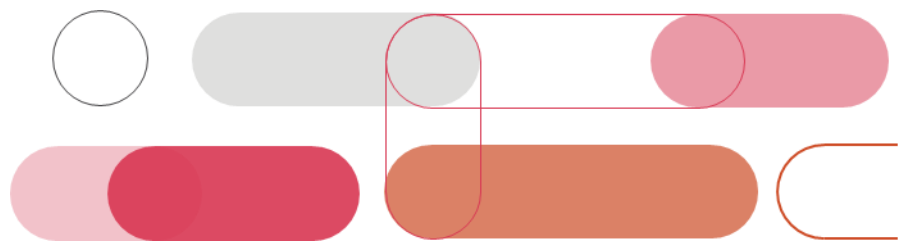


National Office

Foreign currency

May 2022





About the Foreign currency guide

PwC is pleased to offer our updated *Foreign currency* guide. The accounting guidance on foreign currency matters was written more than 40 years ago; yet this topic remains particularly relevant in today's global economy. Since the accounting literature was originally issued, many companies have changed their operating structures, expanded internationally, and often transact business in multiple global currencies. Although accounting for foreign currency matters has always been a challenging area, globalization has led to increased complexities with respect to the application of this guidance.

This guide begins with a summary of the overall framework for accounting for foreign currency matters. The ensuing chapters further discuss each step in the framework, including identifying foreign entities, determining functional currencies, accounting for foreign currency transactions, and translating financial statements of foreign entities. This guide also discusses accounting implications related to highly inflationary economies, intercompany transactions denominated in foreign currencies, and acquisitions and dispositions of foreign operations.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

Guidance on financial statement presentation and disclosure, foreign currency-related hedging activities, and income tax accounting can be found in other PwC guides.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations are:

- [*Business combinations and noncontrolling interests \(BCG\)*](#)
- [*Derivatives and hedging \(DH\)*](#)
- [*Financial statement presentation \(FSP\)*](#)
- [*Income taxes \(TX\)*](#)
- [*Leases \(LG\)*](#)
- [*Loans and investments \(LI\)*](#)

Summary of significant changes

The following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

Revisions made in May 2022

FX 3, Determining the functional currency

- **FX 3.2** was updated to discuss situations in which an operation is not considered distinct and separable, but is not clearly an extension of its immediate (legal) parent.
- The discussion around determining the functional currency of a holding company in **FX 3.2.1** was expanded.
- **Example FX 3-6** was added to **FX 3.3** to address a change in functional currency as a result of business expansion over time.
- **FX 3.3.2** was added to discuss observations from the SEC regarding changes in economic facts and circumstances and considerations around disclosure of changes in functional currency.

FX 4, Foreign currency transactions

- **FX 4.7.1** (after adoption of **ASC 842**) and **FX 4.7.1A** (before adoption of **ASC 842**) were updated to reflect lessee accounting for foreign currency leases.
- **FX 4.7.2** was updated to reflect the impact of the adoption of **ASC 842** on lessor accounting for foreign currency leases.
- **FX 4.8.1** was updated for **ASU 2016-13**.

FX 5, Translating the financial statements of a foreign entity

- **FX 5.5.4** was added to discuss alternative exchange mechanisms.

FX 8, Acquisitions and dispositions involving a foreign operation

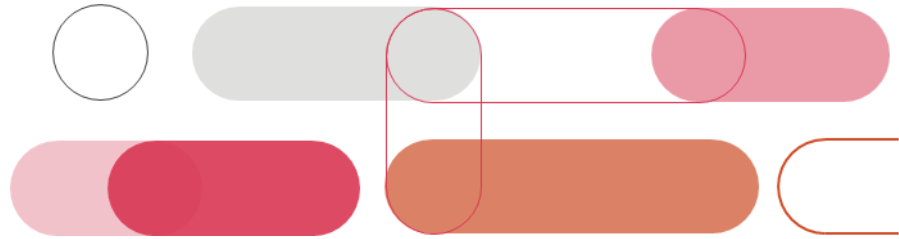
- **FX 8.4** was updated to discuss the evaluation of an investment for impairment when the CTA balance must be included in the carrying amount of assets held for sale.
- **FX 8.4.1** was added to discuss abandonment of a foreign entity.
- **FX 8.5** was added to discuss deconsolidation of a foreign entity.

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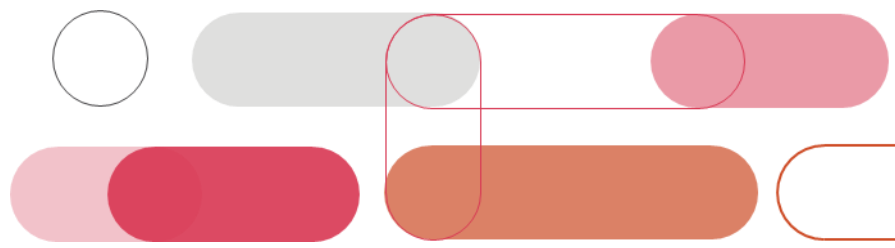


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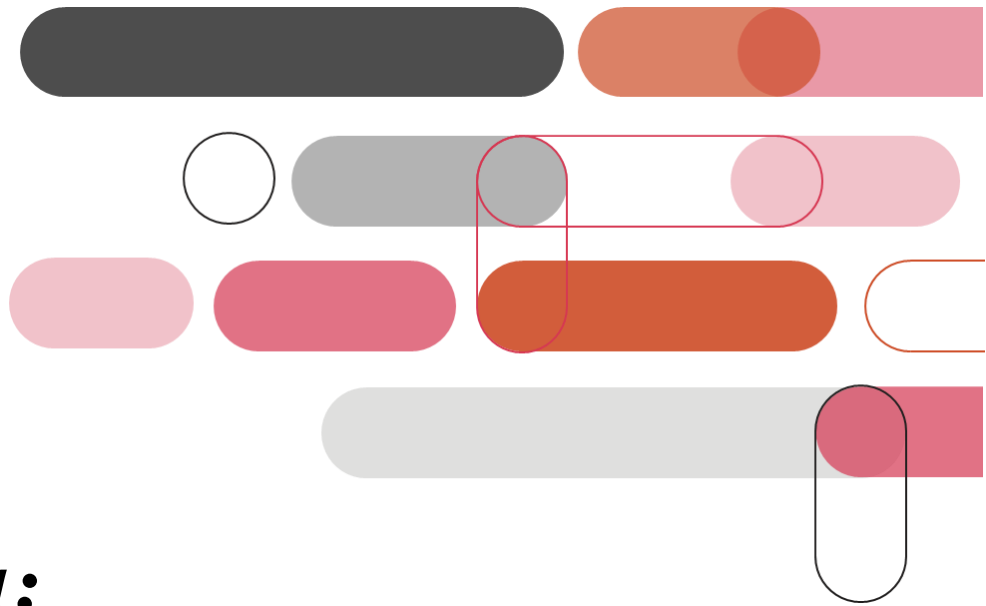
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Chapter 1:
Framework for accounting for
foreign currency

1.1 Overview of framework for accounting for foreign currency

When a reporting entity conducts transactions in more than one currency, preparing financial statements in a single currency requires that changes in the relationship between different units of currency be recognized and measured. [ASC 830](#), *Foreign Currency Matters*, uses the following two distinct processes to express all of a reporting entity's transactions in a single reporting currency.

- Foreign currency measurement—This is the process by which an entity expresses transactions whose terms are denominated in a foreign currency in its functional currency. Changes in functional currency amounts that result from the measurement process are called transaction gains or losses; transaction gains and losses are included in net income.
- Foreign currency translation—This is the process of expressing a foreign entity's functional currency financial statements in the reporting currency. Changes in reporting currency amounts that result from the translation process are called translation adjustments; translation adjustments are included in the cumulative translation adjustment (CTA) account, which is a component of other comprehensive income:

The application of the measurement and translation processes starts with an understanding of the following concepts and definitions. Not all terms listed below are defined in the FASB's Accounting Standards Codification.

Figure FX 1-1 defines common terms used in [ASC 830](#).

FIGURE FX 1-1
Basic foreign currency terms

Term	Definition
Reporting currency	The currency in which a reporting entity prepares its financial statements
Foreign currency	Any currency other than the functional currency of the referenced distinct and separable operation
Foreign entity	A distinct and separable operation whose financial statements are prepared in a currency other than the reporting currency, and that is consolidated, combined, or accounted for on the equity method. A reporting entity must identify its foreign entities to determine which financial statements have to be translated. Distinct and separable operations whose financial statements are prepared in the reporting currency are domestic entities which, by definition, do not need to be translated.
Distinct and separable operation	An operation that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the reporting entity for which a meaningful set of financial statements are routinely prepared

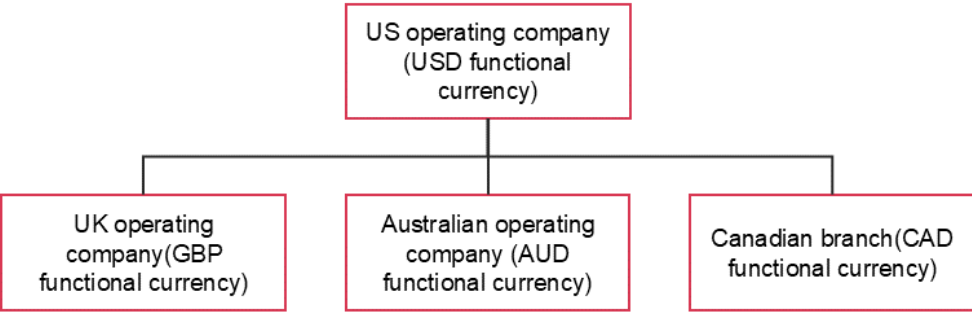
Term	Definition
Functional currency	The currency of the primary economic environment in which a distinct and separable operation operates

This chapter of PwC’s *Foreign currency* guide provides an overall framework for accounting for foreign currency matters.

1.2 Limitations of ASC 830

The guidance codified in [ASC 830](#) has not changed significantly since its issuance in 1981. At that time, the US and the US dollar dominated the global business environment. The international operations of US reporting entities were typically extensions of large, established US operating companies, and “foreign entities” were generally much smaller than the operations in the US. In addition, almost all intercompany transactions flowed from the US to foreign operations. Because of this historical bias, the guidance in [ASC 830](#) assumes that the reporting entity is located in the US, uses the US dollar as its reporting currency, is an operating company with a functional currency of the US dollar, and provides support to its foreign operations. Figure FX 1-2 illustrates the operating structure assumed by the guidance in [ASC 830](#).

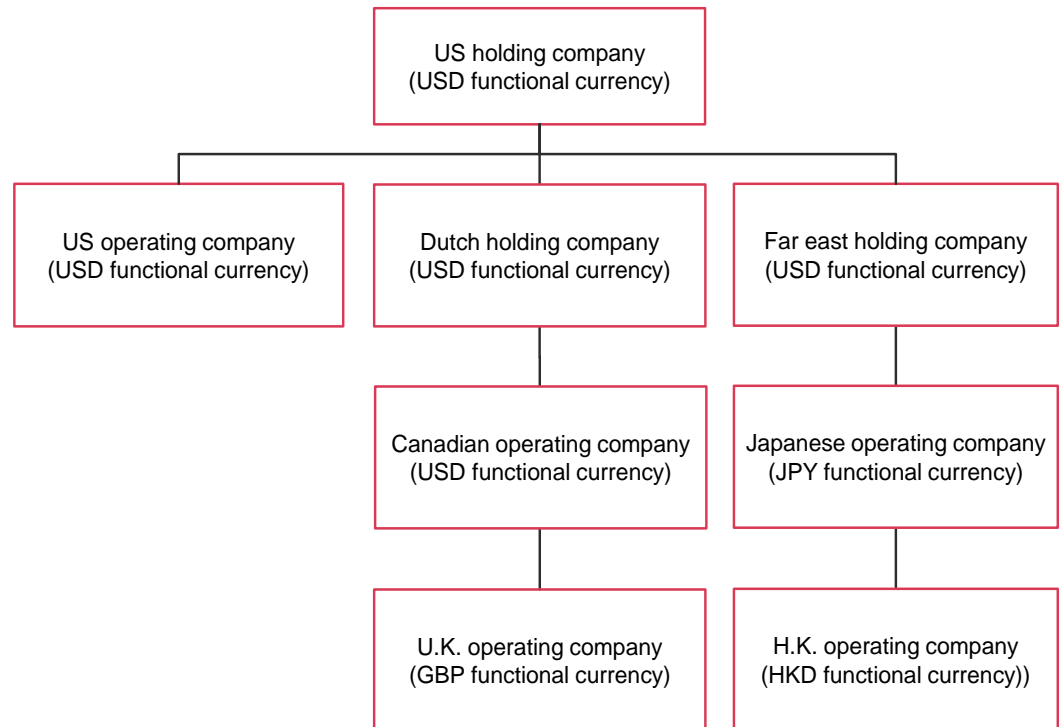
FIGURE FX 1-2
Operating structure assumed by [ASC 830](#)



In today’s economy, many US reporting entities are holding companies with no significant operations; they hold operating companies in the United States and around the world. The US operating company may not be the reporting entity’s largest operating company, and in many cases the foreign operations provide support to the US operations. In addition, transactions in the modern economy may be denominated in a number of global currencies, and an operation’s physical location no longer determines its functional currency. For example, a reporting entity domiciled in Canada may conduct most of its business in the US dollar, while a reporting entity domiciled in the US may conduct most of its business in the Canadian dollar. As a result, determining functional currencies today is much more difficult than when [ASC 830](#) was issued.

Figure FX 1-3 shows an example of a more current operating structure.

FIGURE FX 1-3
Typical current operating structure (2022)



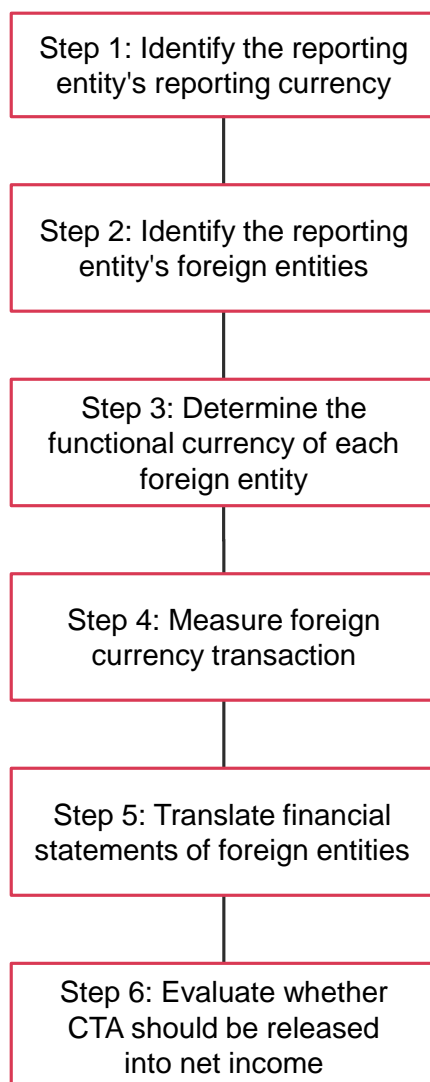
While accounting for foreign currency matters has always been a challenging area that often requires significant judgment, the lack of clarity surrounding how to apply [ASC 830](#) to a modern operating structure and how the definitions and units of account within [ASC 830](#) interact with subsequently issued accounting standards has increased the challenges. To assist in understanding how [ASC 830](#) should be applied today, we have developed additional terms (such as domestic entity) that are not used in [ASC 830](#). In certain places we have included explanations to clarify the ASC references.

1.3 Framework for the application of ASC 830

Depending on the scope and structure of its consolidated operations, a reporting entity may have transactions denominated in a foreign currency (which need to be measured in a functional currency), and it may have foreign entities (which need to be translated into the reporting currency). To prepare consolidated financial statements, all amounts denominated in foreign currencies should be either measured or translated (or both) into the reporting currency.

Figure FX 1-4 summarizes the key steps in the application of [ASC 830](#). An understanding of the various defined terms is critical to navigating the [ASC 830](#) framework.

FIGURE FX 1-4
Framework for the application of [ASC 830](#)



Step 1: Identify the reporting entity's reporting currency

[ASC 830-10-20](#) provides the definitions of reporting entity and reporting currency.

Definitions from [ASC 830-10-20](#)

Reporting Currency: The currency in which a reporting entity prepares its financial statements.

Reporting Entity: An entity or group whose financial statements are being referred to. Those financial statements reflect any of the following:

- a. The financial statements of one or more foreign operations by combination, consolidation, or equity accounting
- b. Foreign currency transactions.

The reporting currency is often the currency of the country in which the reporting entity is located, but it does not have to be. A private reporting entity may select any currency for its reporting currency. For example, a foreign private issuer may choose to prepare financial statements in US dollars for purposes of reporting to investors in the United States. In that case, its reporting currency is the US dollar. [Rule 3-20](#) of Regulation S-X requires US incorporated registrants to present their financial statements in U.S dollars, with limited exceptions.

Step 2: Identify the reporting entity's foreign entities

A foreign entity is a distinct and separable operation that is combined, consolidated, or accounted for using the equity method of accounting and has a functional currency other than the reporting entity's reporting currency.

[FX 2](#) discusses identifying a reporting entity's distinct and separable operations.

Step 3: Determine the functional currency of each distinct and separable operation

The functional currency of a distinct and separable operation is a question of fact. An operation does not choose its functional currency. [ASC 830-10-20](#) provides a definition of functional currency.

Definition from [ASC 830-10-20](#)

Functional Currency: 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.

The determination of a distinct and separable operation's functional currency may be straightforward. For example, the functional currency of a distinct and separable operation integrated within a particular country with self-contained operations would likely be the currency of that country. Similarly, the US dollar is typically the functional currency of an operation that is a direct and integral component or extension of a US parent's operations. However, the determination of the functional currency of a distinct and separable operation is often complex and may require significant judgment. It is not common for the functional currency of a distinct and separable operation to change, unless there are significant changes in external economic facts and circumstances. See [FX 3](#) for further information on factors to consider in determining the functional currency.

In addition, [ASC 830](#) contains specific provisions for determining the functional currency of a foreign entity operating in a country with a highly inflationary economy. See [FX 6](#) for further information on the applicable considerations if a foreign entity operates in a highly inflationary economy.

Step 4: Measure foreign currency transactions

When an operation has transactions denominated in a currency other than its functional currency, they must be measured in the functional currency. Changes in the expected functional currency cash flows caused by changes in exchange rates are included in net income in the period. [ASC 830-10-20](#) defines foreign currency transactions.

Definition from [ASC 830-10-20](#)

Foreign Currency Transactions: Transactions whose terms are denominated in a currency other than the entity's functional currency. Foreign currency transactions arise when a reporting entity [or distinct and separable operation] does any of the following:

- a. Buys or sells on credit goods or services whose prices are denominated in foreign currency
- b. Borrows or lends funds and the amounts payable or receivable are denominated in foreign currency
- c. Is a party to an unperformed forward exchange contract
- d. For other reasons, acquires or disposes of assets, or incurs or settles liabilities denominated in foreign currency.

Foreign currency transactions are initially recorded in an operation's functional currency. Subsequent measurement of foreign currency transactions will depend on whether the transaction gives rise to an account balance that is monetary or nonmonetary.

□ *Monetary assets and liabilities*

Monetary assets and liabilities, such as cash, accounts receivable, accounts payable, and long-term debt, create foreign currency exchange rate risk as they represent amounts that will be settled with counterparties in a currency other than an operation's functional currency. Monetary assets and liabilities are measured at the end of each reporting period based on the then current exchange rates. This measurement gives rise to foreign currency gains and losses, which are recorded in current period net income.

□ *Nonmonetary assets and liabilities*

Nonmonetary assets and liabilities, such as inventory and property, plant, and equipment, do not require future settlement or adjustment. Nonmonetary assets and liabilities are initially measured using historical exchange rates. All aspects of the ongoing accounting for these items (e.g., depreciation, impairment, lower of cost or market) should be measured in terms of the operation's functional currency.

See [FX 4](#) for further information on the measurement of foreign currency transactions.

Step 5: Translate financial statements of foreign entities

Foreign currency translation is the process of expressing a foreign entity's financial statements in the reporting currency of the reporting entity. The purpose of translation is to express a foreign entity's functional currency financial statements in terms of the reporting currency. Thus, when a reporting entity's financial statements include the results of foreign entities, the reporting entity must translate the foreign entity's financial statements before they can be consolidated.

The financial statements of a foreign entity should be translated into the functional currency of its immediate parent company based on the nature of the account as follows:

- The period-end spot rate for assets and liabilities
- The weighted average exchange rate for income statement accounts
- Historical exchange rates for equity accounts (except for the change in retained earnings during the year, which is the result of the income statement translation process)

Once the reporting entity has translated its foreign entity financial statements, it should record these amounts in its consolidated financial statements. We refer to the “immediate” parent, as [ASC 830](#) should be applied to each individual layer of a consolidation, beginning with the lowest level of the consolidated reporting entity’s organizational structure. Gains and losses (and the associated tax effect) from the effect of exchange rate differences in translation are recorded in the CTA account. CTA is a separate component of accumulated other comprehensive income (OCI) in shareholders’ equity.

See [FX 5](#) for further information on foreign currency financial statement translation.

Question FX 1-1 addresses how to translate financial statements when a foreign entity does not maintain its financial statements in its functional currency.

QUESTION FX 1-1

How should the financial statements of a foreign entity that does not maintain its financial statements in its functional currency be translated?

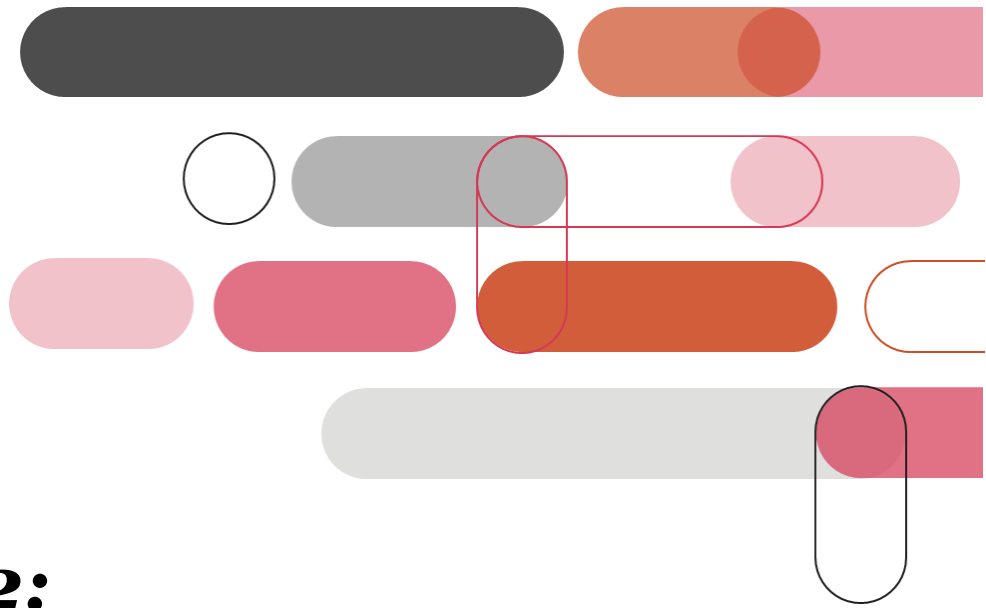
PwC response

A foreign entity may choose (or be required by law) to maintain its books and records in a local currency that is not its functional currency. In accordance with [ASC 830](#), before the local currency financial statements (prepared in accordance with US GAAP) are translated to the reporting entity’s reporting currency, they should be “remeasured” (so called because they were already measured in the local currency, which may have created transaction gains and losses) into the foreign entity’s functional currency. This remeasurement should provide results comparable to those that would have occurred had the entity used its functional currency to maintain its records.

Step 6: Release the cumulative translation adjustment into net income, as applicable

[ASC 830-30-40-1](#) requires CTA to be reclassified from equity to net income “upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity.” Therefore, when disposing of any foreign operation, it is important to understand if that foreign operation constitutes a foreign entity, or is a component of a foreign entity. Acquiring control of a foreign operation in a step acquisition may also require that CTA be released to net income.

See [FX 8](#) for further information on acquisitions and dispositions of foreign operations.



***Chapter 2:
Determining whether an
entity is a distinct and
separable operation***

2.1 *Determining whether an entity is a distinct and separable operation overview*

A critical step in the application of [ASC 830](#) is the identification of a reporting entity's foreign entities, which by definition must be a distinct and separable operation.

Whether an operation is a distinct and separable foreign entity will depend on the manner in which the operations are structured. If an operation does not qualify as distinct and separable, it should be considered an extension of another distinct and separable operation (typically, its most immediate parent). A reporting entity should periodically revisit its assessment to determine whether facts and circumstances have changed in such a way as to impact what are considered distinct and separable operations.

This chapter discusses how to identify distinct and separable operations and how to determine if each is a foreign entity or a domestic entity of a reporting entity.

2.2 *Definition of a foreign entity*

The definition of a foreign entity in [ASC 830](#) describes a foreign entity as something not necessarily the same as a legal entity.

Definition from [ASC 830-10-20](#)

Foreign Entity: An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:

- a. Prepared in a currency other than the reporting currency of the reporting entity
- b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.

In addition to the criteria in [ASC 830-10-20](#), a consolidated operation must be distinct and separable from the reporting entity's other foreign operations to be considered a separate foreign entity. Consequently, we refer to a distinct and separable operation whose financial statements are prepared in a currency other than the reporting currency of the reporting entity as a foreign entity. In contrast, a distinct and separable operation whose financial statements are prepared in the reporting currency is referred to as a "domestic entity."

2.3 *Identifying distinct and separable operations*

To identify its distinct and separable operations, a reporting entity should start by analyzing the business purpose and activities of each legal entity, beginning at the lowest level of its legal structure, to determine whether each legal entity is a distinct and separable operation.

[ASC 830-10-45-5](#)

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

An operation that is distinct and separable has each of the characteristics discussed in Figure FX 2-1.

FIGURE FX 2-1
Characteristics of a distinct and separable operation

	Operation is distinct and separable	Operation is not distinct and separable
Separate operations	Operations are managed independently and can be separated, both operationally and for financial reporting purposes, from the reporting entity's other operations	Operations are not managed independently or cannot be separated, either operationally or for financial reporting purposes, from the reporting entity's other operations
Assets and liabilities	Assets and liabilities of the operation can be separated from those of the reporting entity's other operations and relate directly to the operation's activities	Assets and liabilities of the operation cannot be separated from those of the reporting entity's other operations, the operation holds only certain assets and liabilities (e.g., receivables and inventory), or they hold assets and liabilities that relate directly to a reporting entity's other operations
Financial statements	A meaningful set of all-inclusive financial statements could be routinely prepared for the operation	The operation cannot produce financial statements or produces a limited set of financial statements

A single legal entity might have more than one distinct and separable operation (e.g., a division or branch). In practice, a single legal entity composed of more than one distinct and separable operation occurs infrequently.

If multiple legal entities are domiciled in a country or countries with the same currency, a reporting entity should evaluate whether each legal entity should be considered a distinct and separable operation or if they should be combined with the other legal entities to form a single distinct and separable operation.

An operation does not have to be wholly-owned to be a distinct and separable operation; a joint venture or investment accounted for using the equity method can also be a distinct and separable operation. If an operation does not qualify as distinct and separable, it is considered an extension of another separate and distinct operation, often its most immediate parent.

QUESTION FX 2-1

Is a foreign sales office a distinct and separable operation?

PwC response

Generally, no. A sales office is typically responsible for marketing and selling inventory produced by another operation. Further, sales offices usually rely on another legal entity or operation for funding, management oversight, and accounting. In those situations, the sales office would not be considered distinct and separable, but would instead be considered an extension of another distinct and separable operation (typically its most immediate parent).

2.3.1 Reassessment of distinct and separable operations

The determination of a reporting entity's distinct and separable operations is not static. Management should periodically reassess its operations to determine if its previous conclusions are still valid. Also, certain events, such as mergers and acquisitions, or a reorganization of the reporting entity, may result in a change in whether an operation should be considered distinct and separable.

QUESTION FX 2-2

Can a variable interest entity (VIE) consolidated by a reporting entity be a distinct and separable operation?

PwC response

Yes. If a VIE consolidated by the reporting entity has the characteristics described in Figure FX 2-1, it can be a distinct and separable operation.

Once a reporting entity has identified its distinct and separable operations, it should identify the functional currency of each operation to determine whether it is a foreign entity or a domestic entity. See [FX 3](#) for information on identifying a distinct and separable operation's functional currency.

2.4 Application examples

Example FX 2-1 illustrates how to identify distinct and separable operations when a reporting entity has multiple subsidiaries.

Example FX 2-2 illustrates how to identify distinct and separable operations when a reporting entity has multiple foreign entities within a single country.

Example FX 2-3 illustrates how to identify distinct and separable operations within a single legal entity.

EXAMPLE FX 2-1

Reporting entity with multiple subsidiaries

USA Corp is a US registrant that uses the US dollar as its reporting currency. USA Corp has the following subsidiaries:

- **Mexico SA** – Located in Tijuana, Mexico, Mexico SA is a wholly-owned subsidiary of USA Corp. Mexico SA serves as a regional headquarters. It has a factory that produces products that are sold in Mexico and Latin America, and two warehouses to hold products. Mexico SA has a general manager and management team that are responsible only for Mexico SA operations and who

are compensated based on Mexico SA's performance. Mexico SA also has the accounting systems necessary to process financial transactions and to prepare financial statements.

- **Canadian Sales LLC** – Located in Montreal, Canada, Canadian Sales LLC is a wholly-owned subsidiary of USA Corp. Canadian Sales LLC markets and sells the products produced by USA Corp to Canadian customers in Canadian dollars. Canadian Sales LLC relies on USA Corp for its funding, management, and financial reporting function. USA Corp manages its sales divisions in the US and internationally as a single operation. Canadian Sales LLC reports limited financial information in its local currency, the Canadian dollar.

What are USA Corp's distinct and separable operations?

Analysis

USA Corp has two distinct and separable operations: USA Corp and Mexico SA. Canadian Sales LLC should be considered an extension of USA Corp.

EXAMPLE FX 2-2

Reporting entity with multiple foreign entities within a single country

USA Corp is a US registrant that uses the US dollar as its reporting currency. USA Corp operates fast food restaurants in the US and in various other countries.

USA Corp owns 100% of five separate legal operating entities, each operating a fast food restaurant in Berlin, Germany. All of the operating entities are under the supervision of one regional vice president and finance team. The German fast food market is very different than the US fast food market; therefore, there is a separate team to establish strategy and menus for all German entities due to differences in customer tastes between Germany and the United States.

Each German operating entity pays for all purchases of inventory and equipment, salaries, and other expenses in the local currency, the euro. Each operating entity submits its financial information to the regional finance team, who prepares individual and combined financial statements.

Do the wholly-owned legal entities in Germany represent distinct and separable operations?

Analysis

The operations of the five wholly-owned legal entities in Germany are distinct and separable from USA Corp because they comprise an operation that is separate, both operationally and for financial reporting purposes, from USA Corp. However, the operating entities are not individually distinct and separable from each other because although they may have separable assets and liabilities and are able to prepare financial statements, they are not operated separately. In addition, strategy, menu, and pricing are established centrally for all of the operating entities.

EXAMPLE FX 2-3

One legal entity disaggregated into two distinct and separable operations

USA Corp is a US registrant that uses the US dollar as its reporting currency. USA Corp has a wholly-owned subsidiary located in Canada. Canadian Corp operates a

single manufacturing facility with two production lines. The production lines manufacture similar products, but the output is directed to different markets.

- **Product US** – Product US is produced solely for USA Corp. USA Corp provides all of the production plans and product specifications to be used for Product US. Most of the raw materials used in producing Product US are purchased from USA Corp, in US dollars; some minor inputs are purchased locally in Canadian dollars. All sales contracts for Product US are negotiated with USA Corp in US dollars such that Canadian Corp recovers its cost plus a margin designed to be similar to that of a contract manufacturer.
- **Product C** – Product C is produced solely for Canadian customers. Canadian Corp has a team of engineers that design the specifications for Product C based on the demands of the Canadian marketplace. Production plans are based on the expected sales projected by Canadian Corp’s sales team. Raw materials are purchased equally from US vendors, in US dollars, and Canadian vendors, in Canadian dollars. Pricing for Product C is in Canadian dollars and is based on local demand.

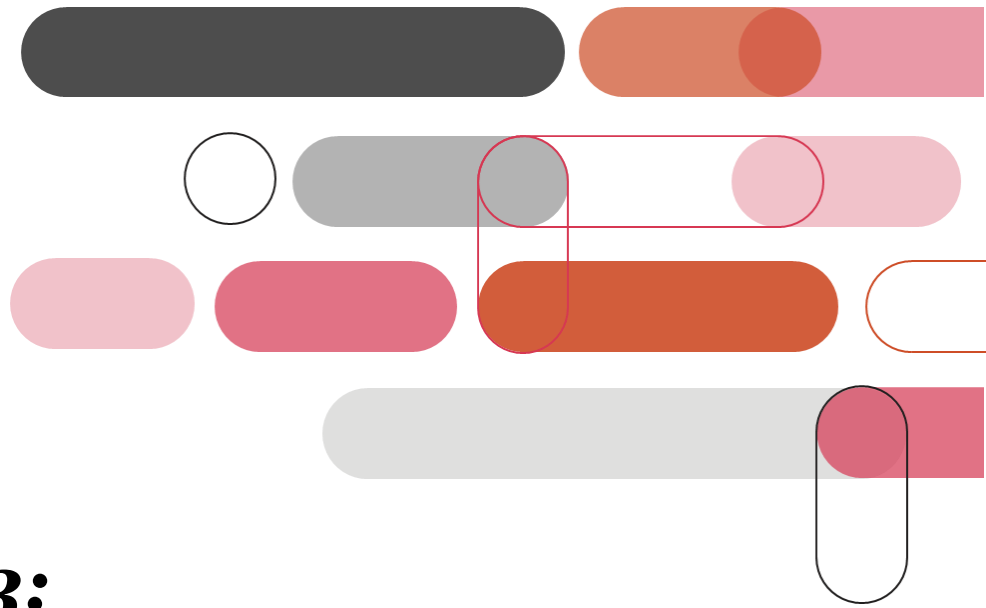
Canadian Corp has separate management teams for each product, and routinely prepares a complete set of financial statements for each product.

Does Canadian Corp represent a single distinct and separable operation?

Analysis

Although Canadian Corp is a single legal entity, because the business of Product US and Product C are clearly separate, both operationally and for financial reporting purposes, they should be evaluated separately.

The Product US “operation” is an extension of USA Corp’s operations; it is the manufacturing arm of USA Corp. It produces a product designed by USA Corp to be sold only in the US. The Product C “operation” is a distinct and separable operation that operates predominantly in the Canadian dollar and produces a distinct product designed for Canadian tastes and is priced based on the Canadian market.



***Chapter 3:
Determining functional
currency***

3.1 *Determining functional currency overview*

To apply the provisions of [ASC 830](#), a reporting entity should determine the functional currency of each distinct and separable operation included in its consolidated financial statements. The functional currency is a factual matter and is not a policy election. Once determined, the functional currency should not change unless there are significant changes in economic facts and circumstances. In this chapter, we use the terms “distinct and separable operation” and “foreign entity” interchangeably.

This chapter discusses how to determine a distinct and separable operation’s functional currency and the impact of changes in that functional currency. See [FX 6](#) for information on the functional currency of a foreign entity in a highly inflationary economy.

3.2 *Determining functional currency*

A distinct and separable operation’s functional currency is the currency of the primary economic environment in which it operates. [ASC 830-10-45-2](#) provides the definition of functional currency. This guidance refers to the functional currency of an entity but, as discussed in [FX 2](#), the better term is distinct and separable operation, since that is the primary attribute of a reporting entity’s foreign entities.

ASC 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.

Often, the functional currency will be the currency of the country in which the distinct and separable operation is physically located. However, some distinct and separable operations operate in an economic environment different than that of their physical location. For example, if a US-based multinational oil and gas company that uses the US dollar as its reporting currency maintains a distinct and separable operating subsidiary in Northern Africa that sells all of its oil production in transactions denominated in the US dollar, the US dollar would be the functional currency of that operation. While the Northern African oil subsidiary is located outside the United States, it would not be considered a foreign entity under [ASC 830](#), as its functional currency is the same as the reporting currency of the reporting entity. If the same US-based multinational used the Canadian dollar as its reporting currency, the Northern Africa subsidiary and the oil and gas operations located in the US would be considered foreign entities for purposes of applying [ASC 830](#) because their functional currencies would be different than the reporting currency of the reporting entity.

When a distinct and separable operation transacts in multiple currencies, it should assess all relevant facts to determine its functional currency.

For purposes of determining functional currency, [ASC 830-10-45-4](#) divides foreign operations into two broad classes. While this guidance uses the term foreign operations, it is equally applicable to any distinct and separable operation. As discussed in [FX 1.2](#), [ASC 830](#) was written assuming a two-tiered organization (i.e., parent and subsidiary). In most modern multinational organizations, there are often multiple layers (i.e., holding company, first-tier operating entity, second-tier operating entity). We believe the guidance in [ASC 830-10-45-4](#) should be applied by analyzing the relationship between a distinct and separable operation and its immediate parent.

ASC 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.

Sometimes an operation will clearly align with one of these two classes; however, more often an operation will have characteristics of both classes. When an operation is clearly an extension of its parent, the operation's functional currency is that of its parent. There may also be situations in which an operation is not considered distinct and separable and is also not clearly an extension of its immediate (legal) parent. In these situations, the operation may be considered an extension of another separate and distinct operation. For example, a sales entity located in Germany with an immediate US (legal) parent that services a distinct and separable operation in the United Kingdom (UK) may be considered an extension of the UK entity for purposes of determining its functional currency.

When an operation is not clearly an extension of its parent, management will need to consider the factors discussed in [ASC 830-10-55-5](#) to determine the operation's functional currency. This guidance provides a list of economic indicators that should be considered individually and collectively when determining a distinct and separable operation's functional currency. [ASC 830](#) does not weight or rank these indicators; however, in our experience, the sales price, sales market, and expense indicators are the most important factors in determining the primary economic environment in which a distinct and separable operation operates. Cash flows can also be an important indicator provided the cash flows are not merely an invoicing or settlement currency, but reflect the underlying transactions' economics. Management should evaluate its specific facts and circumstances to determine which indicators are the most relevant to the distinct and separable operation and the economic environment in which it operates.

ASC 830-10-55-5

The following salient economic factors, and possibly others, should be considered both individually and collectively when determining the functional currency:

- a. Cash flow indicators, for example:
 1. Foreign currency. Cash flows related to the foreign entity's individual assets and liabilities are primarily in the foreign currency and do not directly affect the parent entity's cash flows.
 2. Parent's currency. Cash flows related to the foreign entity's individual assets and liabilities directly affect the parent's cash flows currently and are readily available for remittance to the parent entity.
- b. Sales price indicators, for example:
 1. Foreign currency. Sales prices for the foreign entity's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.
 2. Parent's currency. Sales prices for the foreign entity's products are primarily responsive on a short-term basis to changes in exchange rates; for example, sales prices are determined more by worldwide competition or by international prices.
- c. Sales market indicators, for example:
 1. Foreign currency. There is an active local sales market for the foreign entity's products, although there also might be significant amounts of exports.
 2. Parent's currency. The sales market is mostly in the parent's country or sales contracts are denominated in the parent's currency.
- d. Expense indicators, for example:
 1. Foreign currency. Labor, materials, and other costs for the foreign entity's products or services are primarily local costs, even though there also might be imports from other countries.
 2. Parent's currency. Labor, materials, and other costs for the foreign entity's products or services continually are primarily costs for components obtained from the country in which the parent entity is located.
- e. Financing indicators, for example:
 1. Foreign currency. Financing is primarily denominated in foreign currency, and funds generated by the foreign entity's operations are sufficient to service existing and normally expected debt obligations.
 2. Parent's Currency—Financing is primarily from the parent or other dollar-denominated obligations, or funds generated by the foreign entity's operations are not sufficient to service existing and normally expected debt obligations without the infusion of additional funds from the parent

entity. Infusion of additional funds from the parent entity for expansion is not a factor, provided funds generated by the foreign entity's expanded operations are expected to be sufficient to service that additional financing.

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

Given that an operation's functional currency should not change frequently, the indicators in [ASC 830-10-55-5](#) should be considered from the perspective of a distinct and separable operation's long-term operations.

QUESTION FX 3-1

How should the functional currency of a start-up operation be determined?

PwC response

The functional currency of a start-up operation should be a function of the economic environment the entity expects to operate in over the long-term. The currency of that long-term economic environment is the functional currency of a start-up operation, not the currency that is used to fund initial operations or the currency of its initial cash flows.

Example FX 3-1, Example FX 3-2, and Example FX 3-3 illustrate how to determine the functional currency of a foreign operation, sales office, and foreign manufacturing facility, respectively.

EXAMPLE FX 3-1

Determining the functional currency of a foreign operation

USA Corp is a US registrant that uses the US dollar (USD) as its reporting currency.

Britannia PLC is a consolidated subsidiary of USA Corp located in the United Kingdom. Consider the following facts regarding Britannia PLC:

- Britannia PLC is a distinct and separable operation of USA Corp.
- The local currency of Britannia PLC is the British pound sterling (GBP).
- Britannia PLC manages USA Corp's operations within the European market, including strategy, manufacturing, sales, logistics, billing and collections.

- Customers of Britannia PLC are located across Europe, with the majority of its customers located in the United Kingdom, Germany, France, and Italy.
- Sales are denominated in GBP and euros (EUR); sales prices are primarily driven by local competition.
- Britannia PLC was originally funded by USA Corp with a capital contribution and a USD 100 million intercompany loan. It also has a third-party line of credit of GBP 20 million, which can be drawn in either GBP or EUR.
- Cost of goods sold comprises 75% of Britannia PLC's expenses. It purchases 50% of its raw materials from a USA Corp subsidiary in the United States in USD (at market prices) and 50% of its raw materials from third parties in EUR. Selling, general and administrative expenses comprise 25% of the subsidiary's expenses and are denominated 50% in GBP and 50% in EUR.

Britannia PLC's income statement is shown below. During the period presented, the average exchange rates are EUR 1 = USD 1.4, and GBP 1 = USD 1.7.

Income/ expense	Amount in currency in which income or expense is denominated	Exchange rate	Amount in USD
Sales	GBP 14,950,000	GBP 1 = USD 1.7	USD 25,415,000
	EUR 53,957,000	EUR 1 = USD 1.4	USD 75,539,800
Total sales			<u>USD 100,954,800</u>
Cost of sales	USD 30,000,000		USD 30,000,000
	EUR 21,435,000	EUR 1 = USD 1.4	USD 30,009,000
Selling, general and administrative expenses	GBP 5,885,000	GBP 1 = USD 1.7	USD 10,004,500
	EUR 7,190,000	EUR 1 = USD 1.4	USD 10,066,000
Total expenses			<u>USD 80,079,500</u>
Operating profit			<u>USD 20,875,300</u>
Interest expense			<u>USD 10,000,000</u>
Earnings before taxes			<u>USD 10,875,300</u>

What is the functional currency of Britannia PLC?

Analysis

Since Britannia PLC transacts in multiple currencies, management will need to assess the factors outlined in [ASC 830-10-55-5](#) to determine the appropriate functional currency.

Indicator	Currency	Analysis
Cash flows	EUR, GBP	Operating cash flows are predominantly denominated in EUR (75% of sales and 50% of expenses)
Sales price	EUR, GBP	Local competition in the European sales market dictates the sales price; sales prices are negotiated in both EUR and GBP
Sales market	EUR, GBP	The predominant sales market is EUR denominated
Expenses	USD, EUR, GBP	Raw material purchases are denominated in USD and EUR; selling, general and administrative expenses are denominated in EUR and GBP
Financing	USD, EUR, GBP	A large intercompany loan is denominated in USD

Management considers the sales market, sales price, and related cash flows of the Britannia PLC to be the most significant economic indicators. They believe operating cash flows are a significant indicator in this case. Since operating cash flows are predominantly EUR denominated, the cash flow indicator strongly suggests the EUR is Britannia PLC's functional currency. The sales market and sales price indicators also signal EUR as the functional currency. Expenses are split between USD and EUR.

The financing indicator points to USD. Management does not place significant weight on the financing indicator because the denomination of an intercompany loan can be easily changed. If significant weight were placed on the financing indicator, Britannia PLC's functional currency could be easily influenced by USA Corp.

Based on this analysis, Britannia PLC's functional currency is the EUR.

EXAMPLE FX 3-2

Determining the functional currency of a sales office

USA Corp is a US registrant that uses the US dollar as its reporting currency. Deutsche AG is a wholly-owned subsidiary of USA Corp located in Germany, which functions as the European sales office of USA Corp. Consider the following facts regarding Deutsche AG:

- The local currency is EUR.
- Deutsche AG manages USA Corp sales within the European market, including negotiating sales contracts with its European customers, coordinating delivery of

products, as well as performing billing and collections. Products are produced in the US and shipped directly to customers in Europe.

- Customers of the European sales office are located across Europe, with the majority of the customers located in Germany, France, and Italy.
- Sales are in EUR; the sales price is primarily driven by local competition.
- USA Corp finances Deutsche AG by reimbursing its expenses (which are mostly payroll and administration related) plus an additional 3% each month; the incremental 3% is used to pay the local taxing authority.
- Deutsche AG's assets consist mainly of office equipment, and the hardware and software necessary to execute the sales duties of the organization.

What is the functional currency of Deutsche AG?

Analysis

Deutsche AG is a direct and integral extension of USA Corp's operations (i.e., it is not distinct and separable). Deutsche AG performs a European sales function that could just as easily be performed by USA Corp directly, and Deutsche AG cannot operate without financing from USA Corp. As a result, management concludes that the functional currency of Deutsche AG is USD, the functional currency of its immediate parent, USA Corp.

EXAMPLE FX 3-3

Determining the functional currency of a foreign manufacturing facility

USA Corp is a US registrant that uses the US dollar as its reporting currency. Mexico SA is a wholly-owned subsidiary of USA Corp located in Mexico, which functions as a manufacturing facility of USA Corp. Consider the following facts regarding Mexico SA:

- USA Corp manufactures parts for one of its products at a facility in the United States. USA Corp packages the parts and ships them to Mexico SA for assembly.
- Mexico SA has a manufacturing facility in Chihuahua, Mexico. This facility receives the parts from USA Corp. Employees of Mexico SA assemble the parts into the final product and test them to ensure that the quality of the product is up to USA Corp's standards.
- Mexico SA then ships the completed product back to USA Corp for sale to customers.
- The local currency of Mexico SA is the Mexican Peso (MXN).
- USA Corp funds the expenses of Mexico SA each month, plus a small margin.

What is the functional currency of Mexico SA?

Analysis

Mexico SA is a direct and integral extension of USA Corp's operations; Mexico SA performs assembly that could just as easily be performed by USA Corp directly, and Mexico SA cannot operate without financing from USA Corp. Furthermore, Mexico SA's expenses have a direct impact on USA Corp's cash flows through the cost-plus

reimbursement arrangement. As a result, the functional currency of Mexico SA is USD, the functional currency of its parent, USA Corp.

QUESTION FX 3-2

Can a distinct and separable operation have more than one functional currency?

PwC response

No. A distinct and separable operation cannot have more than one functional currency. However, a single legal entity could comprise more than one distinct and separable operation, in which each has its own functional currency. See FX 2 for information on identifying distinct and separable operations.

3.2.1 Considerations for holding companies and other shell corporations

Holding companies and shell corporations are created for many reasons (e.g., tax, legal). [ASC 830-10-55-5](#) provides guidance regarding the functional currency of a holding company or shell corporation that exists to engage in transactions that its parent company could just as easily engage in.

Excerpt from [ASC 830-10-55-5\(f\)\(2\)](#)

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.

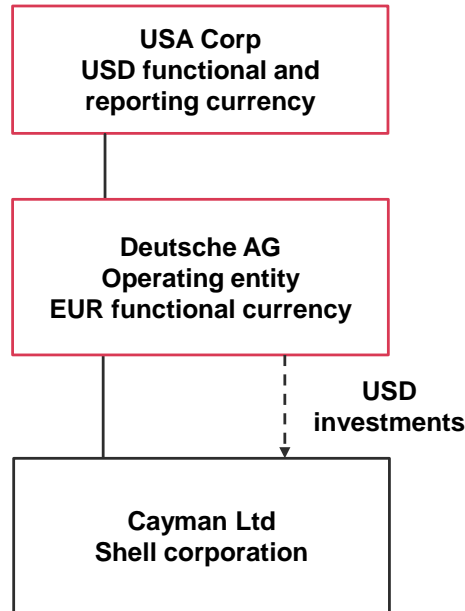
Generally, because a holding company or shell corporation is often considered an extension of the parent's operations (i.e., it is not a distinct and separable operation), its functional currency is considered the functional currency of its immediate parent. In practice, a holding company or shell corporation could have a functional currency different from its immediate parent (e.g., the holding company could be a part of a foreign operation). In this situation, careful analysis and judgment is required to determine the appropriate functional currency of this type of entity. Management should consider the purpose of the entity and how the financial obligations of the entity will be satisfied, among the other relevant factors, to determine the functional currency of a holding company or shell corporation. In addition, a legal entity could be referred to as a holding company, but in fact may also have its own substantive operations. In this case, the entity may be considered a separate and distinct operation requiring its own functional currency.

Example FX 3-4 illustrates how to determine the functional currency of a holding company or shell corporation.

EXAMPLE FX 3-4

Determining the functional currency of a foreign shell corporation

USA Corp has the following organizational structure:



USA Corp is a US registrant that uses the US dollar as its reporting currency. Deutsche AG is a wholly-owned operating subsidiary of USA Corp located in Germany. USA Corp management has determined that Deutsche AG is a foreign entity and its functional currency is EUR.

Cayman Ltd is a wholly-owned subsidiary of Deutsche AG located in the Cayman Islands. Its sole purpose is to hold US dollar-denominated investments (securities issued by an unaffiliated party) transferred from Deutsche AG.

What is the functional currency of Cayman Ltd?

Analysis

As stated in [ASC 830-10-55-5\(f\)\(2\)](#), the functional currency of a shell corporation is generally the functional currency of its immediate parent. In this case, Deutsche AG is the immediate parent and Cayman Ltd is merely a shell corporation designed to hold investments that could readily be carried on its immediate parent's books; therefore, the functional currency of Cayman Ltd is the EUR, the functional currency of Deutsche AG.

QUESTION FX 3-3

What is the functional currency of a holding company (with no immediate parent) established to access the US capital markets?

PwC response

Some foreign operating companies, often from China or Russia, establish a holding company in a jurisdiction such as the Cayman Islands for the sole purpose of

accessing US capital markets. These holding companies are often the top companies in the legal structure with no parent entity above them. The holding company issues securities (e.g., debt, convertible debt, preferred equity, common equity) in the US capital markets and holds investments in operating companies. The sole purpose of the holding company is to serve as a financing vehicle to fund the operations of the operating companies and to serve as the listing company needed to access US capital markets.

Generally, financing proceeds are in US dollars. The ongoing cash flows of the holding company include administrative expenses related to the financing (legal and accounting costs, etc.), interest income, and interest expense. These are typically denominated in US dollars.

There are two views used in practice to determine the functional currency of this type of entity. Under the first view, the functional currency of the holding company is determined by an analysis of the functional currencies of its operating entities, based on the fact that the holding company's sole purpose is to gain access to the US capital markets to fund those operating entities. Further, it is the operations of the operating entities that will ultimately be the source of repayment or returns for the securities issued by the holding company. This view is derived by analogy to [ASC 830-10-45-4\(b\)](#). Proponents of this view believe that the holding company is an extension of the operating entities and, based on the guidance in that subsection, should adopt the functional currency of those entities.

Under the second view, the holding company would determine its functional currency based on its own cash flows without considering the activities of the operating entities. Those who hold this view recognize that the sole purpose of the holding company is to fund the operations of its subsidiaries. However, they note that [ASC 830](#) stipulates that a holding company should assume the functional currency of its parent. In this case, the holding company does not have a parent, and proponents of this view do not believe it is appropriate to look down to the entity's subsidiaries' operations.

3.3 *Change in functional currency*

Functional currency is a matter of fact, not a policy election. As discussed in [ASC 830-10-45-7](#), once the functional currency is determined, a subsequent change can be made only if it is justified by significant changes in facts and circumstances; thus, changes in functional currency are rare.

ASC 830-10-45-7

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

As discussed in [FX 2.3.1](#), the determination of distinct and separable operations is not static. Management should periodically reassess its operations to determine if its previous conclusions are still valid. Similarly, management should consider whether changes in its distinct and separable operations warrant a change in functional currency.

[ASC 830](#) does not provide guidance on what would represent sufficient changes in facts and circumstances to indicate that the functional currency of a distinct and separable operation has changed. Generally, a change is warranted only when an operation encounters a significant and permanent change to its operating paradigm.

A change could result from a discrete event, such as an acquisition or reorganization of a reporting entity, or it could occur over time. For example, a foreign operation may initially be determined to have the same functional currency as its parent because it is a direct and integral extension of its parent; however, over time it may evolve into a self-contained distinct and separable operation that should identify its functional currency based on its own operations. When a change occurs over time, management should carefully assess the facts to determine not only whether a significant change has occurred, but also *when* the change occurred. Management should consider disclosing the potential for a change in functional currency when a change is expected to occur over time. Changes in the currency of transactions with third parties are a stronger indicator that a change in functional currency has occurred than changes in the currency of intercompany transactions.

Management should periodically reassess its distinct and separable operations to determine if a change in functional currency has occurred or if new distinct and separable operations have developed, placing more emphasis on the entity's long-term, rather than short-term economic indicators.

See [FX 6](#) for information on a change in an entity's functional currency when an economy becomes, or ceases to be, highly inflationary.

Example FX 3-5 illustrates how to determine if a change in functional currency is warranted.

EXAMPLE FX 3-5

Change from an extension of the parent to an autonomous entity

USA Corp is a US registrant that uses the US dollar as its reporting currency.

In September 20X1, USA Corp establishes a wholly-owned subsidiary, Turkish Inc, located in Turkey. Turkish Inc serves as the sales arm of USA Corp in Eastern Europe. Products are designed and produced by USA Corp and shipped directly to customers identified by Turkish Inc. USA Corp funds the expenses of Turkish Inc on a monthly basis. USA Corp management concludes that Turkish Inc is an extension of the operations of USA Corp and that the functional currency of Turkish Inc is USD, the functional currency of its parent, USA Corp.

In 20X3, Turkish Inc completes construction of a manufacturing facility, which is intended to produce products designed solely for the European markets. Turkish Inc will continue to import products from USA Corp, but will now take ownership of this inventory pursuant to an at-market transfer pricing agreement. Turkish Inc also hired numerous executives responsible for general management of the European market.

Should Turkish Inc reassess its functional currency?

Analysis

Yes. Turkish Inc should reassess its functional currency because it has migrated from an entity that was fully integrated with its parent to an autonomous entity that is now considered a distinct and separable operation.

EXAMPLE FX 3-6

Change in functional currency as result of business expansion over time

USA Corp is a US registrant that uses the US dollar as its reporting currency.

In March 20X1, USA Corp establishes a wholly-owned subsidiary, Royalty Inc, located in the United Kingdom. Royalty Inc designs and produces products similar to those sold by USA Corp, but are adapted to customer tastes in the United Kingdom. Royalty Inc ships directly to customers in the United Kingdom.

USA Corp establishes this subsidiary to conduct all business in the United Kingdom and hires an executive team to ensure success. Royalty Inc is determined to be a distinct and separable foreign operation. All of Royalty Inc's sales and the predominance of its costs are denominated in GBP at inception and are expected to remain that way long-term. As a result, USA Corp management concludes that the functional currency of Royalty Inc is GBP.

In 20X3, Royalty Inc launches an extension of its original product line that was not anticipated in March 20X1. This extension generates significant demand in Spain, Portugal, Italy, and other parts of Europe. As such, Royalty Inc sales transactions with third parties transition from being all in GBP to 75% in EUR and 25% in GBP. Royalty Inc expects its EUR sales to continue to increase.

Should Royalty Inc reassess its functional currency?

Analysis

Royalty Inc should reassess its functional currency because the unexpected extension of the original product line may represent a significant change in facts and circumstances. Because changes in functional currency are expected to be rare, in performing its functional currency evaluation, Royalty Inc must have significant confidence that the change in facts and circumstances are expected to be other than temporary. As a result, the timing of any change in functional currency will require significant judgment.

3.3.1 Accounting for a change in functional currency

The accounting for a change in functional currency depends on the currency it is changing from and the currency it is changing to. The table below summarizes the accounting treatment for the various types of changes. In this discussion, we have assumed that the immediate parent of the foreign operation is the consolidated reporting entity (i.e., the foreign operation is a first-tier entity). If the foreign operation is a second-tier entity (or lower), the "reporting currency" would be the currency of its immediate parent, not the currency of the consolidated reporting entity.

All changes in functional currency are accounted for currently and prospectively from the date of the change. Since the exact date a change in functional currency occurred may be hard to determine, it is often recognized at the beginning of the reporting period that approximates the date of the change. As discussed in [ASC 830-10-45-7](#), previously released financial information should not be restated for a change in functional currency.

Figure FX 3-1 summarizes the accounting for a change in functional currency at the consolidated level.

FIGURE FX 3-1**Accounting for a change in functional currency at the consolidated level**

Change	Accounting summary
From the currency of the reporting entity to a local currency	<p>Nonmonetary assets and liabilities, as stated in the local currency (i.e., the new functional currency), are translated using the exchange rate in effect at the date of the change. The difference between the consolidated historical carrying values (which would have been a function of the exchange rate that existed when the assets or liabilities arose), and the new translated values using the current exchange rate, is recorded to the cumulative translation adjustment (CTA) account.</p> <p>Monetary assets and liabilities not denominated in the reporting currency are translated at the current exchange rate at the date of the change. This process will produce the same carrying values produced from the measurement process that was performed prior to changing the functional currency. To the extent that the distinct and separable operation has monetary assets and liabilities denominated in the reporting currency, such balances will create transaction gains and losses subsequent to the change in functional currency.</p>
From a local currency to the currency of the reporting entity (including changes due to a highly inflationary economy)	<p>The translated balances of monetary and nonmonetary assets and liabilities recorded in the reporting entity's consolidated financial statements as of the end of the prior reporting period become the new accounting basis for those assets and liabilities in the period of the change. To the extent that the distinct and separable operation has monetary assets and liabilities denominated in the old functional currency, such balances will create transaction gains and losses subsequent to the change in functional currency.</p> <p>The balance recorded in the CTA account for prior periods is not reversed upon the change in functional currency.</p>
From a local currency to a new local currency	<p>Nonmonetary assets and liabilities should be remeasured into the new functional currency, using the exchange rate on the date the asset or liability arose. These amounts should then be translated into the reporting entity's reporting currency based on current exchange rates. The difference between this amount and the prior translated balance should be recorded in CTA.</p> <p>Monetary assets and liabilities not denominated in the new local currency should be remeasured into the new functional currency, based on the exchange rate at the date of the change in functional currency. These amounts should then be translated into the reporting entity's reporting currency based on current exchange rates. To the extent that the distinct and separable operation has monetary assets and liabilities not denominated in the new local currency, such balances will create transaction gains and losses subsequent to the change in functional currency.</p> <p>The balance recorded in the CTA account for prior periods is not reversed upon the change in functional currency.</p>

See [FX 6](#) for information on a change in functional currency due to an economy becoming, or ceasing to be, highly inflationary.

3.3.1.1 *Change from the reporting currency of the reporting entity to a foreign currency*

When the functional currency of a distinct and separable operation changes from the reporting currency of the reporting entity to a local currency, the foreign operation should record its account balances in its new functional currency and then translate those balances into the reporting currency. See [FX 4.4.1](#) for a discussion of nonmonetary and monetary assets and liabilities.

Even when a foreign operation has a functional currency that is the same as the reporting entity's reporting currency, it will often maintain its books and records in its local currency. As such, local currency balances are generally available. Upon a change in functional currency, these local currency balances should be translated into the reporting entity's reporting currency using current exchange rates; the difference between (1) the translated value using the current exchange rate, and (2) the historical values (in the reporting currency) should be recognized as an adjustment to the cumulative translation adjustment account. By measuring nonmonetary items in this manner, the foreign operation is accounting for the items as if the new functional currency had always been its functional currency.

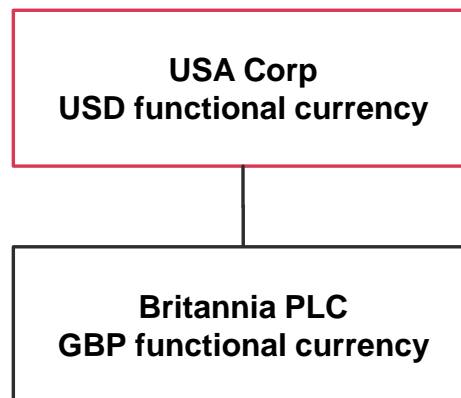
Monetary assets and liabilities should be translated at the current exchange rate at the date of the change.

Example FX 3-7 illustrates the accounting for a change in functional currency of a foreign entity from the currency of the reporting entity to a foreign currency.

EXAMPLE FX 3-7

Change in functional currency – currency of the reporting entity to a foreign currency

USA Corp has the following organizational structure.



USA Corp is a US registrant that uses the US dollar as its reporting currency.

Britannia PLC is a wholly-owned operating subsidiary of USA Corp located in the United Kingdom. The functional currency of Britannia PLC was initially determined to be the US dollar. Due to significant changes in facts and circumstances, in January 20X4, management determined that the functional currency of Britannia PLC should be changed to British pound sterling (GBP).

Consider these facts about a fixed asset purchase by Britannia PLC:

Fixed assets were purchased for GBP 500,000 on January 1, 20X1 when the exchange rate was GBP 1 = USD 1.3. The fixed assets were recorded in the US dollar financial statements of Britannia PLC at USD 650,000.

GBP purchase price	Exchange rate	USD balance
GBP 500,000	GBP 1 = USD 1.3	USD 650,000

The fixed assets had a useful life of five years. Annual depreciation is USD 130,000.

On December 31, 20X3, the functional currency net book value of the fixed assets was USD 260,000 (the fixed assets measured at the historical exchange rate less three years of depreciation expense [USD 650,000 – 3 x USD 130,000 = USD 260,000]).

The exchange rate on January 1, 20X4 is GBP 1 = USD 1.5.

How should Britannia PLC measure the carrying value of the fixed assets when it changes its functional currency from US dollars to British pound sterling?

Analysis

When the functional currency changes, Britannia PLC should measure the fixed assets using the historical exchange rate in effect at the date the fixed assets were purchased.

USD balance	Exchange rate	GBP balance
USD 260,000	GBP 1 = USD 1.3	GBP 200,000

In addition, the difference between the carrying value of the fixed assets calculated using the historical exchange rate, and the carrying value of the fixed assets calculated using the current exchange rate is recorded to the CTA account.

GBP balance	Exchange rate	USD balance
GBP 200,000	GBP 1 = USD 1.3	USD 260,000
GBP 200,000	GBP 1 = USD 1.5	USD 300,000

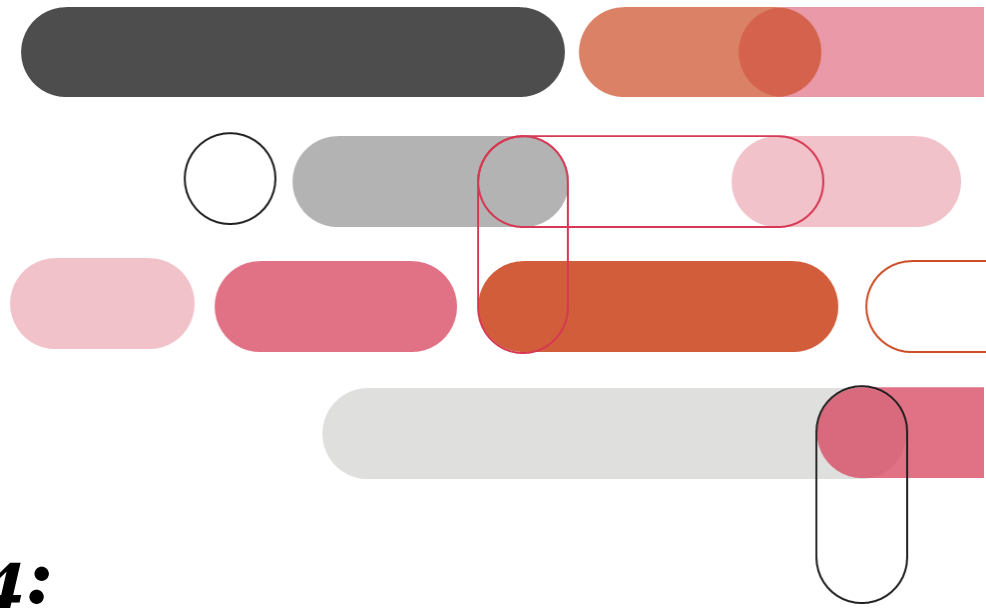
The adjustment recorded to the CTA account is a credit of USD 40,000 (USD 300,000 – USD 260,000).

3.3.2 Change in functional currency-other considerations

The SEC staff has stated in their *Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, dated March 31, 2001, that registrants with foreign operations in economies that have recently experienced economic turmoil should evaluate whether significant changes in economic facts and circumstances have occurred that warrant reconsideration of their functional currencies. Reconsideration of the functional currency is also required when the economy in which a foreign operation is located ceases to be highly inflationary.

The SEC staff would expect a registrant's analysis to focus on factors that affect the specific foreign operation's cash flows. For example, problems in an Asian economy could cause local currency cash flow sources to severely diminish (on an other than short-term basis) for a self-contained foreign operation and clearly indicate a different functional currency. Conversely, these problems generally would not indicate a change in functional currency for a foreign operation that is an integral component or extension of the parent company's operations. The SEC staff generally will be skeptical that currency exchange rate fluctuations alone would cause a self-contained foreign operation to become an extension of the parent company. Remeasurement of assets and results using the registrant's reporting currency in lieu of determining the functional currency is appropriate only when the foreign operations are in a highly inflationary economy as defined by [ASC 830-10-45-11](#).

The SEC staff has also indicated that [ASC 830](#) does not prescribe specific disclosures about a change in functional currency. However, the SEC staff believes that disclosures in the financial statements and MD&A may be necessary to permit an investor to understand the foreign operations and their impact on the registrant's results of operations, liquidity, and cash flows. Registrants should consider the need to disclose the nature and timing of the change, the actual and reasonably likely effects of the change, and the economic facts and circumstances that led management to conclude that the change was appropriate. The effects of those underlying economic facts and circumstances on the registrant's business should also be discussed in MD&A.



Chapter 4:
Foreign currency transactions

4.1 Foreign currency transactions overview

A foreign currency transaction is a transaction denominated in a currency other than an entity's functional currency. To include a foreign currency transaction in its financial statements, an entity must measure it in its functional currency.

Both a reporting entity and its distinct and separable operations may enter into foreign currency transactions. Foreign currency transactions of a distinct and separable operation should first be measured in its functional currency and then, if the operation is a foreign entity, translated into the reporting currency of its immediate parent. See [FX 5](#) for information on financial statement translation and remeasurement.

When there are foreign currency transactions between members of a consolidated group that result in intercompany balances that are not considered to be of a long-term investment nature, the resulting transaction gain or loss survives consolidation even though the balance sheet accounts eliminate in consolidation. See [FX 7](#) for information on intercompany foreign currency transactions.

This chapter discusses the initial and subsequent measurement of foreign currency transactions.

4.2 Foreign currency transactions

Foreign currency transactions can be entered into by a reporting entity or its distinct and separable operations. For example, a subsidiary of a reporting entity with a functional currency of the US dollar may purchase inventory at a price denominated in euros, or a foreign entity with a Mexican peso functional currency may sell products in US dollars; each of these is a foreign currency transaction.

Some commonly occurring foreign currency transactions include:

- Revenue and accounts receivable arising from export sales
- Expenses and accounts payable arising from the purchases of imported goods and the payment of wages in a foreign currency
- Intercompany transactions (see [FX 7](#) for information on intercompany foreign currency transactions)
- Investments in debt denominated in a foreign currency
- Foreign currency denominated loans from financial institutions
- Foreign bank accounts
- Taxes imposed by foreign tax jurisdictions

When identifying foreign currency transactions, only the functional currency of the party that entered into the transaction should be considered; the functional currencies of the counterparty to the transaction and the reporting entity are irrelevant.

4.3 Initial measurement of foreign currency transactions

All foreign currency transactions should be initially measured and recorded in an entity's functional currency using the exchange rate on the date of the transaction.

See [FX 4.4.1](#) for information on monetary and nonmonetary transactions, and see [FX 4.5](#) for information on exchange rates.

Example FX 4-1 illustrates the initial measurement of a foreign currency transaction.

EXAMPLE FX 4-1

Initial measurement of a foreign currency transaction

USA Corp is a US registrant with a US dollar (USD) functional currency.

On August 1, 20X1, USA Corp purchases office printers (capitalized assets) on account for 1,000 British pound sterling (GBP). The exchange rate on August 1, 20X1 is USD 1.5 = GBP 1.

How does USA Corp measure and record this foreign currency transaction?

Analysis

Because the transaction is denominated in a currency other than the USA Corp's functional currency, the purchase of the printers is considered a foreign currency transaction. Accordingly, USA Corp should measure and record the office printers and corresponding account payable in its functional currency, the US dollar, using the exchange rate on the purchase date.

$$\text{GBP } 1,000 \times (1.5 / 1) = \text{USD } 1,500$$

To record its purchase of office printers, USA Corp would record the following entry in US dollars:

Dr. Office printers	USD 1,500	
Cr. Accounts payable		USD 1,500

4.4 Subsequent measurement of foreign currency transactions

The accounting for a foreign currency transaction after initial recognition depends on whether the asset or liability created is considered monetary or nonmonetary.

4.4.1 Measurement of monetary and nonmonetary assets and liabilities

Determining whether an asset or liability is considered monetary or nonmonetary is the first step in applying the measurement provisions in [ASC 830](#).

The ASC Master Glossary defines foreign currency, monetary assets and liabilities, and nonmonetary assets and liabilities.

Definitions from ASC Master Glossary

Monetary Assets and Liabilities: Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short- or long-term accounts and notes receivable in

cash, and short- or long-term accounts and notes payable in cash.

Nonmonetary Assets and Liabilities: Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant, and equipment; and liabilities for rent collected in advance.

Foreign currency denominated monetary assets and liabilities are settled in the foreign currency at a future date. Settlement of foreign currency denominated monetary assets and liabilities has a direct impact on an entity's functional currency cash flows (i.e., the amount of cash, in terms of the entity's functional currency, received or paid at settlement will vary with foreign currency exchange rates). By their inherent nature, nonmonetary assets and liabilities do not result in future settlements in a foreign currency. For example, once purchased, a fixed asset will only be depreciated or impaired. If the fixed asset is later sold, the cash or accounts receivable received in exchange are considered monetary assets, but that designation does not change the fixed asset's nonmonetary nature.

When determining whether an asset or liability is monetary or nonmonetary, a reporting entity should consider the guidance in [ASC 830-10-45-18](#) and [ASC 255, Changing Prices](#). While [ASC 255](#) was not specifically created to be applied to foreign currency transactions, the information is helpful in distinguishing assets and liabilities as monetary or nonmonetary. [ASC 255-10-20](#) also provides definitions of monetary assets and liabilities while [ASC 255-10-50-51](#) and [50-52](#) provide examples.

Definition from [ASC 255-10-20](#)

Monetary Assets: Money or a claim to receive a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods or services.

Monetary Liability: An obligation to pay a sum of money the amount of which is fixed or determinable without reference to future prices of specific goods and services.

Excerpt from [ASC 255-10-50-51](#)

The economic significance of nonmonetary items depends heavily on the value of specific goods and services. Nonmonetary assets include all of the following:

- a. Goods held primarily for resale or assets held primarily for direct use in providing services for the business of the entity.
- b. Claims to cash in amounts dependent on future prices of specific goods or services.
- c. Residual rights such as goodwill or equity interests.

[ASC 255-10-50-52](#)

Nonmonetary liabilities include both of the following:

- a. Obligations to furnish goods or services in quantities that are fixed or

determinable without reference to changes in prices.

- b. Obligations to pay cash in amounts dependent on future prices of specific goods or services.

4.4.2 **Measurement of monetary assets and liabilities**

Foreign currency denominated monetary assets and liabilities should be measured at the end of each reporting period using the exchange rate at that date. The offsetting entry should generally be recorded in the income statement as a foreign currency transaction gain or loss as discussed in [ASC 830-20-35-1](#) and [ASC 830-20-35-2](#).

Example FX 4-2 illustrates the subsequent measurement of a monetary liability.

EXAMPLE FX 4-2

Measurement and settlement of a monetary liability

USA Corp is a US registrant with a US dollar (USD) functional currency.

On August 1, 20X1, USA Corp purchases office printers (capitalized assets) on account for 1,000 British pound sterling (GBP).

USA Corp issues quarterly financial statements on September 30, 20X1, and pays its GBP 1,000 account payable to the counterparty on October 15, 20X1. The exchange rates are shown in the following table.

Date	Exchange rate
August 1, 20X1	USD 1.5 = GBP 1
September 30, 20X1	USD 1.4 = GBP 1
October 15, 20X1	USD 1.3 = GBP 1

How should USA Corp measure and record this foreign currency transaction (a) in its quarterly financial statements for the quarter ended on September 30, 20X1, and (b) upon settlement of its account payable on October 15, 20X1?

Analysis

The GBP denominated account payable is a monetary liability. To prepare its September 30, 20X1 financial statements, USA Corp must first measure the foreign currency account payable using the exchange rate on that date.

$$\text{GBP } 1,000 \times (1.4 / 1) = \text{USD } 1,400$$

USA Corp would then record an entry to recognize the difference between the US dollar balance on September 30, 20X1, and the US dollar balance on August 1, 20X1 (USD 1,500), the date the initial account payable was recognized. The offsetting entry is recorded in the income statement as a foreign currency transaction gain.

Dr. Accounts payable	USD 100	
Cr. Foreign currency transaction gain		USD 100

To record the settlement of its account payable with UK PLC on October 15, 20X1, USA Corp would first measure its foreign currency account payable using the exchange rate on that date.

$$\text{GBP } 1,000 \times (1.3/ 1) = \text{USD } 1,300$$

USA Corp would then record an entry to recognize the difference between the US dollar balance on September 30, 20X1 (USD 1,400), the most recent reporting date, and the US dollar balance on October 15, 20X1. The offsetting entry is recorded in the income statement as a foreign currency transaction gain.

Dr. Accounts payable	USD 100	
Cr. Foreign currency transaction gain		USD 100

Finally, to record the payment of GBP 1,000 and relieve the account payable, USA Corp would record the following entry.

$$\text{GBP } 1,000 \times (1.3/ 1) = \text{USD } 1,300$$

Dr. Accounts payable	USD 1,300	
Cr. Cash		USD 1,300

No changes are recorded to USA Corp's nonmonetary office printer asset balance, which is initially measured and recorded in US dollars and is not adjusted for subsequent changes in foreign currency exchange rates.

[ASC 830-20-35-8](#) provides guidance regarding changes in exchange rates occurring after the end of the reporting period.

[ASC 830-20-35-8](#)

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

If there is a significant change in a foreign currency exchange rate, and the affected foreign currency transactions are material to the reporting entity, disclosure as a nonrecorded subsequent event should be considered. See [FSP 28](#) for further information on financial statement disclosures related to subsequent events.

4.4.3 Foreign currency gain and loss recognition exceptions

[ASC 830-20-35-3](#), [ASC 830-20-35-4](#), and [ASC 830-20-35-5](#) list transactions for which foreign currency transaction gains and losses are not required to be recognized in the income statement. Figure FX 4-1 summarizes these exceptions.

FIGURE FX 4-1

Foreign currency transaction gains and losses not recognized in the income statement

Exception	Treatment	Additional guidance
Net investment hedges	As discussed in ASC 815-35-35-1 , the gain or loss on an instrument that is designated and effective as a hedge of a net investment in a foreign entity is recorded in the cumulative translation adjustment account.	See DH 8.6 for further information on net investment hedging.
Long-term intercompany transactions that are not expected to be settled in the foreseeable future (i.e., are of a long-term- investment nature)	As discussed in ASC 830-20-35-3b , any foreign currency transaction gain or loss related to intercompany balances for which settlement is not planned or anticipated in the foreseeable future is eliminated from earnings in translation of the financial statements and is recorded as CTA in a set of consolidated financial statements. However, this transaction gain or loss is recognized as a foreign currency transaction gain or loss in the income statement of the standalone financial statements of the foreign entity.	See FX 7 for further information on intercompany foreign currency transactions.

4.4.4 **Nonmonetary assets and liabilities**

Nonmonetary assets and liabilities are not subsequently remeasured. Once purchased or incurred, nonmonetary assets and liabilities are accounted for in the functional currency of the purchaser. Similarly, amounts recognized in the income statement related to nonmonetary assets and liabilities, such as cost of goods sold and depreciation, are recorded in the functional currency of the purchaser. See Example FX 4-3 for an illustration of the accounting for fixed asset depreciation where the fixed asset was originally purchased in a foreign currency.

4.5 **Exchange rates**

[ASC 830-20-20](#) provides a definition of an exchange rate.

Definition from [ASC 830-10-20](#)

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

Generally, foreign currency transactions are measured using the exchange rate on the measurement date, which is the date a transaction occurs or, in the case of monetary items, are remeasured at the end of a reporting period.

An average exchange rate may be used to recognize income and expense items earned or incurred evenly over a period. For example, interest expense payable on foreign currency debt may be recognized using an average exchange rate for the period. In some cases, average exchange rates may also be used as a practical expedient in place of measuring similar transactions at the exchange rate on the date each transaction occurred. See [FX 5.5](#) for further information on exchange rates.

4.6 *Property, plant and equipment*

Property, plant and equipment are nonmonetary assets. Property, plant and equipment purchased in a foreign currency should be initially measured and recorded in an entity's functional currency using the exchange rate on the date it is acquired. It should not be subsequently remeasured for changes in exchange rates during the period it is held.

Example FX 4-3 illustrates the depreciation of equipment purchased in a foreign currency.

EXAMPLE FX 4-3

Depreciation of fixed assets purchased in a foreign currency

USA Corp is a US registrant with a US dollar (USD) functional currency.

Britannia PLC is a foreign entity of USA Corp located in the United Kingdom. Britannia PLC maintains its books and records in the local currency, British pound sterling (GBP), but management has determined its functional currency is the euro (EUR).

Britannia PLC purchased fixed assets for GBP 500,000 on January 1, 20X1 when the exchange rate was EUR 1.3 = GBP 1.

The fixed assets have a useful life of five years.

How should Britannia PLC compute annual depreciation expense in the currency of its books and records, British pound sterling, and its functional currency, the euro?

Analysis

Britannia PLC would first measure and record the fixed assets using the exchange rate in effect at the date of purchase.

$$\text{GBP } 500,000 \times [1.3 \text{ EUR} / 1 \text{ GBP}] = \text{EUR } 650,000.$$

Britannia PLC would then calculate annual depreciation using the exchange rate in effect on the date of purchase. The following table shows the calculation of annual depreciation expense.

	GBP	EUR
Purchase price	GBP 500,000	EUR 650,000
Useful life	5 years	5 years
Annual depreciation	GBP 100,000	EUR 130,000

Changes in exchange rates subsequent to the acquisition of the fixed assets do not impact depreciation or the carrying amount of the fixed assets in the functional currency financial statements. For more information on remeasurement of local currency financial statements into a reporting entity's functional currency, refer to [FX 5.4](#).

4.6.1 Impairment of property, plant, and equipment

Property, plant and equipment impairment assessments should be performed in an entity's functional currency.

When an entity maintains its books and records in a currency other than its functional currency (e.g., the currency of the local economy), it is possible to conclude that an item is not impaired for its local currency books and records, but is impaired for its functional currency financial statements (or vice versa). Such differences require an entity to either record or reverse impairment charges to produce its functional currency financial statements.

QUESTION FX 4-1

Will an impairment charge result when a local currency (in which an entity maintains its books and records) declines relative to an entity's functional currency?

PwC response

It depends. When the local currency declines relative to an entity's functional currency, there is a higher likelihood that the impairment assessment (performed in the functional currency) will indicate that an impairment charge should be recorded. However, a decline in the local currency alone does not indicate that an asset is impaired; an undiscounted cash flow analysis should be performed in the functional currency to determine whether an impairment charge should be recorded. For more information on impairment of property, plant, and equipment, please see [Chapter 5](#) of PwC's guide to *Property, plant, equipment, and other assets*.

4.7 Foreign currency denominated leases

The guidance in [ASC 842, Leases](#), was applicable for most public business entities starting in 2019. Private calendar year-end companies have until the beginning of 2022 to adopt the standard. Early adoption is permitted for both public and nonpublic entities. See [LG 9.2](#) for information on the effective date of [ASC 842](#).

4.7.1 Lessee accounting for foreign currency leases - after ASC 842

A lessee classifies a lease as either a finance or operating lease based on the criteria prescribed in [ASC 842, Leases](#). One of those criteria requires reporting entities to determine the present value of the lease payments. When calculating the present value, a lessee should discount the foreign currency lease payments to present value and then remeasure that present value into the functional currency using the exchange rate at lease commencement. The discount rate should be the rate implicit in a lease. If that information is not readily available, a lessee should use an incremental borrowing rate for an assumed borrowing in the foreign currency. See [LG 3](#) for information on lease classification.

A lessee is required to record a right-of-use asset and lease liability for all leases (other than, if elected, those that, at lease commencement, have a lease term of 12 months or less). When calculating the right-of-use asset and lease liability for a foreign currency denominated lease, the present value of future lease payments,

payments made to the lessor at or before the commencement date, lease incentives, and initial direct costs should be measured in the functional currency using the exchange rate at the lease commencement date (or the date the cash flow is paid or received, if before lease commencement). See [LG 4.2](#) for information on initial recognition and measurement of leases by a lessee.

The right-of-use asset is a nonmonetary asset and lease liability is a monetary liability. Over the lease term, a lessee must amortize the right-of-use asset and lease liability. For both operating and finance leases, the right-of-use asset should be remeasured into the functional currency using the exchange rate on the lease commencement date, while the lease liability should be remeasured based on the period end exchange rate. Although [ASC 842](#) describes operating lease expense as a single cost, it is actually comprised of two elements: amortization of the right-of-use asset and the expense associated with the accretion of interest on the lease liability. The expense associated with the amortization of the right-of-use asset should be remeasured using the exchange rate on the lease commencement date while the accretion of interest on the lease liability should be remeasured using the average exchange rate during the period in which it is incurred. See [FX 4.4.2](#) for information on measurement of monetary assets and liabilities and [FX 4.10](#) for information on how to account for the remeasurement of the interest expense and amortization of the lease liability for a finance lease.

4.7.1A Lessee accounting for foreign currency leases - before ASC 842

The accounting treatment of a foreign currency denominated lease depends on whether the lease is a capital lease or an operating lease. [ASC 840, Leases](#), prescribes criteria to be considered to make that determination. Lease classification is based on amounts determined using the functional currency of the reporting entity, not the currency the lease is denominated in. There are alternative methods of determining the present value of the minimum lease payments in accordance with [ASC 840-10-25-1\(d\)](#). One common approach is to discount the foreign currency minimum lease payments using an incremental borrowing rate for an assumed borrowing in the foreign currency. The resulting present value would be remeasured into the functional currency using the exchange rate at the lease inception date.

Capital lease assets and obligations are initially measured and recorded in an entity's functional currency using the exchange rate on the lease inception date. The capital lease asset (owned property) is a nonmonetary asset; the capital lease obligation (debt) is a monetary liability. See [FX 4.6](#) for information on the accounting for property, plant, and equipment purchased in a foreign currency, and [FX 4.10](#) for information on the accounting for foreign currency denominated debt.

An operating lease does not result in an asset or liability being recorded on the balance sheet. Instead, operating lease expense is recognized as it is incurred using the average exchange rate during the period in which it is incurred (e.g., monthly lease expense should be recognized using the average monthly exchange rate).

4.7.2 Lessor accounting for foreign currency leases

There are three types of leases for lessors, sales-type, direct financing, and operating leases. The terms of the lease arrangement will determine how each lease should be classified. See [LG 3](#) for information on lease classification.

Sales-type lease

In a sales-type lease, a lessor derecognizes the leased asset and records its net investment in the lease at lease commencement. When calculating the net investment in a foreign currency denominated lease, the lease payments and the

unguaranteed residual asset should be measured in the functional currency using the exchange rate at the lease commencement date. See [LG 4.3.1](#) for information on initial recognition and measurement of a sales-type lease by a lessor.

For sales-type leases, any selling profit or loss is recognized at the commencement date; interest income is recognized on the lease receivable and the unguaranteed residual asset is accreted over the lease term. These amounts should be measured in the functional currency using the average exchange rate during the period in which it is recognized (e.g., monthly lease expense should be recognized using the average monthly exchange rate). In addition, the net investment in a lease is a monetary asset that should be remeasured at the end of each reporting period using the exchange rate at that date. See [FX 4.4.2](#) for information on the measurement of monetary assets and liabilities. See [LG 4.5.1](#) for information on subsequent recognition of a sales-type lease.

Direct financing lease

In a direct financing lease, a lessor should derecognize the leased asset underlying the lease and record a net investment in the lease at lease commencement. The net investment in the lease should be measured in the same manner as a sales-type lease adjusted for selling profit and initial direct costs. When calculating the net investment in a foreign currency denominated lease, amounts should be measured in the functional currency using the exchange rate at the lease commencement date. See [LG 4.3.1](#) for information on measuring the net investment in a sales-type lease.

For direct financing leases under [ASC 842](#), any selling profit and initial direct costs should be deferred and included in the net investment in the lease. (Note that the definition of a direct finance lease under [ASC 842](#) is different than what it was under [ASC 840](#); a lease that resulted in a selling profit or loss did not meet the definition of a direct financing lease under [ASC 840](#). Rather, a lease that otherwise met the definition of a direct financing lease would have been classified as either a sales-type lease or as an operating lease, in accordance with the lease classification guidance in [ASC 840](#).) These amounts should be recognized over the lease term in a manner that will produce a constant periodic rate of return on the lease when combined with the interest income on the lease receivable and the residual asset. Amounts recorded in the income statement should be measured in the functional currency using the average exchange rate during the period in which it is recognized. Losses on sale should not be deferred; they should be recognized using the impairment guidance for inventory or property, plant, and equipment, as applicable. See [LG 4.5.1](#) for information on subsequent recognition of a direct financing lease. See [FX 4.6.1](#) for information on the impairment of property, plant, and equipment.

The net investment in a lease is a monetary asset that should be remeasured at the end of each reporting period using the exchange rate at that date.

Operating lease

A lessor should recognize rental revenue on a straight-line basis (or another systematic basis) using the average exchange rate during the period in which it is recognized. The lessor would record an unbilled rent receivable when the amount of rental revenue recognized on a straight-line basis exceeds rents currently billed in accordance with the lease. The unbilled rent receivable is a monetary asset that should be measured at the end of each reporting period using the exchange rate at that date. See [FX 4.4.2](#) for information on the measurement of monetary assets. See [LG 4.3.3](#) for information on a lessor's accounting for an operating lease.

4.8 Investments in debt and equity securities denominated in a foreign currency

The accounting for a foreign currency denominated investment security will depend on its classification under [ASC 320](#), *Investments – Debt Securities* or [ASC 321](#), *Investments – Equity Securities*, and whether it is determined to be a monetary or nonmonetary asset. Debt securities classified as held to maturity are considered monetary assets; the amount to be received at maturity is fixed and does not depend on future prices. Debt securities classified as available for sale or trading are considered nonmonetary assets; the amount to be received depends on future prices. Similarly, an equity security investment within the scope of [ASC 321](#) is considered a nonmonetary asset. See Figure FX 4-2 for a summary of which investment securities are considered monetary and which investment securities are considered nonmonetary.

Despite the fact that certain foreign currency denominated debt and equity securities are considered nonmonetary assets, [ASC 320](#) and [ASC 321](#) require that they be measured at fair value each reporting period. Changes in the fair value of foreign currency denominated investments classified as available for sale due to changes in foreign currency exchange rates should be included in other comprehensive income. Changes in the fair value of debt securities classified as trading and equity securities (which includes changes due to changes in foreign currency exchange rates) should be recognized in the income statement.

Figure FX 4-2 summarizes the subsequent measurement of certain foreign currency denominated investment securities.

FIGURE FX 4-2
Measurement of foreign currency denominated investment securities

Classification	Monetary / nonmonetary	Accounting treatment	Treatment of changes in foreign currency exchange rates
Held to maturity (debt securities)	Monetary	Measured at amortized cost	Foreign currency transaction gain or loss is recognized in the income statement
Available for sale (debt securities)	Nonmonetary	Measured at fair value with changes in fair value, excluding the amount recorded in the allowance for credit losses, recorded in other comprehensive income. Amounts related to credit losses are recorded as credit loss expense.	Changes in fair value attributable to changes in the exchange rate between the foreign currency and the functional currency are recognized with other changes in fair value in other comprehensive income

Classification	Monetary / nonmonetary	Accounting treatment	Treatment of changes in foreign currency exchange rates
Trading (debt securities)	Nonmonetary	Measured at fair value with changes in value recorded in the income statement	Changes in fair value attributable to changes in the exchange rate between the foreign currency and the functional currency are recognized in the income statement with other changes in fair value
Equity securities*	Nonmonetary	Measured at fair value with changes in value recorded in the income statement	Changes in fair value attributable to changes in the exchange rate between the foreign currency and the functional currency are recognized with other changes in fair value in the income statement

* Equity securities without a readily determinable fair value may be presented at cost, less impairment, if the measurement alternative is applied. Under that guidance, the historical rate at acquisition should be utilized until a remeasurement event occurs. If the carrying value is adjusted because of either an impairment or an observable price change, the fair value of the instrument should be reflected in the reporting entity's functional currency based upon the spot rates in effect at the time of the remeasurement event. See [LI 2.3.2.4](#) for more information.

Example FX 4-4 illustrates the accounting for a foreign currency denominated investment security classified as held to maturity. Example FX 4-5 illustrates the accounting for a foreign currency denominated investment security classified as available for sale.

EXAMPLE FX 4-4

Accounting for a foreign currency denominated investment security classified as held to maturity

USA Corp is a US registrant with a US dollar (USD) functional currency.

On October 1, 20X1, USA Corp pays 95,000 euros for a 10-year bond issued by Deutsche AG with a par value of 100,000 euros. The bond pays a coupon of 7.00% semi-annually. Because USA Corp bought the bond at a discount, its effective interest rate is 7.736%. USA Corp designates its Deutsche AG bond as held to maturity.

The following table summarizes the exchange rate on the date USA Corp purchased the Deutsch AG bond and on the date of its financial statements, and the average exchange rate for the reporting period.

Date	Exchange rate
October 1, 20X1	EUR 1 = USD 1.499252
December 31, 20X1	EUR 1 = USD 1.401
Average exchange rate for Q4 20X1	EUR 1 = USD 1.449

How should USA Corp measure and record this foreign currency transaction?

Analysis

USA Corp would record the purchase of the Deutsche AG bond in its functional currency using the exchange rate on the purchase date.

$$\text{EUR } 95,000 \times (\text{EUR } 1 / \text{USD } 1.499252) = \text{USD } 142,429$$

Dr. Investment in held-to-maturity security	USD 142,429	
Cr. Cash		USD 142,429

To record Deutsche AG bond in USD using the exchange rate on the date purchased

The following is a simplified bond amortization table in EUR showing the initial purchase on October 1, 20X1 and the interest accrual and discount amortization for the period ending December 31, 20X1. For simplicity, it is assumed that there were no principal and interest payments during the period.

	Balance as of 10/1/20X1	Quarterly entries	Balance as of 12/31/20X1
Bond principal amount	EUR 100,000		EUR 100,000
Discount	EUR 5,000		EUR 4,913
Discount amortization		EUR 87	
Interest accrual		EUR 1,750	
Carrying amount	EUR 95,000		EUR 95,087

To prepare its December 31, 20X1 financial statements, USA Corp would first record the interest accrual and amortization of the discount on its Deutsche AG bond using the average exchange rate for Q4 20X1.

Dr. Accrued interest receivable	USD 2,536
Dr. Investment in held-to-maturity security	USD 127

Cr. Interest income	USD 2,536
Cr. Interest income (discount amortization)	USD 127

To record quarterly accrued interest of EUR 1,750 and amortization of the bond discount of EUR 87 using the average exchange rate during the quarter (EUR 1 = USD 1.449)

Since the interest accrual and held-to-maturity security are monetary assets, they should be measured using the rate on December 31, 20X1. The difference between the accrued interest recorded using the average exchange rate and the accrued interest balance using the exchange rate on December 31, 20X1 is recorded in the income statement as a foreign currency transaction gain or loss.

Accrued interest on 12/31/X1 (EUR)	Exchange rate	Accrued interest on 12/31/X1 (USD)	Recorded accrued interest balance (USD)	FX transaction gain/(loss)
EUR 1,750	EUR 1 = USD 1.401	USD 2,452	USD 2,536	(USD 84)

As a result of measuring the interest accrual using the December 31, 20X1 exchange rate, the following adjustment would be recorded.

Dr. Foreign currency transaction loss	USD 84
Cr. Accrued interest receivable	USD 84

To record the difference between measuring the quarterly interest accrual of EUR 1,750 at the average exchange rate during the quarter (EUR 1 = USD 1.449) and the period end exchange rate (EUR 1 = USD 1.401)

The bond has been classified as a held-to-maturity security, which is a monetary asset and is required to be measured at the December 31, 20X1 spot rate. The offsetting entry is recorded in the income statement as a foreign currency transaction gain or loss.

Bond carrying amount on 12/31/X1 (EUR)	Exchange rate	Bond carrying amount on 12/31/X1 (USD)	Recorded bond carrying amount (USD)	FX transaction gain/(loss)
EUR 95,087	EUR 1 = USD 1.401	USD 133,217	USD 142,556	(USD 9,338)

As a result of measuring the carrying amount of the bond using the December 31, 20X1 exchange rate, the following adjustment would be recorded.

Dr. Foreign currency transaction loss	USD 9,338
Cr. Investment in held-to-maturity security	USD 9,338

To record the foreign currency transaction loss resulting from measuring the bond at the exchange rate at the end of the period

EXAMPLE FX 4-5

Accounting for a foreign currency denominated investment security classified as available for sale

USA Corp is a US registrant with a US dollar (USD) functional currency.

On October 1, 20X1, USA Corp pays 1,400,000 Japanese yen (JPY) for a 10-year bond issued by Nikkei Corp with a par value of JPY 1,400,000. The bond pays a coupon of 5.00% semi-annually on March 30 and September 30. USA Corp designates its Nikkei Corp bond as available for sale.

USA Corp issues annual financial statements as of December 31, 20X1. USA Corp sells its Nikkei Corp bond on January 31, 20X2 for JPY 1,225,000 plus JPY 23,333 in accrued interest due.

The following table summarizes the clean fair value (i.e., excluding the accrued interest) of the Nikkei Corp bond in Japanese yen and US dollars, based on the exchange rate in effect on the date USA Corp purchased the bond, the date of its annual financial statements, and the date it sold the bond. There are no credit related issues with Nikkei Corp. The average exchange rate during Q4 20X1 is JPY 1 = USD 0.014, and for the month of January 20X2, the average rate is JPY 1 = USD 0.012.

Date	Fair value Nikkei Corp bond (JPY)	Exchange rate	Fair value Nikkei Corp bond (USD)
October 1, 20X1	JPY 1,400,000	JPY 1 = USD 0.010	USD 14,000
December 31, 20X1	JPY 1,350,000	JPY 1 = USD 0.017	USD 22,950
January 31, 20X2	JPY 1,225,000	JPY 1 = USD 0.011	USD 13,475

How should USA Corp measure and record these foreign currency transactions?

Analysis

USA Corp would record the purchase of the Nikkei Corp bond in its functional currency using the exchange rate on the date purchased.

Dr. Investment in available-for-sale security	USD 14,000	
Cr. Cash		USD 14,000

To record Nikkei Corp bond in USD using exchange rate on the date purchased (JPY 1 = USD 0.010)

To prepare its December 31, 20X1 financial statements, USA Corp would first record the interest accrual and recognize interest income on its Nikkei Corp bond using the average exchange rate for Q4 20X1.

Dr. Accrued interest receivable	USD 245	
Cr. Interest income		USD 245

To record quarterly accrued interest of JPY 17,500 using the average exchange rate during the quarter (JPY 1 = USD 0.014). Bond coupon payments are semi-annual ((JPY 1,400,000 × 0.05) /4) = JPY 17,500 for one quarter

Since the interest accruals on available-for-sale securities are monetary assets, they should be measured using the rate on December 31, 20X1. The difference between the accrued interest recorded using the average exchange rate for recognizing interest income and the accrued interest balance using the exchange rate on December 31, 20X1 is recorded in the income statement as a foreign currency transaction gain or loss.

As a result of measuring the interest accrual using the December 31, 20X1 exchange rate, the following adjustment would be recorded.

Dr. Accrued interest receivable	USD 53	
Cr. Foreign currency transaction gains and losses		USD 53

To record the difference between measuring the quarterly interest accrual of JPY 17,500 at the average exchange rate during the quarter (JPY 1 = USD 0.014) and the period end exchange rate (JPY 1 = USD 0.017)

USA Corp would then record an entry to recognize the difference between the US dollar balance on December 31, 20X1 and the US dollar balance on October 1, 20X1, the date of acquisition. The offsetting entry would be recorded in other comprehensive income as an unrealized gain on investment securities.

Date	Fair value (JPY)	Exchange rate	Carrying amount (USD)	Accumulated OCI balance (USD)
10/1/X1	JPY1,400,000	JPY 1 = USD 0.010	USD 14,000	USD 0
12/31/X1	JPY1,350,000	JPY 1 = USD 0.017	USD 22,950	USD 8,950

To record the sale of the Nikkei Corp bond on January 31, 20X2, USA Corp should first recognize interest income of JPY 5,833 for the month January 20X2 using the average exchange rate for the month. It should then adjust the full accrued interest receivable amount of JPY 23,333 (JPY 17,500 (USD 298) plus JPY 5,833 (USD 70)) to the USD exchange rate at the date of sale. Then, Nikkei Corp should record an entry to recognize the difference between the sales price of the bond on January 31, 20X2 and the carrying value on December 31, 20X1.

Dr. Accrued interest receivable	USD 70	
Cr. Interest income		USD 70

To record one month accrued interest of JPY 5,833 using the average exchange rate for January 20x2 (JPY 1 = USD 0.012). Bond payments are semi-annual JPY 35,000 /6 = JPY 5,833.

Dr. Foreign currency transaction loss	USD 111	
Cr. Accrued interest receivable		USD 111

To record the difference between measuring the January 31, 20x2 interest accrual of JPY 23,333 at the January 31, 20x2 exchange rate (JPY 1 = USD 0.011) of USD 257 and it's carrying value of USD 368 (USD 245+ USD 53+ USD 70)

Date	Fair value (JPY)	Exchange rate	Carrying amount (USD)	Accumulated OCI balance (USD)
12/31/X1	JPY1,350,000	JPY 1 = USD 0.017	USD 22,950	USD 8,950
1/31/X2	JPY1,225,000	JPY 1 = USD 0.011	USD 13,475	(USD 525)

To record the sale of the Nikkei Corp bond, USA Corp would record the cash receipt of JPY 1,225,000 and accrued interest sold of JPY 23,333 and recognize the previously unrealized loss from OCI in earnings.

Dr. Cash	USD 13,732	
Dr. Realized loss on investment	USD 525	
Cr. Investment in available-for-sale security		USD 13,475
Cr. Other comprehensive income		USD 525
Cr. Accrued interest receivable		USD 257

To record the sale of the Nikkei Corp bond

Cash (JPY 1,225,000 + JPY 23,333)× (USD 0.011/JPY 1) = USD 13,732

Accrued interest (USD 245 + USD 53 + USD 70 - USD 111) = USD 257

4.8.1 **Available-for-sale debt security impairment—after adoption of ASU 2016-13**

An investor in a foreign currency denominated available-for-sale debt security is exposed to the risk that its cost basis in the security will not be recovered because of changes in foreign exchange rates. That is, because the security's cash flows are received in a foreign currency, but are measured into the investor's functional currency, the investor may incur a loss due to changes in foreign exchange rates even when all contractual cash flows are received. However, the change in fair value of a foreign currency denominated available-for-sale debt security that is not credit related (e.g., changes in foreign currency exchange rates) are recorded in other comprehensive income. The change in fair value that is related to the allowance for credit losses is recognized in earnings. Unrealized losses related to changes in foreign exchange rates from an investment in a foreign currency denominated available-for-sale debt security that have been reported in other comprehensive income are recognized in earnings only (1) at the maturity of the security, (2) upon the sale of the security, (3) when a reporting entity intends to sell the security, or (4) when a reporting entity is more likely than not required to sell the security before

recovery of its amortized cost basis. See [LI 8.2.4](#), [LI 8.2.6](#) and [LI 8.2.6.1](#) for additional information.

4.8.1A *Available-for-sale debt security impairment-before adoption of ASU 2016-13*

An investor in a foreign currency denominated available-for-sale debt security is exposed to the risk that its cost basis in the security will not be recovered because of changes in foreign exchange rates. That is, because the security's cash flows are received in a foreign currency, but are measured into the investor's functional currency, the investor may incur a loss due to changes in foreign exchange rates even when all contractual cash flows are received. As a result, an investor in a foreign currency denominated debt security should analyze whether declines in fair value attributable to changes in foreign currency exchange rates are other than temporary.

To determine whether an available-for-sale debt security denominated in a foreign currency is impaired (i.e., has a fair value below its amortized cost), an investor should compare the security's fair value and amortized cost amounts as reported in its functional currency. [ASC 320-10-35-36](#) states that the entire change in the fair value of foreign currency denominated available-for-sale debt security should be presented in other comprehensive income. Mechanically, this is accomplished by measuring the security's fair value in the investor's functional currency using the current exchange rate, while measuring the security's amortized cost using the historical exchange rate. Because fair value for financial reporting purposes is measured in the investor's functional currency, the determination of whether a security is impaired should also be performed using fair value and amortized cost balances in the investor's functional currency.

When an investor recognizes an other-than-temporary impairment of a foreign currency denominated debt security due to changes in foreign exchange rates that it does not expect to recover, the loss recognized should include the entire difference between the functional currency amortized cost of the investment and its functional currency fair value. This is the accounting treatment because the fair value decline related to changes in foreign exchange rates and is not related to contractual cash flows.

4.9 *Deferred revenue*

Obligations to furnish goods or services are typically nonmonetary transactions because they will not be settled in a foreign currency on a future date. Advances from customers that are equivalent to deposits or loans are generally considered monetary transactions because the settlement fluctuates with foreign currency exchange rates.

4.10 Debt

When a reporting entity issues debt denominated in a currency other than its functional currency, it should initially be measured using the exchange rate in effect at the issuance date. Since it is a monetary liability, the debt balance should be measured in the reporting entity's functional currency each reporting date using the exchange rate in effect at the reporting date. Debt premium, discount, and debt issuance costs are considered part of the carrying amount of the debt and should be included in the balance measured in the reporting entity's functional currency. Measuring the premium, discount, and issuance costs at current exchange rates ensures that a level effective yield in the foreign currency is maintained. The effects of the foreign exchange rate movements are reported currently, which also ensures that the foreign exchange movements do not affect the gain or loss amount upon maturity, or in the event the debt is extinguished early.

The application of this guidance may not be intuitive relative to debt issuance costs, which are considered monetary even though they will not be settled in a foreign currency on a future date. This is because debt issuance costs are considered part of the carrying amount of the debt. Debt issuance costs incurred in a currency other than the currency of the debt should be measured in the currency of the debt using the exchange rate at the date the debt is issued.

While [ASC 830](#) does not specifically address the rates at which amortization of the discounts or premiums should be reported in the income statement, we believe that, as the amortization is occurring throughout the period, it is acceptable to record amortization for a period using the average spot rate for that period.

4.10.1 Debt modification

As described in [FG 3.4](#), if a debt instrument is modified, changes that result in more than a 10% change in cash flows are treated as an extinguishment and issuance of new debt. If a debt instrument is modified such that the currency in which the debt is denominated changes, the change in currency should be included in the cash flows as part of the 10% test. To convert the cash flows on the new debt into the currency of the original debt, we believe there are two acceptable methods: (1) use the spot rate in effect at the debt modification date, or (2) use the forward rates corresponding to the payment date of each cash flow (i.e., interest payment and principal). Use of the modification date spot rate captures the impact of changing to a currency that is substantially different from the original currency; use of forward rates neutralizes those differences.

When a foreign currency denominated line of credit or revolving debt arrangement is modified, the exchange rate on the date the arrangement is modified should be used to compare the borrowing capacities to determine whether the transaction should be accounted for as a modification or extinguishment. See [FG 3.5](#) for further information on a modification of lines of credit and revolving debt arrangements.

4.11 Asset retirement obligations

There is no specific guidance regarding whether an asset retirement obligation (ARO) is a monetary or nonmonetary liability. We believe an ARO meets the definition of a nonmonetary liability when an entity must consider future service prices to determine the settlement amount, which is often the case.

4.12 Equity transactions

The issuance of an equity classified instrument (e.g., common shares) is a nonmonetary transaction. When an equity classified instrument is issued in a foreign

currency, it should be initially measured and recorded in the entity's functional currency using the exchange rate on the issuance date. It should not be subsequently remeasured for changes in exchange rates during the period it is outstanding.

Some preferred equity shares are classified as mezzanine (temporary) equity or as a liability. This classification may impact the determination of whether it is a nonmonetary item.

4.12.1 Preferred shares

As discussed in [ASC 480](#), *Distinguishing Liabilities from Equity*, preferred shares can be classified as permanent equity, mezzanine (temporary) equity, or a liability. Figure FX 4-3 summarizes the treatment of foreign currency transaction gains or losses for foreign denominated preferred shares.

FIGURE FX 4-3

Foreign currency transaction gains and losses on preferred shares

Preferred share classification	Example	Treatment of foreign currency transaction gain or loss
Liability	Nonconvertible, mandatorily redeemable preferred share	This is a monetary instrument. It should be initially measured and recorded in the functional currency of the issuer using the exchange rate on the date it is issued and subsequently measured using the exchange rate at each balance sheet date during the period it is outstanding, with an offsetting entry to the income statement as a foreign currency transaction gain or loss.
Temporary (mezzanine) equity	Preferred shares redeemable at the investor's option	We believe a preferred share classified as mezzanine equity (pursuant to ASC 480-10-S99) should be initially measured and recorded in the functional currency of the issuer using the exchange rate on the date it is issued and should be subsequently measured using the exchange rate at each balance sheet date. The offsetting entry should be recognized in stockholder's equity, consistent with the requirements of ASC 480-10-S99 to record these securities at their redemption value. If a preferred stock instrument classified in mezzanine equity is not being accreted to redemption value, because it is not probable that the security will become redeemable, then we believe that that security should not be adjusted until it is probable the security will become redeemable. Any increases or decreases in carrying value of preferred stock classified as mezzanine equity due to currency exchange rate fluctuations should be treated as decreases or increases to income available to common shareholders for purposes of EPS,

Preferred share classification	Example	Treatment of foreign currency transaction gain or loss
		consistent with the treatment of accretions to redemption value.
Permanent equity	Perpetual preferred shares	This is a nonmonetary instrument. It should be initially measured and recorded in the functional currency using the exchange rate at issuance and is not subsequently adjusted for changes in exchange rates during the period it is outstanding.

See [FG 7](#) for information on the accounting for preferred shares.

4.12.2 **Dividends**

Normally, dividends are declared and paid in a foreign entity's functional currency. However, in certain cases, such as when an economy is highly inflationary, or when the functional currency is other than the currency of the economy in which the operation is domiciled, dividends may be declared and paid in other than the functional currency.

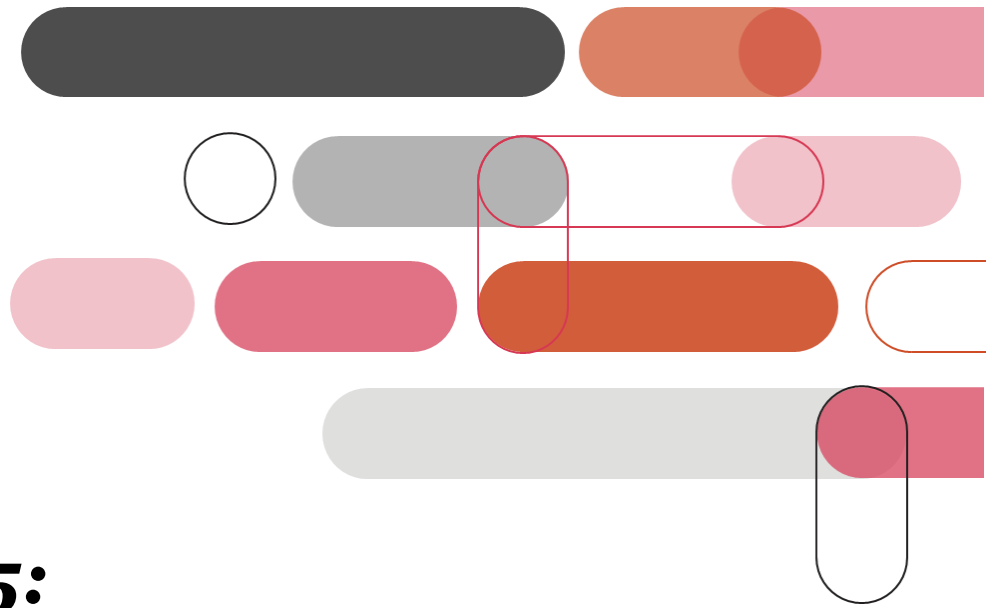
Foreign currency dividends are measured and recorded in the issuer's functional currency using the exchange rate on the declaration date. When dividends are not paid on the declaration date, a dividend payable is recorded that is considered a monetary liability. Accordingly, the dividends payable account should be measured using the exchange rate in effect at the end of each reporting period it is outstanding with an offsetting entry to the income statement.

See [FX 7](#) for information on dividends payable from a foreign entity to its parent.

4.13 **Share-based payments**

The accounting treatment of foreign currency denominated share-based payments depends on the terms of the payments, as well as the entity's specific facts and circumstances. Foreign currency denominated share-based payments are generally accounted for as liabilities unless they meet the requirements in [ASC 718-10-25-14](#), which allow equity awards granted to employees to be classified as equity provided the exercise price is denominated in either (1) the functional currency of the foreign operation, (2) the currency in which the employee is paid, or (3) the currency of a market in which a substantial portion of the entity's equity securities trades.

See [SC 3.3.8](#) for further information on share-based payments with an exercise price denominated in a foreign currency.



***Chapter 5:
Translating the financial
statements of a foreign entity***

5.1 *Translating the financial statements of a foreign entity overview*

In order to consolidate or combine financial statements prepared in different currencies, a reporting entity must have financial statements of its foreign entities in its reporting currency to produce single currency, consolidated financial statements. This process is referred to as translation and is different than remeasuring foreign entity financial statements. A foreign entity remeasures its financial statements into its functional currency when its books and records are maintained in a currency other than its functional currency.

This chapter discusses the steps necessary to remeasure foreign entity financial statements into its functional currency, if necessary, and then how to translate those statements into the reporting currency. This chapter also discusses considerations for determining the appropriate exchange rate at which to translate and remeasure a foreign entity's financial statements.

See [TX 13](#) for information on the effect of changes in foreign currency exchange rates on the accounting for income taxes.

5.2 *Translation procedures*

A reporting entity must translate the functional currency financial statements of any foreign entity, whether consolidated or accounted for using the equity method of accounting, to include them in its consolidated financial statements. This is true whether the reporting entity is a parent company or a subsidiary. For example, in a multi-leveled organization with a parent holding company and first- and second-tier subsidiaries, the financial statements of the second-tier subsidiary are first translated for inclusion in the first-tier subsidiary's financial statements and then those financial statements are translated for inclusion in the parent's consolidated financial statements.

The steps needed to translate a foreign entity's financial statements depend on whether the foreign entity's books and records are maintained in the foreign entity's functional currency or another currency.

As discussed in [ASC 830-10-45-17](#), when a foreign entity's books and records are not maintained in its functional currency, the reporting entity must first remeasure the financial statements into its functional currency and then translate the foreign entity's financial statements into the reporting currency. Figure FX 5-1 summarizes the steps a reporting entity should take to translate the financial statements of its foreign entities into its reporting currency.

FIGURE FX 5-1
Summary of translation steps

Currency in which the books and records are maintained	Translation steps
Functional currency	Translate the foreign entity's financial statements from the foreign entity's functional currency to the reporting currency See Example FX 5-1
Other than the functional currency	First, remeasure the foreign entity's financial statements into the foreign entity's functional currency

Currency in which the books and records are maintained

Translation steps

Then, translate the foreign entity's financial statements from the foreign entity's functional currency to the reporting currency
See Example FX 5-2

A reporting entity should consider whether there are accounts recorded at the parent company level that relate to the foreign entity (e.g., reserves, impairments, goodwill and intangibles, audit adjustments, deferred tax balances). If such accounts exist, the reporting entity should "push down" the balance in the currency in which the foreign entity maintains its books and records (using the historical exchange rate). These accounts would then be remeasured into the foreign entity's functional currency. This approach provides for comparable treatment of a foreign entity's accounts whether they are recorded in the foreign entity's or parent's books and records.

5.3 Translation—when a foreign entity maintains books in functional currency

For consolidation purposes, a foreign entity is required to apply GAAP and prepare financial information in its functional currency. For example, impairment adjustments should be determined and recorded in a foreign entity's functional currency.

To translate a foreign entity's functional currency financial statements into the reporting currency, a reporting entity should utilize the exchange rates as detailed in the Figure FX 5-2. The effect of changes in exchange rates between the foreign entity's functional currency and the reporting currency is recognized in the reporting entity's cumulative translation adjustment (CTA) account. See [FX 5.6](#) for further information on the CTA account.

FIGURE FX 5-2
Exchange rates used to translate the financial statements of a foreign entity

Assets and liabilities	Exchange rate at the end of the reporting period
Income statement	Exchange rate on the date the income or expense was recognized; use of the weighted average exchange rate during the period is generally appropriate
Shareholders' equity, including NCI	Historical exchange rates at the date the entry to shareholders' equity was recorded, except for the change in retained earnings during the year, which is translated using the historical exchange rates used to translate each period's income statement

[ASC 830](#) does not address the translation of amounts in a foreign entity's accumulated other comprehensive income (OCI), such as unrealized gains and losses on derivative instruments designated as cash flow hedges and available-for-sale securities, and unrecognized pension balances. There are two approaches for translating amounts reclassified out of accumulated OCI used in practice. Under the "historical rate approach", amounts reclassified out of accumulated OCI are translated using the same rate used when the transactions were recorded in OCI. Under the "current rate approach" the amount of accumulated OCI reclassified to net

income each period is translated using the exchange rate in the period in which the reclassification adjustment is reflected in net income. The current rate approach is consistent with the FASB's stated view that the issuance of FASB Statement 158 (codified in [ASC 715](#)), *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, was not intended to change the way that net periodic benefit expense for pension plans is determined. Prior to the issuance of [FAS 158](#), the components of the net pension asset or liability remained off balance sheet until they were amortized into net periodic benefit expense. When the net pension asset or liability was amortized, employers translated those amounts, along with the other components of net periodic benefit expense, using current exchange rates (similar to other income statement amounts). Thus, the application of the current rate approach is consistent with practice prior to the issuance of [FAS 158](#).

Although we believe that both the historical rate approach and the current rate approach are acceptable under US GAAP, we believe the arguments in support of the historical rate approach are more conceptually sound (i.e., that accumulated other comprehensive income is analogous to retained earnings and that reclassification adjustments are not recognition events). However, we acknowledge that the use of the historical rate approach gives rise to practical challenges in tracking the historical exchange rates associated with accumulated OCI. We believe that a number of approaches (averaging, first-in, first-out, etc.) to simplify that process would be acceptable. A reporting entity should elect a method of reclassifying amounts out of OCI and apply it consistently.

Example FX 5-1 illustrates the process of financial statement translation when a foreign entity's books and records are maintained in its functional currency.

EXAMPLE FX 5-1

Translation of foreign entity financial statements maintained in a foreign entity's functional currency

USA Corp is a US registrant that uses the US dollar (USD) as its reporting currency.

Britannia PLC is a wholly-owned subsidiary of USA Corp located in the United Kingdom. It is a distinct and separable operation of USA Corp and has a functional currency of the British pound sterling (GBP); therefore, it meets the definition of a foreign entity of USA Corp.

Britannia PLC maintains its books and records in GBP. Its GBP financial statements are shown below.

Balance sheet

	Balance on 1/1/X2	Balance on 12/31/X2
Cash	GBP 10,000	GBP 13,000
Net PP&E	GBP 10,000	GBP 9,000
Total assets	GBP 20,000	GBP 22,000
Common stock	GBP 10,000	GBP 10,000
Retained earnings	GBP 10,000	GBP 12,000
Total shareholders' equity	GBP 20,000	GBP 22,000

Income statement

	12/31/X2
Gross profit	GBP 3,000
Depreciation	(GBP 1,000)
Net income	GBP 2,000
Retained earnings at 1/1/X2	GBP 10,000
Retained earnings at 12/31/X2	GBP 12,000

There is no opening balance in USA Corp's CTA account related to its investment in Britannia PLC because we have assumed that the 1/1/X2 exchange rate between the GBP and USD has not changed since USA Corp acquired Britannia PLC.

The relevant exchange rates are shown in the following table.

Account type	Exchange rate description	Exchange rate
Assets and liabilities	Current exchange rate as of 12/31/X2	GBP 1 = USD 1.35
	Current exchange rate as of 12/31/X1	GBP 1 = USD 1.25
Income and expenses	Weighted average exchange rate	GBP 1 = USD 1.30
Common stock and APIC	Historical exchange rate in effect at the date the common stock was issued	GBP 1 = USD 1.25
Retained earnings	Calculated based on an aggregation of the translated amounts of prior and current period net income	GBP 1 = USD 1.25

How should USA Corp translate Britannia PLC's financial statements for inclusion in its USD consolidated financial statements?

Analysis

The following table shows (1) Britannia PLC's GBP balances on 12/31/X2, (2) the rate used to translate each account, and (3) Britannia PLC's translated USD balances, which are included in USA Corp's consolidated US dollar financial statements. Retained earnings is translated using the historical exchange rate because we have assumed that exchange rate at 1/1/X2 had not changed since Britannia PLC was acquired.

	GBP balance on 12/31/X2	Exchange rate	USD balance on 12/31/X2
Cash	GBP 13,000	GBP 1 = USD 1.35	USD 17,550
Net PP&E	GBP 9,000	GBP 1 = USD 1.35	USD 12,150
Total assets	GBP 22,000		USD 29,700
Common stock	GBP 10,000	GBP 1 = USD 1.25	USD 12,500
Retained earnings	GBP 12,000		USD 15,100
Translation adjustment	—		USD 2,100
Total shareholders' equity	GBP 22,000		USD 29,700

	GBP balance on 12/31/X2	Exchange rate	USD balance on 12/31/X2
Gross profit	GBP 3,000	GBP 1 = USD 1.30	USD 3,900
Depreciation	(GBP 1,000)	GBP 1 = USD 1.30	(USD 1,300)
Net income	GBP 2,000		USD 2,600
Retained earnings at 1/1/X2	GBP 10,000	GBP 1 = USD 1.25	USD 12,500
Retained earnings at 12/31/X2	GBP 12,000		USD 15,100

The entry recorded to the CTA account is calculated as follows:

	GBP balances	Change in exchange rate	Change in CTA account balance
Net assets, beginning of year	GBP 20,000	$1.35 - 1.25 = 0.10$	USD 2,000
Net income for the year	GBP 2,000	$1.35 - 1.30 = 0.05$	USD 100
			USD 2,100

5.4 *Translation—foreign entity maintains books in currency other than functional currency*

As discussed in [FX 5.2](#), when a foreign entity maintains its books and records in a currency other than its functional currency (e.g., if the tax laws in a country require the local currency to be used for books and records), the reporting entity should first remeasure the foreign entity's financial statements into the foreign entity's functional currency and then translate the foreign entity's functional currency financial statements into the reporting currency.

5.4.1 **Remeasurement of financial statements maintained in a foreign currency**

When an entity remeasures its financial statements, it should apply the guidance for foreign currency transactions. Monetary assets and liabilities are remeasured using exchange rates at the end of the reporting period, nonmonetary assets and liabilities are remeasured using the exchange rate on the date the item was initially recognized (i.e., the historical rate). This remeasurement process is intended to produce the same results as if the foreign entity maintained its books and records in its functional currency. See [FX 4.4.1](#) for information on differentiating monetary and nonmonetary accounts.

Example FX 5-2 illustrates the process of financial statement translation when a foreign entity's books and records are *not* maintained in its functional currency.

EXAMPLE FX 5-2

Remeasurement and translation of foreign entity financial statements maintained in a currency other than a foreign entity's functional currency

USA Corp is a US registrant that uses the US dollar (USD) as its reporting currency.

Britannia PLC is a wholly-owned subsidiary of USA Corp located in the United Kingdom. It is a distinct and separable operation of USA Corp and has a functional currency of the euro (EUR); therefore, it meets the definition of a foreign entity of USA Corp.

Britannia PLC maintains its books and records in GBP. Its GBP financial statements are shown below.

Balance sheet

	Balance on 1/1/X2	Balance on 12/31/X2
Cash	GBP 10,000	GBP 13,000
Net PP&E	GBP 10,000	GBP 9,000
Total assets	<u>GBP 20,000</u>	<u>GBP 22,000</u>
Common stock	GBP 10,000	GBP 10,000
Retained earnings	<u>GBP 10,000</u>	<u>GBP 12,000</u>
Total shareholders' equity	GBP 20,000	GBP 22,000

Income statement

	12/31/X2
Gross profit	GBP 3,000
Depreciation	<u>(GBP 1,000)</u>
Net income	GBP 2,000
Retained earnings at 1/1/X2	<u>GBP 10,000</u>
Retained earnings at 12/31/X2	GBP 12,000

There is no opening balance in USA Corp's CTA account related to its investment in Britannia PLC because we have assumed that the 1/1/X2 exchange rate has not changed since USA Corp acquired Britannia PLC.

How should USA Corp translate Britannia PLC's GBP financial statements for inclusion in its USD consolidated financial statements?

Analysis

Britannia PLC's GBP financial statements should first be remeasured into EUR, Britannia PLC's functional currency, and then translated into USD, the reporting currency.

The following exchange rates are used to remeasure and translate Britannia PLC's financial statements. Retained earnings is translated using the historical exchange rate because we have assumed that exchange rates prior to 1/1/X2 had not changed.

	GBP to EUR	EUR to USD
Current exchange rate as of 12/31/X2	GBP 1 = EUR 1.20	EUR 1 = USD 1.13
Current exchange rate as of 12/31/X1	GBP 1 = EUR 1.50	EUR 1 = USD 1.09
Weighted average exchange rate	GBP 1 = EUR 1.18	EUR 1 = USD 1.10
Historical exchange rate in effect at the date the common stock was issued and PP&E was purchased	GBP 1 = EUR 1.15	EUR 1 = USD 1.09

	Remeasurement		Translation		
	GBP balance	Exchange rate	EUR balance	Exchange rate	USD balance
Cash	GBP 13,000	GBP 1 = EUR 1.20	EUR 15,600	EUR 1 = USD 1.13	USD 17,628
Net PP&E	GBP 9,000	GBP 1 = EUR 1.15	EUR 10,350	EUR 1 = USD 1.13	USD 11,696
Total assets	<u>GBP 22,000</u>		<u>EUR 25,950</u>		<u>USD 29,324</u>
Common stock	GBP 10,000	GBP 1 = EUR 1.15	EUR 11,500	EUR 1 = USD 1.09	USD 12,535
Retained earnings	GBP 12,000		EUR 14,450		USD 15,780
Translation adjustment	—		—		USD 1,009
Total shareholders' equity	<u>GBP 22,000</u>		<u>EUR 25,950</u>		<u>USD 29,324</u>
Gross profit	GBP 3,000	GBP 1 = EUR 1.18	EUR 3,540	EUR 1 = USD 1.10	USD 3,894
Depreciation	(GBP 1,000)	GBP 1 = EUR 1.15	(EUR 1,150)	EUR 1 = USD 1.10	(USD 1,265)
Foreign exchange gain	—		EUR 560	EUR 1 = USD 1.10	USD 616

	Remeasurement		Translation	
Net income (loss)	GBP 2,000		EUR 2,950	USD 3,245
Retained earnings, beginning of year	GBP 10,000	GBP 1 = EUR 1.15	EUR 11,500	EUR 1 = USD 1.09 USD 12,535
Retained earnings, end of year	GBP 12,000		EUR 14,450	USD 15,780

The translation adjustment of USD 1,009 above results from translating from EUR to USD. The translation adjustment is calculated as follows:

	EUR balances	Change in exchange rate	CTA account balance
Net assets, beginning of year	EUR 23,000	1.13 – 1.09 = 0.04	USD 920
Net income for the year	EUR 2,950	1.13 – 1.10 = 0.03	USD 89
			USD 1,009

The foreign exchange gain of EUR 560 results from the remeasurement from British pounds to euros and is included in income. It is calculated as follows:

	GBP balances	Change in exchange rate	Foreign exchange gain
Net monetary assets, beginning of year	GBP 10,000	1.20 – 1.15 = 0.05	EUR 500
Gross profit for the year	GBP 3,000	1.20 – 1.18 = 0.02	EUR 60
			EUR 560

5.4.1.1 Remeasurement of assets

The accounting treatment of foreign currency denominated assets depends on whether the assets are monetary or nonmonetary. Assets such as prepaid expenses and deferred charges are often nonmonetary assets; they do not involve future settlement in a foreign currency. Assets such as a deposit or accounts receivable, for which future settlement in a foreign currency is expected, are monetary assets. See [FX 4.4.1](#) for information on differentiating monetary and nonmonetary assets.

Foreign currency denominated monetary and nonmonetary assets should both be initially measured using the exchange rate in effect on the date the asset is created. Foreign currency denominated monetary assets are subsequently measured using the exchange rate in effect at the end of each reporting period. Foreign currency denominated nonmonetary assets are not subsequently adjusted for changes in exchange rates.

Example FX 5-3 illustrates how to account for foreign currency denominated assets other than inventory. See [FX 5.4.1.2](#) for the accounting for foreign currency denominated inventory.

EXAMPLE FX 5-3

Accounting for foreign currency prepaid expenses and other assets

Canadian Corp is a Canadian reporting entity that uses the Canadian dollar as its reporting currency.

Mexico SA is a distinct and separable operation of Canadian Corp located in Mexico. Canadian Corp has determined that Mexico SA's functional currency is the US dollar (USD); however, Mexico SA maintains its books and records in the local currency, the Mexican peso (MXN).

The table below summarizes Mexico SA's prepaid expense and other asset balances at December 31, 20X1, whether each is a monetary or nonmonetary asset as determined by Mexico SA's management, and the exchange rate on the date each asset was recognized.

Asset account	MXN balance	Monetary or nonmonetary asset	Exchange rate on the date the asset was recognized
Deposit on office space	MXN 500,000	Monetary	USD 1 = MXN 10
Prepaid rent	MXN 200,000	Nonmonetary	USD 1 = MXN 14
Prepaid utility contract	MXN 150,000	Nonmonetary	USD 1 = MXN 14
Prepaid insurance	MXN 450,000	Nonmonetary	USD 1 = MXN 14
Loan receivable from unaffiliated party	MXN 100,000	Monetary	USD 1 = MXN 16

The exchange rate on December 31, 20X1 is USD 1 = MXN 12.

What is the balance of Mexico SA's prepaid expenses and other assets at December 31, 20X1 in its functional currency, the US dollar?

Analysis

Mexico SA should remeasure the monetary assets using the exchange rate at December 31, 20X1. The nonmonetary assets are not remeasured; they are measured at the exchange rate on the date the asset was recognized.

Asset account	MXN balance	Exchange rate	USD balance
Deposit on office space	MXN 500,000	USD 1 = MXN 12	USD 41,667
Prepaid rent	MXN 200,000	USD 1 = MXN 14	USD 14,286
Prepaid utility contract	MXN 150,000	USD 1 = MXN 14	USD 10,714
Prepaid insurance	MXN 450,000	USD 1 = MXN 14	USD 32,143
Loan receivable from unaffiliated party	MXN 100,000	USD 1 = MXN 12	USD 8,333

5.4.1.2 Remeasurement of inventory

Inventory should be remeasured into a foreign entity's functional currency using the exchange rate on the date it is acquired. The cost of goods sold associated with inventory recorded in a foreign currency is the amount at which it was initially recorded (i.e., the functional currency balance recorded on the date it was acquired).

Example FX 5-4 illustrates the accounting for inventory purchased in a currency other than a distinct and separable operation's functional currency.

EXAMPLE FX 5-4

Remeasurement of inventory balances

Canadian Corp is a Canadian reporting entity that uses the Canadian dollar as its reporting currency.

Mexico SA is a distinct and separable operation of Canadian Corp located in Mexico. Canadian Corp has determined that Mexico SA's functional currency is the US dollar (USD); however, Mexico SA maintains its books and records in the local currency, the Mexican peso (MXN).

Mexico SA purchases inventory from a supplier in Tijuana, Mexico. Inventory purchases are invoiced and paid in Mexican pesos. Given the even pattern of purchases and the lack of significant volatility in the MXN/USD exchange rate, the MXN denominated inventory purchases are remeasured into the USD functional currency using the average monthly exchange rate.

Mexico SA applies a first-in, first-out (FIFO) inventory costing methodology. On October 1, 20X1, Mexico SA's Mexican peso inventory balance is MXN 750,000, representing 75,000 units. The following table shows Mexico SA's inventory purchases in October through December 20X1 and the average monthly exchange rate for each of those months.

Month	Inventory units	Inventory purchases	Average exchange rate
October	30,000	MXN 300,000	USD 1 = MXN 14
November	50,000	MXN 500,000	USD 1 = MXN 16
December	45,000	MXN 450,000	USD 1 = MXN 18
	<u>125,000</u>	<u>MXN 1,250,000</u>	

On December 31, 20X1, Mexico SA has 100,000 units on hand that are carried at MXN 1,000,000 in the MXN books and records.

What is Mexico SA's ending inventory balance on December 31, 20X1 in its functional currency, the US dollar?

Analysis

Since Mexico SA uses a FIFO inventory costing methodology, the December 31, 20X1 inventory balance comprises the following:

Month of inventory purchase	Units	MXN balance	Average exchange rate	USD balance
October	5,000	MXN 50,000	USD 1 = MXN 14	USD 3,571
November	50,000	MXN 500,000	USD 1 = MXN 16	USD 31,250
December	45,000	MXN 450,000	USD 1 = MXN 18	USD 25,000
	100,000	MXN 1,000,000		USD 59,821

Mexico SA's December 31, 20X1 ending inventory balance is USD 59,821.

LIFO inventory costing methodology

When a foreign entity uses a last-in, first-out (LIFO) inventory costing methodology, its functional currency inventory LIFO layers should be recorded and measured at the exchange rate on the date the inventory is acquired (or the LIFO layer is created).

The LIFO reserve account is a contra inventory account calculated as the difference between the FIFO inventory cost and LIFO inventory cost. For inventory balances recorded in a local currency other than the foreign entity's functional currency, the LIFO reserve must be remeasured. A local currency LIFO reserve is calculated as the difference between the local currency inventory balance using FIFO and the local currency inventory balance using LIFO. In the same way, the functional currency LIFO reserve is calculated as the difference between the functional currency inventory balance using FIFO and the functional currency inventory balance using LIFO.

Lower of cost or market

[ASC 830-10-55-8](#) provides guidance for applying the lower of cost or market test when an entity maintains its books and records in a currency other than its functional currency (e.g., the currency of the local economy).

ASC 830-10-55-8

The guidance on the subsequent measurement of inventory in [Subtopic 330-10](#) requires special application when the books of record are not kept in the functional currency. Inventories carried at cost in the books of record in another currency should be first remeasured to cost in the functional currency using historical exchange rates. Then, historical cost in the functional currency should be evaluated for impairment under the subsequent measurement guidance using the functional currency. Application of the subsequent measurement guidance in functional currency may require a write-down in the functional currency statements even though no write-down has been made in the books of record maintained in another currency. Likewise, a write-down in the books of record may need to be reversed if the application of the subsequent measurement guidance in the functional currency does not require a write-down. If inventory has been written down in the functional currency statements, that functional currency amount shall continue to be the carrying amount in the functional currency financial statements until the inventory is sold or a further write-down is necessary. An asset other than inventory may sometimes be written down from historical cost. Although different measurement guidance may be used to determine that write-down, the approach described in this

paragraph might be appropriate. That is, a write-down may be required in the functional currency statements even though not required in the books of record, and a write-down in the books of record may need to be reversed before remeasurement to prevent the remeasured amount from exceeding functional currency historical cost.

Example FX 5-5 illustrates how to determine whether a lower of cost or market allowance is required when an entity maintains its books and records in its local currency.

EXAMPLE FX 5-5

Assessing the need for a lower of cost or market allowance when books and records are maintained in a local currency

Canadian Corp is a Canadian reporting entity that uses the Canadian dollar as its reporting currency.

Mexico SA is a distinct and separable operation of Canadian Corp located in Mexico. Canadian Corp has determined that Mexico SA's functional currency is the US dollar (USD); however, Mexico SA maintains its books and records in the local currency, the Mexican peso (MXN).

Mexico SA purchases inventory from a supplier in Tijuana, Mexico. Inventory purchases are invoiced and paid in Mexican pesos. Given the even pattern of purchases and the lack of significant volatility in the MXN/USD exchange rate, the MXN denominated inventory purchases are remeasured into the USD functional currency using the average monthly exchange rate.

On December 31, 20X1, Mexico SA's Mexican peso inventory has a carrying amount and replacement cost of MXN 1,000,000 and MXN 1,020,000, respectively. The carrying amount and replacement cost of the inventory in Mexico SA's functional currency, the US dollar, are USD 59,821 and USD 56,830, respectively.

Should Mexico SA record a lower of cost or market allowance on its Mexican peso inventory, either in (1) the local currency, the Mexican peso, or (2) its functional currency, the US dollar?

Analysis

Mexico SA should not record a lower of cost or market allowance on its Mexican peso inventory in its local currency books because the replacement cost of MXN 1,020,000 exceeds the recorded balance of MXN 1,000,000.

Mexico SA should, however, record a lower of cost or market allowance on its Mexican peso inventory in its functional currency books because the replacement cost of USD 56,830 is lower than the recorded balance of USD 59,821.

5.5 Exchange rates

[ASC 830-30-45](#) provides guidance on selecting an exchange rate at which to translate a foreign entity's financial statements.

ASC 830-30-45-3

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

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

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

ASC 830-30-45-4

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

ASC 830-30-45-6

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

The rate applicable to dividend remittances is considered more meaningful for translation than any other rate because that is the rate indicative of ultimate cash flows from the foreign entity to the reporting entity.

When the balance sheet date of a foreign entity differs from that of the reporting entity, [ASC 830-30-45-8](#) requires that the rate in effect at the balance sheet date of the foreign entity be used to translate the foreign entity's financial statements.

The financial statements should not be adjusted for post-balance-sheet exchange rate changes except when the exchangeability between two currencies is temporarily lacking as discussed in [FX 5.5.2](#).

5.5.1 Use of average exchange rates

Income statement items should be translated using the exchange rate in effect at the date the item was recognized; however, [ASC 830-10-55-10](#) and [ASC 830-10-55-11](#) allow management to use an average exchange rate to translate income statement items.

ASC 830-10-55-10

Literal application of the standards in this Subtopic might require a degree of detail in record keeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Accordingly, it is acceptable to

use averages or other methods of approximation. For example, because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Likewise, the use of other time- and effort-saving methods to approximate the results of detailed calculations is permitted.

ASC 830-10-55-11

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

The use of an average exchange rate may result in a difference between intercompany revenues and expenses. See [FX 7](#) for information on the elimination of intercompany transactions.

5.5.2 *Lack of exchangeability at the balance sheet date*

[ASC 830-20-30-2](#) discusses what to do if an exchange rate is temporarily unavailable at the transaction date or the end of a reporting period.

ASC 830-20-30-2

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

The financial statements should not otherwise be adjusted for post-balance-sheet rate changes.

When the lack of exchangeability does not appear to be temporary, a reporting entity should consider whether consolidation, combination, or equity accounting of a foreign operation with a large number of transactions denominated in the non-exchangeable currency is appropriate. A lack of exchangeability is often a precursor to an economy becoming highly inflationary. See [FX 6](#) for information on highly inflationary economies and [FX 8.5](#) for information on deconsolidating a foreign entity.

5.5.3 *Multiple exchange rates*

While most exchange rates fluctuate in accordance with the supply of and demand for foreign currencies, some countries have exchange controls that affect the availability of and exchange rates for foreign currencies. The degree of exchange controls can vary. When there is a high degree of exchange controls that are expected to continue for a period that is other than temporary, it may not be clear which exchange rate, if any, should be used for remeasurement and translation purposes. In such circumstances, transparent disclosure should be made concerning

the reporting entity's exposure (measured in the reporting currency) to the foreign currency in question and the exchange rates that are being utilized.

The IPTF meets and discusses significant issues with the SEC staff including exchange controls. The minutes for these meetings should be considered when assessing the impact of significant exchange controls.

A country may introduce a "preference" exchange rate or a "penalty" exchange rate for its currency. A preference rate is favorable when compared to other available rates; a penalty rate is unfavorable when compared to other available rates. Preferential or penalty rates are pre-determined rates, typically subject to specified requirements and available only for specified transactions, determined by a foreign government. A distinct and separable operation with foreign currency transactions in a currency of a foreign economy that has a preferential or penalty rate should assess its particular facts and circumstances to determine whether the transactions should be measured at either the preferential or penalty rate.

Items qualifying for a preference rate are usually items considered essential for the citizens of the country. A reporting entity usually has to apply for governmental approval to acquire the preference rate; approval is not guaranteed. Judgment may be required to assess, based on prior experience with a particular product in a particular country, whether a transaction will qualify for the preference rate. Monetary assets and liabilities denominated in currencies other than a foreign entity's function currency that relate to transactions that qualify for the preference or penalty rate should generally be remeasured at the relevant preference or penalty rate because it reflects the amounts expected to be received or paid upon their collection or payment. However, the dividend remittance rate should generally be used to translate the financial statements of a foreign entity.

If an unsettled intercompany transaction is subject to and remeasured using a preference or penalty rate, using the dividend remittance rate for translation will result in a difference between intercompany receivables and payables. Example FX 5-6 illustrates this situation.

EXAMPLE FX 5-6

Translating an intercompany transaction recorded using a preference rate

USA Corp is a US registrant that uses the US dollar (USD) as its reporting currency.

USA Corp has a consolidated subsidiary that is a foreign entity in which the functional currency is the local currency (LC).

USA Corp sells 3 units of inventory to the foreign entity at USD 100/per unit when the official rate that is used to pay dividends is 6.25 LC = 1 USD and there is a preference rate of 5.5 LC = 1 USD available for the importation of the inventory item. Upon importation, the inventory is immediately sold to a third party at a profit, but at period end, the intercompany balance between USA Corp and the foreign entity has not been settled.

How are the intercompany balance sheet accounts reflected in the consolidated financial statements of USA Corp?

Analysis

As a result of the intercompany sale of inventory, USA Corp should record an intercompany receivable of USD 300 while the foreign entity would measure its

intercompany payable in its functional currency financial statements using the preference rate, which results in an intercompany payable of LC 1,650.

To translate the foreign entity's financial statements into USD, USA Corp uses the official rate, which results in an intercompany payable of USD 264. Therefore, there would be a mismatch between the USD intercompany receivable (USD 300) on USA Corp's books and the translated USD intercompany payable (USD 264) on the foreign entity's books. [ASC 830-30-45-7](#) allows a reporting entity to record an additional receivable equal to this difference (USD 36), which reflects the USD amount of the exchange rate subsidy that the foreign government is effectively providing.

Unfortunately, not all multiple exchange rate problems can be satisfactorily solved by mechanical application of the approach described in Example FX 5-6, which is presumably why [ASC 830-30-45-6](#) refers to translation of foreign currency financial statements at the dividend remittance rate "in the absence of unusual circumstances." The SEC staff has indicated that given certain facts and circumstances, it may be appropriate to translate a foreign entity's financial statements using an exchange rate other than the dividend rate. However, deviations from the dividend remittance rate should occur only in situations in which there is significant distortion in exchange rates due to temporary and unusual economic factors, and would necessitate transparent disclosure.

5.5.4 *Alternative exchange mechanisms*

Occasionally, in economies that have implemented exchange controls, governments will allow alternative exchange mechanisms to exist. These governments allow these exchange mechanisms to exist in order to provide relief to entities importing goods into the country, without having to acknowledge the devaluation of their official exchange rates. Venezuela allowed such a mechanism to exist for a period of time, known as the "Parallel Rate." As of February 2020, Argentina allows such a mechanism to exist, known as the "Blue Chip Swap Rate."

There are many derivations of these mechanisms. One derivation that has been used is effected through the purchase of a US Dollar-denominated security onshore with local currency, transfer of the security offshore, and sale of the security offshore for US Dollars. The buy and sell of the security creates an implied exchange rate. Once US Dollars have been received, the reporting entity can either hold the US Dollars offshore to hedge against devaluation of the local currency or may be able to use the US Dollars to relieve US Dollar-denominated obligations.

When these alternative exchange mechanisms exist, the question as to whether the implied exchange rate determined by this mechanism can be used to measure transactions denominated in other than the foreign entity's functional currency is often asked. This determination can be very complex and requires a detailed understanding of how the mechanism is designed to work, as well as a detailed understanding of the currency and security laws of the applicable country.

5.5.5 *Black market rates*

When restrictive exchange controls exist, a black market for a foreign currency may exist. Black market rates are established by unauthorized dealers in foreign exchange, often in violation of government regulation, and are invariably higher than the official rate for the same currency. The volume of transactions at black market rates may be limited, and most businesses do not normally obtain funds at these rates.

The black market exchange rate should not be used to apply the provisions of [ASC 830](#) as it is not a legally recognized rate. Rather, as noted in [FX 5.5](#), a reporting entity should generally use the dividend remittance rate to translate the financial statements of its foreign entities because it is the rate indicative of the ultimate cash flows from the foreign entity to the reporting entity.

5.6 *Cumulative translation adjustment*

[ASC 830-30-45-12](#) provides guidance on recording the translation adjustment that arises from translating a foreign entity's financial statements.

ASC 830-30-45-12

If an entity's functional currency is a foreign currency, translation adjustments result from the process of translating that entity's financial statements into the reporting currency. Translation adjustments shall not be included in determining net income but shall be reported in other comprehensive income.

The periodic translation adjustment should be recorded, net of related tax effects, in the CTA account, which is a separate component of other comprehensive income. This treatment differs from the foreign exchange gains and losses that are recorded in net income as a result of the measurement and remeasurement processes.

For information on when to release CTA, see [FX 8](#).

5.6.1 *CTA attributable to translating a noncontrolling interest*

A noncontrolling interest account should be translated as if it were an equity account. That is, it should be translated at the exchange rate in effect when the noncontrolling interest was created. [ASC 830-30-45-17](#) indicates that a proportionate share of the CTA account should be allocated to and reported as part of the noncontrolling interest account in proportion to the noncontrolling interest's ownership percentage.

5.6.2 *CTA attributable to an equity method investee with a functional currency other than the reporting currency*

When a reporting entity's reporting currency is different than the functional currency of an equity method investee, the equity method investment must be translated into the reporting currency.

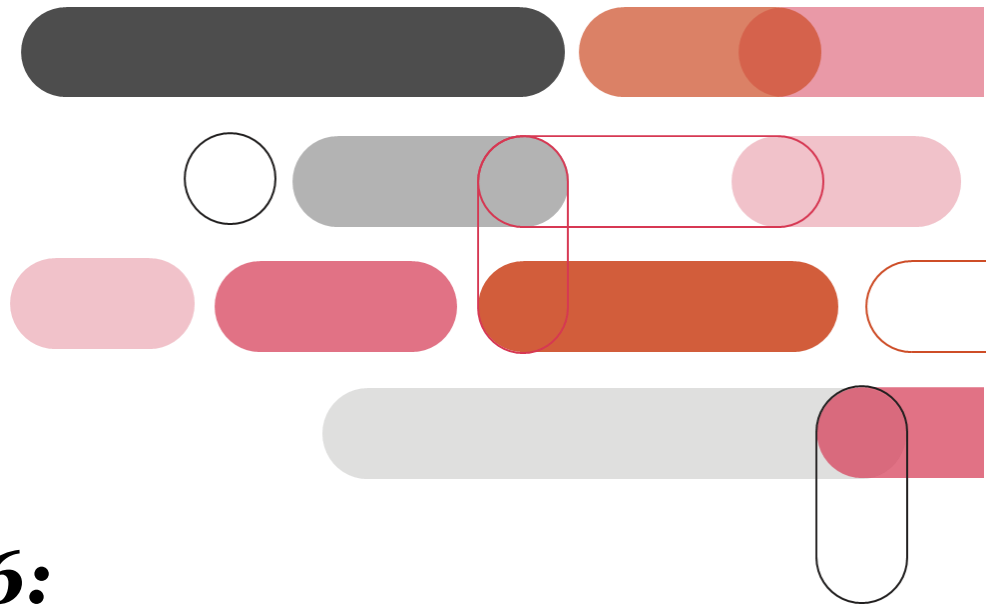
First, determine the carrying value of the investment in terms of the investee's functional currency.

Second, the reporting entity's proportionate share of the investee's undistributed net income is translated using the average exchange rate during the period.

Third, the ending foreign currency investment balance is translated using the exchange rate at the end of the reporting period. This produces the period-end reporting currency balance.

Lastly, the difference between the period-end reporting currency balance and the sum of the reporting currency investment balance at the beginning of the period and the translated proportionate share of the investee's undistributed earnings, is recorded in CTA.

We believe that this is an acceptable method of translating an equity method investment into the reporting currency. However, there may be other acceptable methods.



Chapter 6:
Foreign entities in highly
inflationary economies

6.1 *Foreign entities in highly inflationary economies overview*

Translating the financial results of a foreign entity in a way that provides relevant information requires a relatively stable unit of measure. When the functional currency of a foreign entity is a local currency that is experiencing high inflation, the translated financial information becomes less relevant. For example, in an economy with a high rate of inflation, it may be difficult for financial statement users to determine whether an increase in sales revenue reported in the local currency is due to an increase in the level of sales, or relates to inflation. In addition, translating foreign entity financial statements prepared in the currency of a highly inflationary economy can introduce volatility unrelated to operating performance into the financial statements of the reporting entity when historical cost balances of long-lived assets are translated at inflated exchange rates. Given these concerns, [ASC 830](#) requires that the functional currency of a foreign entity be changed to the reporting currency of its parent when an economy becomes highly inflationary.

This chapter discusses how to determine whether an economy is highly inflationary and the resulting accounting implications. See [TX 13.6](#) for information on indexed net operating losses in highly inflationary economies.

6.2 *Determining whether an economy is highly inflationary*

Reporting entities are responsible for monitoring inflation in countries in which they have operations, and should have proper procedures and controls in place to make this determination.

[ASC 830-10-45-11](#) describes when an economy is considered highly inflationary.

Excerpt from [ASC 830-10-45-11](#)

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.

The example in [ASC 830-10-55-24](#) indicates that the three-year cumulative inflation rate is the compound inflation rate over the three-year period (including interim periods).

If the three-year cumulative inflation rate exceeds 100%, the economy should be considered highly inflationary in all instances. Projected declines in future periods should not be considered. However, when the three-year cumulative inflation rate is significant, but less than 100%, inflation rate trends (increasing or decreasing) and other relevant economic factors should be considered to determine whether the economy should be considered highly inflationary. Similarly, [ASC 830-10-55-25](#) illustrates a fact pattern in which a drop in the three-year cumulative inflation rate below 100% may not mean the economy is no longer highly inflationary if the trend continues to be high, indicating the drop is only temporary.

Although [ASC 830](#) does not require the use of a specific inflation index, a broad-based measure of general inflation should be used, similar to the US Consumer Price Index (e.g., inflation data reported to the International Monetary Fund). Generally, it is not appropriate to use an index based on company or industry data only.

Sometimes, the determination of when an economy has become highly inflationary requires significant judgement. For example, sometimes the inflation data reported by a country may not be reliable.

6.2.1 **The role of the International Practices Task Force**

The International Practices Task Force (IPTF) of the Center for Audit Quality's SEC Regulations Committee meets periodically with the staff of the SEC to discuss and focus on emerging international accounting and reporting issues relating to SEC rules and regulations. In an effort to facilitate greater consistency, the IPTF developed a framework for compiling inflation data to assist reporting entities in monitoring inflation statistics in connection with their determination of the inflationary status of countries in which they operate. The considerations discussed by the IPTF may help registrants (and private companies) determine which economies should be considered highly inflationary. These considerations are discussed in the *Monitoring Inflation in Certain Countries* discussion document available on the Center for Audit Quality website (www.thecaq.org).

QUESTION FX 6-1

If a country's economy is deemed highly inflationary, when should the guidance in [ASC 830](#) regarding foreign entities in highly inflationary economies be adopted?

PwC response

Reporting entities that are SEC registrants should apply the guidance in [ASC 830](#) at the beginning of the quarter following the date the economy was deemed highly inflationary. For example, if a foreign economy is determined to be highly inflationary as of December 1, 20X1, a reporting entity would apply the guidance for highly inflationary economies as of the beginning of its next quarter (e.g., January 1, 20X2).

Private companies that do not have interim reporting requirements may choose to assess the economies in which it has foreign entities as of the beginning of each reporting period. If a country's economy is highly inflationary, the guidance in [ASC 830](#) may be applied prospectively as of the beginning of the next reporting period. For example, if a foreign economy is determined to be highly inflationary as of May 1, 20X1, a calendar year-end reporting entity may apply the guidance for highly inflationary economies as of January 1, 20X2.

6.3 **Accounting for a foreign entity in a highly inflationary economy**

As discussed in [ASC 830-10-45-11](#), once a reporting entity determines that it has a foreign entity operating in a highly inflationary economy, the reporting currency should be considered the foreign entity's functional currency on a prospective basis. To the extent that the foreign entity's books and records are not maintained in its new functional currency, remeasurement into the functional currency is required.

Excerpt from [ASC 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.

Because of the wording in [ASC 830-10-45-11](#), many US preparers assume that the functional currency of a foreign entity operating in a highly inflationary economy must always be the US dollar. As discussed in [FX 1.2](#), [ASC 830](#) has a US dollar bias that reflects the simplistic structure of multinational companies that existed at the time of

its issuance. As a result, some preparers instead interpret [ASC 830-10-45-11](#) to mean that the functional currency of a foreign entity operating in a highly inflationary economy should be changed to the reporting currency of its most immediate parent, which is also likely the immediate parent's functional currency. We believe that this "bottom up" approach (i.e., looking to the most immediate parent) is more representationally faithful to the conceptual underpinnings of [ASC 830](#) and consolidation theory. However, we recognize that practice with respect to this issue is mixed. For the purpose of this chapter, "parent's currency," as used in this context, will be that of the immediate parent.

QUESTION FX 6-2

Should a foreign entity located in a highly inflationary economy apply the guidance for foreign entities in highly inflationary economies in [ASC 830-10-45-11](#) if its functional currency is not the local currency?

PwC response

No. If a foreign entity has determined that its functional currency is something other than the local currency of the country in which it is located, it would not be considered to be operating in a highly inflationary economy.

6.3.1 ***Change in functional currency from a foreign currency to the parent's currency***

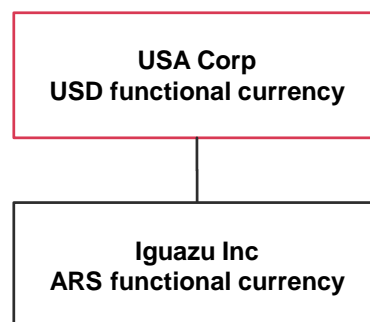
When accounting for a change in functional currency resulting from a highly inflationary determination, the new accounting basis of monetary and nonmonetary assets and liabilities should be the last translated balances prior to the designation as highly inflationary. Equity accounts should be measured at the historical exchange rate in effect when the balances were established. For example, the exchange rate in effect when common stock was issued should be used to measure the common stock outstanding. Retained earnings will reflect an aggregation of the translated amounts of prior and current period undistributed net income. The balance recorded in the cumulative translation adjustment account, which was created from the translation process in prior periods, is not reversed when a foreign entity changes its functional currency because it is operating in a highly inflationary economy.

Example FX 6-1 illustrates the accounting for a change in the functional currency of a foreign entity from the local currency to its parent's reporting currency.

EXAMPLE FX 6-1

Change in functional currency as a result of operating in a highly inflationary economy

USA Corp has the following organizational structure:



Effective 1/1/20X2, USA Corp deemed Argentina to be a highly inflationary economy. Therefore, Iguazu Inc changed its functional currency from the Argentine peso (ARS), the local currency, to the US dollar (USD), the reporting currency of its immediate parent (USA Corp).

The exchange rate on 12/31/20X1 was USD 1 = ARS 800.

Iguazu Inc has a US dollar denominated loan of USD 1,000 from USA Corp which is recorded in the Iguazu Inc financial statements prepared in Argentine pesos at ARS 800,000.

All other balances and transactions are denominated in Argentine pesos.

How should the Iguazu Inc account balances that will be used for consolidation purposes be determined when Argentina is deemed to be a highly inflationary economy?

Analysis

At transition, all accounts should be recorded in Iguazu Inc's financial statements at the prior period translated balances in USA Corp's financial statements. The prior period translated balances were calculated using the exchange rates listed in the following table.

Account type	Exchange rate type	Exchange rate
Monetary assets and liabilities	Current exchange rate	USD 1 = ARS 800
Nonmonetary assets and liabilities	Current exchange rate	USD 1 = ARS 800
Common stock and APIC	Aggregated balance based on the exchange rate in effect at the date common stock was issued	USD 1 = ARS 500
Retained earnings	Calculated rate based on an aggregation of the translated amounts of prior and current period undistributed net income	USD = ARS 625

The following table shows: (1) prior period Iguazu Inc balances, (2) prior period translated balances at USA Corp, and (3) Iguazu Inc balances upon transition to the US dollar.

Account	Prior period balance (Iguazu Inc)	Exchange rate	Prior period translated balance (USA Corp)	Balance upon adoption of USD as functional currency (Iguazu Inc)
Cash	ARS 310,000	USD 1 = ARS 800	USD 388	USD 388
Accounts receivable	ARS 720,000	USD 1 = ARS 800	USD 900	USD 900
Inventory	ARS 640,000	USD 1 = ARS 800	USD 800	USD 800
Fixed assets	ARS 1,000,000	USD 1 = ARS 800	USD 1,250	USD 1,250
Total assets	ARS 2,670,000		USD 3,338	USD 3,338
Accounts payable	ARS 400,000	USD 1 = ARS 800	USD 500	USD 500
Accrued expenses	ARS 100,000	USD 1 = ARS 800	USD 125	USD 125
Loan from USA Corp	ARS 800,000	USD 1 = ARS 800	USD 1,000	USD 1,000
Total liabilities	ARS 1,300,000		USD 1,625	USD 1,625
Common stock	ARS 100,000	USD 1 = ARS 500	USD 200	USD 200
APIC	ARS 420,000	USD 1 = ARS 500	USD 840	USD 840
Cumulative translation adjustment (CTA)			(USD 687)	(USD 687)
Retained earnings	ARS 850,000	USD 1 = ARS 625	USD 1,360	USD 1,360
Total shareholder's equity	ARS 1,370,000		USD 1,713	USD 1,713
Total liabilities and equity	ARS 2,670,000		USD 3,338	USD 3,338

Note that in this example, CTA resides at the parent level, but is shown here for illustrative purposes. In Iguazu Inc's stand-alone financial statements, this balance would be part of retained earnings. This amount represents the difference between translating the ARS balances for common stock, APIC, and retained earnings at the

historical exchange rates indicated, compared to translating these same ARS balances at the current rate.

6.3.2 **Financial statement remeasurement**

Even when a foreign entity's functional currency is changed for consolidation purposes, it will typically continue to transact in the local currency and maintain its financial records in the local currency (i.e., the general ledger balances remain in the local currency).

Excerpt from ASC 830-10-45-17

If an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency.

Based on the guidance in [ASC 830-10-45-18](#), nonmonetary assets and liabilities and the related expenses (e.g., depreciation) should be remeasured at historical exchange rates. Monetary assets and liabilities denominated in a currency other than the new functional currency should be remeasured using current exchange rates. The resulting gains and losses on these monetary assets and liabilities should be reported in net income. Any transaction gains and losses recognized by the foreign entity in its local currency books and records related to monetary assets and liabilities denominated in its new functional currency (or other currencies) should be reversed (or adjusted) in the remeasurement process.

When the immediate parent of the foreign entity is the reporting entity (i.e., the foreign entity is a first-tier entity), only remeasurement into the functional currency is required. It is not necessary to translate the financial statements because they are already in the parent's reporting currency. However, if the foreign entity is a second-tier entity (or lower), the financial statements should first be remeasured into the functional currency of the immediate parent and then translated into the currency of the next highest entity, or the reporting entity, whichever comes next in the organizational structure of the reporting entity.

Example FX 6-2 illustrates the remeasurement of financial statements when an entity maintains its books and records in a currency other than its functional currency.

EXAMPLE FX 6-2

Remeasurement of financial statements when books and records are maintained in a currency other than the functional currency

This example is a continuation of Example FX 6-1. Iguazu Inc continues to maintain its books and records in the local currency, Argentine pesos.

At the end of the period following Iguazu Inc's adoption of the US dollar as its functional currency, the spot exchange rate is USD 1 = ARS 900. In addition, Iguazu Inc:

- Did not produce any additional inventory; therefore, inventory sold during the period was recorded at the exchange rate in effect at the date Iguazu Inc transitioned to a functional currency of US dollars (USD 1 = ARS 800).
- Did not have any changes in the balance of its USD 1,000 loan from USA Corp. The loan is recorded on the Iguazu Inc balance sheet (prepared in Argentine

pesos) at ARS 900,000 (USD 1,000 at the period end exchange rate of USD 1 = ARS 900).

- Did not have any fixed asset additions during the period. Depreciation expense was ARS 100,000 and was recognized in the USD income statement using the exchange rate upon adoption of highly inflationary accounting.

How should Iguazu Inc remeasure its financial statements into US dollars for the period ended 12/31/X2?

Analysis

- Monetary account balances should be remeasured at the current exchange rate (USD 1 = ARS 900).
- Nonmonetary accounts should be measured using the historical exchange rate, which is the rate that was in place when the new accounting basis was established at the time Argentina's economy became highly inflationary (USD 1 = ARS 800). The income tax expense impact created by using the historical rate instead of the average rate for purposes of preparing the USD financial statements has been ignored.
- Equity accounts, with the exception of retained earnings, should be measured at the historical exchange rate in effect when the balances were established (e.g., when common stock was issued).
- The retained earnings generated prior to the point of changing the functional currency should be calculated based on an aggregation of the translated amounts of prior and current period undistributed net income. Retained earnings generated after changing the functional currency will not need to be remeasured.
- The income statement was remeasured using the average rate for the period (USD 1 = ARS 870) with the exception of those accounts that relate to nonmonetary assets or liabilities (cost of goods sold, depreciation expense) which should be recorded at the exchange rate in effect when the asset or liability was established. In this example, no inventory was produced and no fixed assets were acquired in the current period; therefore, these expenses are recorded at the exchange rate in effect when Iguazu Inc adopted USD as its functional currency (USD 1 = ARS 800).
- The foreign currency gain or loss recorded in Iguazu Inc's Argentine peso income statement is calculated by comparing the change in the balance of the USD denominated loan from the beginning of the period (ARS 800,000) to the end of the period (ARS 900,000). This loss will be reversed in the remeasurement process to create the USD functional financial statements because the loan is denominated in USD. The \$103 transaction loss recorded in the USD income statement is created by the ARS denominated net monetary asset which was ARS 530,000 at the beginning of the year and increased by ARS 766,880 during the year. The \$103 transaction loss can be recomputed as follows. The income tax expense impact related to these foreign currency losses has been ignored in the USD financial statements.

(ARS 530,000/900) – (ARS 530,000/800) = (\$74)

(ARS 766,880/900) – (ARS 766,880/870) = (\$29)

(\$103)

Iguazu Inc balance sheet

Account	ARS balance at 12/31/X2	Exchange rate	USD balance at 12/31/X2
Cash	ARS 474,800	USD 1 = ARS 900	USD 528
Accounts receivable	ARS 1,000,000	USD 1 = ARS 900	USD 1,111
Inventory	ARS 340,000	USD 1 = ARS 800	USD 425
Fixed assets	ARS 900,000	USD 1 = ARS 800	USD 1,125
Total assets	ARS 2,714,800		USD 3,189
Accounts payable	ARS 100,000	USD 1 = ARS 900	USD 111
Accrued expenses	ARS 77,920	USD 1 = ARS 900	USD 87
Loan from USA Corp	ARS 900,000	USD 1 = ARS 900	USD 1,000
Total liabilities	ARS 1,077,920		USD 1,198
Common stock	ARS 100,000	USD 1 = ARS 500	USD 200
APIC	ARS 420,000	USD 1 = ARS 500	USD 840
Cumulative translation adjustment (CTA)			(USD 687)
Retained earnings	ARS 1,116,880		USD 1,638
Total shareholder's equity	ARS 1,636,880		USD 1,991
Total liabilities and equity	ARS 2,714,800		USD 3,189

Iguazu Inc income statement

Account	ARS amount for period	Exchange rate	USD amount for period
Revenue	ARS 1,000,000	USD 1= ARS 870	USD 1,149
Cost of goods sold	ARS 300,000	USD 1= ARS 800	USD 375
Expenses:			
General and administrative	ARS 3,000	USD 1= ARS 870	USD 3
Depreciation	ARS 100,000	USD 1= ARS 800	USD 125
Interest	ARS 52,200	USD 1= ARS 870	USD 60
Total expenses	ARS 455,200		USD 563
Foreign currency transaction gain or (loss)	(ARS 100,000)		(USD 103)
Income before taxes	ARS 444,800		USD 483
Income taxes	ARS 177,920	USD 1= ARS 870	USD 205
Net income	ARS 266,880		USD 278

6.3.3 Remeasuring when multiple exchange rates exist

When a foreign entity has a monetary asset or liability denominated in its parent's reporting currency, the existence of multiple exchange rates prior to a highly inflationary determination can produce differences between the parent translated balance and the items' underlying denominated values. This can occur when different rates are used to measure the monetary asset or liability in the foreign entity's functional currency from those used to translate the balance back to the reporting currency.

As discussed in [FX 6.3.1](#), when a foreign entity changes its functional currency due to its local economy being deemed highly inflationary, the "as translated" balances in the financial statements of its parent at the end of the prior period become the accounting basis for the foreign entity's assets and liabilities. If there is a difference between a foreign entity's balance and the translated balance in its parent's financial statements, [ASC 830-30-S99-1](#) states that the difference should be recognized in net income.

Excerpt from [ASC 830-30-S99-1](#)

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

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

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

In our experience, there are very limited circumstances where the difference between the “as translated” balance and the actual US dollar balance can be adequately documented as having been previously recognized through the cumulative translation adjustment. As such, in most cases this difference would be recognized in the income statement when the foreign entity changes its functional currency.

See [FX 5.5.3](#) for additional information on multiple exchange rates and [FX 7.6](#) for information on the effect of multiple exchange rates on intercompany transactions.

Example FX 6-3 illustrates the timing of the recognition of gains and losses in the income statement under the application of highly inflationary accounting, when those gains and losses were not previously recognized as a cumulative translation adjustment.

EXAMPLE FX 6-3

Venezuelan foreign entity that holds US dollars

USA Corp is a US multinational company with a wholly-owned subsidiary in Venezuela, VZ Inc. USA Corp’s functional and reporting currency is the US dollar (USD). VZ Inc’s functional currency prior to transition to highly inflationary accounting is the Venezuelan bolivar (BSF).

Effective February 1, 20X2, USA Corp deemed Venezuela to be a highly inflationary economy, and as a result, VZ Inc changed its functional currency from BSF to USD. Based on its facts and circumstances, USA Corp believes it should continue to use the official rate to translate the financial statement of VZ Inc on December 31, 20X1.

VZ Inc had previously exchanged excess BSF cash into USD in a US bank account using a parallel exchange rate that was higher than the official exchange rate at the time. Because VZ Inc had the intent and the ability to convert the USD cash back into BSF at the parallel market exchange rate, prior to commencement of highly inflationary accounting, the parallel exchange rate was used to remeasure the USD cash balance in VZ Inc’s BSF financial statements. The remeasured balance was then translated into USD using the official rate. This mechanical process created an

“as translated” balance of USD cash that was in excess of the cash balance in the subsidiary’s bank account, as shown below.

USD held by VZ Inc	USD 1,000,000
Parallel rate	5 BSF = 1 USD
BSF as converted	BSF 5,000,000
Official rate	2.15 BSF = 1 USD
USD in consolidation (as translated)	USD 2,326,000

What is VZ Inc’s USD cash balance upon adopting the USD as its functional currency under highly inflationary accounting?

Analysis

Typically, the “as translated” balance of USD cash (USD 2,326,000) would become VZ Inc’s accounting basis of its USD 1,000,000 cash on a prospective basis. However, at the time highly inflationary accounting is adopted and the functional currency is changed to USD, USA Corp would be required to recognize the difference between the “as translated” balance and the actual USD balance in the income statement. Since this difference (USD 1,326,000) was not previously recognized as a cumulative translation adjustment, the adjustment should be recognized in the income statement.

6.3.4 Effect on deferred tax benefits

[ASC 830-10-45-16](#) provides guidance related to the recognition of deferred tax benefits when a foreign entity in a highly inflationary economy adopts the reporting currency of its parent as its functional currency.

ASC 830-10-45-16

When the functional currency is the reporting currency, paragraph [740-10-25-3\(f\)](#) prohibits recognition of deferred tax benefits that result from indexing for tax purposes assets and liabilities that are remeasured into the reporting currency using historical exchange rates. Thus, deferred tax benefits attributable to any such indexing that occurs after the change in functional currency to the reporting currency shall be recognized when realized on the tax return and not before. Deferred tax benefits that were recognized for indexing before the change in functional currency to the reporting currency are eliminated when the related indexed amounts are realized as deductions for tax purposes.

For more information, see [TX 3.3.3](#).

6.3.5 CTA balances that existed prior to highly inflationary accounting

The highly inflationary guidance in [ASC 830](#) should be applied prospectively. Prior period translation adjustments associated with a foreign entity in a highly inflationary economy should not be reversed from the parent company’s CTA account upon commencement of highly inflationary accounting. Absent a derecognition event as described in [FX 8](#), once a foreign entity in a highly inflationary economy changes its functional currency, there should be no changes to the historical CTA.

6.4 Accounting once an economy is no longer highly inflationary

When a reporting entity determines that an economy is no longer highly inflationary, a foreign entity operating in that economy will likely need to change its functional currency back to the local currency.

If the foreign entity determines the local currency is its functional currency, its account balances (measured in the reporting currency of its parent) should be measured into the local currency using the spot exchange rate on the date the local currency is determined to be the new functional currency.

ASC 830-10-45-15

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

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

Monetary assets and liabilities should also be restated in the new functional currency using the current exchange rates at the time it has been determined that the economy ceases to be highly inflationary. Equity accounts should be restated using historical rates.

This guidance differs from the guidance in [ASC 830-10-45-9](#) regarding changes from a parent company's reporting currency to another currency in circumstances other than an economy being deemed no longer highly inflationary. In those circumstances, the CTA account balance is adjusted as if the new functional currency had always been the functional currency (see [FX 3.3.1](#)). Under the guidance in [ASC 830-10-45-15](#), there is no adjustment to the CTA account during the period in which the economy was highly inflationary.

Example FX 6-4 illustrates the accounting for a change in functional currency of a foreign entity when an economy ceases to be highly inflationary.

EXAMPLE FX 6-4

Change in functional currency due to a country's economy ceasing to be highly inflationary

This example is a continuation of Examples FX 6-1 and FX 6-2.

The table below shows the following Iguazu Inc financial statement information at December 31, 20X5: (1) the balance sheet in the local currency (ARS), (2) the exchange rate used to remeasure accounts into the functional currency (USD), and (3) the balance sheet in the USD functional currency.

The exchange rate on December 31, 20X5 is USD 1 = ARS 925.

Account	ARS balance at 12/31/X5	Exchange rate	USD balance at 12/31/X5
Cash	ARS 1,510,000	USD 1 = ARS 925	USD 1,632
Accounts receivable	ARS 1,092,000	USD 1 = ARS 925	USD 1,181
Inventory	ARS 40,000	USD 1 = ARS 800	USD 50
Fixed assets	ARS 700,000	USD 1 = ARS 800	USD 875
Total assets	ARS 3,342,000		USD 3,738
Accounts payable	ARS 250,000	USD 1 = ARS 925	USD 270
Accrued expenses	ARS 450,000	USD 1 = ARS 925	USD 487
Loan from USA Corp	ARS 925,000	USD 1 = ARS 925	USD 1,000
Total liabilities	ARS 1,625,000		USD 1,757
Common stock	ARS 100,000	USD 1 = ARS 500	USD 200
APIC	ARS 420,000	USD 1 = ARS 500	USD 840
Cumulative translation adjustment (CTA)			(USD 687)
Retained earnings	ARS 1,197,000		USD 1,628
Total shareholder's equity	ARS 1,717,000		USD 1,981
Total liabilities and equity	ARS 3,342,000		USD 3,738

On January 1, 20X6, Argentina is no longer deemed to be highly inflationary. The spot exchange rate on that date is USD 1 = ARS 925.

How should Iguazu Inc account for the change in functional currency?

Analysis

The monetary and nonmonetary US dollar balances should be translated into Argentine pesos using the exchange rate on January 1, 20X6.

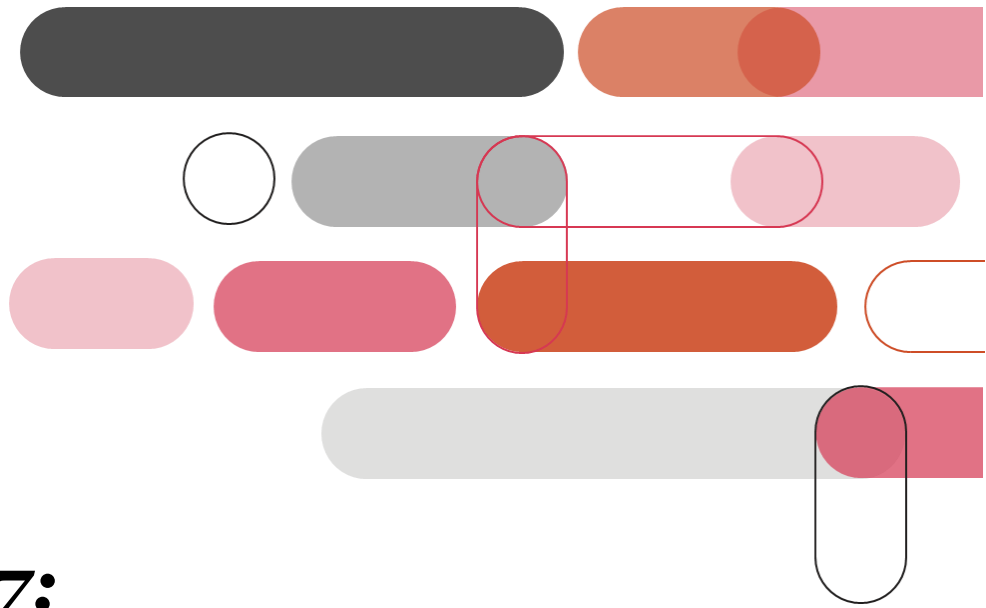
In remeasuring Iguazu Inc's financial statements from USD to ARS, Iguazu Inc's nonmonetary asset balances will change from the amounts as stated in its local books and records. This adjustment is determined by taking the sum of Iguazu Inc's

nonmonetary assets (USD 50 inventory + USD 875 fixed assets) and multiplying it by the difference between the exchange rate on the date Iguazu Inc transitioned to a functional currency of US dollars (USD 1 = ARS 800) and the current exchange rate (USD 1 = ARS 925).

[ASC 830](#) does not provide guidance on how to recognize this adjustment. We believe it is reasonable to recognize it as an adjustment to opening retained earnings on the date of the change in functional currency from USD to ARS.

Account	USD balances on 1/1/X6	Exchange rate	ARS balances at 1/1/X6
Cash	USD 1,632	USD 1 = ARS 925	ARS 1,510,000
Accounts receivable	USD 1,181	USD 1 = ARS 925	ARS 1,092,000
Inventory	USD 50	USD 1 = ARS 925	ARS 46,250
Fixed assets	USD 875	USD 1 = ARS 925	ARS 809,375
Total assets	USD 3,738		ARS 3,457,625
Accounts payable	USD 270	USD 1 = ARS 925	ARS 250,000
Accrued expenses	USD 487	USD 1 = ARS 925	ARS 450,000
Loan from USA Corp	USD 1,000	USD 1 = ARS 925	ARS 925,000
Total liabilities	USD 1,757		ARS 1,625,000
Common stock	USD 200	USD 1 = ARS 500	ARS 100,000
APIC	USD 840	USD 1 = ARS 500	ARS 420,000
Cumulative translation adjustment (CTA)	(USD 687)		
Retained earnings	USD 1,628		ARS 1,312,625
Total shareholder's equity	USD 1,981		ARS 1,832,625
Total liabilities and equity	USD 3,738		ARS 3,457,625

Note that in this example, the CTA balance (that remained frozen during the highly inflationary period) remains on the parent's books and will be adjusted prospectively.



Chapter 7:
Intercompany transactions

7.1 Overview of intercompany transactions

Given the functional currency principle in [ASC 830](#), intercompany foreign currency transactions can create and transfer foreign currency risk between a reporting entity and its foreign entities, and among a reporting entity's foreign entities. This chapter discusses the accounting for intercompany foreign currency transactions. See [TX 13](#) for information on deferred taxes on intercompany loans with foreign subsidiaries.

7.2 Intercompany balances

Intercompany balances denominated in a currency other than the functional currency of the parties to the transaction create foreign currency gains and losses that survive consolidation, even though the intercompany balances do not. For example, a reporting entity that enters into a loan with one of its foreign entities denominated in something other than its functional currency must measure the loan in its functional currency, which will create foreign currency transaction gains and losses that are recorded in the reporting entity's consolidated income statement. These foreign currency transaction gains and losses are not eliminated in consolidation, even though the intercompany loan eliminates. Even when an intercompany balance is denominated in the reporting entity's reporting currency, translating the foreign entity's financial statements into the reporting currency does not reverse the foreign currency transaction gains and losses. Instead, translating the foreign entity's financial statements into the reporting currency generates an equivalent gain or loss within the cumulative translation adjustment (CTA) account, a component of other comprehensive income. Example FX 7-1 illustrates the application of this guidance.

EXAMPLE FX 7-1

Effect of a foreign currency intercompany loan on the consolidated financial statements

USA Corp is a US registrant that uses the US dollar (USD) as its reporting currency.

Mexico SA is a wholly-owned subsidiary of USA Corp located in Tijuana, Mexico. It is a distinct and separable operation of USA Corp and has a functional currency of the Mexican peso (MXN); therefore, it meets the definition of a foreign entity of USA Corp.

On January 15, 20X1, USA Corp loans USD 50,000 to Mexico SA. The loan is payable in one year and USA Corp management believes that Mexico SA will repay the loan when due.

The relevant exchange rates are shown in the following table.

Date	Exchange rate
January 15, 20X1	USD 1 = MXN 10
March 31, 20X1	USD 1 = MXN 13
Average rate during the period	USD 1 = MXN 11

How should USA Corp account for the intercompany loan in its consolidated financial statements for the quarter ended March 31, 20X1?

Analysis

Mexico SA – 1/15/X1

Because the loan is denominated in a currency other than Mexico SA's functional currency, Mexico SA must first measure and record the loan in its functional currency, MXN, using the exchange rate on the date the loan is funded.

$$\text{USD } 50,000 \times (10/1) = \text{MXN } 500,000$$

USA Corp – 1/15/X1

The loan is denominated in USA Corp's functional currency; therefore, the loan and the payment of cash is recorded for USD 50,000.

Mexico SA – 3/31/X1

The USD loan is a monetary liability for Mexico SA. To prepare its March 31, 20X1 financial statements, Mexico SA has to first measure the foreign currency loan using the exchange rate on that date.

$$\text{USD } 50,000 \times (13/1) = \text{MXN } 650,000$$

Mexico SA would record an entry to recognize the difference in exchange rates between March 31, 20X1 and the date the receivable was recognized. The offsetting entry is recorded in the income statement as a foreign currency transaction loss.

Dr. Foreign currency transaction loss	MXN 150,000	
Cr. Intercompany loan payable		MXN 150,000

USA Corp – 3/31/X1

USA Corp translates the financial statements of Mexico SA before including them in its consolidated financial statements. The following table shows the effect of the USD denominated loan on USA Corp's consolidated USD financial statements for the period ended March 31, 20X1.

The CTA balance results from USA Corp's exposure to MXN and represents the impact of the change in foreign currency (between January 15 and March 31, 20X1) on the beginning balance plus the impact of the difference between the average exchange rate for the period and the exchange rate at March 31, on the transaction loss. It is calculated as follows:

$$[(\text{MXN } 500,000/10) - (\text{MXN } 500,000/13)] + [(\text{MXN } 150,000/11) - (\text{MXN } 150,000/13)]$$

	Mexico SA balance	Translated balance	USA Corp balance	Consolidating entries	USA Corp consolidated balance
USD denominated loan			USD 50,000	(USD 50,000)	-
USD denominated loan payable	(MXN 650,000)	(USD 50,000)		USD 50,000	-

	Mexico SA balance	Translated balance	USA Corp balance	Consolidating entries	USA Corp consolidated balance
Foreign currency transaction	MXN 150,000	USD 13,636			USD 13,636(1)
CTA		(USD 13,636)			(USD 13,636)(1)

(1) Illustrates how the foreign currency transaction loss survives consolidation, while the translation of the foreign entity's financial statements into the reporting currency generates an offsetting "gain" within the cumulative translation adjustment (CTA) account.

See [FX 4](#) for information on the accounting for foreign currency transactions and [FX 5](#) for information on translating the financial statements of a foreign entity.

See [FX 7.5](#) for information on the accounting for long-term intercompany loans and advances.

7.3 *Elimination of intercompany profits*

Intercompany inventory sales often result in an intercompany profit for the seller. The purchase price recorded by the buyer in its standalone financial statements has two components: a "true" cost component and an intercompany profit component. [ASC 830](#) provides guidance on determining the exchange rate to use to eliminate intercompany profits.

ASC 830-30-45-10

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

Changes in exchange rates subsequent to the transaction date should not impact the amount of intercompany profit to be eliminated. This requires a reporting entity to maintain intercompany inventory records. The cost component of the purchase price paid by the buyer should be translated using the exchange rate at the end of the reporting period.

Example FX 7-2 illustrates the application of this guidance.

EXAMPLE FX 7-2

Elimination of intercompany profits from a foreign currency inventory sale

USA Corp is a US registrant that uses the US dollar (USD) as its reporting currency.

Mexico SA is a wholly-owned subsidiary of USA Corp located in Tijuana, Mexico. It is a distinct and separable operation of USA Corp and has a functional currency of the Mexican peso (MXN); therefore, it meets the definition of a foreign entity of USA Corp.

The relevant exchange rates are shown in the following table.

Date	Exchange rate
January 15, 20X1	USD 1 = MXN 10
March 31, 20X1	USD 1 = MXN 13

On January 15, 20X1, USA Corp sells inventory to Mexico SA for USD 10,000. USA Corp's cost basis in the inventory is USD 6,000, resulting in intercompany profit of USD 4,000.

Mexico SA has not sold the inventory as of March 31, 20X1.

How should USA Corp account for the inventory sale in its consolidated financial statements for the quarter ended March 31, 20X1?

Analysis

Mexico SA – 1/15/X1

Mexico SA should record the inventory purchase in its functional currency, MXN, using the exchange rate on the date the sale occurred.

Dr. Inventory	MXN 100,000	
Cr. Cash		MXN 100,000

USA Corp – 1/15/X1

USA Corp records the inventory sale in its functional currency, USD.

Dr. Cash	USD 10,000	
Dr. Cost of sales	USD 6,000	
Cr. Inventory		USD 6,000
Cr. Revenue		USD 10,000

USA Corp – 3/31/X1

USA Corp will translate the financial statements of Mexico SA before including them in its consolidated financial statements. Given that intercompany profit needs to be eliminated in consolidation, USA Corp must split Mexico SA's inventory balance into its cost component and intercompany profit component. The original balances for each of these components in Mexico SA's books and records are determined by considering USA Corp's inventory cost and profit related to the inventory, measured in MXN using the exchange rate on the date of the inventory sale. Until Mexico SA sells the inventory to a third party, the exchange rate used to translate the intercompany profit component will remain at the exchange rate on the date that Mexico SA received the inventory from USA Corp. The exchange rate used to translate the cost component on Mexico SA's inventory will be the current exchange rate.

USA Corp's consolidated inventory balance is equal to cost component of the inventory Mexico Corp purchased from USA Corp translated at the exchange rate at the end of the reporting period.

$$\text{MXN } 60,000 \times (1/13) = \text{USD } 4,615$$

The CTA balance results from USA Corp's exposure to MXN and represents the impact of the change in foreign currency (between January 15 and March 31, 20X1) on the beginning balance.

$$(\text{MXN } 60,000/10) - (\text{MXN } 60,000/13) = \text{USD } 1,385$$

The table below shows the effect of the USD inventory sale on USA Corp's consolidated USD financial statements for the period ended March 31, 20X1.

	Mexico SA balance	Translated balance	USA Corp balance	Consolidating entries	USA Corp consolidated balance
Inventory	MXN 100,000	USD 7,692		(USD 3,077)(1)	USD 4,615
Revenue			(USD 10,000)	USD 10,000	-
Cost of sales			USD 6,000	(USD 6,000)	-
CTA		USD 2,308		(USD 923)	USD 1,385

(1) As the entire Mexico SA inventory balance (MXN 100,000) was translated at USD 1 =MXN 13, in consolidation the intercompany profit portion (MXN 40,000) must be reversed in order to avoid generating CTA on this amount.

See [FX 5](#) for information on translating the financial statements of a foreign entity.

7.4 *Intercompany dividends*

As a component of shareholders' equity, dividends are recorded using the exchange rate at the declaration date. A dividend payable is a monetary liability which, when denominated in a currency other than the reporting entity's functional currency, must be measured in the reporting entity's functional currency. This measurement will produce foreign currency transaction gains and losses which should be recorded in net income.

Declared but unpaid dividends to a reporting entity by a foreign entity in the functional currency of the foreign entity have the following effect on the reporting entity's consolidated financial statements:

- The foreign entity's dividend payable is translated, with the foreign entity's other accounts, into the reporting currency of the reporting entity with an offsetting entry to CTA.
- The reporting entity's dividend receivable is a foreign currency transaction which must be measured in the functional currency of the reporting entity. This will cause an equivalent foreign currency transaction gain or loss.

7.5 *Accounting for long term intercompany loans and advances*

Foreign currency transaction gains and losses related to intercompany loans or advances that have been asserted by management to be of a long-term-investment nature should be accounted for as translation adjustments.

Excerpt from [ASC 830-20-35-3](#)

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

...

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

Therefore, when management asserts that an intercompany balance will not be settled in the foreseeable future, the gains and losses from measuring the intercompany balance should be removed from the income statement and recorded in the CTA account upon consolidation (i.e., the gains and losses are recorded in the same manner as translation adjustments).

This accounting is appropriate only when management expects and intends that the loan will not be repaid in the foreseeable future, and only when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements.

QUESTION FX 7-1

If management intends to repay an intercompany loan, but the timing of the repayment is uncertain, can management assert that settlement is not planned or anticipated in the foreseeable future?

PwC response

No. We believe the phrase "not planned or anticipated in the foreseeable future" does not include a loan which is intended to be repaid, but for which the timing is uncertain. Rather, the guidance is intended to apply only to loans for which there is no current intention to repay.

QUESTION FX 7-2

Can a long term advance with a specified maturity date be treated as a long-term-investment under [ASC 830](#)?

PwC response

It depends. A long term intercompany note with a specified maturity would not be considered of a long-term-investment nature under [ASC 830](#), unless management's expressed intent is to renew the note at maturity. Absent management's intention to renew, the note's maturity date, regardless of the duration, implies that its settlement is planned in the foreseeable future.

QUESTION FX 7-3

Can an intercompany loan that requires periodic payments of interest be considered long term in nature and, if so, how should remeasurement gains and losses associated with the corresponding interest receivable/payable be recorded?

PwC response

Yes, an intercompany loan that requires periodic payments of interest may be considered long term in nature if settlement of the principal balance is not anticipated or planned in the foreseeable future. Remeasurement gains and losses associated with the corresponding interest receivable or payable would not be considered to be of a long-term-investment nature, and therefore the impact of changes in the exchange rate should be recorded in the income statement as foreign currency transaction gains and losses. These gains and losses survive consolidation.

QUESTION FX 7-4

If a reporting entity settles or partially settles an intercompany transaction for which settlement was not previously planned (and therefore had been considered of a long-term-investment nature), should the related foreign currency exchange gains and losses previously included in CTA be recognized in the income statement?

PwC response

[ASC 830](#) requires that the accumulated translation adjustment attributable to a foreign entity that is sold or substantially liquidated be removed from equity and included in determining the gain or loss on sale or liquidation. An intercompany loan, while considered a long-term-investment, is essentially a capital contribution, and repayment of the loan is essentially a return of capital or a dividend. Such repayment transactions do not cause a release of CTA, unless they effectively constitute a substantial liquidation of the foreign entity. The characterization of an intercompany loan as being of a long-term-investment nature must be periodically reassessed.

Management's expectations and intent may change due to a change in circumstances; however, such change in circumstances should be carefully evaluated to determine whether management's previous assertions were appropriate. Once repayment of an intercompany loan is contemplated in the foreseeable future, the intercompany loan is no longer viewed as, effectively, a capital contribution. Any exchange gains or losses included in CTA (applicable to the period for which settlement was not planned or anticipated) should remain in CTA. Foreign exchange transaction gains and losses in subsequent periods should be recorded in the income statement. A reporting entity should be cognizant that there is an expectation that there is a period of time between the determination that a loan will be repaid, and the actual date when the loan is repaid.

QUESTION FX 7-5

Under what circumstances may intercompany balances be settled (in part or in full) without raising questions about the appropriateness of the initial long-term-investment nature classification?

PwC response

The facts and circumstances at the time of settlement should be carefully evaluated and compared to those that existed or could have been known at inception. If a reporting entity could have anticipated such a circumstance occurring, it may not have been appropriate to initially classify the balance as being of a long-term-investment nature. Since classification under [ASC 830](#) is primarily based on

management's intent about settlement in the foreseeable future, the following factors may support a settlement in subsequent periods:

- The change in circumstances is such that it could not have been anticipated at the time of initial classification.
- The change in circumstances was outside of the entity's control—for example, a foreign government may have announced an intention to nationalize an industry in which the subsidiary is operating, or some other governmental/regulatory action is taken that makes the country less attractive to do business in (such as unprecedented changes in tax laws).
- The foreign entity's business improves dramatically (to such an extent that could not have been anticipated/foreseen by management) and the subsidiary no longer needs the intercompany advance from the parent.
- A material "windfall" of cash for the foreign entity (from, for example, the sale of a non-operating asset) that was not anticipated initially.

QUESTION FX 7-6

How should exchange gains and losses on intercompany transactions of a long-term-investment nature be presented in a foreign entity's separate financial statements?

PwC response

Transaction gains and losses on intercompany balances of a long-term-investment nature should be recognized in net income in a foreign entity's separate financial statements.

QUESTION FX 7-7

Can intercompany accounts of a trading nature be considered permanent because, although individual transactions are settled, the aggregate balance never drops below a specified minimum amount?

PwC response

No. The FASB staff has indicated that it did not intend for gains and losses on intercompany trading account balances to be deferred. Rather, each individual transaction should be viewed as a separate unit of account. Under such a perspective, gains and losses on active accounts as described above would not qualify for deferral treatment because settlement of each individual transaction is contemplated.

We believe deferral can be achieved on a prospective basis by identifying specific transactions that will not be settled and classifying them as being of a long-term-investment nature, but only from the date of designation. Where such a technique is contemplated, it is important to ensure adequate documentation. Further, companies should be aware that such a technique may have tax or other legal consequences of greater impact than the desired accounting result.

Management's stated intentions used to determine the appropriate accounting for US GAAP purposes should be consistent with those used to determine the appropriate tax treatment. For example, it would be inconsistent for management to assert that an intercompany loan will be continually renewed at maturity for US GAAP purposes (i.e., repayment is not planned or anticipated), yet issue a written representation letter to the tax authorities stating that the intercompany loan will be repaid at maturity.

Example FX 7-3 illustrates the accounting for an intercompany foreign currency denominated loan of a long-term-investment nature.

EXAMPLE FX 7-3

Intercompany loan of a long-term-investment nature

USA Corp is a US registrant that uses the US dollar (USD) as its reporting currency.

Mexico SA is a wholly-owned subsidiary of USA Corp located in Tijuana, Mexico. It is a distinct and separable operation of USA Corp and has a functional currency of the Mexican peso (MXN); therefore, it meets the definition of a foreign entity of USA Corp.

On January 15, 20X1, USA Corp loans USD 50,000 to Mexico SA. USA Corp management has asserted that settlement of the intercompany loan is not planned or anticipated in the foreseeable future. Consequently, management has determined that the intercompany payable is of a long-term-investment nature.

The relevant exchange rates are shown in the following table.

Date	Exchange rate
January 15, 20X1	USD 1 = MXN 10
March 31, 20X1	USD 1 = MXN 13
Average rate during the period	USD 1 = MXN 11

How should USA Corp account for the long term intercompany loan in its consolidated financial statements for the quarter ended March 31, 20X1?

Analysis

Mexico SA – 1/15/X1

Because the loan is denominated in a currency other than Mexico SA's functional currency, it is a foreign currency transaction. Accordingly, Mexico SA should measure and record the loan in its functional currency, MXN, using the exchange rate on the date the loan is funded.

$$\text{USD } 50,000 \times (10/1) = \text{MXN } 500,000$$

USA Corp – 1/15/X1

The loan is denominated in USA Corp's functional currency; therefore, USA Corp will record the loan and the payment of cash for USD 50,000.

Mexico SA – 3/31/X1

The USD loan is a monetary liability for Mexico SA. To prepare its March 31, 20X1 financial statements, Mexico SA will first measure the foreign currency loan using the exchange rate on that date.

$$\text{USD } 50,000 \times (13/1) = \text{MXN } 650,000$$

Mexico SA records an entry to recognize the difference between the MXN balance on March 31, 20X1 and the MXN balance on January 15, 20X1, the date the loan was

recognized. The offsetting entry is recorded in the income statement as a foreign currency transaction loss.

Dr. Foreign currency transaction loss	MXN 150,000	
Cr. Intercompany loan		MXN 150,000

USA Corp – 3/31/X1

USA Corp will need to translate the financial statements of Mexico SA before including them in its consolidated financial statements. The following table shows the effect of the USD denominated receivable on USA Corp’s consolidated USD financial statements for the period ended March 31, 20X1.

The CTA balance results from USA Corp’s exposure to MXN and represents the impact of the change in foreign currency (between January 15 and March 31, 20X1) on the beginning balance plus the impact of the difference between the average exchange rate for the period and the exchange rate at March 31, on the transaction loss. It is calculated as follows:

$$[(MXN 500,000/10) - (MXN 500,000/13)] + [(MXN 150,000/11) - (MXN 150,000/13)]$$

	Mexico SA balance	Translated balance	USA Corp balance	Consolidating entries	USA Corp consolidated balance
USD denominated loan			USD 50,000	(USD 50,000)	-
USD denominated loan payable	(MXN 650,000)	(USD 50,000)		USD 50,000	-
Foreign currency transaction	MXN 150,000	USD 13,636		(USD 13,636)	-
CTA		(USD 13,636)		USD 13,636	-

See [FX 4](#) for information on foreign currency transactions and [FX 5](#) for information on translating the financial statements of a foreign entity.

7.6 *Exchange rate applicable to intercompany transactions*

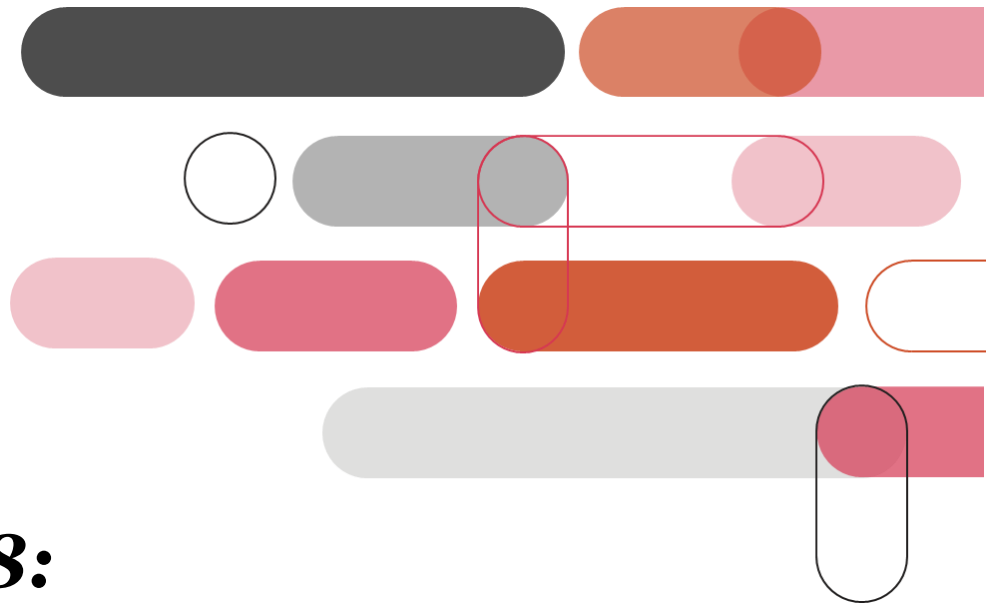
[ASC 830](#) provides guidance regarding how to account for a difference in the exchange rates used to account for foreign currency intercompany transactions. This can occur when an economy has multiple exchange rates as a result of exchange controls. See [FX 5.5.3](#) for information on multiple exchange rates.

ASC 830-30-45-7

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

Therefore, when a difference in the exchange rate used to account for intercompany transaction results in a mismatch between the amounts recorded by entities in a consolidated group, the difference should be recorded as an intercompany receivable or payable until the intercompany transaction is settled.

See [FX 6.3.3](#) for an example that illustrates this guidance.



Chapter 8:
Acquisitions and dispositions
involving a foreign operation

8.1 Overview of acquisitions and dispositions involving a foreign operation

[ASC 805](#), *Business Combinations*, [ASC 810](#), *Consolidation*, and [ASC 323](#), *Investments-Equity Method and Joint Ventures*, provide guidance on how a reporting entity should account for acquisitions and dispositions. This chapter outlines guidance specific to the impact of foreign currency on the accounting for acquisitions and dispositions of foreign operations.

When acquiring or disposing of a foreign operation, a reporting entity will need to consider the following foreign currency questions that impact the accounting for the transaction:

- Whether there has been a change in the selling or acquiring reporting entity's foreign entities
- How to determine the functional currency of a new foreign entity
- Whether an acquisition or disposition causes a change in the functional currency of an existing foreign entity
- How to allocate goodwill resulting from an acquisition of a foreign operation to the appropriate reporting units
- Whether a disposition of a foreign operation has an effect on intercompany transactions
- Whether the cumulative translation adjustment (CTA) account balance for the acquired or disposed foreign entity should be recognized in net income

The accounting for the acquisition or disposition of a business, including a foreign operation, is discussed in PwC's [Business combinations and noncontrolling interests](#) guide (BCG).

8.2 Acquisition of a foreign operation

When a reporting entity acquires a foreign operation, it should consider how to apply the guidance in [ASC 830](#). To do that, the reporting entity should first determine whether the foreign operation (1) will be operating as a distinct and separable foreign operation or (2) will be operationally combined with one of the reporting entity's existing foreign or domestic entities. See [FX 2](#) for information on determining whether an operation is distinct and separable.

If the reporting entity determines that the newly acquired foreign operation will be operated as a distinct and separable operation, it should determine the functional currency of the acquired operation. If the functional currency is different than the reporting currency, the acquired operation is a foreign entity. If the functional currency is the same as the reporting currency, the acquired operation is a domestic entity. If the foreign operation is not distinct and separable, and is therefore combined with one of the reporting entity's existing foreign or domestic entities, the reporting entity should determine whether the newly acquired foreign operation causes a change in the functional currency of the existing foreign or domestic entity. See [FX 3](#) for information on determining functional currency.

8.2.1 Allocation of goodwill to reporting units

The unit of account for goodwill is the reporting unit. A reporting unit is the same as, or one level below, an operating segment as defined in [ASC 280](#). One level below an

operating segment is referred to as a component. After components are identified, a reporting entity should aggregate components into one or more reporting units based upon similar economic characteristics. See [BCG 9.2.4](#) for a discussion of the various criteria that should be considered when evaluating what constitutes similar economic characteristics. Reporting unit balances are impacted by dispositions and deconsolidation events, and the results of annual or event-driven impairment assessments.

Goodwill resulting from a business combination should be assigned to one or more reporting units. See [BCG 9.4](#) for further guidance. Goodwill created by acquiring a foreign operation should be measured in terms of the foreign entity's functional currency based on the exchange rate at the date of acquisition. At subsequent reporting dates, goodwill should be translated like all other assets and liabilities of the foreign entity (see [FX 5](#)). This treatment applies regardless of whether the goodwill is pushed down to the books and records of the foreign entity.

There is currently no guidance which explains how the foreign entity unit of account concept from [ASC 830](#) interacts with the unit of account concept for goodwill (the reporting unit) from [ASC 350, Intangibles — Goodwill and Other](#), for purposes of aggregating components to form a multi-currency reporting unit. When a reporting unit includes components with different functional currencies, the goodwill impairment test by necessity must be performed in the reporting currency, which means that the goodwill balance being tested is impacted by CTA. Alternatively, the goodwill related to a reporting unit that comprises components that share the same functional currency is not impacted by CTA and is tested in the functional currency.

Given the lack of guidance in [ASC 350](#) and the judgment required to determine when components should be aggregated, multi-currency reporting units exist in practice. However, some reporting entities have limited reporting units to a single currency after considering the principles set forth in [ASC 830](#). For example, [ASC 830-10-45-2](#) states that the assets of a foreign entity shall be measured using the functional currency of the foreign entity. Further, the notion of combining components that are also foreign entities based on the similarity of products, processes, customers, distribution methods, and regulatory environment, and their level of operational dependency, as discussed in [ASC 350](#) and [ASC 280](#), appears inconsistent with the “distinct and separable” (see [FX 2](#)) and “self-contained” notions from [ASC 830](#). Lastly, we note that allocating goodwill within a multi-currency reporting unit subsequent to a disposition, impairment, or reorganization can create significant operational challenges.

8.2.2 Obtaining control through a step acquisition

In a step acquisition, an acquirer may obtain control of a business in which it previously held an equity interest. See [BCG 5](#) for information on the accounting for step acquisitions. [ASC 805-10-25-10](#) provides guidance on the accounting for CTA when a reporting entity obtains control of a foreign entity through a step acquisition.

Excerpt from [ASC 805-10-25-10](#)

If the business combination achieved in stages relates to a previously held equity method investment that is a foreign entity, the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that previously held investment.

The accounting for obtaining control of a previously held equity method investment (a step acquisition) is based on the view that the transaction is two distinct events, the disposition of the previously held equity method investment (as discussed in [ASC 830-30-40-1A](#)), and the acquisition of the controlling financial interest. When a reporting entity disposes of a foreign entity, it is required to reclassify any related CTA account to net income (see [FX 8.3](#) for further information).

Based on this guidance, if the previously held equity method investment was a foreign entity in its entirety (i.e., an investment “in” a foreign entity), the deemed disposal would cause the related CTA balance to be reclassified to net income. In contrast, if the previously held equity method investment was only a component of a foreign entity (i.e., an investment “within” a foreign entity), the deemed disposal would not cause the related CTA balance to be reclassified unless it represented a substantially complete liquidation of the foreign entity.

8.3 *Disposition of a foreign operation*

The guidance in [ASC 830](#) related to the reclassification of the CTA account balance to net income reflects a compromise between the guidance regarding the recognition of accumulated CTA balances in [ASC 830](#) and the loss of control concepts in the consolidation guidance in [ASC 810-10](#). [ASC 830-30-40-3](#) precludes the reclassification of a CTA account balance for a derecognition event that occurs within a foreign entity (derecognition of a part of a foreign entity) unless the event is a complete or substantially complete liquidation of the foreign entity. However, CTA should be recognized in net income when a reporting entity ceases to have a controlling financial interest in the foreign entity, even if the reporting entity retains a noncontrolling interest.

The foreign currency accounting effects of a disposition differ for foreign operations that are foreign entities versus those that are not (i.e., operations that are not distinct and separable). See [FX 2](#) for information on determining whether a foreign operation is distinct and separable.

8.3.1 *Disposition of a foreign entity*

When a reporting entity disposes of a foreign entity, [ASC 830](#) requires the reporting entity to recognize the accumulated CTA balance associated with that foreign entity in the income statement as part of the gain or loss on the sale.

ASC 830-30-40-1

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

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

This guidance should be applied when a reporting entity ceases to have a controlling financial interest in the foreign entity even if the reporting entity retains a noncontrolling interest.

Example FX 8-1 illustrates the application of [ASC 830-30-40-1](#), when a reporting entity deconsolidates a foreign entity, subsequent to disposing of a portion of its ownership.

EXAMPLE FX 8-1

Disposition of a portion of a foreign entity – reporting entity deconsolidates foreign entity

USA Corp is a US registrant. Britannia PLC is a foreign entity of USA Corp located in the United Kingdom.

USA Corp reduces its ownership in Britannia PLC from 100% to 40%. USA Corp determines that it should deconsolidate Britannia PLC based on the guidance in [ASC 810](#).

Should USA Corp remove the accumulated CTA account balance associated with Britannia PLC from equity and recognize it in the income statement?

Analysis

Yes. Since USA Corp no longer holds a controlling financial interest in Britannia PLC, it is deemed to have disposed of 100% of its interest in Britannia and acquired a 40% interest in Britannia. Consequently, USA Corp must reclassify 100% of the related CTA balance to net income.

Example FX 8-2 illustrates the application of [ASC 830-30-40-1](#), when a reporting entity continues to consolidate a foreign entity, subsequent to disposing of a portion of its ownership.

EXAMPLE FX 8-2

Disposition of a portion of a foreign entity — reporting entity still consolidates foreign entity

USA Corp is a US registrant. Britannia PLC is a foreign entity of USA Corp located in the United Kingdom.

USA Corp reduces its ownership in Britannia PLC from 100% to 51%. USA Corp determines that it retained a controlling financial interest in Britannia PLC and should continue to consolidate it.

Should USA Corp remove the accumulated CTA account balance associated with Britannia PLC from equity and recognize it in the income statement?

Analysis

No. Since USA Corp retains control of the foreign entity, all of the accumulated CTA balance associated with the foreign entity should remain in equity.

Example FX 8-3 illustrates the application of [ASC 830-30-40-1](#), when a reporting entity disposes of a portion of a legal entity.

EXAMPLE FX 8-3

Disposition of a portion of a legal entity that (portion) represents a foreign entity

USA Corp is a US registrant. USA Corp has a European foreign subsidiary, European Corp, which comprises two distinct and separable operations, European Manufacturing Co and European Sales Co, each of which meets the definition of a foreign entity.

European Corp sells European Sales Co for cash to an unrelated entity.

Should USA Corp reclassify the accumulated CTA account balance associated with European Sales Co to net income?

Analysis

Yes. Since European Sales Co meets the definition of a foreign entity, the associated accumulated CTA balance should be reclassified from equity to net income upon its sale.

8.3.1.1 Substantially complete liquidation of a foreign entity

As discussed above, the sale of a controlling financial interest in a foreign entity leads to the reclassification of accumulated CTA to net income. In addition, a complete or substantially complete liquidation of the net assets of a foreign entity would also lead to the reclassification of accumulated CTA to net income.

We believe the phrase “substantially complete” liquidation, as used in [ASC 830-30-40-1](#), means a significant portion of the investment will be liquidated. Although not a bright line, we believe that at least 90% of the net assets of a foreign entity must be liquidated for a substantially complete liquidation to have occurred.

Accordingly, the following transactions do not represent a substantially complete liquidation:

- Payment of periodic dividends to the parent out of a foreign subsidiary’s net income
- Payment of liquidating dividends in amounts less than a significant portion of the investment’s assets (i.e., less than 90% of the assets)
- Changing the nature of an intercompany advance from permanent (i.e., similar to capital) to debt intended to be settled in the foreseeable future

What happens to the proceeds from a substantially complete liquidation of a foreign entity may also help determine whether the CTA account should be released into net income. The circumstances in which the CTA account may be released include the following:

- The net proceeds are sent to the parent company
- The net proceeds are not reinvested, but are simply held as cash in the bank account of the sold/liquidated subsidiary
- The net proceeds are reinvested in a different business from that of the old liquidated subsidiary

In some circumstances, a reporting entity may conclude that a sale or complete liquidation has occurred in form, but not in substance, and as a result, the CTA should not be released into net income. Examples of such circumstances include the following:

- Reinvesting or planning on reinvesting the sales proceeds in another subsidiary in substantially the same line of business or industry as the one that was sold or liquidated
- Reinvesting the sales proceeds to effect a change in product lines

- Reinvesting the sales proceeds in activities directly related to the restructuring of a business

As a general rule, we would not expect that a reporting entity would reclassify accumulated CTA from equity to net income for the same foreign entity more than once. Therefore, if the net assets of a foreign entity are liquidated but the reporting entity plans to continue the activity of that foreign entity going forward, a substantially complete liquidation of the foreign entity has likely not occurred and the CTA balance should not be reclassified from equity to net income.

Example FX 8-4 illustrates the application of the guidance regarding whether complete, or substantially complete, liquidation has occurred as a result of the sale of assets of a foreign entity.

EXAMPLE FX 8-4

Sale of assets of a foreign entity

USA Corp is a US registrant. Britannia PLC is a foreign entity of USA Corp located in the United Kingdom.

Britannia PLC sells a group of assets constituting a business comprising 95% of its net assets, and accordingly deconsolidates the business. The sales proceeds are retained by Britannia PLC to be reinvested in similar assets.

Should USA Corp reclassify the accumulated CTA account balance associated with Britannia PLC from equity to net income?

Analysis

No. While the transaction was, in form, a liquidation of substantially all of Britannia PLC's net assets, the substance of the transaction reflects a continuation of Britannia PLC's historical business. Therefore, the CTA account balance should remain in equity.

Example FX 8-5 illustrates the application of the guidance regarding whether complete, or substantially complete, liquidation has occurred as a result of the dissolution of a foreign entity.

EXAMPLE FX 8-5

Dissolution of a foreign entity

USA Corp is a US registrant. Britannia PLC is a foreign entity of USA Corp located in the United Kingdom.

USA Corp decides to cease the operations of Britannia PLC and directs it to sell 95% of its net assets and remit the proceeds to USA Corp. USA Corp intends to sell the remaining assets of Britannia PLC and has no intent of reinvesting in similar activities.

Should USA Corp reclassify the accumulated CTA account balance associated with Britannia PLC from equity to net income?

Analysis

Yes. Since the asset sale represents a substantially complete liquidation of a foreign entity, USA Corp should reclassify the entire accumulated CTA balance associated

with Britannia PLC from equity to net income. Further, the impact of future exchange rate changes on the remaining 5% of net assets should not be recorded to CTA. Essentially, this results in Britannia PLC becoming an extension of its parent, USA Corp, along with Britannia PLC assuming the functional currency of USA Corp.

Substantially complete liquidations when disposition occurs over time

When a reporting entity intends to dispose of a foreign entity over time, it should determine when the liquidation process of the foreign entity begins. This determination should be based on the facts and circumstances surrounding the disposition. For example, if a reporting entity establishes a formal plan to dispose of a foreign entity in stages, and there is limited uncertainty regarding the completion of each stage, it may be appropriate to recognize the accumulated CTA balance in net income when the liquidation is substantially complete, which would be based on the foreign entity's assets at the outset of the planned disposal. However, if no formal plan is initiated, each disposal round should be measured against the foreign entity's assets at the date of each disposal event. This would delay the achievement of a substantial liquidation until a single sale represented at least 90% of the remaining assets.

8.3.2 Disposition of a legal entity in a multi-tiered legal entity organization (including holding companies)

As discussed in [FX 2](#), a foreign entity can be comprised of numerous legal entities if those legal entities are engaged in similar operations. The sale of a legal entity within such a foreign entity should not result in the recognition of the accumulated CTA account balance in net income when it is not a substantial liquidation of the foreign entity. Example FX 8-6 illustrates the application of this guidance.

EXAMPLE FX 8-6

Sale of a second-tier foreign operation

USA Corp is a US registrant. USA Corp has a first-tier European operating subsidiary, European Corp, which has a wholly-owned second-tier subsidiary, Deutsche AG. Although European Corp and Deutsche AG are separate legal entities, they are not distinct and separable operations, and are therefore considered a single foreign entity.

European Corp sells 100% of its interest in Deutsche AG and distributes the proceeds to USA Corp.

Should USA Corp reclassify the accumulated CTA account balance associated with the foreign entity from equity to net income?

Analysis

No. Unless the disposition of Deutsche AG represents a complete, or substantially complete liquidation of the entire foreign entity (i.e., Deutsche AG represents substantially all of the foreign entity), the accumulated CTA account balance should remain in equity.

8.3.3 Disposition of a foreign operation accounted for using the equity method

As discussed in [FX 5](#), the financial statements of an equity-method investee with a functional currency different from the reporting entity's reporting currency must be

translated into the reporting currency. An equity-method investment in a foreign operation may be a standalone foreign entity or it may be part of a larger foreign entity. The guidance in [ASC 830-30-40-1](#) regarding the recognition of an accumulated CTA balance upon the disposition or complete or substantially complete liquidation of an investment in a foreign entity also applies to the disposition or liquidation of an equity-method investment.

If a reporting entity sells its entire ownership interest in an equity-method investment that is an investment “within” a foreign entity (i.e., the disposition of the equity-method investment did not involve the entire foreign entity), it should not recognize the CTA account balance in net income unless the sale is a substantially complete liquidation of that foreign entity, as discussed in [FX 8.3.1.1](#).

Example FX 8-7 illustrates the guidance in [ASC 830-30-40-1](#) as applied to the disposition of a foreign operation accounted for using the equity method of accounting.

EXAMPLE FX 8-7

Disposition of a foreign operation accounted for using the equity method of accounting

USA Corp is a US registrant. Nippon Corp is a wholly-owned subsidiary of USA Corp located in Japan. Nippon Corp holds a 50% investment in Honshu Ltd, which it accounts for using the equity method of accounting. Nippon Corp and Honshu Ltd have similar operations (i.e., they are not distinct and separable from one another), and both have a functional currency of Japanese yen. Therefore, they are considered a single foreign entity of USA Corp. Nippon Corp comprises 60%, and Honshu Ltd comprises 40% of the foreign entity’s total assets respectively.

USA Corp directs Nippon Corp to sell its investment in Honshu Ltd and remit the sales proceeds to USA Corp.

Should USA Corp remove the accumulated CTA account balance associated with Honshu Ltd from equity and recognize it in the income statement?

Analysis

No. Since USA Corp’s sale of its indirect investment in Honshu Ltd did not involve the entire foreign entity (i.e., Nippon Corp was not sold), and the sale of 40% of the total assets of the foreign entity does not represent a substantially complete liquidation of the foreign entity, USA Corp should retain the CTA account related to Honshu Ltd in equity.

8.3.3.1 Equity method investments that represent a foreign entity

If a reporting entity sells a portion of a foreign entity that is accounted for using the equity method, and its retained interest will also be accounted for using the equity method, it should recognize a pro rata portion of the accumulated CTA account attributable to the equity method investment when measuring the gain or loss on the sale as prescribed by [ASC 830-30-40-2](#).

Excerpt from [ASC 830-30-40-2](#)

If a reporting entity sells part of its ownership interest in an equity method investment that is a foreign entity, a pro rata portion of the accumulated translation adjustment component of equity attributable to that equity method investment shall be recognized in measuring the gain or loss on the sale.

Example FX 8-8 illustrates the accounting for the CTA account balance upon the disposition of a portion of an equity method investment that represents a foreign entity.

EXAMPLE FX 8-8

Disposition of a portion of an equity method investment that represents a foreign entity

USA Corp is a US registrant. USA Corp has a 40% investment in European Corp that it accounts for using the equity method of accounting. European Corp is a foreign entity of USA Corp.

USA Corp reduces its investment to 30% by selling a portion of its investment in European Corp. At the date of sale, USA Corp's CTA account balance associated with European Corp is a credit balance of USD 100.

How should USA Corp account for its CTA account balance in European Corp upon the sale of a portion of its investment?

Analysis

USA Corp should recognize 25% of the USD 100 CTA account balance, or USD 25, in net income. This is the pro rata portion of CTA related to the decrease in ownership from 40% to 30%.

Alternatively, if the reporting entity sells part of an ownership interest in an equity method investment that is part of a larger foreign entity (i.e., an investment "within" a foreign entity), the CTA account balance should not be recognized in the income statement, unless the disposition represented the complete, or substantially complete, liquidation of the foreign entity that holds the equity method investment.

8.3.3.2 Retained interest is not accounted for using the equity method

When a reporting entity sells a portion of an equity method investment and, as a result, can no longer exercise significant influence over an investee as described in [ASC 323-10-15-6](#), it should discontinue accruing its share of the income or losses of the investee for its investment as it no longer qualifies for the equity method. Going forward, the retained interest should be accounted for under the guidance in [ASC 321](#).

Upon the application of [ASC 321](#), the remaining CTA account balance should be reclassified to the carrying value. Provided the equity security does not qualify for a measurement alternative in [ASC 321](#), the retained equity interests should be carried at fair value with changes in value recorded in net income. Any initial difference between the investment's carrying value and fair value should be recognized in net income. If the retained equity interest does not have a readily determinable fair value, it may be eligible for the measurement alternative discussed in [LI 2.3.2](#). See [LI 2.4.2](#)

for information on accounting for a decrease in level of equity ownership under [ASC 321](#).

[ASC 323-10-35-37](#) and [ASC 323-10-35-39](#) provide guidance on how to account for the investor's proportionate share of the investee's equity adjustments for other comprehensive income.

[ASC 323-10-35-37](#)

Paragraph [323-10-35-39](#) provides guidance on how an investor shall account for its proportionate share of an investee's equity adjustments for other comprehensive income in all of the following circumstances:

- a. A loss of significant influence
- b. A loss of control that results in accounting for the investment in accordance with [Topic 321](#)
- c. Discontinuation of the equity method for an investment in a limited partnership because the conditions in paragraph [970-323-25-6](#) are met for accounting for the investment in accordance with [Topic 321](#).

[ASC 323-10-35-39](#)

In the circumstances described in paragraph [323-10-35-37](#), an investor's proportionate share of an investee's equity adjustments for other comprehensive income shall be offset against the carrying value of the investment at the time significant influence is lost. To the extent that the offset results in a carrying value of the investment that is less than zero, an investor shall both:

- a. Reduce the carrying value of the investment to zero
- b. Record the remaining balance in income.

Example FX 8-9 illustrates the accounting for the CTA account balance upon the disposition of a portion of an equity method investment in a foreign entity, with the retained interest being accounted for under the guidance in [ASC 321](#).

EXAMPLE FX 8-9

Disposition of a portion of an equity-method investment in a foreign operation

USA Corp is a US registrant. USA Corp has a 40% investment in Nippon Corp that it accounts for using the equity method of accounting. Nippon Corp is a foreign entity of USA Corp.

USA Corp reduces its investment to 10% by selling a portion of its investment in Nippon Corp. At the date of sale, USA Corp's CTA account balance associated with Nippon Corp is a debit balance of USD 100.

How should USA Corp account for its CTA balance in Nippon Corp upon the sale of a portion of its investment?

Analysis

USA Corp should recognize 75% of the USD 100 CTA account balance, or USD 75, in net income. This is the pro rata portion of CTA related to the decrease in

ownership from 40% to 10%. The remaining USD 25 balance of CTA would be reclassified out of OCI to USA Corp's remaining investment in Nippon Corp.

Upon the application of [ASC 321](#), USA Corp would adjust the investment's carrying amount to fair value and any difference between the carrying value and fair value would be recognized in net income.

8.3.4 Long-term intercompany advances

As discussed in [ASC 830-20-35-3\(b\)](#), foreign currency gains and losses on intercompany transactions that are of a long-term-investment nature (i.e., those for which settlement is not planned or anticipated) should not be included in the income statement. Instead, any gain or loss on the measurement of a long-term advance should be included in the CTA account in consolidation.

When a reporting entity decides to sell a foreign operation, and the sale is expected to result in the repayment of an intercompany advance that has been previously designated by the reporting entity as being of a long-term-investment nature, the reporting entity should begin to record foreign currency gains and losses on the intercompany advance in net income, rather than CTA. As soon as repayment of a long-term advance becomes foreseeable, foreign currency gains and losses related to the measurement of that advance in a reporting entity's functional currency should be recorded in net income. We believe it would be unusual to conclude that the repayment of a loan is only foreseeable on the day that the loan is repaid.

See [FX 7.5](#) for information on long-term advances.

8.4 Impairment calculations that should consider accumulated CTA

[ASC 830-30-45-13](#) through [45-15](#) provide guidance on when a reporting entity should include the CTA account balance attributable to a foreign entity in an impairment assessment. This guidance applies to situations when accumulated CTA will be released to income upon the disposition of an investment in a foreign entity. This guidance does not apply to situations involving an investment within a foreign entity.

Based on the guidance in [ASC 830-30-45-13](#) through [ASC 830-30-45-15](#), a reporting entity that has committed to a plan that will result in the reclassification of a CTA account related to an equity-method investment or a consolidated investment in a foreign entity being reclassified to net income should include the CTA account balance in the carrying amount of the investment when evaluating that investment for impairment. Given that the guidance focuses on planned sale transactions of a foreign entity and the CTA relates to the reporting entity's outside basis investment in a foreign entity, the impairment assessment must be performed in terms of a reporting entity's reporting currency. This is in contrast to the accounting performed on the individual assets and liabilities within the foreign entity, which must be performed in terms of the foreign entity's functional currency.

ASC 830-30-45-13

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

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

ASC 830-30-45-14

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

ASC 830-30-45-15

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

Example FX 8-10 illustrates the concepts discussed in [ASC 830-30-45-13](#) through [ASC 830-30-45-15](#) when a reporting entity has committed to a disposal plan resulting in the reclassification of the CTA account to net income. It also addresses the long-lived asset impairment analysis.

EXAMPLE FX 8-10

Cumulative translation adjustment impairment assessment

USA Corp is a reporting entity located in the United States that has a reporting currency of the US dollar.

Britannia PLC is a wholly-owned subsidiary of USA Corp located in the United Kingdom. It is a distinct and separable operation of USA Corp and has a functional

currency of the British pound sterling (GBP). Britannia PLC represents USA Corp's only foreign entity.

On December 31, 20X1, USA Corp contracts to sell 90% of its interest in Britannia PLC, for USD 100, on January 15, 20X2. USA Corp has an accumulated CTA balance related to its investment in Britannia PLC. Britannia PLC qualifies as an asset held for sale and, based on the guidance in [ASC 360](#), Britannia PLC should be recorded at the lower of its cost or fair value less costs to sell; therefore, an impairment test needs to be conducted as of December 31, 20X1.

How should USA Corp perform the long-lived asset impairment analysis of Britannia PLC?

Analysis

By selling 90% of its ownership interest in Britannia PLC, USA Corp will lose control and deconsolidate Britannia PLC, which results in 100% of the accumulated CTA balance being reclassified to net income upon sale. Accordingly, USA Corp includes 100% of the CTA balance in the Britannia PLC carrying amount when evaluating it for impairment, which necessitates performing the impairment test in USD instead of GBP.

Britannia PLC's translated USD balance sheet prior to the impairment test (and before classification of the subsidiary as held for sale) is as follows.

Working capital	USD 20	Retained earnings/APIC	USD 140
Long-lived assets	USD 100	CTA	(USD 20)
Total assets	<u>USD 120</u>	Total liabilities and equity	<u>USD 120</u>

For simplicity, any control premium is ignored and the total fair value of the remaining 10% interest is USD 11. The simplified impairment test is calculated as follows:

Working capital	USD 20
Long-lived assets	USD 100
CTA	USD 20
Total carrying value	<u>USD 140</u>
Sale consideration for 90% interest	(USD 100)
Fair value of noncontrolling interest retained	(USD 11)
Loss upon classification as held-for-sale	<u>USD 29</u>

The entries to record the loss upon classification as held for sale as of December 31, 20X1 are as follows:

To classify subsidiary as held for sale:

Dr. Assets held for sale	USD 120	
Cr. Working capital		USD 20
Cr. Long-lived assets		USD 100

To record the loss upon classification as held for sale:

Dr. Loss	USD 29	
Cr. Assets held for sale		USD 29

At January 15, 20X2, to record the sale and deconsolidation:

Dr. Cash	USD 100	
Dr. Noncontrolling investment	USD 11	
Cr. CTA		USD 20
Cr. Assets held for sale		USD 91

In some situations, when the CTA account balance must be included in the carrying amount of the assets held for sale when evaluating the investment for impairment, the difference between the carrying amount (including CTA) and the fair value less cost to sell of the assets held for sale (i.e., the implied loss on disposal) may exceed the actual carrying amount (excluding CTA) of the assets held for sale. This can happen when the cumulative CTA balance is a significant debit. In these situations, the SEC staff has indicated there are two acceptable interpretations of the literature for accounting for the impairment loss on the held-for-sale date. The first is to recognize an impairment loss in excess of the carrying amount of the assets held for sale (excluding CTA). Under this interpretation, a valuation allowance on the assets held for sale would be established until such time as the CTA account balance can be released (i.e., upon the actual sale occurring). The second interpretation is to limit the impairment loss to the carrying amount of the assets held for sale (excluding CTA). See [PPE 5.3](#) for more information on accounting for long-lived assets to be disposed of by sale.

8.4.1 Abandonment of a foreign entity

If a reporting entity determines that its best course of action is to abandon a foreign entity, the concepts put forth in [ASC 830-30-45-13](#) continue to apply. We have occasionally observed reporting entities take this course of action in countries with severe exchange controls. In these situations, if a reporting entity has committed to a plan to abandon a foreign entity, the cumulative translation account must be included in the carrying amount of the investment when considering impairment. Essentially, the abandonment is similar to a sale of the investment for zero proceeds. In these situations, the amounts recorded as cumulative translation adjustments would not be released until the foreign entity's operations have ceased, by analogy to [ASC 360-](#)

[10-35-47](#), "...a long-lived asset to be abandoned is disposed of when it ceases to be used..." There is a considerable judgement involved in determining when a plan to abandon has been established.

8.5 *Deconsolidation of a foreign entity*

[ASC 830-20-30-2](#) and [ASC 810-10-15-10](#) indicate that a lack of currency exchangeability can cause reporting entities to evaluate the appropriateness of continuing to consolidate a foreign entity (or continuing to apply the equity method).

Excerpt from [ASC 830-20-30-2](#)

If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the reporting entity shall be carefully considered.

Excerpt from [ASC 810-10-15-10](#)


A reporting entity shall apply consolidation guidance for entities that are not in the scope of the Variable Interest Entities Subsections (see the **Variable Interest Entities Subsection** of this Section) as follows:

(a)(1)(iii) The subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary.

We believe a lack of exchangeability alone may not be enough evidence for a reporting entity to conclude that it has incurred a loss of control of a foreign entity. Some countries have implemented strict exchange controls. Other regulations may be enacted in these countries that could serve to decrease the ability of a reporting entity to effectively make key operational decisions in regard to its foreign operations (e.g., determining capital structure, product development, purchasing, production scheduling, product pricing, labor relations). Once a reporting entity concludes that a lack of exchangeability is other than temporary and other government regulations impede the reporting entities ability to effectively operate, then deconsolidation of these operations may be appropriate.

The SEC staff has indicated that the application of US GAAP in this area requires reasonable judgment to determine when foreign exchange restrictions and/or government-imposed controls or uncertainties are so severe that a majority owner no longer controls a subsidiary. In the same way, a restoration of exchangeability or loosening of government-imposed controls may result in the restoration of control and consolidation. The SEC staff also expects consistency in a reporting entity's judgments around whether it has lost control or regained control of a subsidiary.

The SEC staff has also indicated that, to the extent a majority owner concludes that it no longer has a controlling financial interest in a subsidiary as a result of foreign exchange restrictions and/or government-imposed controls, careful consideration should be given to whether that subsidiary would be considered a variable interest entity upon deconsolidation because power may no longer reside with the equity-at-risk holders. As a result, reporting entities should not only think about clear and appropriate disclosure of the judgments around, and the financial reporting impact of,



deconsolidation, but also of the ongoing disclosures for variable interest entities that are not consolidated.

For more information on deconsolidation due to other than temporary lack of exchangeability, please see PwC's *Consolidation* guide.