Tip:** In some cases, the inflation trend may be as important as the absolute rate of inflation.

It is necessary to provide meaningful financial reporting using historical cost accounting, so ASC 830 requires a change in functional currency when a country experiences high rates of inflation. As an example, in a highly inflationary economy, any assets recently acquired at higher prices due to inflation will appear significantly larger than assets purchased only a few years prior. The foreign entity's financial statements in a very inflationary environment are unstable and should be remeasured as if the functional currency were the reporting currency. In this case, the investor's reporting currency is used directly. Consequently, if a foreign entity's financial statements in a highly inflationary economy are expressed in a currency different from the reporting currency, they have to be remeasured into the reporting currency.

If the U.S. dollar is used directly as the functional currency because of high inflation, balance sheet conversion would be as follows:

- Cash, receivables, and payables are converted at the foreign exchange rate in effect at the balance sheet date.
- Other assets and liabilities are converted at foreign exchange rates (historical rates) in effect at the date of transaction, except that the exchange rate in effect at the balance sheet date is used to translate assets and liabilities that are accounted for on the basis of current prices, such as marketable securities carried at market and estimated warranty obligations.

If the U.S. dollar is used as the functional currency because of high inflation, translation of income statement items is based on the weighted average rate for the period. However, revenues and expenses that relate to assets and liabilities translated at historical rates should be translated at such historical rates. Examples are depreciation on fixed assets, amortization expense on intangible assets, and amortized revenue arising from deferred revenue.

In a highly inflationary environment in a foreign country requiring the use of the reporting currency directly, gains and losses from converting foreign currency financial statements into reporting currency financial statements are recognized in net income rather than reported in stockholders' equity.

Exhibit 2 presents a portion of Dana annual report regarding foreign currency translation.

## EXHIBIT 2

Dana

2003 Annual Report

Foreign Currency Translation

The financial statements of subsidiaries and equity affiliates outside the United States (U.S.) located in non-highly inflationary economies are measured using the currency of the primary economic environment in which they operate as the functional currency, which for the most part is the local currency. Transaction gains and losses which result from translating assets and liabilities of these entities into the functional currency are included in net earnings. Other income includes transaction gains of \$3 in 2003, \$19 in 2002 and \$8 in 2001. When translating into U.S. dollars, income and expense items are translated at average monthly rates of exchange and assets and liabilities are translated at the rates of exchange at the balance sheet date. Translation adjustments resulting from translating the functional currency into U.S. dollars are deferred as a component of accumulated other comprehensive income in shareholders' equity. For affiliates operating in highly inflationary economies, non-monetary assets are translated into U.S. dollars at historical exchange rates and monetary assets are translated at current exchange rates. Translation adjustments for these affiliates are included in net earnings.

According to ASC 830-10-45-15, *Foreign Currency Matters: Overall*, when a foreign subsidiary's environment is no longer highly inflationary, the entity must convert the amounts expressed in the reporting currency into the local currency based on the exchange rates on the date of change.

According to **Accounting Standards Update (ASU)** No. 2010-19 (May 2010) (ASC 830, *Foreign Currency*), *Foreign Currency Issues*, in the case of a foreign company's financial statements in a highly inflationary environment, there should be a remeasurement, assuming the functional currency is the reporting currency. If there is a difference existing before using the mandates of a highly inflationary accounting between the financial reporting balances and the U.S. dollar denominated balances, it should be reflected in the profit and loss statement.

Disclosure should be made of translation and remeasurement rates, why U.S. dollar denominated balances are different from financial reporting balances and the reasons why different rates were employed for translation and remeasurement. (ASC 830-30-S99-1)

# Hedging

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Foreign currency transaction gains and losses on assets and liabilities, denominated in a currency other than the entity's functional currency, can be hedged if the U.S. company enters into a forward exchange contract or a foreign currency option.

An entity may enter into hedging transactions to minimize the adverse effects of changes in exchange rates on cash flows and net income. An entity's aim is to recognize a gain or loss from the hedge in the same period as the loss or gain on the risk being hedged.

ASC 815-10-05, *Derivatives and Hedging: Overall*, and ASC 815-20-25, *Derivatives and Hedging: Hedging—General*, permit hedge accounting for foreign currency derivatives only if the following three conditions are satisfied:

1. The derivative is used to hedge either a fair value exposure or a cash flow exposure.
2. The derivative is highly effective in offsetting changes in the fair value or cash flows.
3. The derivative is documented as a hedge.

A fair-value exposure exists if changes in exchange rates can affect the fair value of assets or liabilities. If the exposure is not hedged, it must have the potential to affect net income. A fair value hedge also may exist for foreign currency firm commitments.

A cash flow exposure exists if changes in exchange rates can affect the amount of cash flow that will be realized from a transaction, where changes in cash flow are reflected in net income.

To use hedge accounting, derivatives must be designated as either a fair value hedge or a cash flow hedge. An entity may use either a fair value hedge or a cash flow hedge for:

- Recognized foreign currency assets and liabilities.
- Foreign currency firm commitments.

Hedges of forecasted foreign currency transactions can only qualify for a cash flow hedge. Gains or losses on fair value hedges are recognized immediately in net income, whereas gains or losses on cash flow hedges are included in other comprehensive income.

To use hedge accounting, the hedge must be expected to be highly effective in offsetting gains and losses on the items being hedged. Critical terms of the hedging instrument, such as currency type, amount, and settlement date should match those of the hedged item. The hedging entity should document the:

- Hedged item;
- Hedging instrument;
- Nature of risk;
- Means of assessing the hedging instrument's effectiveness; and

- Management's objectives and strategies for undertaking the hedge.

## Sale or Liquidation of an Investment in a Foreign Entity

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If there is a sale or liquidation of an investment in a foreign entity, the amount attributable to that entity and accumulated in the translation adjustment component of equity is removed from the stockholders' equity section. It is considered a part of the gain or loss on sale or liquidation of the investment in the income statement for the period during which the sale or liquidation occurs.

As per ASC 830-30-40-2, *Foreign Currency Matters: Translation of Financial Statements*, sale of an investment in a foreign entity may include a partial sale of an ownership interest. In that event, a proportionate amount of the cumulative translation adjustment reflected as a stockholders' equity component is included in determining the gain or loss on sale.

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### EXAMPLE

If a business sells 30% ownership in a foreign investment, 30% of the translation adjustment applicable to it is included in computing gain or loss on sale of that ownership interest.

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ASC 830-30-45-13, *Foreign Currency Matters: Translation of Financial Statements*, provides that a company that plans to dispose of an equity method investment in a foreign operation or a consolidated foreign subsidiary should include in the book value of the investment both the foreign currency translation adjustments associated with the foreign entity's disposal as well as the part of the foreign currency translation adjustments applicable to the gain or loss from the hedge of the company's net investment in the foreign operation.

## Intercompany Profits

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In the elimination of intercompany profits, the company should use the exchange rate in existence at the date of the intercompany transaction. A transaction is either at the date of sale or transfer. However, a reasonable average or estimated rate may be used when there are frequent intercompany transactions during the year.

ASC 970-470-05-2, *Real Estate—General: Debt*, covers the hedging of intercompany foreign currency risks.

# Excluding a Foreign Entity from Financial Statements

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In some cases, a foreign entity may be excluded from consolidated or combined financial statements. This may arise if serious political problems exist in the foreign country (e.g., civil war) or if exchange restrictions are extremely restrictive, inhibiting any reliability to exchange rates. In this situation, profits of a foreign activity should be included in the financial statements only to the degree of receipt of unrestricted cash. When the foreign entity is excluded from the financial statements, proper disclosure should be made of the reasons therefor, other pertinent information, and dollar effect. Such disclosure may be in a supplemental schedule or in footnote form.

## Foreign Operations in the United States

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An entity in the United States may be a subsidiary of a parent company domiciled in a foreign country. In this case, the local company's financial statements may be presented separately in the United States or combined with the financial statements in the foreign country.

## Taxes

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### Accounting Standards Codification

#### 830-740-25-1

This Section addresses basis differences that result remeasurement of assets and liabilities due to changes in functional currency and price levels. These remeasurement changes will often affect the amount of temporary differences for which deferred taxes are recognized.

#### 830-740-25-2

Subtopic 830-30 requires that change in functional currency from the reporting currency to the local currency when an economy ceases to be considered highly inflationary shall be accounted for by establishing new functional currency bases for nonmonetary items. Those bases are computed by translating the historical reporting currency amounts of nonmonetary items into the local currency at current exchange rates.

**830-740-25-3**

As a result of applying those requirements, the functional currency bases generally will exceed the local currency tax bases of nonmonetary items. The differences between the new functional currency bases and the tax bases represent temporary differences under Subtopic 740-10, for which deferred taxes shall be recognized. Paragraph 830-740-45-2 addresses the presentation of the effect of recognizing these deferred taxes.

**830-740-45-1**

As indicated in paragraph 830-20-45-3, when the reporting currency (not the foreign currency) is the function currency, remeasurement of an entity's deferred foreign tax liability of 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.

**830-740-45-2**

The deferred taxes associated with the temporary difference that arise from a change in function currency discussed in paragraph 830-740-25-3 when an economy ceases to be considered highly inflationary shall be presented as an adjustment to the cumulative translation adjustments component of shareholders' equity and therefore shall be recognized in other comprehensive income.

Deferred taxes will typically be recorded for the future tax impact of temporary differences, resulting in taxable translation and/or transaction gains or losses. Tax effects may be presented in either the income statement or stockholders' equity section, depending on the nature of the taxable item. However, deferred taxes may not need to be recorded for a foreign subsidiary's unremitted earnings. In such a case, proper disclosure should be made.

According to ASC 830-740-25-2 and 25-3 and 830-740-45-2, *Foreign Currency Matters: Income Taxes*, deferred taxes on temporary differences arising because of a change in the functional currency are accounted for as an adjustment to the cumulative translation adjustments presented in stockholders' equity.



# Disclosures

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Footnote disclosure is required of:

- ☐ Profits earned from overseas. This also includes the amount of foreign earnings in excess of amounts received in the United States.
- ☐ Foreign currency transaction gains or losses, including that associated with forward exchange contracts.
- ☐ The impact on unsettled balances regarding foreign currency transactions.
- ☐ Cumulative translation adjustments reported in stockholders' equity. This includes the reasons for the change in the balance from the beginning to the end of the year.
- ☐ Gains or losses arising from hedging a foreign currency position.
- ☐ Effect of exchange rate changes on operating results and financial position. This disclosure includes the impact of a change in exchange rates from the prior year to the current year associated with translation of revenues and expenses. It also includes the effect of a change in exchange rate on revenue and cost components, such as sales volume, sales price, and cost of sales. The nature of restated figures should be noted.
- ☐ A significant change in exchange rate taking place after year-end and before the audit report date. This is a subsequent event disclosure.

Exhibit 3 shows an excerpt from Monsanto's annual report for foreign currency translation.

## EXHIBIT 3

### Monsanto

#### 2003 Annual Report

#### Foreign Currency Translation

The financial statements for most of Monsanto's ex-U.S. operations are translated into U.S. dollars at current exchange rates. For assets and liabilities the year-end rate is used. For revenues, expenses, gains and losses the average rate for the period is used. Unrealized currency adjustments in the Statement of Consolidated Financial Position are accumulated in equity as a component of accumulated other comprehensive loss. The financial statements of ex-U.S. operations in highly inflationary economies are translated at either current or historical exchange rates, in accordance with SFAS No. 52, *Foreign Currency Translation*. These currency adjustments are included in net income. As of Jan. 1, 2003, Monsanto identified Turkey, Russia, Romania and Ukraine as hyperinflationary countries in which it has operations.

Significant translation exposures are the Brazilian real, the euro, and the Canadian dollar. Other translation exposures include the Polish zloty, the U.K. pound sterling, and the Australian dollar. For all periods presented, Monsanto designated the U.S. dollar as the functional currency in Argentina. In January 2002, Argentina formally abandoned the fixed exchange rate regime between the Argentine peso and the U.S. dollar, and the peso subsequently was devalued by approximately 70 percent. Argentina simultaneously imposed various banking and exchange controls, and the government has instituted additional controls since that time. Included in the net transaction loss were losses of \$34 million in 2002 and \$15 million in 2001. These amounts reflect the effect of this devaluation on Argentine peso-denominated transaction exposures (primarily value-added taxes and other taxes due to or recoverable by Monsanto). See Note 20— Commitments and Contingencies—for further details on the Argentine devaluation. Currency restrictions, with a possible exception in Argentina, are not expected to have a significant effect on Monsanto's cash flow, liquidity, or capital resources.

## Summary

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If the foreign statements have any accounts expressed in a currency other than their own, they have to be converted into the foreign statement's currency prior to translation into U.S. dollars or any other reporting currency.

In most cases, assets and liabilities are translated at the current exchange rate at the balance sheet date. Revenue and expenses are usually translated at the weighted-average exchange rate for the period. Translation adjustments are reported as a part of comprehensive income and ultimately as a separate component of stockholders' equity as accumulated other comprehensive income. Foreign currency transaction gains and losses are reported in the income statement.

# Review Questions – Section 2

7. When remeasuring foreign currency financial statements into the functional currency, which of the following items would be remeasured using historical exchange rates?

- A. Inventories carried at cost.
- B. Equity securities reported at fair values.
- C. Bonds payable.
- D. Accrued liabilities.

8. Gains from remeasuring a foreign subsidiary's financial statements from the local currency into its functional currency should be reported

- A. As a deferred foreign currency transaction gain.
- B. In other comprehensive income.
- C. As an extraordinary item, net of income taxes.
- D. As a part of continuing operations.

9. When the functional currency of a foreign operation is the U.S. dollar, transaction gains and losses resulting from remeasuring foreign currency financial statements into U.S. dollars should be included as

- A. A deferred item in the balance sheet.
- B. An extraordinary item in the income statement.
- C. An ordinary item in the income statement for losses but a deferred item in the balance sheet for gains.
- D. An ordinary item in the income statement.

10. Which of the following is debited to other comprehensive income (OCI)?

- A. Discount on convertible bonds that are dilutive potential common stock.
- B. Premium on convertible bonds that are dilutive potential common stock.
- C. Cumulative foreign currency translation loss.
- D. Organizational costs.

11. The economic effects of a change in foreign exchange rates on a relatively self-contained and integrated operation within a foreign country relate to the net investment by the reporting enterprise in that operation. Consequently, translation adjustments that arise from the consolidation of that operation

- A. Directly affect cash flows but should not be reflected in income.
- B. Directly affect cash flows and should be reflected in income.
- C. Do not directly affect cash flows and should not be reflected in income.
- D. Do not directly affect cash flows but should be reflected in income.

# Glossary

**Conversion.** The exchange of one currency for another.

**Currency swap.** The exchange between two business entities of the currencies of two different countries in accordance with a contract to re-exchange the two currencies at the same exchange rate at an agreed upon future date.

**Denominate.** To pay or receive in the same foreign currency. The account can be denominated only in one currency (e.g., Euros). It is a real account (asset or liability) fixed in terms of a foreign currency regardless of the exchange rate.

**Exchange ratio.** The ratio of one unit of a currency to that of another at a given date. If a temporary lack of exchangeability exists between the two currencies at the transaction date or balance sheet date, the first rate available thereafter should be used.

**Foreign currency.** A currency other than the functional currency of a business. For example, the dollar could be a foreign currency for a foreign entity. Composites of currencies (e.g., special drawing rights) may be used to establish prices or denominate amounts of loans.

**Foreign currency transactions.** Transactions in which the terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions occur when a company (1) purchases (imports) or sells (exports) on credit merchandise or services the prices being denominated in a foreign currency; (2) buys or sells assets or incurs or settles liabilities denominated in foreign currency; (3) takes out or gives international loans in which the amounts payable or receivable are denominated in a foreign currency; (4) is a participant in an unperformed forward exchange contract; and (5) borrows or lends money, and the amounts payable or receivable are expressed in a foreign currency.

**Foreign currency statements.** Financial statements using as the measuring unit a functional currency other than the reporting currency of the business.

**Foreign entity.** An operation (e.g., division, subsidiary, branch, joint venture) whose financial statements are prepared in a currency other than the reporting currency of the reporting entity.

**Foreign currency translation.** Stating in a company's reporting currency those amounts denominated or measured in a different currency.

**Functional currency.** A company's functional currency is the currency of the primary economic environment in which the company operates. It is usually the currency of the environment in which the business mostly receives and pays cash. Once determined, the functional currency should be used consistently unless significant changes clearly indicate a change. Note: The currency of a highly inflationary environment (three-year rate of 100% or more) is not stable enough to be used for this purpose. In such

circumstances, the U.S. dollar is the functional currency. The functional currency of a foreign operation may be the same as that of a related affiliate where a foreign activity is a “key” component or extension of a related affiliate. If remeasurement (restatement) of a subsidiary’s foreign currency financial statements is required before translation can be accomplished (i.e., when the functional currency is the U.S. dollar), a transaction gain or loss results.

**Local currency.** The currency of a particular foreign country.

**Monetary assets and liabilities.** Cash, receivables, and obligations to pay a fixed amount of debt.

**Measure.** Translating into a currency other than the original reporting currency. Foreign financial statements are expressed in U.S. dollars by using the relevant exchange rate.

**Nonmonetary items.** All balance sheet items except for cash, claims to cash, and cash obligations.

**Reporting currency.** The currency the business prepares its financial statements in, typically U.S. dollars.

**Spot Rate.** The exchange rate for immediate delivery of currencies exchanged.

**Translation adjustments.** Adjustments derived from translating financial statements from the entity’s functional currency into the reporting one.

**Transaction gain or loss.** Transaction gain or loss is produced from redeeming receivables/payables that are fixed in terms of amounts of foreign currency received/paid. An example is a French subsidiary having a receivable denominated in Euros from a Swiss customer. A transaction gain or loss takes place when there is a change in exchange rates between the functional currency and the currency in which a foreign currency transaction is denominated.

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# Appendix – Annual Report References

Note: Skim through this section

## Johnson & Johnson

### 2008 Annual Report

#### 9. International Currency Translation

For translation of its subsidiaries operating in non-U.S. Dollar currencies, the Company has determined that the local currencies of its international subsidiaries are the functional currencies except those in highly inflationary economies, which are defined as those which have had compound cumulative rates of inflation of 100% or more during the past three years, or where a substantial portion of its cash flows are not in the local currency.

In consolidating international subsidiaries, balance sheet currency effects are recorded as a component of accumulated other comprehensive income. This equity account includes the results of translating all balance sheet assets and liabilities at current exchange rates, except for those located in highly inflationary economies. The translation of balance sheet accounts for highly inflationary economies are reflected in the operating results.

An analysis of the changes during 2008, 2007 and 2006 for foreign currency translation adjustments is included in Note 12.

Net currency transaction and translation gains and losses included in other (income) expense were losses of \$31 million, \$23 million and \$18 million in 2008, 2007 and 2006, respectively.

## Varian

### 2004 Annual Report

#### Note 4. Forward Exchange Contracts

The Company enters into foreign exchange forward contracts to minimize the short-term impact of foreign currency fluctuations on assets and liabilities denominated in non-functional currencies. These contracts are accounted for under SFAS 133, Accounting for Derivative Instruments and Hedging Activities. The Company records these contracts at fair value with the related gains and losses recorded in general and



administrative expenses. The gains and losses on these contracts are substantially offset by transaction losses and gains on the underlying balance being hedged.

From time to time, the Company also enters into foreign exchange forward contracts to minimize the impact of foreign currency fluctuations on forecasted transactions. These contracts are designated as cash flow hedges under SFAS 133. During the year ended October 1, 2004, there were no outstanding foreign exchange forward contracts designated as cash flow hedges of forecasted transactions. During the year ended October 1, 2004, no foreign exchange gains or losses from hedge ineffectiveness were recognized.

The Company's foreign exchange forward contracts generally range from one to 12 months in original maturity. A summary of all foreign exchange forward contracts that were outstanding as of October 1, 2004 follows:

	<i><b>Notional Value Sold</b></i>	<i><b>Notional Value Purchased</b></i>
<i>(in thousands)</i>		
Euro .....	\$ -	\$45,525
Australian dollar .....	-	13,610
Japanese yen .....	9,415	-
Canadian dollar .....	4,945	-
British pound	-	3,295
Swedish krona .....		-
	792	
Total .....	<u>\$15,152</u>	<u>\$62,430</u>

## **IBM**

### **2003 Annual Report**

#### **Translation of Non-U.S. Currency Amounts**

Assets and liabilities of non-U.S. subsidiaries that operate in a local currency environment are translated to U.S. dollars at year-end exchange rates. Income and expense items are translated at weighted-average rates of exchange prevailing during the year. Translation adjustments are recorded in Accumulated gains and (losses) not affecting retained earnings within Stockholders' equity.

Inventories, Plant, rental machines and other property-net, and other nonmonetary assets and liabilities of non-U.S. subsidiaries and branches that operate in U.S. dollars, or whose economic environment is highly inflationary, are translated at approximate exchange rates prevailing when the company acquired the assets or liabilities. All other assets and liabilities are translated at year-end exchange rates. Cost of sales and depreciation are translated at historical exchange rates. All other income

and expense items are translated at the weighted-average rates of exchange prevailing during the year. Gains and losses that result from translation are included in net income.

## **DuPont**

### **2002 Annual Report**

#### **Foreign Currency Translation**

The U.S. dollar is the functional currency of most of the company's worldwide operations. For subsidiaries where the U.S. dollar is the functional currency, all foreign currency asset and liability amounts are remeasured into U.S. dollars at end-of-period exchange rates, except for inventories, prepaid expenses, property, plant and equipment, and intangible assets, which are remeasured at historical rates. Foreign currency income and expenses are remeasured at average exchange rates in effect during the year, except for expenses related to balance sheet amounts remeasured at historical exchange rates. Exchange gains and losses arising from remeasurement of foreign currency-denominated monetary assets and liabilities are included in income in the period in which they occur.

For subsidiaries where the local currency is the functional currency, assets and liabilities denominated in local currencies are translated into U.S. dollars at end-of-period exchange rates, and the resultant translation adjustments are reported, net of their related tax effects, as a component of Accumulated Other Comprehensive Income (Loss) in stockholders' equity. Assets and liabilities denominated in other than the local currency are remeasured into the local currency prior to translation into U.S. dollars, and the resultant exchange gains or losses are included in income in the period in which they occur. Income and expenses are translated into U.S. dollars at average exchange rates in effect during the period.

## **United Technologies 2004 Annual Report**

### **Note 12—Foreign Exchange**

UTC conducts business in many different currencies and, accordingly, is subject to the inherent risks associated with foreign exchange rate movements. The financial position and results of operations of substantially all of UTC's foreign subsidiaries are measured using the local currency as the functional currency. Foreign currency denominated assets and liabilities are translated into U.S. dollars at the exchange rates existing at the respective balance sheet dates, and income and expense items are translated at the average exchange rates during the respective periods. The aggregate effects of translating the balance sheets of these subsidiaries are deferred as a separate component of Shareowners' Equity.

UTC had foreign currency net assets in more than forty currencies, aggregating \$8.5 billion and \$6.5 billion at December 31, 2004 and 2003, respectively.

The notional amount of foreign exchange contracts hedging foreign currency transactions

and some commodity exposures to acceptable limits through the use of derivatives designated was \$5.7 billion and \$4.9 billion at December 31, 2004 and 2003, respectively.

### **Note 13—Financial Instruments**

UTC operates internationally and, in the normal course of business, is exposed to fluctuations in interest rates, foreign exchange rates, and commodity prices. These fluctuations can increase the costs of financing, investing and operating the business. UTC manages its foreign currency transaction risks as hedges.

By nature, all financial instruments involve market and credit risks. UTC enters into derivative and other financial instruments with major investment grade financial institutions and has policies to monitor the credit risk of those counterparties. UTC limits counterparty exposure and concentration of risk by diversifying counterparties. UTC does not anticipate non-performance by any of these counterparties.

The non-shareowner changes in equity associated with hedging activity for the twelve months ended December 31, 2004 and 2003 were as follows:

<i>(millions of dollars)</i>	<b>2004</b>	<b>2003</b>
Balance at January 1	<b>\$55</b>	<b>\$ 4</b>
Cash flow hedging gain, net	<b>86</b>	66
Net (gain) reclassified to sales or cost of products sold	<b>(76)</b>	(15)
Balance at December 31	<b>\$65</b>	\$55

Of the amount recorded in Shareowners' Equity, a \$67 million pre-tax gain is expected to be reclassified into sales or cost of products sold to reflect the fixed prices obtained from hedging within the next twelve months. Gains and losses recognized in earnings related to the discontinuance or the ineffectiveness of cash flow and fair value hedges were immaterial for the years ended December 31, 2004 and 2003. At December 31, 2004, all derivative contracts accounted for as cash flow hedges mature by October 2009.

All derivative instruments are recorded on the balance sheet at fair value. At December 31, 2004 and 2003, the fair value of derivatives recorded as assets is \$165 million and \$162 million, respectively, and the fair value of derivatives recorded as liabilities is \$43 million and \$56 million, respectively. UTC uses derivatives to hedge forecasted cash flows associated with foreign currency commitments or forecasted commodity purchases, which are accounted for as cash flow hedges. In addition, UTC uses derivatives, such as interest rate swaps, which are accounted for as fair value hedges.

The carrying amounts and fair values of financial instruments at December 31 are as follows:

<i>(in millions of dollars)</i>	<u>2004</u>		<u>2003</u>	
	<i>Carrying Amount</i>	<i>Fair Value</i>	<i>Carrying Amount</i>	<i>Fair Value</i>
<b>Financial Assets and Liabilities</b>				
Marketable equity securities	<b>\$746</b>	<b>\$746</b>	\$79	\$79
Long-term receivables	<b>170</b>	<b>166</b>	128	125
Customer financing Note receivables	<b>483</b>	<b>465</b>	439	425
Short-term borrowing	<b>(1,320)</b>	<b>(1,320)</b>	(669)	(669)
Long-term debt	<b>(4,243)</b>	<b>(4,941)</b>	(4,614)	(5,363)

The above fair values were computed based on comparable transactions, quoted market prices, discounted future cash flows or an estimate of the amount to be received or paid to terminate or settle the agreement, as applicable.

The values of marketable equity securities represent UTC's investment in Common Stock that is classified as available for sale and is accounted for at fair value. The increase in marketable equity securities primarily reflects the initial purchases of Kidde shares.

UTC had outstanding financial and rental commitments totaling \$838 million at December 31, 2004. Risks associated with changes in interest rates on these commitments are mitigated by the fact that interest rates are variable during the commitment term and are set at the date of funding based on current market conditions, the fair value of the underlying collateral and the credit worthiness of the customers. As a result, the fair value of these financings is expected to equal the amounts funded.

The fair value of the commitment itself is not readily determinable and is not considered significant itself is not readily determinable and is not considered significant. Additional information pertaining to these commitments is included in Note 4.

# Review Question Answers

## Section 1

1. In preparing consolidated financial statements of a U.S. parent company with a foreign subsidiary, the foreign subsidiary's functional currency is the currency

- A. Incorrect. The currency in which the subsidiary maintains its accounting records may not be the currency indicated by the salient economic indicators, such as cash flows, sales prices, sales markets, expenses, financing, and intercompany transactions.
- B. Incorrect. The currency of the country in which the subsidiary is located may not be the currency indicated by the salient economic indicators, such as cash flows, sales prices, sales markets, expenses, financing, and intercompany transactions.
- C. Incorrect. The currency of the country in which the parent is located may not be the currency indicated by the salient economic indicators, such as cash flows, sales prices, sales markets, expenses, financing, and intercompany transactions.
- D. **Correct.** The method used to convert foreign currency amounts into units of the reporting currency is the functional currency translation approach. It is appropriate for use in accounting for and reporting the financial results and relationships of foreign subsidiaries in consolidated statements. This method identifies the functional currency of the entity (the currency of the primary economic environment in which the foreign entity operates), measures all elements of the financial statements in the functional currency, and uses a current exchange rate for translation from the functional currency to the reporting currency.

2. Fogg Co., a U.S. company, contracted to purchase foreign goods. Payment in foreign currency was due one month after the goods were received at Fogg's warehouse. Between the receipt of goods and the time of payment, the exchange rates changed in Fogg's favor. The resulting gain should be included in Fogg's financial statements as a(n)

- A. **Correct.** This foreign currency transaction resulted in a payable denominated in a foreign currency. The favorable change in the exchange rate between the functional currency and the currency in which the transaction was denominated should be included in determining net income for the period in which the exchange rate changed. It should be classified as a component of income from continuing operations because it does not meet the criteria for classification under any other caption in the income statement, for example, as an extraordinary item.
- B. Incorrect. GAAP states that gains or losses from exchange or translation of foreign currencies are not extraordinary items except in rare situations. They are usual in nature and may be expected to recur in the course of customary and continuing business activities.

- C. Incorrect. The gain should not be deferred but should be recognized in the period in which the exchange rate changed.
- D. Incorrect. Translation adjustments, not transaction gains and losses, are included in other comprehensive income (OCI).

3. On September 22, 2X12, Yumi Corp. purchased merchandise from an unaffiliated foreign company for 10,000 units of the foreign company's local currency. On that date, the spot rate was \$.55. Yumi paid the bill in full on March 20, 2X13, when the spot rate was \$.65. The spot rate was \$.70 on December 31, 2X12. What amount should Yumi report as a foreign currency transaction loss in its income statement for the year ended December 31, 2X12?

- A. Incorrect. A loss resulted when the spot rate increased.
- B. Incorrect. \$500 results from using the spot rates at 12/31/2X12 and 3/20/2X13.
- C. Incorrect. \$1,000 results from using the spot rates at 9/22/2X12 and 3/20/2X13.
- D. **Correct.** GAAP requires that a receivable or payable denominated in a foreign currency be adjusted to its current exchange rate at each balance sheet date. The resulting gain or loss should ordinarily be included in determining net income. It is the difference between the spot rate on the date the transaction originates and the spot rate at year-end. Thus, the 2X12 transaction loss for Yumi Corp. is \$1,500  $[(\$0.55 - \$0.70) \times 10,000 \text{ units}]$ .

4. Which of the following statements regarding foreign exchange gains and losses is true (where the exchange rate is the ratio of units of the functional currency to units of the foreign currency)?

- A. Incorrect. The payable will become more expensive in the functional currency, resulting in a loss.
- B. **Correct.** A foreign currency transaction gain or loss (commonly known as a foreign exchange gain or loss) is recorded in earnings. When the amount of the functional currency exchangeable for a unit of the currency in which the transaction is fixed increases, a transaction gain or loss is recognized on a receivable or payable, respectively. The opposite occurs when the exchange rate (functional currency to foreign currency) decreases.
- C. Incorrect. The payable will become less expensive in the functional currency, resulting in a gain.
- D. Incorrect. An exchange gain occurs.

5. On October 1, 2X12, Mild Co., a U.S. company, purchased machinery from Grund, a German company, with payment due on April 1, 2X13. If Mild's 2X12 operating income included NO foreign currency transaction gain or loss, the transaction could have

- A. Incorrect. Foreign currency transaction gains and losses are ordinarily operating items.
- B. **Correct.** The terms of a foreign currency transaction are denominated in a currency other than the functional currency. A fluctuation in the exchange rate between the functional currency and the

other currency is a gain or loss that ordinarily should be included in determining net income when the exchange rate changes. If Mild Co.'s functional currency is the U.S. dollar and the transaction was denominated in U.S. dollars, no foreign currency transaction gain or loss occurred.

- C. Incorrect. Foreign currency transaction gains and losses not included in the determination of net income (certain intercompany transactions and certain hedges) are reported in other comprehensive income.
- D. Incorrect. Translation expresses in the reporting currency amounts denominated in the functional currency. Because the U.S. dollar is presumably the reporting and the functional currency of Mild Co., no translation is required.

6. On October 1, 2X12, Velec Co., a U.S. company, contracted to purchase foreign goods requiring payment in euros 1 month after their receipt at Velec's factory. Title to the goods passed on December 15, 2X12. The goods were still in transit on December 31, 2X12. Exchange rates were one dollar to 1.06 euros, 1.04 euros, and 1.05 euros on October 1, December 15, and December 31, 2X12, respectively. Velec should account for the exchange rate fluctuation in 2X12 as

- A. Incorrect. The strengthening of the dollar resulted in a gain.
- B. **Correct.** ASC 830-10-15 requires that a receivable or payable denominated in a foreign currency be adjusted to its current exchange rate at each balance sheet date. The transaction gain or loss arising from this adjustment should ordinarily be reflected in current income. Because title passed on December 15, the liability fixed in euros should have been recorded on that date at the 1.04 euro exchange rate. The increase to 1.05 euros per dollar at year-end decreases the dollar value of the liability and results in a transaction gain. Such a gain is ordinarily treated as a component of income from continuing operations.
- C. Incorrect. An extraordinary item is infrequent and unusual in nature. Exchange rates change frequently.
- D. Incorrect. An extraordinary item is not frequent. Exchange rates change frequently.

## Section 2

7. When remeasuring foreign currency financial statements into the functional currency, which of the following items would be remeasured using historical exchange rates?

- A. **Correct.** GAAP requires the current rate of exchange to be used for remeasuring certain balance sheet items and the historical rate for other balance sheet items. Nonmonetary balance sheet items and related revenue, expense, gain, and loss accounts are remeasured at the historical rate. Monetary accounts are remeasured at the current rate. Inventories valued at cost are nonmonetary items and are measured at historical rates.

- B. Incorrect. Equity securities reported at fair values are monetary items valued at the current rate.
- C. Incorrect. Bonds payable are monetary items valued at the current rate.
- D. Incorrect. Accrued liabilities are monetary items valued at the current rate.

8. Gains from remeasuring a foreign subsidiary's financial statements from the local currency into its functional currency should be reported

- A. Incorrect. The gain is not deferred.
- B. Incorrect. A gain arising from translation, not remeasurement, is reported in other comprehensive income.
- C. Incorrect. The criteria for treatment as an extraordinary item have not been met.
- D. **Correct.** If the books of record of a foreign entity are maintained in a currency other than the functional currency, ASC 830-10-15 requires that the foreign currency amounts first be remeasured into the functional currency using the temporal method and then translated using the current rate method into the reporting currency. The gain arising from remeasurement should be reported as part of continuing operations.

9. When the functional currency of a foreign operation is the U.S. dollar, transaction gains and losses resulting from remeasuring foreign currency financial statements into U.S. dollars should be included as

- A. Incorrect. A remeasurement gain or loss must be included in income, and use of a deferred account is not appropriate.
- B. Incorrect. Transaction gains and losses arising from remeasurement are ordinary.
- C. Incorrect. Transaction gains and losses are treated the same.
- D. **Correct.** When an entity's functional currency is the U.S. dollar, ASC 830-10-15 requires that a foreign operation's financial statements be remeasured in terms of the U.S. dollar. The resulting transaction gains and losses from remeasurement of assets and liabilities should be included in income for the period as ordinary items.

10. Which of the following is debited to other comprehensive income (OCI)?

- A. Incorrect. A discount on bonds is a contra account to bonds payable in the liability section of the balance sheet.
- B. Incorrect. Premium on bonds is a contra account to bonds payable in the liability section.
- C. **Correct.** When the currency used to prepare a foreign entity's financial statements is its functional currency, the current rate method is used to translate the foreign entity's financial statements into the reporting currency. The translation gains and losses arising from applying this method are reported in OCI in the consolidated statements and are not reflected in income. Accumulated OCI is a component of equity displayed separately from retained earnings and additional paid-in capital



in the statement of financial position. Because a cumulative foreign currency translation loss reduces the balance, it is a debit item.

D. Incorrect. Organizational costs are expensed when incurred.

11. The economic effects of a change in foreign exchange rates on a relatively self-contained and integrated operation within a foreign country relate to the net investment by the reporting enterprise in that operation. Consequently, translation adjustments that arise from the consolidation of that operation

- A. Incorrect. When an operation is relatively self-contained, the assumption is that translation adjustments do not affect cash flows.
- B. Incorrect. Translation adjustments do not affect cash flows.
- C. **Correct.** FASB 52, Foreign Currency Translation (ASC 830-10-15) concludes that foreign currency translation adjustments for a foreign operation that is relatively self-contained and integrated within its environment do not affect cash flows of the reporting enterprise and should be excluded from net income. When an operation is relatively self-contained, the cash generated and expended by the entity is normally in the currency of the foreign country, and that currency is deemed to be the operation's functional currency.
- D. Incorrect. Translation adjustments should be included in other comprehensive income, not recognized in income.